Research Series on the Chinese Dream and China's Development Path

Changhong Pei
Wen Zheng

China's Outbound Foreign Direct Investment Promotion System

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Series Preface

Since China's reform and opening began in 1978, the country has come a long way on the path of socialism with Chinese Characteristics, under the leadership of the Communist Party of China. Over 30 years of reform efforts and sustained spectacular economic growth have turned China into the world's second largest economy and brought many profound changes in the Chinese society. These historically significant developments have been garnering increasing attention from scholars, governments, and the general public alike around the world since the 1990s, when the newest wave of China studies began to gather steam. Some of the hottest topics have included the so-called China miracle, Chinese phenomenon, Chinese experience, Chinese path, and Chinese model. Homegrown researchers have soon followed suit. Already hugely productive, this vibrant field is putting out a large number of books each year, with Social Sciences Academic Press alone having published hundreds of titles on a wide range of subjects.

Because most of these books have been written and published in Chinese, however, readership has been limited outside China – even among many who study Chinese – for whom English is still the lingua franca. This language barrier has been an impediment to efforts by academia, business communities, and policy makers in other countries to form a thorough understanding of contemporary China, of what is distinct about China's past and present may mean not only for her future but also for the future of the world. The need to remove such an impediment is both real and urgent, and the *Research Series on the Chinese Dream and China's Development Path* is my answer to the call.

This series features some of the most notable achievements from the last 20 years by scholars in China in a variety of research topics related to reform and opening. They include both theoretical explorations and empirical studies and cover economy, society, politics, law, culture, and ecology, the six areas in which reform and opening policies have had the deepest impact and farthest-reaching consequences for the country. Authors for the series have also tried to articulate their visions of the "Chinese Dream" and how the country can realize it in these fields and beyond.

All of the editors and authors for the *Research Series on the Chinese Dream and China's Development Path* are both longtime students of reform and opening and recognized authorities in their respective academic fields. Their credentials and expertise lend credibility to these books, each of which having been subject to a rigorous peer review process for inclusion in the series. As part of the Reform and Development Program under the State Administration of Press, Publication, Radio, Film and Television of the People's Republic of China, the series is published by Springer, a Germany-based academic publisher of international repute, and distributed overseas. I am confident that it will help fill a lacuna in studies of China in the era of reform and opening.

Xie Shouguang

Acknowledgments

After a relatively short gestation period, the *Research Series on the Chinese Dream and China's Development Path* has started to bear fruits. We have, first and foremost, the books' authors and editors to thank for making this possible. And it was the hard work by many people at Social Sciences Academic Press and Springer, the two collaborating publishers, that made it a reality. We are deeply grateful to all of them.

Mr. Xie Shouguang, president of Social Sciences Academic Press (SSAP), is the mastermind behind the project. In addition to defining the key missions to be accomplished by it and setting down the basic parameters for the project's execution, as the work has unfolded, Mr. Xie has provided critical input pertaining to its every aspect and at every step of the way. Thanks to the deft coordination by Ms. Li Yanling, all the constantly moving parts of the project, especially those on the SSAP side, are securely held together and as well synchronized as is feasible for a project of this scale. Ms. Gao Jing, unfailingly diligent and meticulous, makes sure every aspect of each Chinese manuscript meets the highest standards for both publishers, something of critical importance to all subsequent steps in the publishing process. That high-quality, if also at times stylistically as well as technically challenging, scholarly writing in Chinese has turned into decent, readable English that readers see on these pages is largely thanks to Ms. Liang Fan, who oversees translator recruitment and translation quality control.

Ten other members of the SSAP staff have been intimately involved, primarily in the capacity of in-house editor, in the preparation process for all the Chinese manuscripts. It is time-consuming work that requires attention to details, and each of them has done this and is continuing to do this well. They are, in alphabetical order of their surname, Mr. Cai Jihui, Ms. Liu Xiaojun, Mr. Ren Wenwu, Ms. Shi Xiaolin, Ms. Song Yuehua, Mr. Tong Genxing, Ms. Wu Dan, Ms. Yao Dongmei, Ms. Yun Wei, and Ms. Zhou Qiong. In addition, Xie Shouguang and Li Yanling have also taken part in this process.

Ms. Shi Xiaolin is the SSAP in-house editor for the current volume.

Our appreciation is also owed to Ms. Li Yan, Mr. Chai Ning, Ms. Wang Lei, and Ms. Xu Yi from Springer's Beijing Representative Office. Their strong support for the SSAP team in different aspects of the project helped to make the latter's work that much easier than it would have otherwise been.

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Abstract

The global financial crisis has provided a historic opportunity for outbound foreign direct investment (FDI) by Chinese enterprises. China should grasp this opportunity by prioritizing and accelerating outbound FDI while continuing to open up. As part of this effort, the Chinese government should take the lead in planning, regulating and guiding – from a macroeconomic development strategy perspective – outbound FDI made by companies. Furthermore, it should make, change and implement relevant laws, regulations and policies in a timely manner to suit the latest outbound FDI trends, while encouraging, guiding and protecting outbound FDI by Chinese companies through a combination of support and regulation. This will ensure sustainable and healthy development of outbound FDI, allowing Chinese companies to profit while also accomplishing national economic strategy objectives.

Improving China's outbound FDI promotion system will facilitate the implementation of China's "go global" strategy, the acceleration of China's modernization process, and the achievement of long-term, stable and sustainable socioeconomic development in the context of globalization. This is a significant issue in terms of practical value and theoretical innovation. In this book, we design and build an outbound FDI promotion system for China in the new era based on extensive research of China's history, basic situation, and major challenges related to outbound FDI. The system presented in this book is comprised of eight subsystems, including the legal, supervision/management, taxation/financial, intellectual property (IP)/standards, risk prevention and control, overseas economic and trade cooperation zone promotion, outward securities investment promotion and service subsystems.

Keywords Investment • Outbound foreign direct investment • Promotion system

Introduction

Capital outflow is an important approach for an open economy to engage in economic globalization. Outward investment can enable: interconnections between domestic and international markets; advantages in global pricing differences for factors of production so as to increase economic competitiveness of a nation; and improvement and optimization of a nation's domestic economic structure. Outward investment has replaced international trade as the primary force for economic globalization since the 1990s. Strategically, all the world's economic powers are major outward investors, which indicates that outbound FDI has become a key growth approach for mature economies. In order for the Chinese economy to mature and become more globally competitive, it is vital for China to continue to implement the "go global" strategy and accelerate outbound FDI.

The 1992 report to the 14th National Congress of the Communist Party of China (CPC) made clear that Chinese companies should aggressively increase outbound FDI and transnational operations. The report to the 15th National Congress of the CPC proposed that outbound FDI in fields where China had comparative advantages should be encouraged such that domestic and foreign markets and resources could be better utilized. The report to the 16th National Congress of the CPC noted that implementation of the 'going out' strategy is an important measure to take China into a new stage of opening up. The report went on to propose that China should encourage and support relatively competitive enterprises with various forms of ownership to invest abroad in order to increase exports of goods and labor services and cultivate a number of strong multinational enterprises and brand names. China should also take an active part in regional economic exchanges and cooperation. The report to the 17th National Congress of the CPC stated: "Expand opening up in scope and depth and improve our open economy. By adhering to the basic state policy of opening up, we will better integrate our 'bring in' and 'go global' strategies, expand the areas of opening up, optimize its structure, raise its quality, and turn our open economy into one in which domestic development and opening to the outside world interact and Chinese businesses and their foreign counterparts engage in win-win cooperation, and one that features security and efficiency, in order to gain new advantages for China in international economic cooperation and competition amid economic globalization."

Measures specific to implementing the "go global" strategy have been defined in every report on the Chinese government's work since the strategy was first announced. The 2012 *Report on the Work of the Government* stated that: "We will implement the 'go global' strategy. With China's outbound FDI in an important stage of accelerated development, we will enhance macro-guidance, increase policy support, streamline approval procedures, and improve services for Chinese investors. We will guide Chinese enterprises under various forms of ownership in making overseas investments, mergers and acquisitions in energy, raw materials, agriculture, manufacturing, service industries, and infrastructure in an orderly manner. We will explore new models for overseas economic and trade cooperation zones, and support companies making overseas investments in coordinating their growth and forming clusters. We will standardize development of cooperative overseas labor services. Restrictions on individuals investing overseas will be relaxed. We will strengthen risk management of overseas investments and protect the safety of employees and assets of Chinese enterprises operating overseas."

After delving into the characteristics of the current era from a historical perspective, we believe that the global financial crisis has provided a historic opportunity for Chinese outbound FDI, and accordingly China should grasp this opportunity by prioritizing and accelerating outbound FDI while further opening up. The Chinese government should be responsible for planning, regulating and guiding – from a macroeconomic development strategy perspective – outbound FDI made by companies. Furthermore, the Chinese government should make, change and implement relevant laws, regulations and policies in a timely manner to suit the latest outbound FDI trends, while encouraging, guiding and protecting outbound FDI by Chinese companies through a combination of support and regulation. This will ensure sustainable and healthy development of outbound FDI, allowing Chinese companies to profit while also accomplishing national economic strategy objectives.

Implementing China's "go global" strategy, accelerating China's modernization process, and achieving long-term, stable and sustainable socioeconomic development are significant issues in terms of practical value and theoretical innovation. Based on our research efforts, we recommend that China build a forward-looking, comprehensive and easy-to-implement outbound FDI promotion system comprised of eight subsystems, including the legal, supervision/management, taxation/financial, IP/standards, risk prevention and control, overseas economic and trade cooperation zone promotion, outward securities investment promotion and service subsystems.

Outward investment, which is the core concept in this book, refers to investment in cash, kind or other forms of investment made by investors in a country other than that from which they are based, so as to increase the value of their assets. Investors refer to those who make investment decisions and are responsible for the results of relevant investment, including multinational companies (MNCs), multinational financial institutions (MFIs), governmental or semi-governmental organizations, and individuals. The term outward investment covers both direct investment, whereby investors open, merge and/or acquire overseas financial or non-financial companies and/or secure the ownership or control of, or the right to operate and manage, such companies, and indirect investment whereby they buy shares of foreign companies and/or bonds of foreign governments and/or companies, and/or make loans overseas so as to receive dividends, interests or price difference-based benefits.

Chapter 1
China's Outbound Foreign Direct Investment Promotion System: Overall Design

1.1 History of China's Outbound Foreign Investment

We divided the history of China's outbound Foreign Direct Investment (FDI) since it began reform and opening up more than 30 years ago into three periods: the 1979–1989 period, when outbound foreign investment was tightly controlled by relevant plans; the 1990–1999 period, when outbound foreign investment was in transition to market rules; and the 2000–2009 period, when outbound foreign investment grew rapidly thanks to the "go global" strategy and China's accession to the World Trade Organization (WTO). The development of China's outbound foreign investment has four primary characteristics: transition to a market economy from a planned economy; transition from low levels of outbound foreign investment to higher levels; gradual expansion from low-end industries into high-end industries; and transition from inexperience to an accumulated wealth of experience. Overall, China's outbound foreign investment has fundamentally kept pace with its reform and opening up and reflects the basic characteristics of each phase of reform.

1.1.1 China's Outbound Foreign Investment: Fundamentally Keeping Pace with Reform and Opening Up

1.1.1.1 The 1979–1989 Period, When Outbound Foreign Investment Was Tightly Controlled by Relevant Plans

After rapid growth in the 1950s through the mid-1960s, the Chinese economy sunk into deep decline due to the Cultural Revolution, and by the late 1970s was on the verge of collapse. Dominated by the ossified systems typical of a planned economy, with obsolete technologies and undynamic state-owned enterprises (SOEs), the national economy during this period remained stagnant. It was within this backdrop

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that the Communist Party of China (CPC) shifted the focus of its efforts away from a planned economy and toward modernization, making the major decision to implement a basic state policy of reform and opening up during the 3rd Plenary Session of the 11th Central Committee of the CPC in late 1978. Since then, outbound foreign direct investment (FDI) has been growing steadily as an important part of international economic cooperation together with China's reform and opening up. Later, the central government announced that it would focus on economic development, utilizing both domestic and foreign resources in the modernization process, and develop both domestic and overseas markets. In 1979, the State Council formulated 15 measures for economic reform, making it clear that relevant organizations should open and run businesses outside China. The *Decision of the Central Committee of the Communist Party of China on Economic System Reform* was passed unanimously at the 3rd Plenary Session of the 12th Central Committee of the CPC on October 20, 1984. The CPC made it clear in this document that the guidelines for reinvigorating the economy while opening up to the outside world should be further implemented, that the overall reform of the economic system should be accelerated and focused on cities, and that a vibrant planned socialist commodity economy typical of China should be established, thereby fueling an increase in social productivity. These guidelines laid the institutional basis for the development of China's outbound FDI.

In December 1978, the Chinese government allowed Chinese companies to open overseas representative offices so as to improve international marketing and to better introduce advanced technologies and equipment into China. All outbound foreign investment projects in the 1978–1982 period required approval by the State Council. In 1982, the then Ministry of Foreign Trade and Economic Cooperation (MOFTEC) was established as the successor to the former Ministry of Foreign Trade, which was established in 1952; this organization was responsible for approving and administering outbound FDI. With regard to outbound FDI administration, the former MOFTEC issued a series of policy documents such as the *Interim Regulations on Opening Cooperative Enterprises Outside China*, the *Interim Regulations on Opening Non-trading Companies Outside China*, the *Interim Regulations on the Approval Procedures and Administrative Measures for Opening Non-trading Companies Outside China*, the *Interim Approval Procedures and Administrative Measures for Investing to Open Non-trading Companies Outside China*, and the *Approval Procedures and Administrative Measures for Opening Non-trading Joint Ventures Outside China*. By standardizing outbound foreign investment approval and administration, these documents promoted China's outbound foreign investment. In addition, the State Administration of Foreign Exchange (SAFE) issued the *Measures for Administering Foreign Exchange Involved in Outbound Foreign Investment*; and the former State Planning Commission (SPC) issued the *Opinions on Enhancing the Administration of Outbound Foreign Investment Projects*.

China entered a more favorable international environment from the late 1970s onward. In 1971, China became a member of the United Nations (UN); US President Richard Nixon visited China in 1972, which concluded with the two governments issuing *The Joint Communiqué of the United States of America and the People's*

Republic of China, also known as the *Shanghai Communiqué*. The *Communiqué* restored trade ties and established the goal of working toward the normalization of diplomatic relations. On December 16, 1978, China and the United States issued the *Joint Communiqué on the Establishment of Diplomatic Relations between the People's Republic of China and the United States of America*, which reiterated the principles upon which both sides had agreed in the *Shanghai Communiqué,* issued 6 years earlier on February 28, 1972, while announcing that both sides had agreed to recognize each other and to establish diplomatic relations as of January 1, 1979. During this period, China established diplomatic ties with Japan, the United States and some European countries and signed economic and trade cooperation agreements with them. The Chinese and US governments officially signed the *Agreement on Trade Relations between the People's Republic of China and the United States of America* in Beijing on July 7, 1979, granting each other the most-favored-nation (MFN) trading status. The two countries have had normal economic and trade relations with each other since this agreement became effective in February 1980. China's international economic and trade ties in this period were much better than that of the 1950s through the early 1970s, when China was isolated from the rest of the world. The establishment of these ties created a favorable international environment for China to carry out economic and trade activities with other countries and regions.

In the 1979–1989 period, most Chinese enterprises were SOEs or collectively owned enterprises (COEs). Local enterprises had very limited means of earning foreign exchange through exports; the amount of outbound foreign investment introduced into China was small; and national foreign exchange reserves were at very low levels. Local enterprises mainly served the domestic market, and had little presence in international markets. Consequently, they lacked sufficient capability, and intention, to make outbound foreign investments in order to acquire such growth factors as resources, markets, technologies, brand assets and sales channels. It was in this period that China's capital accumulation was very small, with little money for domestic investment, much less outbound foreign investment. Moreover, the Chinese economy was then a so-called shortage economy, in which demand exceeded supply in the market. On the one hand, Chinese enterprises lacked advanced technologies and suffered from low productivity, bringing about undersupply in the market. On the other, there was an excessive amount of money in circulation as a result of excessive investment and deficit financing, causing strong demand and high prices, relatively speaking, in the market. Since local enterprises had rather high operating margins in China, they had little or even no intention of entering or investing in foreign markets. At that time, China's outbound foreign investment was mostly initiated by the government and finished by SOEs. In other words, outbound foreign investment was largely made under national plans and regulated by the government, while neither the commodity economy nor the market mechanism had any significant effect on outbound foreign investment.

China's accumulated total outbound foreign investment was only $39,358,350 USD in 1981 and $44,000,000 USD in 1982, according to UNCTAD statistics (see Table 1.1). China's accumulated flow of outbound foreign investment reached $3.625 billion in the 1982–1989 period. In the early stages of reform and opening

Table 1.1 Changes in China's outbound FDI flow and accumulated total, 1981–2012 (Unit: in millions of USD (calculated with the exchange rate each year))

Year	Outbound FDI flow	Overseas M&A flow	Accumulated outbound FDI total
1981	–	–	39.36
1982	44	–	44
1983	93	–	137
1984	134	–	271
1985	629	–	900
1986	450	–	1,350
1987	645	–	1,995
1988	850	16.5	2,845
1989	780	202.1	3,625
1990	830	60.3	4,455
1991	913	3.2	5,368
1992	4,000	572.7	9,368
1993	4,400	484.7	13,768
1994	2,000	307	15,768
1995	2,000	249.1	17,768
1996	2,114	451.4	19,882
1997	2,562.49	798.8	22,444.49
1998	2,633.807	1,276.2	25,078.3
1999	1,774.313	101	26,852.61
2000	915.777	470	27,768.39
2001	6,885.398	452.435	34,653.79
2002	2,518.407	1,046.515	37,172.19
2003	2,854.65	1,646.524	33,222.22
2004	5,497.99	1,125.11	44,777.26
2005	12,261.17	5,278.97	57,205.62
2006	21,160	14,904.29	73,330
2007*	22,468.86	6,300	95,798.86
2008*	52,150	30,200	147,948.9
2009*	48,000	19,200	229,600
2010*	68,810	29,700	317,210
2011*	74,650	27,200	424,781
2012*	87,800	27,600	531,940

Source: UNCTAD, Outbound FDI/TNC database (www.unctad.org/outboundFDIstatistics)
Note: the numbers with * are Outbound FDI statistics released by the Ministry of Commerce (MOFCOM) and only include statistics about companies registered at, or inspected annually by, relevant government agencies. Numbers from such government agencies generally are much smaller than the actual ones, as a great deal of companies are established overseas without approval by, or registration at, these agencies (XiongZhigen 2004), making it impossible for the latter to collect investment and operating statistics about these companies

up, China's outbound foreign investment was primarily intended to develop international trade outlets and networks. Later on, trade offices were gradually opened outside China. Sino-foreign joint ventures began appearing in the late 1980s. China's SOEs had little or even no experience in making outbound foreign investments, with the exception of a few companies such as the former China International Trust and Investment Corporation (CITIC). Chinese SOEs mostly invested in joint ventures, with only a handful of investments in wholly owned subsidiaries and international M&As. The total value of overseas M&As made by Chinese companies was only $16.50 million USD in 1988, before rising sharply to $202.10 million USD in 1989.

In the 1979–1984 period, China's outbound foreign investment was mostly made in agriculture and the mining industry, which switched to the processing/manufacturing industry and resources exploitation in the 1985–1989 period. It was in this latter period that China also began making outbound foreign investment in other sectors such as the commerce, restaurant, financial, shipping, chemical, health service, tourism, and fishing industries. Most of the investment projects were small in size, with only a few exceptions. In addition to traditional major destinations such as Hong Kong, Macao, the United States, Europe and Japan, China also began making outbound foreign investments in other countries in Asia, Africa and Latin America.

The leading investors in the 1985–1989 period mainly included SOEs specializing in foreign trade and cooperative enterprises that were experienced in international trade and familiar with relevant markets. In 1979, there were only four Chinese companies that engaged in outbound FDI, and by 1984 this number had risen to 113. However, the 1985–1989 period saw a rapid increase in the number of Chinese companies making outbound foreign investments. By the end of 1989, there were 645 companies engaged in outbound FDI, driven by the use of overseas investment funds amounting to $2.23 billion USD, $715 million of which came from Chinese companies (see Table 1.2). These numbers were much smaller than

Table 1.2 China's non-trade outbound FDI, 1979–1989 (Unit: in million USD)

Year	Year-end number of companies	Year-end accumulated total investment	Incl. year-end accumulated investment from Chinese companies
1979	4	1.21	0.53
1980	17	69.2	31.7
1981	30	76	34.2
1982	48	82	37.2
1983	66	101.2	46
1984	113	204	127
1985	189	296	197
1986	221	407	230
1987	345	1,780	640
1988	524	1,898	715
1989	645	2,223	951

Source: Deng Liqun, Ma Hong and Wu Heng: *International Economic Cooperation in Contemporary China*, China Social Sciences Press, 1989; the *Yearbook of China's Foreign Economic Relations and Trade 1986–1990*

Note: this table only includes statistics about companies registered at, or inspected annually by, relevant government agencies that reported in United Nations Conference on Trade and Development (UNCTAD) statistics, which came from international balance sheets released by the State Administration of Foreign Exchange (SAFE). There are differences in calculation methods between these two sets of statistics, as well as statistical omissions.

1.1.1.2 The 1990–1999 Period: Outbound Foreign Investment Transitions to Market Rules

The Chinese government began deepening economic system reforms in the early 1990s. Deng Xiaoping made his famous southern tour of China in early 1992, during which he delivered important speeches about a series of major issues such as adhering to the CPC's basic guidelines, staying on a socialist road typical of China, grasping opportunities for accelerating reform and opening up, and focusing on economic development. This tour took China into a new stage of reform and opening as well as modernization. The CPC held its 14th National Congress on October 12, 1992, calling for further emancipation of minds and the grasping of opportunities for accelerating reform and opening up and modernization. It set a goal of establishing a socialist market economy system, including by increasing outbound foreign investment and multinational operations by Chinese enterprises.

The former MOFTEC formulated the *Approval Procedures and Administrative Measures for Opening Companies that Make Outbound Foreign Investment* in 1993. The Ministry of Finance (MOF) issued the *Notice on the Power of Approving Direct Investment by Foreign Partners of Sino-Foreign Cooperative Enterprises* in 1998. The former State Economic and Trade Commission (SETC), the former MOFTEC and the MOF co-issued the *Notice Concerning the Opinions on Encouraging Enterprises to Carry out Processing and Assembly with Overseas Customers' Materials* in 1999. These policy documents further standardized policies for approving, administering and encouraging outbound foreign investment projects.

In 1992, the former National State-Owned Assets Administration Bureau (NSAAB), the MOF and the SAFE co-formulated the *Interim Measures for Administering the Registration of the Ownership of Overseas State-owned Assets* in order to streamline and re-register existing companies engaged in outbound foreign investment, rigorously approve the opening of new ones, establish a tight financial management system, and standardize the administration of overseas state-owned assets. In 1993, the former NSAAB, the former MOFTEC and the General Administration of Customs (GAC) co-formulated the *Regulations on Opening Businesses by Investing Physical State-Owned Assets Overseas*. In 1994, the former MOFTEC formulated the *Interim Regulations on Strengthening the Administration of State-Owned Assets in Sino-Foreign Joint Ventures and Cooperative Enterprises*. These documents strengthened, in different respects, the administration and supervision of outbound foreign investment with state-owned assets.

In 1995, the People's Bank of China (PBC) issued the *Measures for Administering the Establishing of Overseas Chinese Industry Investment Funds*. In 1997, the former SPC and SAFE co-issued the *Interim Measures for Administering Overseas*

Project Financing and SAFE formulated the *Regulations on Administering Overseas Foreign Currency Accounts*. In 1998, SAFE adage co-formulated the *Regulations on Administering Entry/Exit with Foreign Exchange*. These documents strengthened the administration of outbound foreign investment activities in such respects as overseas financing, financial management and administration of foreign exchange.

As economic globalization began to rise in developed countries in the West, so began a wave of outbound foreign investment by developed nations. In 1991, to counter the poor quality and weak competitiveness of Chinese goods exports, as well as China's narrow share of the global market, the Chinese government proposed two strategies – success through quality and market diversification. Since the strategy of market diversification was implemented in the field of international trade in the early 1990s, Chinese companies have made significant progress in developing global markets. In 1994, the Chinese government proposed the strategy of expanding international trade and economic cooperation in order to suit the need for deepened reform and opening up. Chinese companies have since made remarkable achievements in bilateral and multilateral trade and economic cooperation. While further developing traditional markets such as the United States, Japan, the EU, Hong Kong and Taiwan, Chinese companies began tapping into important or emerging markets in Africa, Latin America, the Asia Pacific, and Central and Eastern Europe (CEE), including Russia and other members of the Commonwealth of the Independent States (CIS). Some industry-leading Chinese companies specializing in international trade, project contracting and economic/technological cooperation began making outbound foreign investment through means such as opening joint ventures instead of opening outlets and representative offices like they did in earlier years. In 1997, it was announced at the 15th National Congress of the CPC that relevant government agencies and departments would work to make the China market more open to the rest of the world, to encourage outbound foreign investment that would enable the full use of China's comparative advantages, and to better utilize domestic and foreign markets and resources. Outbound foreign investment contributed significantly to exploiting global markets and resources and to fully utilizing domestic and foreign markets and resources in favor of China's modernization. In 1998, it was made clear at the 2nd Plenary Session of the 15th Central Committee of the CPC that, while aggressively increasing exports, relevant government agencies and departments should systematically organize and support a number of industry-leading SOEs in tapping into overseas markets, especially in opening businesses in regions such as Africa, Central Asia, the Middle East, Central Europe and South America. The "go global" strategy has greatly fueled the growth of China's outbound foreign investment.

China became significantly more open and its national economy stronger more than a decade after it began reform and opening up. The Chinese government then began encouraging local companies with comparative advantages to make outbound foreign investments, taking China's outbound foreign investment to a new stage. The Chinese government provided a series of incentives for Chinese companies to conduct overseas processing trade, to open offshore plants using existing equipment, proven technologies, parts and raw materials, and to expand global markets.

Many industry-leading Chinese companies have since entered global markets and successfully achieved multinational operations.

The growing size of China's outbound foreign investment in this period is attributable to: a growing national economy; changes in the international environment; the domestic need for economic growth and development; and local companies that had become better able to invest overseas. In 1990, China's outbound FDI flow was only $830 million USD; it reached $4.0 and $4.4 billion USD in 1992 and 1993 respectively thanks to Deng Xiaoping's speeches during his southern tour of China. It dropped and stayed at about $2.0 billion USD each year in the 1994–1996 period, when the Chinese government was carrying out an economic overhaul, according to UNCTAD statistics. The accumulated total of China's outbound foreign investment topped $26.8 billion USD by the end of 1999. In contrast, the numbers from the *Yearbook of China's Foreign Economic Relations and Trade* were much smaller than the UNCTAC statistics. The former showed that the accumulated total of outbound foreign investment made by Chinese organizations was only $3.174 billion USD by the end of 1999 (see Table 1.3).

The number of Chinese companies involved in outbound foreign investment in the 1990s was nearly a thousand more than in the 1980s. In addition to SOEs that played a leading role in outbound foreign investment, COEs and private/joint-stock companies began making aggressive outbound foreign investment with their advantages in making flexible operating decisions. This led to a diversified range of foreign investors. In addition to manufacturing and foreign trade, sectors engaged in outbound foreign investment included resource exploitation, agriculture/fishing, processing/assembly, transport, medical and health services, real estate, financial/insurance, tourism and restaurant sectors. Instead of opening outlets and representative offices like they did in the early period, Chinese companies generally opened joint ventures and/or wholly-owned subsidiaries and might even conduct interna-

Table 1.3 China's non-trade outbound FDI, 1990–1999 (Unit: in million USD)

Year	Year-end number of companies	Annual investment flow	Year-end investment total
1990	801	75	1,058
1991	1,008	367	1,395
1992	1,363	195	1,591
1993	1,657	117	1,687
1994	1,764	77	1,785
1995	1,882	130	1,858
1996	1,985	350	2,152
1997	2,143	196	2,349
1998	2,396	259	2,583
1999	2,616	591	3,174

Source: the *Yearbook of China's Foreign Economic Relations and Trade 1991–2000*
Note: this table only includes statistics about companies registered at, or inspected annually by, relevant government agencies

tional M&As. The total value of overseas M&As by Chinese organizations in the 1990–1999 period was $4.3 billion USD, according to UNCTAD statistics. Chinese outbound foreign investment began appearing in more regions, rising to nearly 100 regions from 45 in the 1980s. Instead of only focusing on Hong Kong, Macao, Europe, the United States and Southeast Asian countries, China's outbound foreign investment was expanding into other developed or developing countries.

1.1.1.3 The 2000–2010 Period: Outbound Foreign Investment Grows Rapidly Thanks to the "Go Global" Strategy

In October 2000, the *Proposal of the CPC Central Committee for the Formulation of the Tenth Five-Year Plan for National Economic and Social Development* was adopted at the 5th Plenary Session of the 15th Central Committee of the CPC, pointing out that the "go global" strategy would be carried out in the 10th Five-Year Plan period and beyond. In 2002, it was decided at the 16th National Congress of the CPC that the "go global" strategy would be implemented to encourage and help relatively competitive enterprises with various forms of ownership to directly invest abroad in order to increase exports of goods and labor services and establish a number of strong multinational enterprises and brand names. In October 2005, the *Proposal of the CPC Central Committee for the Formulation of the Eleventh Five-Year Plan for National Economic and Social Development* was adopted at the 5th Plenary Session of the 16th Central Committee of the CPC. This proposal called on relevant government authorities to work to continuously deepen reform and opening up; implement the "open up" strategy for a mutually beneficial, "win-win" situation; help Chinese companies go global and make outbound foreign investments under internationally accepted principles; encourage overseas project contracting and the export of labor services; expand mutually beneficial cooperation and promote common development. In 2007, it was proposed at the 17th National Congress of the CPC that relevant organizations should develop innovative ways to make outbound foreign investment and cooperate internationally.

It was in the 2000–2010 period that relevant ministries, commissions and administrations of China issued a series of policy incentives for outbound foreign investment in response to the call for implementing the "go global" strategy. In 2002, the former MOFTEC issued the *Interim Regulations on Establishing Chambers of Commerce (or Associations) of Chinese Enterprises outside China*; in October, it issued the *Interim Measures for Making Joint Annual Inspections on Outbound Foreign Investment* and the *Measures for Assessing the Overall Performance of Outbound Foreign Investment (Trial)*. In October 2004, the Chinese government issued the *Notice on Granting Credit Incentives for Government-encouraged Major Outbound Foreign Investment Projects*; the National Development and Reform Commission (NDRC) and the Export-import Bank of China (China Exim Bank) jointly established a credit support mechanism for outbound foreign investment. In its annual export credit plan, China Exim Bank would have a certain amount of credit funds for supporting government-encouraged major outbound foreign investment projects. In November 2004, the MOFCOM issued a notice regarding the *Reporting System for Problems with Investment Operations by Country*. In October 2006, the State Council approved, in principle, the *Opinion on Encouraging and Standardizing Outbound Foreign Investment and International Cooperation by Chinese Enterprises* at an executive meeting. In 2007, the MOF and the MOFCOM co-issued the *Notice on a Number of Issues Concerning Policies for Funds Specific to International Economic and Technological Cooperation in 2006*.

China has established a preliminary socialist market economy system after more than three decades of reform and opening up. Local enterprises with various forms of ownership have accomplished significant advancements in different respects, especially in gaining competitiveness in global markets. China has achieved considerable economic success in strengthening its national economy, which has drawn the attention of the world. Local enterprises have become more willing and better able to make outbound foreign investments. Given intensifying competition in the domestic market, local enterprises have a stronger need to invest overseas in order to better control upstream supply chains, product R&D and design, sales and services in downstream markets, and important technologies and brand assets. This is certainly feasible considering the increasingly high national income level, availability of a large amount of surplus capital, exploration by local banks to use the huge amounts of savings in outbound foreign investment, and China's sufficient foreign exchange reserves. Despite a low GDP per capita, China is not behind most other countries in terms of outbound FDI development (Huang Wujun and Yan An 2010). Chinese organizations have attained basic skills and experience in business operation and management, investment/financing and HR management. Today, Chinese organizations have trading partners in over 200 countries and regions, including the Unites States, Europe and Japan; they've made outbound foreign investments in 174 countries and regions. China is already a member of eight free trade agreements (FTAs), is negotiating six free trade zones (FTZs), and has signed bilateral investment treaties (BITs) with 129 countries and regions. China has seen significant improvement in the environment for international trade and investment cooperation. Now is the right time for China to further develop its outbound foreign investment strategy.

The annual outbound foreign investment flow of China increased from $0.55 billion USD in 2000 to $68.81 billion USD in 2010; the accumulated total of outbound foreign investment in the same period increased from $3.73 billion USD to $317.21 billion USD, according to MOFCOM statistics (see Table 1.4). Chinese organizations are now making outbound foreign investments in significantly more sectors than before, and now such sectors as wholesale/retail, commercial services, financial, mining and logistics represent the vast majority of Chinese outbound foreign investments. Construction/real estate, technology services, information services, water/electricity/gas supply and agriculture have also become increasingly hot sectors for outbound foreign investment.

China's outbound foreign investments continue to focus on traditional greenfield investments (GFIs). However, a variety of investment instruments, such as international M&As, stock swaps, venture capital, strategic alliances, technical licensing

Table 1.4 China's outbound FDI, 2000–2012 (Unit: in billions of USD)

Year	Year-end number of companies	Annual investment flow	Year-end accumulated total investment
2000	2,859	0.551	3.725
2001	3,091	0.708	4.433
2002	6,960	2.70	29.90
2003	7,470	2.85	33.20
2004	5,163	5.50	44.80
2005	6,426	12.26	57.20
2006	Nearly 10,000	21.16	90.63
2007	Over 10,000	26.51	117.91
2008	Over 12,000	55.91	183.97
2009	Over 13,000	56.53	245.75
2010	Over 16,000	68.81	317.21
2011		74.65	424.78
2012		87.8	531.94

Source: the *Yearbook of China's Foreign Economic Relations and Trade 2001–2012*; the *2013–2012 Statistical Bulletin of China's Foreign Outbound Foreign Direct Investment*
Note: this table only includes statistics about companies registered at, or inspected annually by, relevant government agencies

as a form of non-equity investment, outsourcing and build–operate–transfer (BOT) contracts are increasingly used. The value of M&As as part of China's outbound foreign investments reached $470 million USD in 2000; it rose to $29.7 billion USD in 2010, or 43 % of the annual flow, and was 54.7 % less than in the previous year, according to MOFCOM and UNCTAD statistics.

China's outbound FDI has diversified in terms of the types of investors, sectors and destinations for investment. The number of Chinese enterprises that invest overseas increased sharply from 2,859 in 2000 to over 16,000 in 2010. Apart from a small number of large-scale investment projects and transactions, an overwhelming majority of these enterprises invest small amounts of money to open trade outlets and representative offices in tax havens such as Hong Kong, the Cayman Islands, the British Virgin Islands (BVI), Singapore and Macao.

Large-sized central and local SOEs play a leading role in China's outbound foreign investment, while private companies are just beginning to emerge. In 2003, private companies had a total outbound FDI flow of only 42 million USD, or 1.5 % of China's net outbound FDI in the year; enterprises managed by the central government represented over 90 % of China's accumulated total outbound FDI. In 2008, central SOEs and state-controlled enterprises (SCEs) represented over 85 % of the non-financial flow, whereas private companies represented only 0.3 %. In the meantime, limited liability companies (LLCs) represent a growing share year by year of Chinese enterprises that invest overseas. Non-publicly owned enterprises in coastal Chinese provinces such as Zhejiang also represent an increasing share of China's outbound foreign investments.

A number of competitive, renowned multinational companies (MNCs) have emerged in China, such as China Ocean Shipping Company (COSCO), China National Petroleum Corporation (CNPC), Sinopec, Sinochem, China National Cereals, Oils, and Foodstuffs Corporation (COFCO), China International Trust and Investment Corporation (CITIC Group), China National Offshore Oil Corporation (CNOOC), Bank of China (BOC), Huawei, ZTE, Haier, Lenovo, Chery and Wanxiang Group. Nevertheless, Chinese MNCs generally face high risks in outbound foreign investment operations and worse-than-expected results due to low business concentration, small sizes, and a lack of significant advantages in terms of the division of labor. Accordingly, Chinese companies have shown certain advantages when it comes to cluster-based outbound foreign investment in relevant industries.

1.1.2 Main Characteristics of China's Outbound Foreign Investment

1.1.2.1 China's Outbound Foreign Investment Is Greatly Influenced by Changes in Its Economic System

The development path of China's outbound foreign investment basically mirrors the process of its reform and opening up. In other words, it is directly tied to changes in China's economic system. China's outbound FDI is significantly correlated to its economic growth – the latter serving as the driving force for the former (ZhaiHaoran 2008). China has been transforming its economic system from a planned economy to a market economy since it began reform and opening up, and the Chinese government has changed greatly in terms of how it administers outbound foreign investment. Specifically, the way in which the Chinese government administers outbound foreign investment is influenced primarily by the progress of economic system reforms – government administration has transitioned from a system of tight control in the early stages of reform and opening up into a loose policy system that facilitates and supports investments. The history of China's outbound foreign investment reflects the basic characteristics of every stage of its reform and opening up.

Outbound foreign investment was approved directly by the State Council in the first few years of China's reform and opening up. Today, local governments have been granted the power to approve outbound foreign investment projects except for a few very important ones, and a project registration system has been employed, greatly facilitating investment approval. Instead of administering outbound foreign investments under relevant plans like they did in the early period, local governments are now promoting and encouraging outbound foreign investment, as well as providing relevant services to facilitate outbound foreign investment. This reflects a basic characteristic of China – it is in transition from a planned economy to a socialist market economy. This major characteristic can be seen in every stage of China's outbound foreign investment, mirrored in the sectors, destinations, investors and means of investment, all of which are significantly affected by China's economic system, policies and strategies.

The finding that the development of China's outbound FDI bears the stamp of its socioeconomic system and policies fundamentally aligns with the conclusion drawn by Hinrich Voss et al. (Voss 2008), who after studying the history of China's outbound FDI, determined that outbound FDI by developing countries is largely characterized by home country institutions and development under a regulatory framework.

1.1.2.2 China's Outbound Foreign Investment Is in Transition from Lower Levels to Higher Levels

So far, foreign trade has been the primary way in which China conducts international trade and economic cooperation, for which the main strategy is oriented toward exporting goods or services. Outbound FDI is primarily intended to promote trade. This characteristic was particularly apparent in the first two decades of China's reform and opening up. Accordingly, outbound foreign investment in the 1980s was carried out mainly by opening trade outlets/representative offices, working with agents, including regional ones, sending trade representatives, developing export channels and gathering market information.

Chinese organizations have been shifting the focus of outbound foreign investment toward greenfield investments since the 1990s; they increasingly invest in joint ventures, cooperative enterprises, wholly owned subsidiaries and/or majority-owned companies. In addition, large-scale M&A projects have occurred in the twenty-first century. From sending business representatives to field offices, to investing in new businesses, to M&As and indirect equity investments, China's outbound foreign investment is transitioning from lower levels of investment to higher ones.

1.1.2.3 China's Outbound Foreign Investment Is Expanding from Low-End Industries to High-End Industries

The first Chinese enterprises that had overseas operations and investments were large-scale state-owned foreign trade companies, financial institutions, shipping companies, business service providers, restaurants, as well as enterprises in agriculture and the fishing/mining industries. In other words, enterprises in the primary and tertiary sectors represented the largest share of China's outbound foreign investment. In 1979, for example, the then Beijing Friendship Business Service Corporation partnered with Tokyo-based Maruichi Syouji Co., Ltd. to open Kyowa Co., Ltd.; in 1980, COSCO partnered with Australian company Burns Philps Ltd. to open Five Star Shipping & Agency Company Pty., Ltd.; Also in 1980, BOC partnered with institutions such as First Chicago Bank to open CCIC Finance Limited in Hong Kong. Most of the first overseas enterprises were trade agencies or firms that Chinese trade companies set up outside China.

Later on, Chinese organizations began expanding outbound foreign investment into such industries as manufacturing, metallurgical, chemical, transport, construction and real estate. In 1984, for example, CITIC Group opened CITIFOR Inc. as a joint venture in the United States specializing in wood processing, before changing it into a wholly owned subsidiary in 1986. Also in 1986, CITIC secured 50 % shares in Canadian company Celga Pulp Mill and 10 % shares in Australian company Portland Aluminum Smelter. From 1987 to 1989, CITIC acquired 12.5 % shares in Cathay Pacific Airways, 38.3 % shares in Dragon air, and 20 % shares in Companhia de Telecomunicações de Macau S.A.R.L. (CTM) and HKT respectively. In 1988, CITIC purchased a Delaware steelmaker to set up CitiSteel USA Inc. In 1988, China National Chemicals Import and Export Corporation, the predecessor of Sinochem Group, acquired 50 % shares in an oil refinery of Coastal Corp. In 1987, the then China Metallurgical Import and Export Company (CMIEC) opened Channar iron ore joint venture with Australian company Hamersley Iron Pty Ltd., and held 40 % shares in this joint venture. In 1988, Shougang purchased 70 % shares in American engineering company MASTA through Pennsylvania Shougang Machinery, its wholly owned subsidiary registered in the United States. In 1992, Shougang purchased 98.4 % shares in HierroPerú S.A.A. In 2003, Wanxiang Group purchased 33.5 % shares in Rorkford. In 2005, Lenovo acquired the PC business unit of IBM for $1.8 billion USD. In 2005, CNPC acquired PetroKazakhstan (PK) for $4.2 billion USD. In 2006, CNOOC acquired the Karazhanbas Oil Field and other oil assets in Kazakhstan for $1.91 billion USD. In 2006, Sinopec acquired OAO Udmurtneft for $3.6 billion USD. In addition, China Construction Bank (CCB) bought 14 branches of the Bank of America (Asia) in Hong Kong and three in Macao for $1.248 billion USD in August 2006. The Industrial and Commercial Bank of China Limited (ICBC) bought 20 % shares in Standard Bank, the largest bank in Africa, for $5.46 billion USD in October 2007. Private company Geely purchased Volvo from Ford for $1.8 billion USD in March 2010. These overseas investments have contributed greatly to the expansion of China's outbound foreign investment into high-value industries and services such as manufacturing, transportation, financial, R&D, legal and consulting services, metallurgical and chemicals, whereas investments were previously limited to lower-value industries such as agriculture, fishing, mining, commerce and restaurants.

1.1.2.4 China's Outbound Foreign Investment Is in Transition from Inexperience to Experience

In the early stage of China's reform and opening up, both Chinese enterprises – which were just emerging from the planned economy system-and relevant government authorities were inexperienced in outbound foreign investment, which posed huge challenges for them. At that time, the Chinese government lacked experience and knowledge in administering outbound foreign investment, so it was unable to create a system of effective laws, institutions and policies in this field. Consequently, it administered outbound foreign investment in a rather arbitrary manner. After several decades of reform and opening up, however, the Chinese government has gradually changed its practice, and has started facilitating outbound foreign investment approvals, loosening regulation, and relaxing the limits for the use of foreign exchange and financing for outbound foreign investment. In addition, the Chinese government has started encouraging various local organizations to engage in outbound foreign investment by increasing policy incentives and support while providing local enterprises with many relevant services and protective measures. With growing experience in administering outbound foreign investment, the Chinese government no longer imposes excessive restrictions or intervenes in outbound foreign investment made by local enterprises. As an example, approval procedures no longer require the provision of a feasibility report or any other information on matters about which the enterprise has the power to decide. This allows relevant enterprises to play a role as the leading foreign investor. In short, the Chinese government is endeavoring to provide local enterprises with as sufficient public services for outbound foreign investment as possible, thereby creating an external environment characterized by high levels of fairness, freedom and safety.

Likewise, Chinese enterprises have also accumulated a wealth of experience in outbound foreign investment. From gathering market information and defining a global growth strategy, to assessing the feasibility of an investment project and making a decision on it, to operating and managing overseas assets, Chinese enterprises have gradually adopted scientific approaches to decision making and management, as opposed to the old practice of making investment decisions based on impulse. With an increasingly global view in terms of deploying resources in different markets, Chinese MNCs have gradually familiarized themselves with trading and transfer pricing. They have learned how to localize the management of human, financial and physical resources with advanced operating and managerial skills. Moreover, they usually employ localization strategies and cross-culture management methods to ensure that their overseas assets are safe, efficient and value adding.

1.2 Main Problems with China's Outbound Foreign Investment

Given that China's outbound foreign investment is still in its early stages, various problems such as lack of control, blind development, high risk and widespread losses/corruption keep occurring. Rule of man often causes too tight, or too loose, control. Not all of these problems result from resource gaps between Chinese enterprises and developed country MNCs in terms of capital, technologies, brand assets and managerial capacity, nor does it stem from discrimination by foreign countries against Chinese enterprises. Instead, these problems arise more from the lack of relevant scientific theories, strategies, institutions, policies and market mechanisms.

There are two main problems with China's outbound foreign investment: the lack of a market mechanism, and lack of a scientific and comprehensive outbound foreign investment administration system.

1.2.1 Lack of a Top-Down Design

Today, the problems with China's outbound foreign investment – which include small sizes, inconvenience, high risks, inefficiency and heavy losses- are not only due to China's low level of economic development, but more importantly, to a lack of guidance by scientific theory and, hence, of scientific development strategies, institutions and policies.

With regard to China's outbound foreign investment, there has always been a lack of guidance by scientific theory, resulting in a lack of scientific development strategies, institutions and policies for outbound foreign investment. The Chinese government announced the "go global" strategy in the late 1990s, but has yet to further research and expound on its contents, principles and implementation. In addition, there remains no institutional framework with regard to outbound foreign investment, including laws/regulations, an administration system, organizational structure, supervision, statistics collection and auditing. Relevant interim measures issued by the government are developed with little scientific reasoning.

Theories concerning China's outbound foreign investment must be developed in favor of national interest and satisfy the corporate need for growth and profits. They must reveal how the motives of MNCs for investment relate to a country's economic development amid economic globalization, and enable stable, rapid and sustainable development characteristic of an open economy. The Chinese government needs to increase spending on researching basic theories of outbound foreign investment, before developing specific applied theories and policies. The skills needed to develop outbound foreign investment-relevant strategies and policies are not unknown. Many of the problems with outbound foreign investment administration can be avoided as long as relevant organizations conduct research and reasoning in accordance with scientific theories, while improving relevant strategies and policies.

1.2.2 A Market Mechanism for China's Outbound Foreign Investment Has Yet to Be Established

1.2.2.1 Some Investors Are Too Big, Others Too Small

Today, central SOEs play a leading role in China's outbound foreign investment, representing over 85 % of the total investment value. A growing share of SOEs in outbound foreign investment leads to managerial complexity, an increase in management costs, more difficulties in effective management, and a decrease in efficiency. While there are a great deal of joint-stock companies and LLCs, they tend to be smaller investors and represent a small share of China's outbound foreign investment, making it difficult for them to contribute greatly to its rapid growth. When compared with SOEs, these enterprises generally are smaller in size, financially weaker, less able to invest, and economically less efficient. By comparison, non-state-owned capital faces problems with small size, non-standardized management, changeable operations and high growth risk. Since Non-SOEs are less able to invest outside of China in terms of size and profitability, they are in weaker positions in terms of competition for strategic investment projects worldwide. Large central SOEs vs. small non-publicly owned enterprises are detrimental to the rapid growth of China's outbound foreign investment.

1.2.2.2 The Market Has Yet to Become Fully Open

Today, China's capital account is basically open to foreign capital inflow except for indirect investment. By comparison, outbound foreign investment is still not fully open, and the mechanism for overseas investment is not free or convenient enough for Chinese organizations to invest overseas. There remain many difficulties in the international flow of money and human resources. Tight regulation by the Chinese government over outbound foreign investment constitutes a hindrance to effective adjustment by market mechanisms. The Chinese government has approval procedures that vary with the size of outbound foreign investment, and unapproved investment projects are ineligible for foreign exchange, financial and policy support.

Today in China, both current and capital accounts are opening up, and foreign exchange settlement is no longer compulsory. In August 2010, SAFE issued the *Notice on Implementing the Policy of Depositing Export Revenues outside China in Pilot Regions*. This allowed authorized enterprises in Beijing, Guangdong, Shandong and Jiangsu to deposit their export revenues outside China. Although this policy allows enterprises to hold larger amounts of foreign exchange than before, there are still a lot of restrictions on the holding and use of foreign exchange by enterprises; as such, the capital account remains insufficiently open. In July 2009, SAFE issued the *Regulations on Administering Foreign Exchange in Outbound Foreign Direct Investment by Chinese Organizations*, adjusting provisions regarding the sources of foreign exchange and the ways of auditing it. Chinese organizations may make outbound foreign investment with money from multiple sources such as their own foreign exchange in the current foreign exchange account, as part of profits from outbound foreign investment, from foreign exchange loans in China, foreign exchange bought by renminbi, or from their tangible/intangible assets. In addition, the pre-check procedure has been replaced by post-registration. Despite these improvements, restrictions on foreign exchange purchased by individuals, entry/exit, and securities investment in global financial markets needs to be further loosened.

While significant loosening of regulations over outbound foreign investment has occurred, further improvements are much needed. Since there are tight restrictions on the overseas listing of non-SOEs, a large number of companies have gotten listed by registering shell companies in offshore financial centers (OFCs). However, indirect investment by these companies remains inconvenient as there are insufficient policies and support for investment transactions by Chinese enterprises in global financial markets, including shares purchases, acquisitions and stock swaps. In addition, financial mechanisms, services and channels for outbound foreign investment by Chinese enterprises have yet to be created.

1.2.2.3 The Outbound Foreign Investment Tax System Is Incomplete

The tax system is an important market regulation mechanism that has significant regulatory effects on investment activities. Today, an unclear outbound foreign investment tax system and inefficient administration have become major hindrances to Chinese enterprises' efforts to "go global." The Chinese government has yet to develop a complete set of laws/regulations regarding the levying and administering of outbound foreign investment taxes as well as policy incentives. In June 2010, the State Administration of Taxation (SAT) issued the *Opinion on further Improving Taxation Services and Administration for Enterprises that Are Going Global*. With regard to corporate income tax, it has been made clear, under the *Enterprise Income Tax Law* and the *Notice of the Ministry of Finance and the State Administration of Taxation on Issues Regarding Tax Credit for Overseas Incomes of Enterprises* (CS [2009] No. 125), that local enterprises that go global are eligible for a tax credit. Nonetheless, there are difficulties in implementing this policy due to the lack of specific guidelines for granting the tax credit. With regard to personal income tax, no laws/regulations regarding personal income tax involved in outbound foreign investment by local enterprises have been established. The Chinese government also needs to research and improve policies relevant to overseas business tax in order to avoid double taxation. With regard to import/export taxes, the Chinese government needs to research and improve policies related to export rebates for outbound foreign investment by local enterprises. This will enable investment to better fuel export growth while promoting the growth of enterprises that invest overseas.

China's outbound foreign investment tax system needs deeper reform, as it has many key problems including: the lack of laws/regulations regarding outbound foreign investment taxation; the lack of a comprehensive set of policies relevant to outbound foreign investment taxation; the lack of complete information on outbound foreign investment operations and tax payment by local enterprises; the lack of a scientific taxation and administration system regarding carryover of losses and tax sparing amounts/methods, especially indirect credits against overseas income tax on dividends and interests; the lack of a tax policy system that orients the selection of industries, destinations and investment methods in terms of outbound foreign investment, with few tax relief options. In addition to these problems, China's incomplete outbound foreign investment tax system has left investors in the dark, sending mixed signals in terms of market regulation. It is therefore necessary for the Chinese government to step up research and make a complete set of laws/regulations and policies regarding tax payer registration, overseas income declaration, related transaction declaration, transfer repricing, and tax payment/credits.

1.2.2.4 The Current Renminbi Exchange Rate Regime Hinders the Expansion of Outbound Foreign Investment

The renminbi exchange rate policy greatly influences local enterprises' efforts to "go global" and make international investments. The actual renminbi exchange rate and outbound FDI have a "Granger" effect on each other, that is, there is significant influence and long-term equilibrium between them (NieMinghua and Ma Xiang 2008). The exchange rate is an important lever in adjusting the efficacy of investors' money. However, the current renminbi exchange rate regime is not yet market-oriented, there are uncertainties in the appreciation of renminbi, and outbound foreign investment by Chinese enterprises comes with high exchange-rate risks. Wang Fengli (2008) found out that the appreciation of the renminbi will fuel China's outbound foreign investment whether in the short or long term, and that fluctuations in the exchange rate have no noticeable effects on the latter. Nonetheless, a non-market-oriented renminbi exchange rate regime causes a false and unpredictable value of the renminbi, making it difficult for its exchange rate to play a regulatory role in the market. In the long run, the ongoing appreciation of the renminbi will promote China's outbound foreign investment, yet at the same time, some investors have opted to wait to make investments due to the uncertainties of the rate and appreciation of the renminbi.

The current managed fluctuation of the renminbi exchange rate mainly suits the export trade and the strategy of promoting economic development by orienting the use of outbound foreign investment. Such an exchange-rate policy will cause decreasing contributions to economic development when both trade and incoming foreign capital reach certain heights. It is therefore necessary to duly adjust this policy in order to satisfy the need for further outbound foreign investment. The Chinese government should work to facilitate the creation of a market-oriented renminbi exchange rate regime, develop and improve relevant financial systems, and foster a financial market while establishing basic financial institutions. This will not only facilitate the full convertibility and internationalization of the renminbi as well as allowing it to become a hard currency, but will also be conducive to reducing the impact of exchange-rate risks on outbound foreign investment and, hence, to its steady growth.

1.2.3 China Lacks a Complete Set of Laws and Policies Regarding Outbound Foreign Investment

1.2.3.1 The Lack of a Complete Legal Subsystem Regarding Outbound Foreign Investment

Given that there remains no scientific, underlying theories relevant to China's outbound foreign investment, the Chinese government lacks a solid foundation for researching and establishing a market system, basic laws, strategies and policies with respect to outbound foreign investment. That is why it has yet to make any complete law regarding outbound foreign investment. Although the NDRC, SAFE, MOFCOM and other authorities involved in outbound foreign investment have issued a large number of documents such as interim administrative measures, policies, opinions and notices, these documents only cover a few parts of the field of outbound foreign investment and, hence, are far from comprehensive and perfect. Since none of these administrative documents have been translated into national law, China has long been short of a basic legal subsystem for administering and promoting outbound foreign investment.

By comparison, a series of laws are available in the United States to regulate and administer outbound foreign investment and ensure its security, such as the *Outbound Foreign Investment and National Security Act of 2007* (FINSA), the *Economic Cooperation Act*, the *Foreign Assistance Act*, the *Foreign Corrupt Practices Act* (FCPA), the *Mutual Security Act* and the *Homeland Investment Act*. European countries and Japan have also built legal subsystems for outbound foreign investment, and many other countries and regions with good legal systems have made laws to regulate and protect outbound foreign investment.

The National People's Congress (NPC) of the People's Republic of China passed the *Foreign Trade Law* in May 1994, before amending it in April 2004. This law has greatly fueled the growth of foreign trade in China. In contrast, there is no law regarding outbound foreign investment. This has caused stagnancy in the administration of, and administrative services for, outbound foreign investment, and as a result has led to significant obstacles to growth. It is now necessary for the NPC to accelerate legislation for outbound foreign investment, including provisions concerning the administrative agency, approval procedures and content, tax/financial/insurance incentives, intellectual property, sources of investment funds, financing, foreign guarantees, change/exit reports and statistics, protection services from consulates, social responsibility, security and public interest.

1.2.3.2 The Lack of a Complete Policy System for Outbound Foreign Investment

The Approval Policy Adds to the Investment Cost of Enterprises While Limiting the Freedom of Investors

The approval function is an important tool in a planned economy and has played a significant role in regulating outbound foreign investment. It was primarily intended to control SOEs' outbound foreign investment in terms of direction, size, method, industry and risk. As foreign investors have become increasingly diverse, the Chinese government has expanded the function of approval from administering the production and operations of only SOEs to all investors. As one of the most important means of macro-administration, the function of approval has produced further effects at the macro level. With their resources and influence, SOEs tend to easily receive approval for outbound foreign investment. Approval procedures are minimal to their outbound foreign investment costs, and have an insignificant effect on their freedom as investors. By comparison, however, the function of approval has few positive effects on outbound foreign investment by non-SOEs. These organizations are very careful about outbound foreign investment decisions using their own capital. Nonetheless, their applications for outbound foreign investment are usually denied by government officials in charge of approval because their projects are not in line with these officials' personal preferences. In such cases, these organizations are actually deprived of the power to make decisions on their investment projects. The function of approval constitutes a big obstacle to the growth of China's outbound foreign investment for many key reasons including: cumbersome approval procedures; unclear approval criteria; lack of limitations on the deadline to receive an approval; a high degree of arbitrariness in approval; and lack of clear institutional assurance. There has been no radical change in the administrative method despite the fact that the NDRC, SAFE and MOFCOM have adjusted relevant approval policies many times to grant greater approval powers. Consequently, the function of approval imposes undue restrictions on outbound foreign investment, reducing the freedom of investors and the convenience of investment. As a matter of fact, an enhanced function of approval will encourage enterprises to change their reports from a focus on the feasibility of outbound foreign investment projects into a focus on approvability. This is in contrast with the government's original intention of encouraging enterprises to strengthen research on the feasibility of outbound foreign investment projects. Reforming China's outbound foreign investment administration system is the ultimate solution to address the problems with macro-administration (Yang Hai 2008, p. 145). SOE executives usually blame the government authority that approved their investment reports for erroneous decisions on outbound foreign investment, thereby attempting to avoid punishment for having missed the best opportunity for investment by changing the investment plan and/or catering to the preferences of the approver.

There Are No Effective Approaches to Regulating Outbound Foreign Investment

When it comes to administering outbound foreign investment, many scholars point out that the Chinese government pays more attention to approval than to regulation. However, this is only one side of the issue. Chinese authorities in charge of outbound foreign investment also pay a great deal of attention to regulation, but are short on effective approaches to regulating local enterprises that have overseas operations. As a result, they have no choice but to pay more attention to approval in China. It is impossible for Chinese enterprises that have overseas operations to send the competent authorities a report on every operating activity. The competent authorities are unable to fully access information on Chinese enterprises' investment operations outside China, including business performance, assets, debts, profits/losses and investment transactions. Even if they are able to gather information on the operating status of most enterprises through joint inspections conducted once a year, there are often differences between the reported data/information and the actual ones. Organizations that represent the Chinese government in foreign countries provide a lot of services and support for Chinese enterprises with overseas operations, but they are unable, and have no power, to access information on the latter's operations, nor to regulate the activities of Chinese MNCs in a foreign country. Since the Chinese government lacks effective approaches to regulate enterprises with outbound foreign investment projects, it suffers a heavy loss of state-owned assets outside China, for which, however, the lack of regulations in itself not the primary cause. The competent authorities should improve communication with investors in China in order to achieve government regulation over multinational SOEs' outbound foreign investment through in-house monitoring, thereby increasing operating efficiencies and avoiding investment risks and the loss of state-owned assets. SOEs generally grant their overseas subsidiaries the power to make decisions at their discretion; as proxies, the officials of these subsidiaries may want to conceal business performance and investment profits/losses by exaggerating successes and covering up failures. Consequently, SOE headquarters also have limited access to information on their overseas businesses, which decreases managerial efficiency. On July 1, 2010, SAFE began implementing the *Notice of the State Administration of Foreign Exchange on Adjusting the Power to Approve Certain Foreign Exchange Matters Pertaining to the Capital Account* (HF [2010] No. 29) in order to streamline pre-approval, enhance post-supervision, inspection and statistical monitoring, and improve the regulation system of overseas enterprises.

There Is No Effective Outbound Foreign Investment Adjustment/Control Mechanism

With regard to the macro-administration of China's outbound foreign investment, more attention is paid to control than to adjustment. As a result, the size of outbound foreign investment is controlled, but there is no mechanism for governing macro-adjustments of China's outbound foreign investment mix. Accordingly, China's outbound foreign investment mix shows natural market characteristics – Chinese-dominated regions and free ports such as Hong Kong, Macao and Singapore represent an excessively large share of China's outbound foreign investment; industries such as mining and commercial services receive most of China's outbound foreign investment; new businesses or facilities represent a large share. International indirect investment by Chinese organizations is big in size and also focuses on the simplest bonds investment, as opposed to a mixed portfolio of complex financial investments in smaller amounts. These natural characteristics of outbound foreign investment directly reflect the lack of competent managers in the fields of internationalization and cross-culture operations, of global growth strategies, and of basic skills and experience in international investment, operation and management, both on the side of Chinese enterprises as well as on the side of the Chinese government, which lacks policies relevant to the macro-adjustment of outbound foreign investment.

With regard to outbound foreign investment by Chinese enterprises, guidance and adjustment by the Chinese government with respect to the destinations, industries, methods and type of investor have failed to produce positive effects, including: shifting manufacturing with overcapacity to less developed countries or regions, investing in R&D and high-tech industries in developed countries or regions, and investing in agriculture in countries or regions with large land areas. China's foreign indirect investment excessively focuses on the American market; the Chinese government has not yet had a significant effect on increasing direct investment, decreasing indirect investment and adjusting indirect investment in terms of destination and financial asset structure. Such large-scale indirect investment not only has low returns but also high risks due to an excessive focus on the American market. It is necessary for state-owned financial institutions and sovereign wealth funds (SWFs) to tightly control risks in overseas securities investment and increase the shares of individuals and organizations in things other than financial institutions when making indirect investment in global financial markets. As Chinese enterprises gain experience in international operations, they need to gradually shift assets from indirect investment to industry asset investment outside the United States and securitized indirect investment. China should increase investment in Latin America, Africa and the rest of Asia, especially countries in the Middle East and Central Asia. In other words, it should shift its capital from strategic competitors such as the United States into countries in the rest of Asia, Africa and Latin America as well as the member states of the EU and the CIS where it is welcomed. In the meantime, the Chinese government should encourage non-publicly owned enterprises to open more small-scale high-tech R&D centers in developed countries and regions such as Europe, the United States and Japan, where they will be able to learn the latest developments in leading-edge technologies, before absorbing them and inventing new ones. The Chinese government should also assist enterprises in investing in globally renowned brands, advanced technologies, marketing networks and R&D organizations.

There is a diversity of macro-adjustment methods available to choose from, but the Chinese government now emphasizes adjustment/control only via investment approval, with few adjustment/control methods in other aspects. Moreover, the Chinese government has yet to provide sufficient fiscal policies to support local enterprises' early research on outbound foreign investment. Many Chinese enterprises make investment decisions without sufficient early research, resulting in a high likelihood of investment failure. The Chinese government should gradually improve the policy system for promoting, adjusting/controlling and supporting outbound foreign investment; it should make good use of policies related to funding/support, tax credit/sparing, export rebates, foreign exchange supply and guidance on the exchange rate structure, foreign exchange credit and financing guarantees, and foreign exchange capital inflow/outflow, while strengthening the capacity of adjustment/control. Macro-adjustment/control over outbound foreign investment should be intended not only to achieve rapid growth of outbound foreign investment and a better balance of payments (BOP), but also to promote domestic economic development, optimization of the mix of industries, technological advancement, employment, as well as an increase in national income and in China's tangible/intangible assets worldwide.

There Is No Complete Outbound Foreign Investment Protection System

With regard to China's outbound foreign investment, the problems of high risk, low returns, heavy losses, and a heavy loss of assets have much to do with the government's outbound foreign investment administration and protection systems. The prevalence of these problems suggests that the Chinese government needs to improve outbound foreign investment administration and protection. Developed countries, the leaders in outbound foreign investment, each have a complete investment protection system. In private overseas investment, for example, financial derivative instruments can be used to maintain the value of overseas investment assets or to buy commercial investment insurance. States may open private overseas investment banks or companies, set up guarantee funds for overseas investment or for compensating for investment losses, and/or establish relevant investment agreements and protective legal systems. By comparison, China's outbound foreign investment is faced with higher political and commercial risks, including its nationalization and unpredictable changes in the exchange rate, which have been exacerbated by the severe crises within the financial systems of many developed countries since the Global Financial Crisis. China has yet to establish a powerful, complete outbound foreign investment protection system.

Chinese enterprises differ from western MNCs when it comes to outbound foreign investment activities. Chinese enterprises that invest overseas generally lack experience in international investment and the ability to gather relevant information. They therefore need government support, guidance and services. In contrast, western MNCs are comparable with most countries when it comes to the capacities of managing international investment and public relations, and therefore seldom need much government support, although they may require government intervention and support when major issues arise. Since Chinese enterprises typically are much less able to operate international businesses than their western counterparts, government support is necessary and critical for the success of their international businesses. Owing to insufficient protective measures of the government for their outbound foreign investment, however, Chinese enterprises are faced with very high risks, especially political and commercial ones, caused by changes in a host country's policies. In the midst of a global wave of investment in Mongolian mines, for example, the Mongolian government is considering a series of laws regarding the exploitation of mineral resources. If the Mongolian government fails to provide notice of relevant policy changes and the resulting risks, investors may suffer investment failure. In August 2010, MOFCOM issued the *Overseas Security Risk Warning and Information Disclosure Systems for Outbound Foreign Investment and Economic Cooperation* in order to: further improve overseas security risk control systems for outbound foreign investment and economic cooperation; guide relevant enterprises in understanding changes in the international security situation; take effective measures to prevent and tackle security risks outside China; improve overseas security management; and ensure the implementation of the "go global" strategy. The Chinese government should continue adjusting and improving the current legal, financial, insurance and policy systems for outbound foreign investment in order to prevent and tackle risks against outbound foreign investment, especially political and commercial ones. It should provide policy support and institutional arrangements, including Free Trade Zone (FTZ) and investment protection agreements as well as diplomatic and military support, for the effective use of hedging instruments for outbound foreign investment by Chinese enterprises. In addition, the Chinese government should improve its legal system to protect outbound foreign investment and the interests of Chinese enterprises as foreign investors, while guiding and encouraging them to engage in international investment activities.

There Is No Sufficient Service and Policy Support for Outbound Foreign Investment

With insufficient service awareness and policies, the Chinese government is still not a service-oriented government and lacks a good outbound foreign investment service system. There are no relevant service organizations within the competent authorities, nor are there relevant service policies, especially ones intended to encourage intermediary organizations.

With regard to information consulting and risk assessment, MOFCOM has provided many services, including issuing the *Guide to Outbound Foreign Investment and Economic Cooperation by Country or Region*. In contrast, other government authorities are far from providing sufficient relevant information. Overall, relevant government services remain insufficient; the competent authorities fail to continually provide enterprises with complete and timely information on overseas markets. Intermediary organizations that provide information and risk assessment services lack policy guidance and support. To rectify this problem, relevant commercial and diplomatic departments should improve overseas security risk prevention and emergency response systems; strengthen information gathering, assessment and analysis; enhance warnings against, and monitoring of, overseas investment and personnel security risks in hot spots; establish a security risk assessment system; and release timely security risk warnings and messages.

With regard to training services, MOFCOM has made some efforts in improving business management and security training. Nonetheless, other government agencies and departments have yet to satisfy the needs of foreign investors for professional services and training in the fields of tax, finance, insurance, foreign affairs, foreign exchange and others. In short, the Chinese government has yet to further develop service awareness.

Chinese financial institutions have limited ability to provide local enterprises with services and support for the latter's financing, subscription, stock swaps and acquisitions in overseas securities markets. These institutions have immense potential in providing individuals with overseas securities investment information and platform services in order to satisfy their need for investing in global capital markets. Unfortunately, Chinese financial institutions have no strong need for going global and growing industrial enterprises, probably because they have long been protected by government policy, which has led to insufficient competition and reform, strong monopolistic advantages in the domestic market, and much higher domestic profits than overseas ones.

The major reasons for failure and investment losses center on the significant difficulties both individuals and enterprises face in accessing valuable investment information; information asymmetry; the lack of in-depth and comprehensive research on the viability of investment projects; and unreasonable investment decisions. The Chinese government should improve public information services for outbound foreign investment, improve service platforms that help local enterprises go global, and always conduct administration with services in mind.

1.2.4 Chinese Foreign Investors Are Frequent Victims of Investment Protectionism

Since the Global Financial Crisis, there has been a growing trend of trade and investment protectionism in developed countries. Chinese enterprises are more likely to face protectionism when investing outside China. Most countries would welcome outbound foreign investment during a global economic downturn, but the Global Financial Crisis has led to the rise of investment protectionism, as governments are more concerned about investment-relevant competition and the need to protect local employment and industries.

There were 2,748 changes in investment policies around the world from 1992 through 2009, according to UNCTAD statistics. In the 1992–2002 period, only 5.7 % of global investment policies restricted outbound Foreign Direct Investment (FDI). This number rose to 16.7 % in the 2003–2008 period and 30.4 % in 2009 (see Table 1.5).

Nearly 70 % of global investment policies are in favor of free investment and outbound FDI. Nevertheless, there is a growing trend of restricting outbound FDI through investment policies since the Global Financial Crisis. In 2010, for example, 74 countries adjusted their outbound foreign investment policies, including 101 policies in favor of free investment and 48 others that restricted outbound foreign investment, an increase of 54.84 % over the previous year. This suggests that most countries, especially developed ones, maintain favorable policies and welcome the use of foreign capital, both out of the need for domestic capital investment as well as the desire for outbound foreign investment liberalization in other countries. At the same time, however, there are increasingly tight restrictions in the space of foreign capital policies.

Table 1.5 Changes in global investment policies, 1992–2010

Year	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
The number of countries with policy changes	43	56	49	63	66	76	60	65	70	71
The number of policy changes	77	100	110	112	114	150	145	139	150	207
The number of favorable policies	77	99	108	106	98	134	136	130	147	193
The number of restrictive policies	0	1	2	6	16	16	9	9	3	14
Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	
The number of countries with policy changes	72	82	103	92	91	58	54	50	74	
The number of policy changes	246	242	270	203	177	98	106	102	149	
The number of favorable policies	234	218	234	162	142	74	83	71	101	
The number of restrictive policies	12	24	36	41	35	24	23	31	48	

Source: the *World Investment 2011*, UNCTAD national legal database

Most countries conduct cost-benefit analysis (CBA) of outbound FDI. They not only want economic benefits, but also policy frameworks to minimize the negative socioeconomic effects of outbound FDI and to identify desirable outbound FDI projects in order to maximize their positive socioeconomic effects. The United States, for example, has been using the FINSA to further restrict outbound foreign investment over the past few years. There are some examples involving Chinese companies. In the name of national security, 50 US senators jointly called for an investigation into a $175 million USD deal between China's Anshan Iron & Steel Group (Ansteel) and the Steel Development Company (SDC) to jointly build a steel rebar plant in Mississippi. The Chinese company Huawei has failed on several occasions to acquire American companies, including the attempted acquisitions of networking solution provider 3COM in 2008 and private broadband service delivery platform provider 2Wire and the mobile network infrastructure business unit of Motorola in 2010. These failures by Chinese companies to secure outbound foreign investment due to obstruction by the US government, senate and quasi-governmental organizations fully demonstrate the rise of investment protectionism in the United States. Although the United States is an investment destination strategically significant for China in terms of securing advanced technologies, managerial skills and market space, it is now not an ideal choice for Chinese investors given all the uncertainty, rejections and unfair treatment that they receive in this country, in addition to the high investment risks and transaction costs.

Moreover, the Chinese government fails to sufficiently protect China's outbound foreign investment by diplomatic means and investment protection agreements. Previously signed bilateral investment agreements are no longer suit the needs of the current global situation. The Chinese government often can do nothing amid a global wave of investment protectionism. Today, the Chinese government should first increase diplomatic efforts in dealing with protectionism, and relevant government departments should protect the interests of Chinese investors in the host country by acting as a coordinator when Chinese enterprises are hurt by protectionism. Both the Ministry of Foreign Affairs (MFA) and MOFCOM need to monitor and assess the performance of investment agreements in relevant countries, through which they should carry out timely communication about discrimination against Chinese investors in terms of entry, exit and rights/interests protection, and update the agreements whenever necessary. The Chinese government should also pay more attention to promoting outbound foreign investment by non-SOEs; aggressively buy shares or otherwise invest in non-SOEs using national foreign exchange reserves; keep good communication with governments of host countries at all levels; conduct public relations (PR) events; increase positive reports on how Chinese investment contributes to employment and industry growth in host countries; and increase coordination, assistance and support for Chinese investors.

1.2.5 China's Poor Outbound Foreign Investment Structure and Returns

By the end of 2011, China's external financial assets reached \$4.72 trillion USD, and its liabilities reached \$2.94 trillion, with net foreign financial assets at \$1.77 trillion USD, according to the latest international investment position (IIP) statement published by the SAFE (see Table 1.6). With regard to external financial assets, outbound FDI stood at \$364.2 billion USD, securities investment at \$260 billion USD, other investments at \$838.2 USD, and reserve assets at \$3.26 trillion USD, or 8 %, 6 %, 18 % and 69 % of China's external foreign assets respectively. With regard to external financial liabilities, incoming outbound FDI stood at \$1.8 trillion USD, securities investment at \$248.5 billion USD, and other investments at \$890.7 billion USD, or 61 %, 9 % and 30 % of China's external financial liabilities respectively.

The following data shows characteristics of China's international investment.

Table 1.6 China's IIP, 2009–2012 (Unit: in billion USD)

Item	The end of 2009 (revised)	The end of 2010 (revised)	The end of 2011 (revised)	The end of 2012 (revised)
Net position	1,490.5	1,688.0	1,774.7	1,736.4
A. Assets	3,436.9	4,118.9	4,718.2	5,174.9
1. Outbound FDI	245.8	317.2	364.2	502.8
2. Securities investment	242.8	257.1	260.0	240.6
2.1 Equity securities	54.6	63.0	61.9	129.8
2.2 Debt securities	188.2	194.1	198.1	110.8
3. Other investments	495.2	630.4	838.2	1,043.7
3.1 Trade credit	144.4	206.0	276.9	338.7
3.2 Loans	97.4	117.4	223.2	277.8
3.3 Currency and deposits	131.0	205.1	282.9	381.6
3.4 Other assets	122.4	101.8	55.2	45.7
4. Reserve assets	2,453.2	2,914.2	3,255.8	3,387.9
4.1 Monetary gold	37.1	48.1	53.0	56.7
4.2 Special drawing rights (SDRs)	12.5	12.3	11.9	11.4
4.3 Reserve positions in funds	4.4	6.4	9.8	8.2
4.4 Foreign exchange	2,399.2	2,847.3	3,181.1	3,311.6
B. Liabilities	1,946.4	2,430.8	2,943.4	3,438.5
1. Incoming outbound FDI	1,314.8	1,569.6	1,804.2	2,159.6
2. Securities investment	190.0	223.9	248.5	336.4
2.1 Equity securities	174.8	206.1	211.4	262.2
2.2 Debt securities	15.2	17.8	37.1	74.2
3. Other investments	441.6	637.3	890.7	942.6
3.1 Trade credit	161.7	211.2	249.2	291.5
3.2 Loans	163.6	238.9	372.4	368.0
3.3 Currency and deposits	93.7	165.0	247.7	244.6
3.4 Other liabilities	22.7	22.2	21.4	38.4

Source: the official website of the SAFE

1.2.5.1 An Irrational Investment Structure

First, foreign exchange reserves represent the majority of China's external financial assets, reaching as high as 69 % in 2011. They are followed by other investment positions consisting of trade credits, loans, currency and deposits, and other assets, reaching $1.04 trillion USD in 2011. The sum of outbound FDI and foreign security investments was only $743.4 billion USD, $300.3 billion USD less than other investment types.

Second, outgoing FDI is much smaller than incoming FDI. By the end of 2012, China's outgoing FDI reached $502.8 billion USD, while its incoming FDI reached $2.1 trillion USD, a ratio of 1:4. This indicates that there is a severe imbalance between China's outgoing outbound foreign investment and incoming foreign investment.

Third, there is a gap between China's securities investment mix and that of other countries. By the end of 2012, China's overseas securities investment position was $240.6 billion USD, while other countries' securities investment position in China was $336.4 billion USD. The gap between them is becoming wider, as are differences in the securities investment mix. By the end of 2012, China's foreign equity securities investment position was only $129.8 billion USD, while other countries' equity securities investment position in China was $211.4 billion USD – a ratio of about 1:2. In addition, China's foreign debt securities investment position was $110.8 billion USD, while other countries' debt securities investment position in China was only $74.2 billion USD. This indicates that debt securities investment with low returns represents a large share of China's overseas securities investment, while equity securities investment with high returns represents the majority of other countries' securities investment in China. In other words, China's foreign equity securities investment has great potential.

1.2.5.2 Low Returns on Investment (ROI)

In 2011, China saw returns on its outbound foreign investment of only $128 billion USD,[1] a rate of return of only 2.7 % of China's total external financial assets valued at $4.72 trillion USD. Most of the returns were the result of operating income from foreign exchange reserves. With regard to China's external financial liabilities, however, outbound FDI holds the largest share at 61 %, and has a significantly higher return rate. The 500 largest foreign-invested enterprises (FIEs) in China, for example, had a combined rate of return of 10.54 % in 2009.[2] In other words, China has low returns on overseas assets and high costs of external liabilities, or put even more simply, China's investment costs exceed its returns.

[1] The official website of the SAFE: the answers of Guan Tao, the head of the international payment department at the SAFE, to journalists' questions about the return on China's outbound foreign investment, April 29, 2012, http://www.safe.gov.cn

[2] The calculations were based on data on Page 167 of the *China Outbound Foreign Investment Report 2011*, the Economy & Management Publishing House, 2011.

1.3 Restructuring of China's Foreign Investment Promotion System

With regard to its outbound foreign investment promotion system, China lacks a systematic, long-term development strategy at a time when economic globalization is on the fast track. It is therefore critical to make adjustments to, and systematic arrangements for, the current system. This system should be an organic whole that is built under specific principles with a clear mission and defined functions.

Since China's outbound foreign investment is still in its early developmental stages, it is also necessary for the Chinese government to plan, regulate and guide overseas investment activities by Chinese enterprises within a global view and long-term development strategy. It should make, adjust and implement, in a timely manner, relevant laws, regulations and policies according to the ever-changing developmental characteristics of outbound foreign investment, thereby encouraging, supporting, guiding, regulating and protecting local enterprises in overseas investment activities while ensuring the sustainable and healthy growth of China's outbound foreign investment. This will maximize China's strategic interests while enabling Chinese enterprises to secure economic benefits. Accordingly, China's outbound foreign investment promotion system should include legal, supervision/administration, fiscal/taxation/financial, IP/standards, risk prevention and control, overseas economic and trade cooperation zone promotion, overseas securities investment promotion and service subsystems.

Overall Framework of China's Outbound Foreign Investment Promotion System		
Legal Subsystem	Risk Prevention and Control Subsystem	Overseas Economic and Trade Cooperation Zone Promotion Subsystem
Supervision/Administration Subsystem	IP/Standards Subsystem	Overseas Securities Investment Promotion Subsystem
Fiscal/Taxation/Financial Subsystem	Service Subsystem	

1.3.1 The Legal Subsystem

A complete set of laws regarding outbound foreign investment will allow Chinese organizations to conduct outbound foreign investment activities under governing laws/regulations. Most problems with China's outbound foreign investment policies are caused by low compatibility among, and operability of, investment-relevant laws, regulations and rules. On the one hand, the Chinese government should enact legislation to regulate overseas investment activities by local enterprises, on the other hand, it should also focus on providing support for such activities by governmental and non-governmental organizations. China's domestic legal subsystem for outbound foreign investment should be built upon legislative experience and

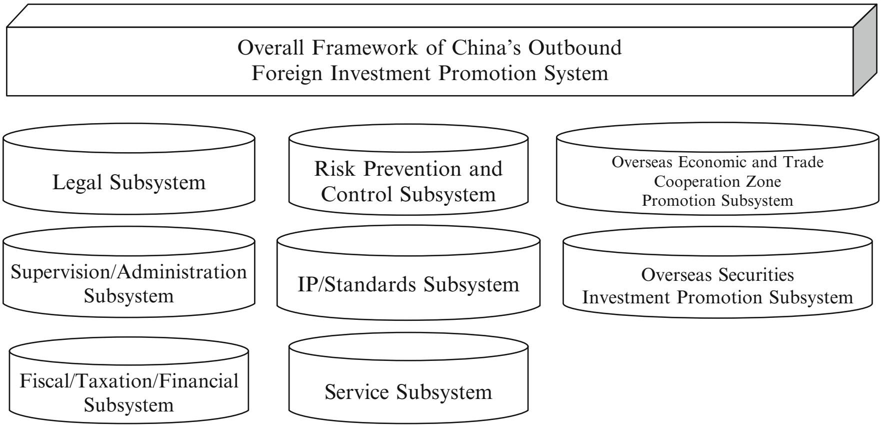

Fig. 1.1 Overall framework of China's outbound foreign investment promotion system

methods from the rest of the world. Because China remains in the early developmental stages of outbound foreign investment and needs more time to understand relevant issues, it is difficult for the Chinese government to make a comprehensive set of basic laws before necessary special laws are made. To address this issue, the Chinese government should make necessary special laws such as the *Outbound Foreign Investment Regulatory Law*, the *Outbound foreign investment Insurance Law*, the *Outbound Foreign Investment Tax Law*, the *Foreign Exchange Administration Law Governing Outbound Foreign Investment*, the *Overseas Investment Banking Promotion Law*, the *Outbound Foreign Investment Protection Law Governing State-owned Assets*, and the *Foreign Assistance Law*, before duly drafting and considering a *Basic Outbound Foreign Investment Law*. When it comes to overseas investment regulation, laws in a home or host country are far from enough, because such investments are transnational and involve relations between private investors and the host country, and between the home and host countries. Legal provisions that encourage and protect investment have limited capacity to achieve their goals without inter-state cooperation and coordination. The Chinese government should therefore step up its efforts to sign and improve bilateral or multilateral investment treaties with other countries, such as bilateral investment protection and tax treaties, in order to seek greater international legal protection for Chinese foreign investors.

1.3.2 The Supervision/Administration Subsystem

Growing outbound foreign investment by Chinese enterprises requires the government to strengthen macro-adjustment/control while providing further incentives for such investment. Today, several Chinese agencies, including MOFCOM, NDRC, MOF, SAFE, GAC, NSAAB, and other authorities are involved in administering China's outbound foreign investment, leading to decentralized administration and a lack of unified planning and guidance. This is detrimental to the sustainable growth of China's outbound foreign investment. It is therefore necessary to set up a single authority – the National Outbound Investment Commission (NOIC) – which is responsible for developing China's outbound foreign investment strategy and, at the macro level, conducting unified administration and coordination of outbound foreign investment activities by Chinese organizations in various sectors across China. This will replace the current decentralized administration of outbound foreign investment with centralized regulation and guidance on outbound FDI activities. The Chinese government may set up representative offices to provide administration and services in areas of the host country that house a large number of Chinese enterprises; it also should develop a scientific statistics system to monitor outbound foreign investment projects, production operations and actual business performance. In the meantime, the Chinese government should properly manage state-owned assets outside China to ensure that their value is maintained or increased. In terms of foreign exchange administration, the Chinese government should undertake several initiatives, including: deepening reform of the foreign exchange administration system, including liberalizing the administration of foreign exchange to a certain extent; combining tight control over the inflow of foreign exchange with tight, or loose, control over its outflow as needed; administering foreign exchange reserves by functional category; and setting up an independent internal auditing department to increase the transparency of foreign exchange administration.

1.3.3 The Tax/Financial Subsystem

In terms of taxes, the Chinese government should consider the following initiatives: increase tax policy support for outbound foreign investment projects in important sectors, especially those relevant to energy and other natural resources, as well as strategic emerging industries; improve the corporate income tax system for outbound foreign investment and the method for calculating taxable income from overseas, and increase tax incentives for outbound foreign investment by Chinese enterprises; further refine policies relevant to indirect tax credits; improve tax levying/administration measures for outbound foreign investment; and strengthen international tax cooperation. In terms of finance, the Chinese government should: improve the financial support system for the growth of China's outbound foreign investment, while facilitating bank-enterprise cooperation and financial innovation; establish a multi-tier guarantee system for outbound foreign investment and combine policy-based financing with commercial financing in order to increase financial support for outbound foreign investment; provide extra financial support for important projects outside China relevant to the energy, other natural resources and strategic emerging industries; allow more financial institutions to provide more services for outbound foreign investment; make good use of various capital markets and develop equity investment funds. In addition, the Chinese government should: promote reforms to make the administration of foreign exchange more market-oriented, and allow more organizations to enter the foreign exchange market; improve the market for renminbi and foreign exchange derivatives; enhance foreign exchange regulation; promote renminbi regionalization and internationalization through measures such as strengthening currency cooperation in East Asia; create offshore renminbi financial markets; promote the use of renminbi in international settlement and in more countries and regions, for example.

1.3.4 The IP/Standards Subsystem

With rapid technological advancement and economic globalization, economic competition between countries is increasingly embodied as competition related to intellectual property and technical standards. Creating, owning and using IP and technical standards has become a critical factor for a company or even a country to gain competitive advantage. MNCs in developed countries obtain innovation resources from obtaining IP information, on the one hand, and elevate their status and competitiveness through IP protection, on the other. With significant IP advantages in the field of high technology, MNCs protect their interests using IP barriers in order to achieve their strategic goals in international operations. Developed countries endeavor to maintain a dominant position in the field of international standards by means such as granting patents to relevant technologies, making patent standards and exercising a monopolistic role in standardization. In so doing, they aim to maximize their competitive advantage through a combination of IP and standards setting. This trend has posed tough challenges for Chinese enterprises that are going global. As a result, strengthening international IP protection and promoting international competition in the field of standardization is critical for fueling outbound foreign investment by Chinese enterprises.

1.3.5 The Risk Prevention and Control Subsystem

Nowadays, there are various international investment risks. In addition to traditional operating and political risks, non-traditional security risks such as pirate, terrorist and cyber-attacks have become frequent security threats to Chinese enterprises and nationals. Severe emergencies such as epidemics and natural disasters also impact the safety of Chinese enterprises and nationals at a growing rate. To address these risks, relevant Chinese authorities, sectors and enterprises need to work closely with each other to: create a risk prevention and control subsystem and gain full access to information on Chinese enterprises, projects and individuals outside China; strengthen monitoring, analysis and research on the security situation in hot spots, regularly release guides to outbound foreign investment and economic cooperation, and trade/investment environment reports, by country or region, together with timely warnings; conduct security/safety assessments on opening businesses or implementing projects in high-risk countries; provide enterprises with guidance on how to protect themselves from risks outside China, provide relevant company staff members with overseas security/safety training, and assist enterprises in tackling risks outside China. Moreover, relevant Chinese authorities must be able to rapidly and properly respond to risks and express concerns after they occur. Only by so doing can the Chinese government help local enterprises avoid or minimize risks and resulting losses.

1.3.6 The Overseas Economic and Trade Cooperation Zone Promotion Subsystem

China began building overseas economic and trade cooperation zones in 2006. MOFCOM plays a leading role in this process by reaching agreements with the governments of politically stable countries with which China has good relations. A Chinese enterprise authorized by the Chinese government then plays a major role in building and managing the zone after signing an agreement with the foreign government. After that, this enterprise invites worldwide companies to set up operations in the zone in order to form an industry cluster. This set up is equivalent to outbound FDI by Chinese enterprises in the form of a single cluster or group. The authorized enterprise will receive 200–300 million yuan worth of financial support and no more than two billion yuan worth of mid- and long-term loans for building the zone. With regard to building overseas economic and trade cooperation zones, Chinese enterprises play a dominant role in implementing the "go global" strategy, while the Chinese government provides relevant services and protects the rights/interests of the former. Since this is a method of outbound foreign investment for which little experience is available from the rest of the world, issues such as unreasonable zone plans, unclear industrial positioning and private companies' need for more support have arisen. Strong support from the Chinese government is needed to address these issues.

1.3.7 The Overseas Securities Investment Promotion System

In the process of economic globalization, the factors of production, the mix of industries, and economic benefits are readjusted and redistributed around the globe. How these activities are carried out differ greatly from how goods were distributed and trade was conducted globally. Financial and investment activities are increasingly characterized by globalization. Overseas securities investment allows for: more efficient allocation of China's financial assets and conversion of domestic savings into investments; provision of Chinese capital with more possibilities for investment; greater resilience of China's economic and financial systems against external impacts, and improved economic and financial security; increased Chinese competitiveness and overall strength amid globalization. By the end of 2011, China's foreign exchange reserves reached $3.18 trillion USD. It is difficult for China to achieve the goal of maintaining and increasing the value of such a huge sum of foreign exchange reserves only through outbound FDI. Therefore, there is more reason to expect that the Chinese government will aggressively promote overseas securities investment. To this end, the Chinese government should focus on improving the qualified domestic institutional investor (QDII) system and fueling the growth of investors such as SWFs.

1.3.8 The Service Subsystem

Since overseas investment now has higher requirements for relevant services, the Chinese government urgently needs to accelerate the development of credit rating services and industry associations.

Chapter 2
The Legal Subsystem

The Chinese legal subsystem regarding overseas investment by Chinese entities includes relevant domestic laws and international treaties, primarily bilateral investment treaties (BITs), international tax treaties -mainly bilateral tax treaties (BTTs)- and free trade agreements (FTAs). Chinese laws governing overseas investment are far from perfect, as overseas investment administration, promotion and protection generally remain at the level of departmental regulations, which is out of sync with the fast-growing overseas investment activities by Chinese organizations. China has signed a multitude of international treaties, but these treaties are generally outdated since most of them were institutionally designed with the idea that China would be the receiving, not contributing, country for such investments. In other words, these treaties are unable to meet China's current overseas investment needs, and hence, urgently require amendments and improvements. Accordingly, accelerating domestic legislation for investment while improving relevant international treaties is a top priority in building China's overseas investment promotion system.

2.1 Accelerating Domestic Legislation for Investment

2.1.1 The Legislative Framework

China's domestic legal subsystem for overseas investment should be built upon legislative experience and methods from the rest of the world. Because China remains in the early developmental stages of overseas investment and needs more time to understand relevant issues, it is difficult for the Chinese government to enact a comprehensive basic law before a full range of necessary special laws are made. To address this issue, the Chinese government should make special laws such as the *Foreign Investment Regulatory Law*, the *Foreign Investment Insurance Law*, the *Foreign Investment Tax Law*, the *Foreign Exchange Administration Law Governing*

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Foreign Investment, the *Foreign Investment Banking Promotion Law* and the *Foreign Assistance Law*, before duly drafting and considering a *Basic Foreign Investment Law*. Among them, making the *Foreign Investment Regulatory Law* and the *Foreign Investment Insurance Law* is the top priority, and we will focus our discussion on these two laws, with abbreviated explanations for the design of the other laws because of the length of this book.

2.1.2 Legislative Points

2.1.2.1 Legislation for Overseas Investment Regulation

Global laws regulating overseas investment generally are made in two manners – the indirect manner in developed countries and the direct manner in developing countries. With mature market economies and comprehensive laws, developed countries typically have policies that encourage free investment. Instead of a special law governing the approval of overseas investment activities, legal provisions governing the approval and supervision of such activities are included in relevant legal documents. Alternatively, indirect adjustments are made under other laws, such as cancelling incentives, or avoiding political risks, for particular projects. By comparison, developing countries, including emerging industrialized countries, face a variety of problems, such as a shortage of capital, technical limitations and insufficient capacity, to varying extents. Therefore, when implementing policies for free trade and investment amid economic globalization, these countries have to take into account a series of issues, such as the economic strength, industrial orientation, technical structure and the types of investors, and follow the principle of paying equal attention to approval and regulation when making laws/regulations governing overseas investment. South Korea, for example, is a paragon among developing countries when it comes to making overseas investment. It has a legal system regarding the approval of overseas investment projects that encompasses investment approvals and regulations, the types of investors and investments, and incentives and prohibitions. In short, every aspect of overseas investment is within the purview of the regulators.

As a developing country, China has the opportunity to absorb the advantages of both the indirect and direct manners of regulating overseas investment as it works to improve its overseas investment administration system. The *Foreign Investment Regulatory Law*, for example, should cover the following: regulators, investors, the method for approval, the scope of approval and prohibitions, clear and streamlined approval procedures, penalties for wrongdoing, the legal status of relevant incentives and prohibitions, legal requirements for overseas investment reporting, and statistical and state-owned assets monitoring systems, among others.

The Regulators

In order to change the situation where overseas investment is administered by multiple regulators and, hence, to better regulate and guide overseas investment activities, it is necessary to set up a single regulatory authority – the NOIC – which is responsible for conducting unified, macro-level administration and coordination of overseas investment activities by Chinese organizations in various sectors across China. The NOIC should act as a coordinator among other relevant authorities such as MOCFOM, MFA, NDRC, MOF, SAFE, GAC, NSAAB and SAT and clarify their respective responsibilities. This will remedy the current problematic lack of coordination and clear division of responsibilities among these authorities.

The Investors

The *Foreign Investment Regulatory Law* should provide that any and all economic organizations or natural persons eligible for overseas investment shall have the right to make such investment. In China, there has long been a lack of clear legal or regulatory provisions regarding the capacity of natural persons or research organizations as outbound investors. The SOEs, private companies and FIEs that engage in overseas investment activities are "enterprises and other economic organizations as juridical persons". Such a legal framework already lags behind the current practice of overseas investment.

First, natural persons are already de-facto investors who engage -and greatly outnumber enterprises and other economic organizations-as players in China's overseas investment activities. Denying the capacity of natural persons as investors indeed is discriminatory, as they are ineligible for tax, financial or other incentives available to other investors. Second, both natural persons and research organizations as investors are very likely to implement investment projects that require the approval of the state, so they should not be excluded from the types of investors who can receive such approval. Third, the capacity of natural persons as international investors has long been made clear in BITs signed between China and other countries. The *Foreign Trade Law* enacted in 2004 explicitly allows natural persons to carry out foreign trade activities. *The Regulations of the People's Republic of China on the Administration of Foreign Exchange* amended in August 2008 already recognizes natural persons as investors. Moreover, some research organizations also may carry out overseas investment activities with technologies.

The Chinese government should therefore recognize natural persons and research organizations as investors who can receive its approval for their overseas investment activities. Given that the Chinese government has denied the capacity of natural persons as investors in all previous relevant documents, the Chinese government should take steps to ensure future amendments to these documents or include this provision in new relevant laws/regulations.

Approval Methods

Countries around the world administer overseas investment mainly through an approval, automatic authorization, or registration regime. In Japan, for example, the Ministry of Finance decided after 1972 to allow the Bank of Japan (BOJ) to automatically approve more kinds of overseas investment projects – giving it the power to approve nearly all FDI projects except for those in industries where overseas investment is restricted. Both the United Kingdom and France have replaced the approval regime with the registration regime, although this is not yet a prevalent practice. Most countries still use the approval regime, and even liberal countries like the United States administer overseas investment activities. In order to ensure national security or perform international obligations, the French government still regulates investment projects that involve sensitive sectors or countries despite the fact that it does not, in principle, exercise the power of approval to administer overseas investment activities by French companies.

These foreign practices show that narrowing the scope of approval is definitely a trend that China should explore as it reforms its overseas investment approval regime, but the Chinese government must also maintain the power of approval in particular aspects. Given the current situation in China, it is unrealistic to employ a pure registration regime. Global trends in the approval of foreign investment suggest that the Chinese government should replace the current tight approval regime with an automatic authorization or registration regime for foreign investment projects that do not influence special matters such as China's diplomacy or economic security. In other words, the Chinese government should maintain the power of approval if foreign investment projects relate to issues such as China's economic security or the shifting of massive state-owned assets to other countries of regions. Otherwise, it can safely follow the principle of free investment and let investors make relevant decisions. Specifically, such a regime would allow investors to get registered at the foreign investment administration without prior approval, and allow them to receive a foreign investment permit with which they can go through necessary procedures including foreign exchange/tax payment, goods inspection and customs clearance by the competent authorities.

Given the current situation, China' foreign investment approval regime should be designed by combining elements of the approval, automatic authorization and registration regimes. New relevant laws should clarify the applicability of tight approval, loose approval, automatic authorization and registration while increasing the applicability of both automatic authorization and registration.

The Scope of Approval and Prohibition

A clear scope of approval cannot be complete without prohibitive provisions in fields where foreign investment is not allowed. Countries generally prohibit local residents and enterprises from carrying out particular foreign investment activities in areas that it deems sensitive. In Canada, for example, technologies and products for which the government restricts exports are also subject to restrictions on foreign investment. The most important Canadian law governing import and export trade is the *Export and Import Permits Act* passed in 1974. The Export and Import Control Board under Canada's Ministry of Foreign Affairs, Trade and Development –which is responsible for managing international trade- controls the import and export of goods listed on a special catalog provided in this law.

Based on foreign experience, the Chinese government should prohibit foreign investment projects in areas including: investments that seriously threaten China's economic security, such as investments in hostile countries; investments that harm China's reputation, public order and/or its revered traditions; investments that may cause the heavy loss of state-owned assets; investments that may cause a severe imbalance between outbound and inward payments; investments that involve the outflow of important technologies unique to China; investments that might have adverse effects on China's economic interests, such as a significant decrease of jobs or a destructive impact on relevant industries in China, for example. As China's foreign investment grows rapidly, the *Foreign Investment Regulatory Law* should have clear prohibitive provisions regarding foreign investment.

Clear, Streamlined Approval Procedures

There is a global trend to define clear, streamlined approval procedures for foreign investment activity. South Korea performs remarkably well in this respect. The South Korean government categorizes investment projects, depending on the targeted industry and investment size, into projects that require general approval, that require declaration, and that require approval by the foreign investment review board. The required materials and procedures differ from category to category. This practice deserves close study since it has achieved the goal of regulation while reducing the workload and time to a certain extent.

With regard to the approval of overseas investment, the Chinese government should focus on assessing risks in the use of foreign exchange and compliance with the state's industry policies. As for the other aspects of approval, the Chinese government may replace approval with registration, wherein enterprises get registered at the competent authorities after receiving overseas investment permits. It is advisable for the Chinese government to clarify approval procedures before streamlining them. In the meantime, both liberalizing small-scale investments and allowing automatic authorization under certain conditions would be significant moves. Liberalizing small-scale overseas investments means that eligible outbound investors – those who plan to make overseas investments below a certain value, i.e. $100,000 USD, and whose projects comply with the state's overseas industry policies- may receive overseas investment permits, without prior approval, simply by getting registered at the overseas investment administration. With such a permit, investors can go through procedures with respect to foreign exchange/tax payment, goods inspection and customs clearance by the competent authorities. Automatic authorization means that an outbound investor shall be considered as having automatically received approval if the competent authority takes no action a particular number of days after the investor submits an application to this authority and has relevant documents verified. The South Korean government, for example, announced that it would implement the automatic overseas investment authorization regime after it issued a program to further liberalize overseas investment. This liberalization program increased the upper limit of overseas investment by individuals and individual businesses to one million USD from $500,000 USD. Investment projects below this limit are only required to get registered with no need for approval. This was how the South Korean government realized the liberalization of overseas investment by local capital. For China, a great deal of small-scale overseas investments will represent a significant share of its total overseas investment since individual investors and non-publicly owned economic organizations have become increasingly important for the Chinese economy. It is therefore important to liberalize small-scale overseas investment and to research relevant laws/regulations.

Penalties for Wrongdoing

Violations of laws/regulations governing overseas investment in terms of management of state-owned assets, foreign exchange, finance, taxes and accounting can be punished by a variety of means, including: warnings, prohibiting violators from receiving payments within a certain period of time, cancelling tax incentives, stopping financial support, or revoking overseas investment permits. For companies that suffer losses due to mismanagement or non-promising investments, it may be recommended that they withdraw investment. Those who violate China's the criminal law shall be brought to justice. All these provisions should be specified in the section of the *Foreign Investment Regulatory Law* regarding penalties.

Other

The *Foreign Investment Regulatory Law* should also specify relevant incentives and prohibitions, call for overseas investment reporting and statistics systems, and define the legal status of overseas state-owned assets regulation, among others.

2.1.2.2 Legislation for Foreign Investment Insurance

The Organizational Setup

Under the principle of the government playing a leading role, overseas investment insurance service providers are generally entities under direct control of the central government. Nonetheless, overseas investment insurance institutions vary from country to country. First, these institutions fall under three categories according to their nature. The first category is government-owned companies. The Overseas

Private Investment Corporation (OPIC) is a typical government-owned overseas investment insurance institution. Taking overseas investment risks in this way avoids confrontation between governments in international investment disputes and, instead, commercially solves political issues. The second category is governmental organizations. In Japan, for example, the overseas investment insurance institution is the Trade Bureau of the Ministry of Economy, Trade and Industry (METI); the Enterprise Bureau of METI is in charge of approving insurance applications, and relevant insurance services are provided by the Long-Term Transport Department of this bureau. The third category is partnerships between the government and state-owned companies. Germany is the most typical example of this category, as its overseas investment insurance institutions include Treuatbeit AG and Euler Hermes Kreditversicherungs-AG.[1] Second, overseas investment insurance institutions are either two-in-one entities or separate entities depending on whether the organization has both the power to approve overseas investment insurance services and is the organization that provides such services. In both the United and States and Japan, for example, the overseas investment insurance institutions belong to the first type since they have the power of approval while providing overseas investment insurance services. In comparison, Germany's overseas investment insurance institutions are separate service institutions, as a relevant authority has the power to approve and administer overseas investment insurance services, while a state-owned insurer provides such services.

Given the situation in China, Chinese overseas investment insurance institutions should be of a third type – cooperation between the government and particular state-owned companies on a separate basis. Specifically, the statutory insurer, the approver and the insurance service provider should be different from each other. Today, credit insurance in China is managed by a relevant government agency and a commercial organization together and, to a certain extent, belongs to this third type. With regard to the specific organization, the Chinese government may act as the statutory insurer; MOFCOM, MOF, MFA, NDRC and SAFE may co-establish the Overseas Investment Insurance Management Board (OIIMB) to be responsible for the approval of overseas investment insurance services; and the China Export & Credit Insurance Corporation (SINOSURE) may be responsible for providing and managing relevant insurance services and rights of subrogation. The advantage of this model is a clear division of work and the ability for both the approver and the insurance service provider to function separately. By avoiding or reducing the possibility of a single organization acting as the approver/decision maker and service provider, this model facilitates refinement and specialization within each functional department with limited human, physical and financial resources, thereby better protecting

[1] Treuatbeit AG and Euler Hermes Kreditversicherungs-AG are only responsible for providing investment guarantee services; the organizations in charge of insurance review and approval include a committee with the power to make final decisions that is made up of representatives of the Federal Ministry of Economics and Technology, the Federal Ministry of Finance and the Federal Foreign Office, and an advisory committee made up of representatives of the accounting review committee and the Deutsche Bundesbank.

the interests of Chinese overseas investors. Moreover, the two organizations would have separate protective relations with outbound investors –vertical relations between the approver and outbound investors, with the former managing the latter; and insurance contract-based relations between the insurance service provider and outbound investors. Since flaws in either type of relations would not affect the other, this regulatory method better suits relevant investment practices in China.

Step 1: Ensure that the approver and the insurance service provider are separate entities:

Given the current situation, the separation of approval and services is a better choice for China. First, an organizational setup where the approver is separate from the service provider favors a clear division of work and an increase in operating efficiencies. A new, single governmental organization that doubles as a corporation is very likely to experience conflicts of interest, as has been demonstrated by the chronic problems with SOE operation and management in China. This organization, if endowed with comprehensive functions, would probably become too big and functionally overlap with other departments, or on the other hand, would be unable to perform its important functions if too small. In contrast, an approver separate from the service provider favors a clear division of work. The approver may be responsible for making regulations regarding the overseas investment insurance regime, approving insurance applications, regulating the businesses of the insurance service provider, and coordinating relations involved in the insurance business. The insurance service provider may be responsible for taking political risks against the approved overseas investment projects, thereby fully performing its function as an insurer. Second, an organizational setup on a separate basis ensures that insurance is available for all overseas investment projects favorable for the growth of the Chinese economy, whereas those that do not meet relevant insurance requirements will not be insured. The approver can focus on approving compliant overseas investment projects, and the insurance service provider on providing overseas investment insurance services. This will allow both organizations to become more specialized. Third, an organizational setup on a separate basis significantly reduces the possibility of corruption, which is also a long-term objective for administrative law enforcement in China. This is significant at a time when China has yet to establish a good legal system. By comparison, a single organization that operates as a two-in-one entity inevitably makes it easier for organization officials to collude with lawless outbound investors, and damage national interests in various aspects of overseas investment insurance. Operating on a separate basis would allow for vertical relations between the approver and policy holders, with the former managing the latter, and horizontal, insurance contract-based relations between the insurance service provider and policy holders. Accordingly, the approver and the insurance service provider can interact better with each other.

Step 2: Establish the OIIMB as the Approver with Respect to Overseas Investment Insurance.

Today, the NDRC, MOFCOM and SAFE are all responsible for approving overseas investment projects. This regime is plagued with problems such as cumbersome procedures and functional overlap. This is detrimental to strengthening overseas investment administration and makes it impossible to properly arrange, in the state's fiscal program, compensation for insurable overseas investment projects. To address these problems, China should consider an overhaul to its overseas investment insurance regime[2] and establish a single special organization directly under the State Council, like the proposed OIIMB, as the approver with respect to overseas investment insurance. It is noteworthy, however, that purchasing insurance for an overseas investment project is not a requirement, but a voluntary decision by overseas investors depending on whether they need insurance for the sake of security/safety. Only overseas investors who have received approval from the approver can purchase insurance from the insurance service provider. This has nothing to do with whether the competent authority allows Chinese residents to make overseas investments. Given various interests involved in overseas investment, the proposed OIIMB should be made up of representatives from MOFCOM, MOF, MFA, NDRC and SAFE. With regard to specific staffing, the experience and competence of the staff are critical – the head of this board should be appointed by the State Council; the other members should include corporate representatives experienced in managing multinational operations as well as government staff from the above-listed authorities. Furthermore, a political risk warning mechanism for overseas investment may be set up within this board as needed; technical specialists and experts should take on the task of quantitative analysis of the probabilities of political risks in relevant countries and regions in order to assure the quality of approval.

Step 3: Allow SINOSURE to Act as the Overseas Investment Insurance Institution.

Given the nature of overseas investment insurance and the characteristics of the proposed hybrid investment guarantee model, we conclude that the Chinese overseas investment insurance institution should have two characteristics. First, it should be a public corporation that is backed by the government, plays a guiding role on behalf of the government, and mirrors the government's overseas investment policy. Second, it should be a commercial organization. Regarding the first characteristic, the status of this insurance institution as a public corporation does not conflict with its commercial nature, as has been demonstrated by the investment insurance regime in the United States, with respect to legal practice. This facilitates subrogation under the bilateral model. It is therefore necessary to set up a state-controlled Chinese company specializing in providing overseas investment insurance services. This company is supposed to differ from ordinary insurers in that it is not profit-driven, but instead aims to provide services for China's foreign investment. It should operate independently under certain corporate regulations, have independent accounts and be subject to independent accounting, with operating funds available from the public purse as needed. If it is costly and time-consuming to set up a new, special-

[2] Note that approval with respect to overseas investment insurance should differ from the approval of overseas investment projects.

ized overseas investment insurance institution, then it is advisable to elevate SINOSURE as an organization specializing in overseas investment insurance. SINOSURE works under a business model that combines the characteristics of governmental and commercial organizations – it provides policy-oriented insurance in a commercial manner. This nonprofit organization (NPO), which is oriented by national economic policies and works under relevant corporate regulations, has basic characteristics of an insurer that takes political risks against Chinese overseas investment projects. Moreover, SINOSURE is already China's only overseas investment insurance institution, so it is advisable to develop it into an institution specializing in overseas investment insurance services under the hybrid model. To this end, the Chinese government should consider: making legal provisions that explicitly define the responsibilities of SINOSURE; modify its articles of association; set up an overseas investment insurance business unit within SINOSURE that provides relevant insurance services for overseas investment projects approved by the OIIMB; and gradually improve the functions of SINOSURE as an overseas investment insurance institution.

The Applicability of Insurance Coverage

Overseas investment insurance generally covers only non-commercial risks, or political risks, usually including foreign exchange, expropriation and war risks,[3] according to global laws and practices. Other political risks such as a government's breach of contract, delay in payment, currency depreciation and business interruption also are covered in some countries as needed. Given the current situation in China, the Chinese government should establish an open regime with specific national requirements that keep in mind lessons learned from the experience of developed countries. Risks other than foreign exchange, expropriation and war risks may also be added as needed.

1. Foreign Exchange Risks

Foreign exchange risks generally include inconvertibility and transfer risks, both of which are covered in the rest of the world and, hence, also should be covered in China. Besides, an obvious controversy regarding foreign exchange risks lies in whether the risk of discriminatory exchange rates should be covered. The risk of discriminatory exchange rates refers to investor losses caused by the host country's employment of an exchange rate system where the exchange rate varies with the party to the transaction. We think that this issue should be addressed depending on the specific situation – the risk of discriminatory exchange rates should not be covered if the discriminatory exchange rate system of the host country already existed before an investor made the investment. This is because this risk is predictable to investors and does not align with the basic purpose of insurance. On the other hand,

[3] Some countries also take other political risks, such as the government's breach of contract, delay in payment, currency depreciation and business interruption, as needed.

the risk of discriminatory exchange rates should be covered if the discriminatory exchange rate system of the host country is unknown to investors prior to an investment, for example an act of government intervention characterized by specificity and unfairness. Losses caused by exchange depreciation or reduction of the relative value of some other currency by the host country, if such an act is purely commercial with no characteristics of specificity or unfairness, should of course not be covered. In addition, losses resulting from foreign exchange regulations by the host country should be deemed inherent investment risks and, hence, should not be covered if knowledge that a host country may conduct, or has conducted, foreign exchange regulation was previously known or should have been known at the time of signing the insurance contract. The OIIMB needs to make relevant decisions depending on the nature of such risks.

2. Expropriation Risks

Expropriation risks refer to the loss of part or all of an investor's assets because their businesses or capital have been naturalized, expropriated or confiscated by the host country, or the host country has deprived the investor of his rights of ownership or rights to manage, use and/or control the investment projects without going through proper legal procedures. Nevertheless, not all expropriation risks are covered by overseas insurance, as developed countries generally believe that expropriation is legal -or at least does not cause insurable risks-as long as the expropriation is made for the sake of the public interest, complies with national laws without discrimination or arbitrariness, and comes with timely and sufficient compensation. There are several things that deserve attention when providing insurance services for expropriation risks. First, only the government of the host country can make expropriations. Such acts include all acts attributable to the government, that is, acts taken directly by government, or authorized, entrusted to others, approved, or acquiesced by the government. Expropriation risks should be covered as long as the aforementioned acts are not in line with either the investment contracts that the government of the host country signed with Chinese overseas direct investors under its national laws or its obligations under international laws, and have resulted in the loss of part or all of these investors' investment assets or incomes. Second, acts of expropriation include direct, indirect and gradual ones. Direct expropriation refers to the investors' being directly deprived of the ownership of their assets; indirect expropriation generally refers to the owners of assets being unable to use, possess or dispose of their assets. Compensation is unavailable if expropriation is caused by faults or offenses of Chinese overseas investors or their businesses, or if the expropriation is non-discriminatory and general, or moves with similar effects, and is properly made by the host country under its national laws in order to manage its economic activities. Third, it must be emphasized that there must be a direct cause and effect relationship between acts that the government of the host country has taken, authorized, accepted or acquiesced in and the resulting risks against, and losses of, investors. Compensation is available only for expropriation risks with direct cause-effect relationships. This is critical for the success of the subsequent subrogation and favors the interests of the home country.

3. War Risks

War risks refer to the loss of investment assets caused by wars, revolutions, internal disturbances, etc. Compensation is available for losses caused by the destruction, loss, seizure or distrainment of investment assets as a result of wars, revolutions, riots or internal disturbances, or by direct consequences of prevention, resistance or defense by either party against any sudden or expected hostilities during chaos caused by wars. But such causes exclude riots and terrorist activities resulting from general labor disputes or economic conflicts.[4] Since there are no globally accepted definitions of war and internal disturbances, war risks can be broadly defined in order to provide guarantees against not only organized acts of violence aimed at overturning the government of the host country or removing it from a particular region, such as revolutions, revolts, rebellions and military coups, but also riots and civil disturbances. However, terrorist activities, kidnappings and other similar acts against policy-holders are outside internal disturbance risks. The coverage of war risks varies widely from country to country. U.S. laws, for example, only cover the direct losses of tangible assets caused by war risks; Japanese laws provide that war risks shall cover the losses of both tangible and intangible assets. The reason for this difference lies in that the two countries have different overseas investment insurance regimes. It is therefore necessary for the Chinese government to specify the coverage of war risks according to its overseas investment insurance regime; the insurer needs to make informed decisions in specific cases.

Insurance Terms and Conditions

Insurance conditions mainly include eligible investors, investments and host countries.

1. Eligible Investors

Eligible investors refer to individuals and organizations legally eligible to apply for overseas investment insurance. Provisions of overseas investment insurance laws regarding eligible investors vary from country to country, although they all require fairly close ties between investors as applicants and the country where the insurer is based. In the current context of diversified foreign investments, many private companies have begun implementing the "go global" strategy. As the economy grows and private capital goes global, the insured under China's overseas investment insurance regime will become increasingly diverse. With regard to eligible investors, we recommend the principle of combining the "territorial principle" with "capital control." In other words, all organizations based in China, whether or not Chinese nationals own the majority of shares, can apply for overseas investment

[4] Compensation for war risks is unavailable for riots and terrorist activities resulting from general labor disputes or economic conflicts.

insurance; enterprises that are based outside China but are controlled by Chinese individuals or organizations can also apply for overseas investment insurance.

Eligible investors under China's overseas investment insurance regime should cover three types. First, natural persons in China should become eligible investors. Under current Chinese laws, natural persons as individuals are prohibited from engaging in international direct investment activities, so they are excluded from insurance. However, as individuals play a growing role in international economic activities, it is forward-thinking to include natural and juridical persons and other economic organizations into the insured. Including natural persons as eligible policy-holders is consistent with both internationally accepted practice and the fact that nearly all BITs signed between China and other countries include natural persons as eligible investors. Second, Chinese juridical persons and business organizations that are established under Chinese laws should become eligible investors. This aligns with the territorial principle. Among them, Sino-foreign joint ventures and cooperative enterprises and wholly foreign-owned subsidiaries should be among the insured under China's overseas investment insurance regime. According to the current FIE-relevant laws, all three of the above-mentioned types of enterprises are economic entities established in China, where they are governed and protected by Chinese laws.[5] In reality, all three types of enterprises opening branches outside China become a form of China's FDI. These enterprises therefore should be among the insured under China's overseas investment insurance regime, as this will fuel the growth of China's overseas investment. Third, juridical persons or other organizations outside China whose assets are 100 % or at least 95 % owned by Chinese nationals, juridical persons or other Chinese organizations should become eligible investors. This is consistent with the principle of capital control that is followed by BITs signed by China. There are two reasons for this. First, juridical persons or other entities outside China that are 100 % or at least 95 % owned by Chinese nationals, juridical persons or other Chinese organizations generally are considered, under the principle of capital control, as juridical persons or other enterprises based in a hostile or other country and, hence, can be sanctioned or expropriated by some host countries in special periods such as wars or internal disturbances. In such cases, these enterprises or organizations will become stateless if China, as the home country of the asset owners, does not consider them to be Chinese enterprises or organizations. Consequently, Chinese outbound investors or assets will suffer damages and losses, which is clearly inconsistent with the purpose and the principle of China's overseas investment insurance regime. Second, Chinese enterprises, especially China-based foreign-controlled enterprises, may have foreign companies whose assets are 100 % or at least 95 % controlled or owned by Chinese enterprises or other Chinese organizations, if they make overseas investments in the form of wholly-owned subsidiaries. In such cases, excluding these enterprises from eligible holders of overseas investment insurance policies also will hinder the growth of China's overseas investment sector.

[5] Sino-foreign joint ventures and cooperative enterprises and wholly foreign-owned subsidiaries established in China are commonly known in this country as the "three types of FIEs".

2. Eligible Investments

Eligible investments include eligible investment projects and forms.

First, investment projects should be eligible. Most developed countries, such as the United Kingdom, the United States, Belgium, Germany and Holland, each have an overseas investment insurance regime that gives the highest priority to carrying out the state's economic, political and diplomatic policies, that requires insured investments to meet the state's economic and diplomatic policies, and, to a certain extent, that includes fueling the economic growth of the host country as one of its objectives. China's overseas investment insurance institution should insure investment projects under the principle that they will promote the growth of the Chinese economy. In addition, it should take into account the interests of the host country. Only by so doing can it better harmonize the interests of investors with China's economic interests and that of the host country, all while reducing investment risks. First, overseas investment projects must be in the political and economic interests of China and be able to increase employment, improve the BOP, fuel domestic trade growth, and facilitate the introduction of advanced technologies, the exploitation of foreign natural resources or the return of world-leading technologies/products. Second, investment projects should be in the interests of the host country, align with the development objectives and priorities announced by its government, promote the economic growth of the host country, and receive the approval of the host country government. Third, only new overseas investments are eligible, including the expansion, reconstruction and modernization of existing enterprises. This provision aims to reduce risks, as new investments can better harmonize the interests of investors, the home country and the host country.

Second, the forms of investment should be eligible. Eligible forms of investment mainly include direct investments, loans from financial institutions and other approved forms of investment. Direct investments include equity investments and shareholder loans/guarantees. Direct investments are confined to direct engagement in business operations, and generally exclude securities investments. Other approved forms of investment may include: movables, immovable and other rights in rem; copyright, industrial property, processes, proprietary technologies, trade names and goodwill; privileges granted under laws of the host country or legal contracts, etc. All the forms of investment are supposed to facilitate the maximum efficacy of the regime. In general, given the ever-changing world of investments, restrictions on the forms of investment eligibility for overseas investment insurance in China should not be too tight, thereby letting these forms keep pace with the dynamic economic landscape. Eligible forms of investment may be left at the discretion of the OIIMB in order to make relevant laws more flexible.

3. Eligible Host Countries

The eligibility of host countries depends on how the overseas investment insurance law is made. We believe that China's overseas investment insurance regime should lead to a hybrid model that combines the bilateral and, in fewer cases, unilateral models. Accordingly, eligible host countries should include not only countries that have signed BITs with China, but also those that have yet to do so.

Insurance Terms, Premiums and Benefits

1. Terms

Since China remains in the initial stage of creating an overseas investment insurance regime, it is necessary to design and continuously adjust this regime according to situations as they arise. Given that the current regime is not mature, it is inadvisable to have long insurance terms. On the other hand, however, such terms should not be too short since overseas investment projects tend to have long cycles. Given foreign experience in overseas investment insurance and the situation in China, overseas investment insurance terms should range between 10 and 15 years and depend on the type, nature and host country of the investment, as well as risks covered. An initial term may be chosen for the insured, who can then be granted a right to renew the insurance as needed. Longer terms are available, if approved by the OIIMB, for strategically important projects with long cycles and slow returns. Such insurance terms align with relevant Chinese institutions, on the one hand, and general characteristics of overseas investments, on the other.

2. Premiums

With regard to overseas investment insurance, the competent Chinese authority should determine premium rates depending on industries, risks and coverage. Specifically, insurance benefits should be calculated according to the percentage of invested capital in the total capital and to an annual increase in capital, before determining reasonable premium rates. Annual premiums based on the total capital should not be charged until the total capital is already invested. It is inadvisable to set very high premium rates, since the Chinese overseas investment insurance institution is an NPO aiming to protect investments rather than make money.

3. Benefits

The maximum and current-period benefits should be defined. The maximum benefits refer to the limit of liability of the insurer in the agreed-upon insurance term; these benefits are chosen by the insured and agreed by the insurer before the term begins. The insured may demand reduction of the maximum benefits when renewing the insurance. The maximum benefits will automatically and accordingly decrease after compensation occurs. The current-period benefits refer to the limit of liability of the insurer in the current insurance period; these benefits are chosen by the insured and agreed by the insurer before the current period begins. The current-period benefits will automatically and accordingly decrease after compensation occurs, and they must never exceed the maximum benefits.

Benefits are generally calculated according to losses caused by risks and compensation percentages. Countries around the world generally provide only for indemnity rather than total benefits. Benefits should be determined under several principles. First, benefits must not exceed a certain percentage of the total value of the insured overseas investment. This is because investors are supposed to take, for themselves, certain risks in overseas investment activities so that they will not excessively rely on the insurer. This will significantly reduce ethical risks in investment activities while enabling investors to avoid or reduce as many losses as they can. As a result, the globally accepted practice is that the determined benefits must not exceed a certain percentage of the total value of the insured overseas investment. Second, given China's policy support for overseas investment activities, the percentage of benefits to the total value of the insured overseas investment should not be too low. An unreasonably low percentage would make it impossible to provide investors with favorable compensation insurance and, hence, would be detrimental to the growth of overseas investment. Today, overseas investment insurance contracts worldwide generally provide that the insurer compensate the insured for up to 90 % of the losses that the latter suffers, with the remaining 10 % or more to be borne by the investor. The Multilateral Investment Guarantee Agency (MIGA), a member of the World Bank Group, proposes that the compensation percentage be agreed upon by the two parties in advance and be up to 90 % (or 95 % in exceptional circumstances) of losses. In order to encourage Chinese enterprises to invest overseas and align with globally accepted practices, therefore, the Chinese government should require that the insured bear 10 % of the losses for themselves. With regard to overseas investment projects in countries or regions with which China has yet to sign BITs, however, the insured may bear a higher percentage (but no more than 15 %) of the losses given higher risks and cumbersome claim procedures; this percentage should be determined by the OIIMB.

Subrogation Rights

Subrogation rights in overseas investment insurance refers to the right of the insurer to claim against the host country for compensation on behalf of the policy holder after an insured accident occurs and the insurer pays benefits to the investor. The right of subrogation is one of the key elements of the overseas investment insurance regime, because this regime generally does not reduce risks, but instead only transfers them to the government's insurance institution, which claims against the host country on behalf of the policy holder after paying out benefits to the latter. Today, the right of subrogation in worldwide overseas investment guarantee systems accords with relevant investment insurance regimes and generally falls under three models – the unilateral, bilateral and hybrid models. The primary difference among these three models lies in the grounds on which to exercise the subrogation right. As for China's overseas investment insurance regime, it is advisable to establish a hybrid model that combines bilateral and, in fewer cases, unilateral investment guarantees. Accordingly, the way of exercising subrogation rights should be based on the hybrid model. In other words, the subrogation right should be exercised under the BIT between two parties, or under the general principle regarding the right of diplomatic protection. On the side of the party that has the right to claim, we believe that this right should be exercised in a hybrid manner. In other words, restrictions regarding principles such as the exhaustion of local remedies and the Calvo Doctrine should be minimized when exercising the right to a claim, thereby increasing investor protection while reducing assistance costs. This will protect the interests of investors while ensuring the efficacy of investment guarantees from the home country.

2.1.3 Others

There is a complex system of domestic laws governing overseas investment. The *Foreign Investment Regulatory Law*, the *Foreign Investment Insurance Law*, the *Foreign Investment Tax Law*, the *Foreign Exchange Administration Law Governing Foreign Investment*, the *Overseas Investment Banking Promotion Law*, and the *Foreign Assistance Law*, are subsystems that relate to, share information with, and functionally supplement, each other, but are also relatively independent. These laws should be duly considering before making a *Basic Foreign Investment Law*. In doing so, these laws should be linked, and never conflict with each other. In addition to compatibility between them, these domestic laws must also be compatible with the international treaties of which China is a member. This will be another important legislative task in China.

2.2 Improving Relevant International Treaties

BITs, international tax treaties (mainly BTTs) and FTAs are the main international treaties relevant to China's overseas investment. To date, China has signed a large number of BITs, international tax treaties and FTAs. Signing more treaties is of course important, but improving the current ones is even more important. The need for improvement is due to the fact that China's overseas investment was small in size, and China was mainly seen as an investment destination, when the relevant treaties were signed. As a result, these treaties are unable to sufficiently protect the interests of China's outbound investors, which has become an increasingly obvious problem over time. In addition, significant changes have occurred in the global investment environment in recent years, and thus corresponding changes to these treaties are needed. As a result, modifying and improving investment-relevant international treaties is, and will remain, at least for a certain period of time, a very important task.

2.2.1 BITs

From a bilateral perspective, legislative efforts should focus on improving and strengthening the network of Sino-foreign BITs. The primary purpose of a BIT is promoting investment through clear and compulsory protective rules. With BITs, issues involving domestic laws in the host country can be addressed under international laws. Dispute resolution mechanisms add to legal stability and certainty. From China's first signed BIT with Sweden in 1982, to one of its most recent signed BITs with the Democratic Republic of the Congo on August 11, 2011, China has signed 127 BITs, making it second only to Germany. Sino-foreign BITs are the most direct and powerful instruments in protecting the interests of Chinese investors in their overseas investment projects, making it a priority area for the Chinese government to make efforts in research and improvement.

2.2.1.1 Establishment of Investments

An analysis of provisions regarding the establishment of investment in Sino-foreign BITs shows that there are no restrictions on investors' rights or the scope of access, with only a scattering of performance/transparency requirements. In some cases, BITs have provisions on pre-establishment treatment and on establishment exceptions. Sino-foreign BITs are textually simple when compared with the 2004 Model US BIT or the 2004 Canadian Model BIT. Moreover, Sino-foreign BITs vary widely from each other in terms of provisions since they were signed at different times. For example, among the 14 main BITs China has signed with other countries (i.e. the United Kingdom, Australia, Pakistan, Mongolia, Kazakhstan, India, Saudi Arabia, Zambia, Nigeria, South Africa, Germany, Russia and South Korea), only the China-Australia BIT (signed in 1988) and the China-South Korea BIT (signed in 2007) contain relatively sufficient transparency requirements. In contrast, China is subject to transparency requirements since its WTO accession commitments became binding on December 11, 2001. Accordingly, China should perform this obligation to the other WTO members whether there are provisions on this issue in Sino-foreign BITs or not. However, adding transparency clauses into these BITs will improve their structure and content and facilitate their use. Furthermore, it will better satisfy China's needs and requirements in making overseas investment decisions, while helping protect the interests of Chinese investors in countries and regions other than WTO members.

We have several recommendations on improving establishment of investment in BITs:

Provisions for Restrictions on Investors' Rights in Sino-foreign BITs

To date, provisions regarding establishment-of-investment assurance are mostly specified in WTO agreements. However, China's major investment destinations include such countries as Sudan and Kazakhstan which are not WTO members. It is therefore recommended that provisions should be included in Sino-foreign BITs – especially the ones between China and non-WTO member countries – that the host country shall reduce restrictions on investors' rights.

Refer to the US or Canadian Model BITs to Detail Performance Requirements

Sino-foreign BITs should emphasize performance requirements, especially ones with incentives. In providing allowances to foreign investors who meet particular performance requirements, a host country is actually discriminating against potential Chinese investors who do not satisfy these requirements and damaging their interests. It is recommended that performance requirements be detailed in Sino-foreign BITs by referring to Article 8 of the 2004 US Model BIT or Article 7 of 2004 Canadian Model BIT.

Adhere to Current Provisions Regarding Pre-establishment Treatment

All of the existing bilateral and multilateral investment treaties of which China is a member have consistent provisions regarding pre-establishment treatment – that is, most favored nation (MFN) treatment, but not national treatment, is granted in the establishment phase of investment. Such a provision meets relevant requirements of international investment law while balancing China's needs and requirements for introducing FDI and making overseas investment. The Chinese should hold fast to this position, in the foreseeable future, that national treatment should not be granted until an investment is established.

Improve Provisions Regarding Establishment Exceptions

Detailed exceptions are outlined in Article 9 (Reservations and Exceptions), Article 10 (General Exceptions) and Article 11 (Health, Safety and Environmental Measures) of the 2004 Canadian Model BIT. Relevant schedules are offered in both ANNEX I: Reservations for Existing Measures and Liberalization Commitments and ANNEX II: Reservations for Future Measures. It is recommended that clauses regarding establishment exceptions be specified in Sino-foreign BITs by referring to relevant provisions in the Canadian Model BIT, thereby ensuring that Chinese investors have clearer expectations when making investment decisions. This will better protect the interests of Chinese investors in overseas investment projects.

2.2.1.2 Treatment for Investors

Treatment for investors is at the core of investment support in the investment operation phase. We have the following recommendations in this area:

Adhere to Granting National Treatment After an Investment Is Established

Since it is a relative standard, national treatment can be distinguished on the basis of investments and treatment of investors in the host country itself. Accordingly, there are not many investment disputes caused by national treatment. Disagreements on provisions regarding national treatment focus on whether national treatment applies to overseas investments before they are established. We believe that the Chinese government should adhere to granting national treatment after an investment is established, while specifying reservations for national treatment in regional integration and some special arrangements. Such a position is not only consistent with existing provisions, but also instrumental to balancing China's interests to introduce FDI and invest overseas.

In the meantime, we recommend that Sino-foreign BITs be duly modified to unify provisions regarding national treatment. On the one hand, it is necessary to delete language which no longer aligns with international law or investment practices, such as the "whenever/wherever possible" language in Article 3.3 of the 1986 China-UK BIT. On the other hand, both national treatment and its exceptions should be provided with details.

Deny a Broader Application of MFN Treatment to Dispute Settlement

Theoretically, the International Center for the Settlement of Investment Disputes (ICSID) is inclined, to a certain extent, to overemphasize the significance of the object and purpose of relevant treaties when it comes to deciding on a broader application of MFN treatment. According to Article 31.1 of the *Vienna Convention on the Law of Treaties* (VCLT), "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose." In this sentence, three basic principles should be followed when interpreting a treaty: (1) a treaty shall be interpreted in good faith; (2) the ordinary meaning shall be given to the terms of the treaty; and (3) the ordinary meaning of the terms of the treaty shall be determined in their context and in the light of its object and purpose. The ordinary meaning of the terms and the object and purpose of the treaty apply in a prioritized manner when interpreting a treaty – the former is prioritized, theoretically, over the latter. The ICSID has extended the application of MFN treatment to dispute settlement only on the ground that the object and purpose of MFN treatment-relevant provisions in BITs are eliminating discrimination, enhancing the protection of foreign investors and, thus, promoting and protecting overseas investments. It has substantially distorted the meaning of relevant provisions in BITs and overemphasized their object and purpose. A broader application of MFN treatment-relevant provisions to dispute settlement may cause treaty shopping and the abuse of BITs. Moreover, a broader application of MFN treatment to dispute settlement will also bring about potential instability – restrictions made in previous, specific treaties will be overturned because of a broader application of provisions regarding dispute settlement in new treaties. Additionally, ICSID arbitral tribunals have not agreed upon this issue either. We therefore believe that a broader application of MFN treatment to dispute settlement has not been generally accepted.

On the side of practice, however, a large amount of investors have invoked the MFN treatment clause in BITs and argued that the application of MFN treatment should be extended to dispute settlement, in large part due to effects of the Maffezini v. Spain Decision on Jurisdiction, a case handled by ICSID arbitral tribunals over the past few years. Moreover, most ICSID arbitral tribunals have employed an extended interpretation, which, to a certain extent, mirrors their basic position of trying to expand arbitral jurisdiction. In future cases, the arbitral tribunals will probably hold their position that the application of MFN treatment can be extended to dispute settlement, according to most of their opinions in previous relevant cases.

Although they all provide for MFN treatment, Sino-foreign BITs have no provisions regarding whether MFN treatment applies to dispute settlement. MFN treatment in these BITs is usually described in the following terms: Each Contracting Party shall in its territory accord to "investments and activities associated with investments" (or "investments and returns", or "the management, maintenance, use, enjoyment or disposal of investments", etc.) of investors of the other Contracting Party treatment which is fair and equitable and not less favorable than that which it accords to investments (or "investments and activities associated with investments", or "investments and returns", etc.) of its own investors or to investments and returns of investors of any third State, whichever is more favorable. This description neither covers settlement of disputes nor explicitly excludes it. In order to protect their interests in relevant investments, therefore, Chinese investors may argue, once investment disputes arise, that the application of MFN treatment should be extended to the settlement of disputes. From this perspective, provisions regarding MFN treatment contribute indirectly to the protection of Chinese investors' interests. Given the applicability of BITs to both sides, however, a broader application of MFN treatment may also cause China's frequent appearance as a respondent at the ICSID.

Instead of a broader application of MFN treatment to the settlement of disputes, we recommend that it be provided in Sino-foreign BITs that MFN treatment shall not apply to the settlement of disputes, thereby avoiding the abuse of MFN treatment.

Unify the Description and Meaning of Just and Equitable Treatment

With regard to ICSID arbitrations, cases that involve just and equitable treatment outnumber the ones that involve each of the other three standards of treatment, and lead to more identification criteria. Many Sino-foreign BITs provide for just and equitable treatment or describe it with similar wording, but do not explain its meaning. Given that ICSID arbitral tribunals offer very detailed explanations for just and equitable treatment, similar wording in different BITs will probably lead the tribunals to draw very different conclusions regarding whether the host country has failed to provide just and equitable treatment. It is recommended that Sino-foreign BITs be modified as follows:

(1) Establish the right relationship between clauses regarding just and equitable treatment and other investment clauses. Just and equitable treatment is an absolute standard of treatment given to foreign investors, while national and MFN treatment are relative standards. There should be clear differences between them. Some Sino-foreign BITs fail to clearly distinguish the absolute treatment from the relative treatment, and may even include just and equitable treatment into provisions regarding MFN or national treatment. The China-Lebanon BIT of 1996 provides in Article 3: Most Favored Nation Treatment, that "investments and activities associated with investments of investors of either Contracting Party shall be accorded fair and equitable treatment and shall enjoy protection in the territory of the other Contracting Party." The China-Cote d'Ivoire BIT of 2004 provides in Article 3: National Treatment and Most Favored Nation Treatment, that "investments of investors of each Contracting Party shall all the time be accorded fair and equitable treatment in the territory of the other Contracting Party." Just and equitable treatment as an absolute standard is parallel with national and MFN treatment and, hence, must never be considered as part of the latter.
(2) Unify the wording of provisions regarding just and equitable treatment. In the Chinese language, there are no major differences in the meaning of the wording regarding just and equitable treatment, because it is very difficult to determine which cases are just but not equitable and which ones are both just and equitable. However, in order to fully protect the security/safety of overseas investment projects of Chinese investors and to ensure that policies for just and equitable treatment are unified and relevant legal provisions are rigorous, it is recommended that the wording of provisions regarding this treatment be unified in Sino-foreign BITs.
(3) Clarify the applicability of just and equitable treatment. On the one hand, it is necessary to make clear what exactly is eligible for just and equitable treatment. Should it just be "investments" as provided in the China-Germany BIT of 2003, or "investments and activities associated with investments" as provided in the China-Russia BIT of 2006? The term "investments and activities associated with investments" is too broad and prone to cause disagreements between investors and the host country as to its meaning. It is recommended that the

applicability of just and equitable treatment be explicitly confined to the management, maintenance, use, enjoyment and disposal of the investments, the assurance of investors' rights to their investments, etc. On the other hand, the duration of the applicability of just and equitable treatment should be made clear. Should the word "always" in the China-Germany BIT of 2003, for example, be construed to mean that just and equitable treatment should be given to foreign investors before their investments are established? It should be made clear in Sino-foreign BITs, as is generally accepted practice in international investment activities, that just and equitable treatment shall not be given before investments are established.

2.2.1.3 Investment Repatriation Guarantee

Emphasize Provisions Regarding Fund Transfer

Both active repatriation of investments and passive repatriation of investments caused by expropriation, nationalization or other similar measures involve the transfer of funds, including investments and their returns. Sino-foreign BITs generally have provisions specific to the transfer of funds, containing similar language and content with the exception of a few BITs. From a textual perspective, the right of Chinese investors to transfer funds from overseas investments is fundamentally assured. In order to achieve a better BOP or address financial difficulties, however, a host country may impose certain restrictions on fund transfer by Chinese investors. Such restrictions can take a variety of forms. In Chinese BITs with countries such as Singapore, Australia, and Pakistan, the permissible ways of transferring funds are enumerated in an exhaustive manner. The China-UK BIT of 1986 provides in Article 6.2 that "the right referred to in paragraph (1) above is subject to the right of each Contracting Party in exceptional balance of payment difficulties and for a limited period to exercise equitably and in good faith powers conferred by its laws. Such powers shall not however be used to impede the transfer of profits, interests, dividends, royalties or fees; as regards investments and any other form of return, transfer of a minimum of 20 % a year is guaranteed." The China-South Korea BIT of 2007 details in Article 6.3 exceptions to the free transfer of funds. Nowadays, Chinese legal restrictions on outbound transfer of foreign exchange funds by Chinese investors to their overseas investment projects have been loosened due to China's fast-increasing foreign exchange reserves, as well as other factors such as the appreciation of the renminbi over recent years. Nonetheless, some host countries still impose restrictions on the outbound transfer of funds by Chinese investors, for reasons such as BOP difficulties. It is therefore necessary to refine restrictions in Sino-foreign BITs on the transfer of funds. It is recommended that these restrictions be specified by means of non-exhaustive enumeration plus detailed exceptions as found in Article 6 of the China-South Korea BIT of 2007, thereby fully protecting Chinese investors' rights with respect to the transfer of funds.

While relevant provisions in Sino-foreign BITs are being improved, Chinese investors should of course obey relevant laws/regulations in the host country. In order to transfer funds, Chinese investors must perform obligations regarding tax payment, settlement, legal issues and other issues in the host country in order to avoid their actions being labeled abnormal repatriation and, hence, being held responsible under the host country's civil, administrative or even criminal laws.

Both the *Measures for Administering Foreign Exchange* of 1989 and the *Notice on Issues Relevant to Administering Foreign Exchange Involved in Listing outside China* of 2005 require that Chinese investors repatriate relevant funds into China within specified periods of time. The second document significantly loosened the time requirement on repatriation. As the Chinese economy grows, there have been an increasing number of overseas investment activities, and returns on overseas investments are more likely to be reinvested for further development. Accordingly, compulsory time requirements on repatriation of funds should be further loosened to allow investors to exercise their right to freely use their funds.

Duly Improve Compensation Standards for Expropriation and Nationalization

As the Chinese economy develops, China's interest in overseas investment will continue to grow. Accordingly, the discussion is open on whether or not it is advisable for China to stick to the compensation standards established two decades ago. When it comes to provisions on expropriation and nationalization, Sino-foreign BITs are fundamentally consistent with relevant multilateral treaties in terms of form and content. Provisions in Sino-foreign BITs on expropriation and nationalization generally contain four elements – public interest, accordance with the law of the Contracting Party, non-discrimination and reasonable compensation. Previous domestic discussions on expropriation and nationalization focused on compensation standards."Prompt, adequate, and effective" compensation, known as the "Hull Rule", was explicitly rejected and replaced with words such as "reasonable" and "proper," which favor the interests of the host country. The China-Germany BIT of 2003 includes a "groundbreaking" provision that allows investors to request competent courts to investigate compensation standards. This also signals, at least to a certain extent, that the Chinese government has loosened its position on the issue of reasonable compensation standards.

Emphasize and Improve Provisions on Indirect Expropriation

Traditional direct expropriation and nationalization are no longer the main issues in the field of expropriation since the 1990s. Instead, indirect expropriation will have a growing influence as host countries are diversifying and refining internal regulation methods. There has been more debate on due to differences in the definition and identification of indirect expropriation. In global investment arbitrations, the focus is no longer on which compensation standard to adopt, but on how to identify expropriability. Both the Chinese government and Chinese investors should pay sufficient attention to this change and familiarize themselves with interpretations in arbitral awards. This will help them better seek remedies in case of expropriation and nationalization.

We believe that the concept of "indirect expropriation" derives from the fact that there is indeed a gray area between expropriation by the state and legal administration by the government of economic and social affairs, and that it is very difficult to determine the nature of government actions in this gray area through their forms. How to determine the nature of actions in the gray area will relate directly to the government's performance of its administrative function for the public interest and protecting foreign investors. Since public interest itself is an abstract concept, however, its definition is also an issue that deserves in-depth discussion. If the administrative power exercised by the host country for the public interest is interpreted in a narrow sense, then tightly confining relevant measures to the traditional authorities and main purposes, such as maintaining internal security and order, will not necessarily align with the environment of rapid social change, implementation of new government policies, and adjustments to government function and role.

In recent years, investors in both the ICSID and North American Free Trade Agreement (NAFTA) systems have frequently accused host country governments of indirect expropriation that go against the government's measures to maintain the environment/public health or to make economic adjustments. This has posed a severe threat to the ability of the host country government to maintain its public interest, and has prompted individuals to call for the reform of indirect expropriation rules to address the clear imbalance between the private interests of investors and the sovereign powers of the host country.

The Chinese government should also pay sufficient attention to the issue of indirect expropriation. The China-India BIT of 2006 defines indirect expropriation and how to identify it. Unfortunately, however, subsequent Sino-foreign BITs fail to further provide for indirect expropriation. Improving provisions regarding indirect expropriation will facilitate the protection of Chinese investor interests in overseas investment projects. In the meantime, the Chinese government will of course be required to better protect FDI in China. We recommend that, as the Chinese economy and overall national strength grow, duly improving investment protection is a trend that cannot be avoided, regardless of whether the focus should be protecting the safety of overseas investments of Chinese investors or protecting FDI in China. The Chinese government may refer to the development of indirect expropriation in ICSID and other international investment arbitrations, and duly include the applicable contents into Sino-foreign BITs.

2.2.1.4 Investment Dispute Resolution Mechanisms

Investment dispute resolution for overseas investment should be sufficiently addressed in the Chinese legal subsystem since it is the last layer of protection for investor rights. It should be understood that, as China has deepened its reform and opening up, and its relations with other countries, investment dispute resolution mechanisms have developed greatly in Sino-foreign BITs. Resolving such disputes through arbitration mechanisms has become a major part of relevant provisions. International investment arbitration has unmatchable advantages over political and judicial solutions. From this perspective, the Chinese government should also adapt to this trend and consider the wider use of international investment arbitration in order to protect the interests of Chinese investors in overseas investments while avoiding the escalation of investment disputes to inter-state ones. Since some Sino-foreign BITs no longer suit current needs, we recommend that improvements be duly made as follows:

Weaken Provisions in Sino-foreign BITs on Establishing Other Special Arbitral Tribunals

Early Sino-foreign BITs tended to allow for special arbitral tribunals be set up before making relevant procedural provisions by referring to ICSID rules. It is unnecessary and uneconomical to redevelop a set of rules since there are already detailed descriptions of arbitral rules in the *Convention on International Trade in Endangered Species of Wild Fauna and Flora* (CITES) -also known as the *Washington Convention*-the *ICSID Rules and Regulations*, the *ICSID Additional Facility Rules*, and the *UNCITRAL Arbitration Rules*.

Impose Certain Restrictions on the Arbitrariness in Selecting the Arbitral Tribunal

1. If the host country is a member of the *Washington Convention*, then an investment dispute shall be submitted to the center for arbitration or receive mediation, arbitration and fact-finding under the *ICSID Additional Facility Rules*;
2. Otherwise, an investment dispute shall be submitted to an ad-hoc arbitral tribunal in accordance with the *UNCITRAL Arbitration Rules* (1976);
3. Investors can select only one arbitral mechanism to get disputes resolved; if they select two or more mechanisms, then the first one selected by them shall prevail, unless otherwise agreed upon in writing by the parties involved in the dispute.

Provide in Sino-foreign BITs That MFN Treatment Not Be Applicable to Dispute Resolution

A broader application of MFN treatment to the settlement of disputes has occurred many times in ICSID arbitrations, but with no sufficient legal grounds. Such a broader application may bring weaker benefits in protecting the interests of Chinese investors in overseas investment projects than the risk of repeated lawsuits caused by the frequent appearance of the Chinese government as a respondent at the

ICSID. It is therefore recommended that, in signing or modifying a Sino-foreign BIT, a broader application of MFN treatment to the settlement of disputes be explicitly excluded in order to achieve a better balance between the protection of Chinese interests in overseas investments and in introducing FDI.

Adopt Country-Specific Standards for Arbitrable Issues

BITs signed by China after 1998 tend to fully accept the jurisdiction of the ICSID rather than confining arbitrable issues to disputes on the amount of compensation. This change is consistent with a worldwide megatrend, in general, and changes in the needs and requirements in the field of China's overseas investment, in particular. For future Sino-foreign BITs, the Chinese government should pay attention to the type of the other Contracting Party. Regarding developed countries, it is recommended that the Chinese government choose a "qualified agreement" upon the acceptance of the jurisdiction of the ICSID when signing or modifying BITs with these countries. For developing countries, especially those that serve as the main destinations for Chinese investments, the Chinese government should choose "full agreement plus important exceptions" when concluding BITs. In the meantime, it should continue including provisions such as access to local remedies in the host country and the application of the law of the host country when concluding Sino-foreign BITs.

In Provisions Regarding the Application of the Law, Emphasize the Supplementary and Corrective Effects of Sino-foreign BITs on the Law of the Host Country

With regard to provisions regarding governing laws, the Chinese government may refer to Article 42 of the *Washington Convention* and should include the law of the host country (including its rules relevant to the law of conflicts), BITs and possibly applicable rules of the international law. Given that a BIT is an agreement of the Contracting Parties specific to the flow of investments between them, however, we recommend that it be provided that, among the optional legal rules, the BIT shall prevail over the domestic law of the host country.

Narrow the Scope of Disputes That Apply the Exhaustion of Administrative Review Procedures

Local administrative remedies may first be requested in the event of disputes arising from administrative acts, such as acts by the host country that impact foreign investors and the returns on their investments, including taxation, industry/commerce administration, the transfer of relevant investments and the returns on these investments. Globally, disputes arising from the amounts of compensation involved in expropriation or nationalization tend to be submitted to the competent international arbitral tribunals for direct resolution. It is therefore recommended that the scope of disputes to which administrative review procedures apply be narrowed.

2.2.2 International Tax Treaties

China's signature of tax treaties has kept pace with its reform and opening up. In the first phase of reform and opening, which lasted from the 1980s till the mid-1990s, China signed tax treaties mainly with developed countries. The second phase, which lasted from the mid-1990s till 2000, saw China begin to negotiate tax treaties with emerging developing countries while also continuing to sign or negotiate such treaties with developed countries. In phase three, which began in 2000, China has focused on negotiating tax treaties with other developing countries or its major investment destinations. By the end of March 2011, China had signed 96 BITs, plus has made tax arrangements with the Hong Kong and Macao special administrative regions. These treaties and arrangements cover almost all of China's major investment sources and destinations, creating a good international tax law framework for overseas investment by Chinese enterprises. Tax treaties bring legal protection, tax incentives, and consultation/cooperation in international tax administration. They are the grounds on which the power of relevant countries to levy taxes in transnational economic activities is defined, and they also provide important legal protections for a country's taxation interests and the interests of enterprises in overseas investments. Tax treaties not only create a favorable tax environment in the host country for Chinese enterprises with international operations, but also provide a legal foundation for the Chinese tax authority to negotiate with its counterpart in the host country about the resolution of tax disputes involving Chinese enterprises. Chinese enterprises with international operations are eligible for many benefits under tax treaties, including exemption from income tax or eligibility for tax relief in the host country, freedom from double taxation, non-discriminatory treatment, and resolution of transnational tax disputes, among others.

The current double taxation agreements (DTAs) signed by China are all based on a relevant working text developed by the Chinese government in February 1996. As global economies have developed, this working text has become partly outdated since it was created more than a decade ago, making modification necessary. We will examine Articles 5, 10 and 12 of this working text as examples:

2.2.2.1 Article 5: Discussion and Proposed Modification

When compared with Article 5 of the UN model tax convention, Article 5 of the 1996 working text defines the concept of "permanent establishment" by excluding the following places, sites, activities and agents: the provision of labor services, including consulting services, in the source country by non-resident companies within a certain period of time; facilities used, or the inventory held, to deliver the cargoes or goods of a non-resident company in the source country; any non-independent business agent that often holds the stock of the cargoes or goods of a non-resident company and often delivers such cargoes or goods on behalf of this company; any non-independent insurance agent that represents a non-resident insurance company to collect premiums or contract risks in the country of this agent. The scope of permanent establishment specified in Article 5 of the 1996 working text is smaller than that in the UN model convention and is more similar to provisions in the OECD model tax convention.

We can therefore see that the scope of permanent establishment in Article 5 of the 1996 working text does not match the current position of China in international tax relations, as it fails to take into account the reality that -since China became a member of the WTO- non-resident companies enjoy significantly easier market access into China, especially with respect to the provision regarding insurance and labor services, including consulting services.

We believe, on the basis of the above-mentioned analysis, that Article 5 of the 1996 text should be modified to add a clause that allows non-resident companies labor and insurance services, including consulting services, to constitute permanent establishments in China. Specifically, the structure of this article should be modified as follows: An "Item 2" should be added to Article 3.3 to provide that permanent establishments shall also include "labor services, including consulting services, provided by enterprises through their employees or other persons employed by them, but with a lower limit of xx consecutive or accumulated months for which activities of this nature (they belong to the same or related projects) are carried out within any twelve months in a country." Additionally, an item between Articles 3.5 and 3.6 should be added to provide that "insurance companies in either Contracting Party, except for reinsurance companies, shall be deemed as having permanent establishments in the other Contracting Party if they collect premiums or contract risks therein through persons other than independent agents specified in Article xx, despite the provision in the preceding item of this article". The Chinese government is more likely to levy income taxes on labor services, including consulting services, and insurance services provided by non-resident companies in China if the current tax treaties are modified or new ones are signed in accordance with the above-mentioned recommendation.

2.2.2.2 Article 10: Discussion and Proposed Modification

Article 10 of the 1996 working text does not distinguish dividends from direct investments from dividends of indirect investments and, consequently, is useless in promoting the growth of transnational direct investments, and incompatible with tax neutrality.

It is recommended that Article 10.2 of this working text refer to the most important two model tax conventions, the OECD and UN conventions, and be changed to: "if the owner of the dividends is a resident in the other Contracting Party." Such a description is clearer and, hence, better than the 1996 working text from a logical and contextual perspective.

The Chinese government distinguishes dividends from direct investments and levies taxes on them separately. From an economic perspective, it is natural to levy taxes, in the same manner, on various forms of incomes from capital investments. From a corporate law perspective, however, it is necessary to distinguish one possible form from another. Globally, a growing number of tax treaties and domestic tax laws differentiate between dividends from cross-border direct investments and those from indirect ones. Rules governing dividends from direct investments apply to cases where companies that receive dividends own substantial shares or the right to vote in companies that provide dividends; dividends from other investments that are taxable differ from those from indirect investments. Differentiating between them in this manner and granting special tax incentives to dividends from direct investments is aimed at facilitating direct investments and eliminating double and even multiple legal/economic taxation on companies. From a tax neutrality perspective, taxes on dividends from direct investments should be equivalent to the taxes on profits of permanent establishments, whereas taxes on dividends from indirect investments need not equal the ones on such profits. Accordingly, it is unreasonable to tax all dividends, whether from direct or indirect investments, in the same way. Moreover, direct and indirect investments are differentiated from each other in tax treaties between China and other countries such as Germany, Singapore and Canada.

When differentiating direct and indirect investments, the Chinese government needs to focus on two core questions: (1) how they should be differentiated, and (2) what the withholding tax rate for each type of investment should be. The OECD and UN model conventions differ widely from each other with respect to these two questions.

With regard to the first question, the OECD and UN model conventions adopt 25 % and 10 %, respectively, as the lowest capital requirement for dividends from direct investments. The UN model convention uses 10 % to encourage investments and because, since non-resident investors are allowed to have no more than 50 % shares in some developed countries, 10 % is already a very big percentage. To attract overseas investment, the Chinese government has set the lower, not the higher, limit for investments, making it unnecessary for China to consider the aforementioned issue.

With regard to the second question, the OECD model convention provides that the highest withholding tax rate is 5 % for direct investments and 15 % for the others. In comparison, the UN model convention leaves this question to the contracting parties for negotiations, but it recommends that “If the developed (residence) country uses a credit system, treaty negotiations could appropriately seek a withholding tax rate at source that would, in combination with the basic corporate tax rate of the source country, produce a combined effective rate not exceeding the tax rate in the residence country. The parties’ negotiating positions may also be affected by whether the residence country allows credit for taxes spared by the source country under tax incentive programs. If the developed country uses an exemption system for double taxation relief, it could, in bilateral negotiations, seek a limitation on withholding rates on the grounds that (a) the exemption itself stresses the concept of not taxing inter-corporate dividends, and a limitation of the withholding rate at source would be in keeping with that concept, and (b) the exemption and resulting departure from tax neutrality with domestic investment are of benefit to the international investor, and a limitation of the withholding rate at source, which would also benefit the investor, would be in keeping with this aspect of the exemption."

We therefore recommend that Article 2 of the 1996 working text refer to the method of differentiating direct and indirect investments as proposed by both model conventions. However, the specific line between the two types of investments and the withholding tax rate for each type should be left to the contracting parties in the negotiations. When differentiating the two types of investments, it is necessary to take into account the actual investment status of either contracting party in the country of the other contracting party, especially the percentage of the leading type of investments. When establishing the withholding tax rate, attention should be paid to current contracting practices around the world. According to these practices, the withholding tax rates for dividends provided in tax treaties between developed and developing countries are higher than the ones in tax treaties between developed countries – the former tend to be in the 5–15 % range for direct investments and the 15–25 % range for indirect investments. In the meantime, there are new developments in contracting practices: for two countries that have different tax rates, the developing country allows a higher rate; in some cases there are no limitations on the tax rates; some preferential tax rates are available only for returns on new investments; low rates or exemptions can apply only to particular forms of investments; low rates can apply only when the holding of shares lasts a certain period of time.

In addition, when establishing the tax rate, it is necessary to take into account the following technical factors: the corporate tax system in the source country (i.e., the traditional or comprehensive system specific to dividends and its characteristics) and the overall tax burden on corporate profits under this system; the extent to which dividend tax credits are available in the residence country, and the overall tax burden on the taxpayer after tax credits are received in the source and residence countries; the extent to which the residence country allows credit for taxes spared by the source country under tax incentive programs; and how well the source country can balance between increasing the state revenue and attracting overseas investments.

2.2.2.3 Article 12: Discussion and Proposed Modification

Article 12.1 Should Be Retained

It is recommended that Article 12.1 of the 1996 working text be retained, that is, the principle of revenue sharing should be adhered to in terms of international royalties. We believe that, when it comes to the allocation of the right to tax, neither the taxpayer's country of residence nor the country of the source of royalties should demand exclusive taxation. On the side of the source country, since relevant properties and technologies are used in its territory and the resulting incomes have close ties with economic activities herein, the source country has sufficient reason to exercise the right to tax the royalties received by the non-resident in its territory. On the side of the taxpayer's country of residence, the purchase of relevant properties and/or the R&D of relevant technologies generally are carried out in its residence country despite the fact that these properties and/or technologies, through which the royalties are generated, are not used herein. The costs and expenses of these investments generally are already amortized in the taxpayer's country of residence. It is therefore necessary to ensure that the taxpayer's country of residence has access to appropriate taxes regarding the royalties received by its resident outside its territory. Only is such a result fair and reasonable. Accordingly, a more feasible and acceptable practice is to recognize that both countries have the right to tax royalties.

Considering that China is still a developing country that needs to introduce a large number of technologies, the Chinese government should follow the principle of revenue sharing when negotiating tax treaties with other countries, as reflected in relevant articles of the UN model convention, to address conflicts arising from the right to tax international royalties.

Some Statements in the Following Articles Should Be Improved

1. It is recommended that the language in Article 12.2 of the 1996 working text be changed from "if the payee is the beneficial owner of the royalties" to "if the beneficial owner of the royalties is a resident of the other Contracting State." Although there are no essential differences between the two statements, the latter is clearer than the former from a logical and contextual perspective. Moreover, since the latter language is similar to relevant statements in both the OECD and UN model conventions, this working text should be adjusted as noted above.
2. Article 12.3 of the 1996 working text contains no Chinese words corresponding to words such as "plan" and "process" in the English version. It should therefore be adjusted to the English version.
3. It is recommended that the part of Article 12.4 of the 1996 working text that relates to the relationship between royalties and permanent establishments be retained. With regard to this issue, the OECD model convention adopts the "be effectively connected" rule, whereas the UN model convention partly adopts a limited "force of attraction" rule. We believe that, since Article 7 of the 1996 working text already adopts the "be effectively connected" rule, Article 12.4, if changed to reflect the "force of attraction" rule, would become inconsistent with the entirety of the current working text. Moreover, the "force of attraction" rule is prone, to a certain extent, to cause abuse of this provision, so Article 12.4 should continue to reflect the "be effectively connected" rule.
4. It is recommended that the language in Article 12.5 of the 1996 working text, "is the government, other local authorities or a resident of this Contracting State" be changed to "is a resident of this Contracting State." To this end, the definition of "resident" in Article 4 of this working text must be modified to include "the government, any political subdivisions or local authorities of this Contracting

State". This modification would achieve stricter logic between statements of this working text.

2.2.2.4 Other Proposed Modifications

Pay More Attention to Jurisdiction Over Residents and to Equitable Taxpayer Protection

International tax avoidance will become more prevalent as China's new corporate income tax law, along with adjustments to its tax relief policy for overseas investments, become more effective. Companies will transfer funds in hidden ways or, through nominal investors, set up associated enterprises in an attempt to continue transferring profits or avoid taxes altogether through "special tax adjustment" provisions after regulations are strengthened under the new corporate income tax law. Some real non-associated enterprises may even get involved in the process of transfer pricing and thus become so-called "enterprises that cross the bridge" in an attempt to confuse, or divert the attention of, the competent tax authorities. The Chinese government should take precautions against this issue when signing or using tax treaties.

The Dispute Resolution Mechanism

Practices with respect to dispute resolution mechanisms vary across countries/regions. French government officials in charge of international auditing, for example, make adjustments to the revenues of American companies, but stress that they "will not pursue tax payments unless an agreement is already reached with the U.S. tax authority beforehand." As a result, resolving disputes in good faith presupposes that there is a tax treaty between the two sides and that there is evidence that relevant enterprises operate in good faith. In addition to this, numerous countries have signed, and in some regions implemented, specific bilateral or multilateral agreements to enhance bilateral or regional cooperation, make taxation more efficient, and effectively fight international tax evasion. These cooperative agreements -which include taxation cooperation, international simultaneous investigation, and cross-auditing agreements- partly overcome difficulties like the lack of data/information access. The Chinese government has made few efforts in this respect since there are already relevant principles specified in tax treaties, plus specific issues in practice. These practices are good enough to serve as a reference and can be embodied in this working text.

2.2.3 FTAs

To date, China has signed and enforced ten FTAs, including with the ASEAN, Singapore, Pakistan, New Zealand, Chile, Peru and Costa Rica. China has also made closer economic and trade arrangements between the mainland and Hong Kong/Macao, and has an economic cooperation framework agreement with Taiwan.

2.2.3.1 Main Problems with FTAs

There Is No Unified Model Agreement

All the current FTAs signed by China, whether the early agreements with specific countries or subsequent umbrella agreements, are based on WTO agreements and tailored to the distinct characteristics of contracting states, with no unified model agreement available. Distinctive texts are truly helpful for rapidly signing FTAs, but distinctions also necessitate FTA-specific rules and cooperation terms and conditions, adding to management difficulties. Looking forward, China will doubtlessly sign more FTAs, but if it continues to make agreements with distinctive characteristics, then these FTAs will add further difficulties with respect to regulation by Customs, response by enterprises, policy-based regulation, maintenance of consistent foreign economic policies, and coordination by the Chinese government. Reducing textual differences between agreements, and hence, the difficulty of coordination, is a growing trend among countries. For example, Mexico has signed FTAs with over 30 countries. In 2003, the Mexican government announced that it would slow down signing FTAs in order to reduce the difficulty of coordination under different agreements. The United States now relies on NAFTA as the template for new agreements, announcing that future FTAs should be closely consistent with NAFTA in terms of provisions concerning competitive and industrial standards, intellectual property, etc. There are many other similar examples, which suggest that China should prepare in advance by making arrangements for a model agreement to serve as a template for future FTAs, before it becomes too difficult to coordinate relevant matters. This will allow China to minimize the potential adverse effects of future FTAs.

Difficulties in Implementing Particular Provisions

All the FTAs signed by China have problems with respect to implementation. When it comes to sanitary and phytosanitary (SPS) measures and technical barriers to trade (TBTs), for example, both the China-ASEAN FTA and the Asia-Pacific Trade Agreement (APTA) contain no more than simple and general principles, which is likely to cause problems during implementation by the parties of the agreements. Both TBT and SPS measures have become the main barriers against the healthy growth of international trade in an environment where tariff barriers are on the decline and traditional non-tariff barriers are better regulated. In recent years, foreign TBT and SPS measures have had increasingly adverse effects on China's exports, much greater than the effects of any other non-tariff barriers. To address this issue, China should sign supplementary or new cooperation agreements with its FTA partners. Establishing an effective agreement requires implementable provisions in order to provide a stable, predictable framework. FTAs previously signed by China are especially short of implementable provisions in fields other than trade in goods.

FTAs Signed by China Lack Standardization with Respect to Text Template and Language

Apart from the APTA, FTAs as legal documents signed by China all make provisions for the language of the formal text. Among them, the Framework Agreement, the Agreement on Trade in Services and the Agreement on Dispute Settlement Mechanism under the China-ASEAN FTA were all written in English. The Agreement on Trade in Goods, the Agreement on Investment, and the China-Pakistan, China-New Zealand and China-Singapore FTAs provide that the formal legal texts shall be written in Chinese and English, and both languages are equally authentic. The China-Chile and China-Peru FTAs provide that the agreement shall be written in Chinese, Spanish and English, and all three texts of the agreement are equally authentic. It also stipulates that, in the event of discrepancy, the English text shall prevail. Apart from the China-Chile and China-Peru FTAs, no FTA provides for which language shall prevail in the event of discrepancy regarding the interpretation of the agreement. This absence makes it more difficult to interpret the agreement in the event of discrepancies during the implementation of the agreement. When one reads the texts of the FTAs signed by China, which are downloadable from http://fta.mofcom.gov.cn/, it is clear that the texts are far from standardized in terms of the use of language. First, the Chinese texts were all translated literally from the English texts, with exception of the agreements with Hong Kong, Macao and Taiwan, which were all in Chinese. Some of the translations are inaccurate or even incorrect. For example, take the full Chinese titles of the Amending Protocol to the China-Pakistan FTA and the China-Pakistan Agreement on Trade in Services. The Chinese title of the former is "中华人民共和国政府和巴基斯坦伊斯兰共和国政府自由贸易协定补充议定书" ("Amending Protocol to the Free Trade Agreement between the Government of the People's Republic of China and the Government of the Islamic Republic of Pakistan"), whereas that of the latter is "中华人民共和国政府和巴基斯坦伊斯兰共和国政府自由贸易区服务贸易协定" ("Agreement on Trade in Services between the Government of the People's Republic of China and the Government of the Islamic Republic of Pakistan"). It is obvious that "自由贸易区" ("Free Trade Area") in the Chinese title of the latter should instead be "自由贸易协定" ("Free Trade Agreement"). Second, the language is not used in a precise and standardized manner. As an example, in the China-Chile FTA, the ordinal numbers of articles are in Chinese words or Arabic numerals, such as "第八十二条" and "第 82 条" (they both mean "Article 82"). Different words are used for the same meaning, such as "英语" and "英文" (they both mean "English"), "争端解决场所" and "争端解决机构" (they both mean "the forum in which to settle the dispute"), "预确定" and "预裁定" (they both mean "advance rulings"), " 商务" and "商业" (they both mean "business"), "研究员" and "研究人员" (they both mean "researcher"), etc.

2.2.3.2 Recommendations on the Standards for FTA Texts

The General Principle for the Template of Sino-foreign FTAs

An FTA template established by the Chinese government should be based on a combination of WTO and China-unique principles. Principles consistent with the WTO should include: trade without discrimination (i.e., the MFN and national treatment); gradually freer trade through negotiation; allowance of some forms of protection in limited circumstances; special treatment; exception allowances; and transparency. China-unique principles, based on previously signed FTAs, should include: obeying WTO rules; the inapplicability of particular clauses; and the "one country, two systems" principle. These three principles should be followed in future FTA negotiations.

The Format of a China FTA Template

As China becomes more experienced and capable in negotiating FTAs, a unified, integrated text should be adopted as a template for signing future FTAs. In other words, this FTA text should encompass all required content, to be negotiated and finalized by China at one time.

The Makeup of a China FTA Template

A China FTA model template should be comprised of the main text and all annexes. Specifically, the main text should include the preamble and chapters that contain specific articles. The preamble lists the purpose, objectives and approaches to the objectives of the agreement. The annexes provide detailed interpretations of, or supplement, the main text. The makeup of the main text is rather complex mainly because Sino-foreign FTAs each have a wide coverage and a simple makeup is no longer able to satisfy relevant needs and requirements. Some of the existing Sino-foreign FTAs also have a similarly complex makeup, and are divided into parts or chapters. It is recommended that a China FTA template be organized by chapter, each of which lists specific articles, and that both chapters and articles should be named. The chapters and articles should be numbered in a unified manner, that is, in either Arabic numerals or Chinese words.

The Content of a China FTA Template

The template of a China FTA should contain information in seven categories. Category one should consist of articles for implementing free trade, including those relevant to tariff concessions and non-tariff issues in the field of trade in goods, to free trade in services such as commitments to trade in services, to investment, and to enhancing cooperation. These articles need to be clear, specific, implementable and, to a certain extent, flexible in order to realize free trade. Category two should consist of articles that standardize domestic policies in favor of free trade, including those relevant to national treatment, to rules of origin and customs procedures, to the protection of intellectual property, to TBT and SPS measures, and to domestic measures such as border measures. These articles primarily aim to address the inefficiency of unilateral trade policies and measures. Not all existing Sino-foreign FTAs contain clear provisions regarding TBT or SPS measures. Category three should consist of ad hoc articles intended to promote deep free trade, including those relevant to anti-dumping and anti-subsidy measures, to safeguard measures, and to safeguarding the BOP. Category four should consist of articles regarding dispute resolution that give mutual confidence in each other's commitments to free trade, including articles relevant to jurisdiction, consultation, mediation/conciliation/good offices, arbitration, the enforcement of arbitration awards, and other matters involved in dispute resolution. Category five should consist of transparency articles that ensure the feasibility of free trade, including those relevant to preferential tariff arrangements and schedules of tariff concessions, to schedules of commitments to trade in services, to transparency such as announcements/notifications, contact points and confidential information, and to review. Category six should consist of articles regarding institutional arrangements for implementing free trade, including those relevant to trade committees, their subcommittees and associated functions, etc. Category seven should refer to how the content of this template is sequenced. The aforementioned content of this template should be sequenced into articles regarding: trade in goods and relevant matters, such as tariff concessions and non-tariff barriers, rules of origin, customers procedures, trade remedies, SPS measures, and TBT; trade in services; movement of natural persons (or temporary entry of business visitors); investment; intellectual property; cooperation; transparency; dispute settlement; and institutional arrangements. This content should be preceded by initial provisions and general definitions, and followed by exceptions (general and security ones) and final provisions.

A Chinese Version of Standardized Language Should Be Developed for This Template

The template for a China FTA should include a Chinese language version for comparison with the foreign-language version of the foreign country. The two states should then agree upon the official text language through negotiation. To this end, lawyers should be hired to participate in drafting the Chinese version and finalizing the texts of the agreement. A standardized legal language should be used. In no case should the Chinese text or articles be drafted simply by translating and modifying the foreign-language text, as this will bring about potential problems or difficulties in future understanding and enforcement of the agreement. The Chinese text or articles should be used whenever possible. If the agreement provides that no text in any single language shall be authentic, then a note should be added to explain which language shall prevail in the interpretation of articles in the event of discrepancy. All the words and terms used in the text should be unified and have clear meanings.

The Template Should Be Flexible and Adaptable

The parties to a trade agreement can neither foresee all future issues nor record every detail. When dealing with such a situation, it is necessary to maintain predictability and stability on the one hand, and flexibility and adaptability on the other, and to seek the best possible balance between the two sides. The Chinese government needs to establish an FTA template, but the intention is not to develop the same set of articles for all of China's future FTA partners. Instead, the template is intended only to standardize Sino-foreign FTAs in respects that can be predetermined, such as principles, format, content, sequence and language. Regarding specific provisions or key items, it remains necessary to conduct case-specific analysis in order to ensure sufficient flexibility and adaptability.

2.2.4 Other Issues

2.2.4.1 Clearly Define Basic Concepts and Their Applications in Relevant International Treaties

It is recommended that the term "investment" be defined in a hybrid manner. Specifically, qualifying statements such as "with characteristics of investment" should be added to supplement a non-exhaustive, asset-based list of examples, thereby avoiding the misuse of the investment agreement. It is recommended that the definition of "investor" clearly provide for natural persons and organizations other than juridical persons to become outbound investors, and that, when identifying whether an investor is a Chinese national or not, it is advisable to adopt comprehensive criteria that combines a primary criterion of nationality with a secondary criterion of country-of-control. It is recommended that the applicability of MFN treatment be explicitly restricted to exclude a broader application to the resolution of disputes, while retaining exceptions in the applicability of MFN treatment, such as regional integration, customs unions and special arrangements for border areas. Also, the basic concept of "just and equitable treatment" and its applicability should be clearly defined to avoid the misuse of relevant provisions.

2.2.4.2 Add Provisions Regarding the Environmental Obligations of Investors and Their Home Country When Signing or Modifying a Sino-foreign BIT or FTA

First, the preamble of an agreement should state that the objectives of the agreement shall be achieved in ways compatible with the protection of health, security/safety and the environment, and accept that the articles of the treaty shall be interpreted in ways that enable mutual support and recognition of provisions of international treaties related to the environment. Second, there should be a requirement that investors must work under domestic environmental laws/regulations and nationally/internationally accepted practices. Third, agreements should impose stringent obligations upon investors regarding disclosures, including the disclosure of information on corporate environmental policy and the corporate code of conduct. Fourth, agreements should provide that the home country of outbound investors be obligated to manage the overseas investment environment. The addition of provisions in bilateral or multilateral investment treaties regarding the environmental obligations of the contracting states is, in effect, an application of the principle of cooperation in international environmental law. This principle mirrors the fact that environmental protection is the common responsibility of human beings. The Stockholm Declaration emphasizes the importance of international cooperation in protecting the environmental. The Rio Declaration also reiterates the obligation of cooperation, stating in Principle 7 that "States shall cooperate in a spirit of global partnership to conserve, protect and restore the health and integrity of the Earth's ecosystem." Fifth and lastly, the host country is entitled to sue any foreign investor at the ICSID on behalf of victims of environmental damages caused by the investor.

2.2.4.3 Multilateral Investment Treaties (MITs)

Since current MIT negotiations are blocked, it is unlikely that China will make substantial progress in this area anytime soon. Additionally, China is still not strong enough to produce a decisive or dominant influence on the development of MITs despite the fact that it has had significantly greater overall strength in recent years. Research on the legal system relevant to overseas investment, therefore, should focus on Sino-foreign BITs and domestic laws. On the multilateral side, research on legal safeguards should focus on the understanding of articles in MITs and the proper use of relevant rules. Also, gaining a timely understanding of the latest developments in international investment arbitration practices is critical for protecting the interests of China in overseas investment projects. Examples in this area include strengthening research on, and the use of, the MIGA and the ICSID, gaining a timely understanding of the commitments of members in investment-relevant WTO agreements (e.g., commitments to market access), encouraging Chinese investors to familiarize themselves with, and properly use, multilateral investment rules as well as international organizations such as the MIGA and the ICSID to protect their interests in overseas investments. In the meantime, the Chinese government should aggressively participate in negotiations on, and the development of, MITs. Promoting free investment and improving investment safeguards through MITs is not only consistent with the growing interests of Chinese investors in overseas investments, but is also critical for China to become a major investor.

Chapter 3
The Supervision/Administration Subsystem

Regulation of outbound foreign investment mainly entails approval and supervision. Pre-approval enables the Chinese government to prevent investment projects deemed to be high risk, low return or potentially damaging to the development of the Chinese economy. It also restricts individuals and organizations that do not qualify as overseas investors from carrying out overseas investment activities. Post-supervision, on the other hand, enables the Chinese government to understand the operating status of overseas investments and correct illegal operating activities. Based on studies of the status and practices of China's outbound foreign direct investment regulations, foreign experience, and China's current situation, this chapter will offer recommendations and proposals on how to improve China's outbound investment supervision/administration subsystem.

3.1 Optimizing Institutional Setup

3.1.1 Overview of Current Chinese Outbound Investment Regulatory Authorities

Today, the main Chinese authorities and agencies regulating corporate overseas investment include:

C. Pei, W. Zheng, *China's Outbound Foreign Direct Investment Promotion System*, Research Series on the Chinese Dream and China's Development Path,
DOI 10.1007/978-3-662-45631-6_3

3.1.1.1 Administrations of Finance, Commerce, Development/Reform and State-Owned Assets

With regard to administering overseas investment, the MOF and the State-Owned Assets Supervision and Administration Commission of the State Council (SASAC) focus on administering the property rights to state-owned assets outside China. In June 1996, the MOF issued the *Interim Measures for Administering the Finance of Overseas Investment*, which stipulated that, concurrent to undertaking procedures at the competent state-owned assets administration to register property rights to state-owned assets outside China, investors must also submit the property rights registration form to the finance authority at the same level as that of the relevant state-owned assets administration reviewing their registration. The competent finance authority then files the aforementioned registration form into its administrative records regarding the financing of the overseas investment, on which basis it establishes administrative relations with Chinese overseas investors.

In April 2001, the MOF issued the *Notice on Printing and Issuing the Interim Measures for Administering State-Owned Assets and Finance of Enterprises* (CQ [2001] No. 325), stressing that enterprises should invest overseas under relevant domestic regulations, establish ownership of assets outside China, and assume limited liabilities. After registering the property right to state-owned assets outside China, overseas investors should also share a certain portion of the returns on their overseas investments with the state. Under the *Interim Measures for Administering the Finance of Overseas Investment*, returns on overseas investments include: after-tax profits of wholly-owned subsidiaries outside China; profits (including dividends, etc.) distributed to Chinese partners of joint ventures and cooperative enterprises outside China; dividends arising from direct purchasing of shares of foreign companies; other returns on overseas investments. State-owned investors should distribute the aforementioned returns in accordance with the following regulations.

When compared with the administrative function of the MOF, the SASAC now focuses on regulating outbound investment. With regard to the management regime for property rights to state-owned assets outside China, central SOEs are allowed to create the management regime for themselves, and SASAC only acts as a director and supervisor. Up to this day, SASAC still administers outbound investment by SOEs within the framework established by the *Guide to Total Risk Management within Central State-Owned Enterprises*, issued on June 27, 2006, and the *Basic Norms for Internal Corporate Control*, issued on June 28, 2008, with no administrative measures specific to outbound investment.

The NDRC focuses on approving large-scale outbound investment activities. In October 2004, NDRC issued the *Interim Administrative Measures for Approving Overseas Investment Projects*, providing that both overseas resources exploitation activities and projects that involve the use of large amounts of foreign exchange shall be administered on the basis of case-by-case approval. In February 2011, NDRC issued the *Notice on Granting Lower-Level Authorities the Power to Approve Outbound Investment Projects*, which granted lower-level authorities the power to approve certain outbound investment projects. This notice gives development and reform committees at the province level –which includes provinces, autonomous regions, municipalities directly under the central government, and municipalities with independent planning status and Xinjiang Production and Construction Corps (XPCC)-the power to approve overseas investment projects implemented by local enterprises in which the investments are less than $300 million USD for projects in the field of resources exploitation, or less than $100 million USD for projects outside the field of resources exploitation (with exceptions for special projects). Enterprises managed by the central government are entitled to decide on the aforementioned projects for themselves and shall report them to the NDRC for registration. The NDRC must approve any overseas investment projects in which Chinese enterprises plan to invest at least 300 million USD for projects in the field of resources exploitation, or at least $100 million USD for projects outside the field of resources exploitation.

In August 2008, the State Council approved a new scheme designed to establish internal institutional setup, staffing and functionality of MOFCOM. Under the *Regulations on the Main Functions, Internal Departments and Staffing of the Ministry of Commerce*, MOFCOM was put in charge of domestic and foreign trade and international economic cooperation. The Department of Outbound Investment and Economic Cooperation within MOFCOM was made responsible for: organizing and coordinating the implementation of the "go global" strategy; directing and administering outbound investment and economic cooperation activities such as outbound investment, overseas processing trade and R&D, cooperation with regard to exploitation of overseas resources, overseas project contracting, and overseas labor services (including the overseas employment of Chinese nationals). The economic and commercial counsellor's offices of Chinese embassies and consulates are responsible for guiding, coordinating, regulating and servicing Chinese enterprises in carrying out economic cooperation activities in countries where these offices are located. The China International Contractors Association (CHINCA) and the China Association of International Engineering Consultants (CAIEC) are national industry organizations for self-regulation of the industry. They both aim to provide member companies with guidance, consulting and services, and to assist the competent authorities in carrying out coordination, maintaining fair competition, and protecting the interests of member companies.

3.1.1.2 Industry Authorities

Industry authorities in this context include the China Insurance Regulatory Commission (CIRC), the China Banking Regulatory Commission (CBRC) and the China Securities Regulatory Commission (CSRC). Among them, the CIRC has the tightest regulation over outbound investment; it issued the *Measures for Administering the Opening of Overseas Insurance Organizations by Insurance Companies* on July 31, 2006, the *Interim Measures for Administering Outbound Investment with Insurance Funds* on July 31, 2007, and the *Measures for Administering Investment in Overseas Insurance Companies by Non-Insurance*

Organizations on July 31, 2006. The CBRC has looser regulation over outbound investment by commercial banks. The existing administrative regulations regarding overseas affiliates of commercial banks primarily includes the *Guidelines of Regulating Overseas Affiliates of Commercial Banks* issued by the PBC on August 9, 2001 and, later on, enforced by the CBRC. Regarding commercial banks that invest overseas, this document contains no requirements on what needs to be approved, although it does require that relevant organizations submit quarterly, semiannual and annual reports on the operating status of their overseas affiliates to the PBC. The existing administrative regulations of the CSRC regarding outbound investment primarily include the *Interim Measures for Administering Outbound Securities Investment by Qualified Domestic Institutional Investors* issued in July 2007.

3.1.2 Main Problems with Chinese Authorities Regulating Outbound Investment

Since China remains in the initial stage of outbound investment and is still testing the opening of its capital account, there remain some apparent limitations with respect to the outbound investment regulation system, which is characterized by multi-level administration and multiple approvers. This system is still partially based on the planned economy, and, hence, does not suit a market economy in which market players, especially overseas investors, are in intensifying competition. Also the current investment regulation system is flawed in that it makes investors less aggressive, less creative and may even relegate them to a passive position.

Although MOFCOM is the regulatory authority overseeing the international operations of Chinese companies, a considerable amount of relevant policy-making and corresponding administrative power are now in the hands of other authorities and agencies, including the NDRC, MOF, SAFE, and the Hong Kong and Macao Affairs Office of the State Council (HMO). This has led to functional overlap among these authorities. For example, there is functional overlap among several major general authorities such as the NDRC and the MOFCOM in terms of approval for outbound investment projects. These authorities each formulate their own respective administrative measures independently without any coordination and communication. This has inevitably caused certain difficulty and confusion for Chinese enterprises seeking early preparation for outbound investment. Since it is rather difficult for the authorities to coordinate with each other- a problem exacerbated by a varying degree of departmental protectionism- the international operations of Chinese enterprises are influenced, or even suffer interference, by particular authorities and other authorized organizations. To a certain extent, this has added to the difficulty of proper outbound FDI administration by the state, and of reducing outbound FDI risks. Under the same regime, different persons or groups tend to receive different results, and those that already benefit from the existing institutional arrangements or that may benefit from particular future institutional arrangements will definitely do all they can to maintain or fight for such benefits.

In the meantime, Chinese enterprises must receive approval for international investment projects from multiple authorities (at least including MOFCOM, SAFE, NDRC and the Ministry of Public Security (MPS)) and at multiple levels (preliminary approval by local governments before final approval by the central government). This, in addition to buck-passing between relevant authorities, causes the possibility that it takes months, or even more time in the event of very important projects, to receive project approval. This practice is prone to make Chinese enterprises lose business opportunities in global markets and has therefore greatly reduced their interest in making international investment. Under such an approval system, the lack of a single authority in charge of approving and, at a macro level, administering outbound investment with a global view is apt to lead Chinese overseas investors to overly invest in similar projects in the same region and to compete, sometimes in a cut-throat manner, with each other. This often brings about losses, which could otherwise be avoided, to both the state and Chinese overseas investors. Chinese enterprises are obviously in a poor domestic administrative environment, as is shown by the fact that China ranked 131st among 142 countries in this respect, according to *The Global Competitiveness Report 2011–2012*.

3.1.3 Set Up a Single Authority Managing the Outbound Investment Strategy

As Chinese enterprises develop their outbound foreign investments, it is necessary for the Chinese government to enhance macro control and provide further incentives for Chinese enterprises to invest overseas. With regard to enhancing macro control, a critical step will be the establishment of a single authority – the National Outbound Investment Commission (NOIC).

Globally, American companies have long utilized FDI to make full use of foreign resources and markets in order to manage production and sales worldwide. Foreign direct investment has thus become a major contributor to the growth of the U.S. economy. This has everything to do with the U.S. government's long-term policy of encouraging and promoting investment overseas. The OPIC, as mentioned above, is a U.S. government department financed by private capital that provides overseas investors with relevant services. It is both a governmental and private organization. As a governmental organization, the OPIC makes guidelines and plans according to government policies, and manages insurance reserve funds derived from the latter; as a private organization with juridical status, it also may make charges and accusations, in its own name, to resolve disputes. Such a status allows OPIC to avoid conflicts with a host country government, claims of jurisdiction by the host country, and intergovernmental debates, while also facilitating the filing of claims against the host country.

In South Korea, the Bank of Korea (BOK) is responsible for approving and supervising outbound investment projects. The Overseas Investment Deliberation Committee run by the BOK consists of officials from the BOK and 13 other government departments and has established a robust outbound investment management system. In 1977, the then Ministry of Energy and Resources was established with the responsibility to make policies and measures regarding overseas investment, to control and coordinate overseas investment business, and to approve overseas investment projects. As outbound FDI deepened, the South Korean government gradually expanded the sectors permissible for overseas investment by local companies. In 1993, South Korea began implementing a new outbound foreign direct investment policy with the release of a catalog of industries where outbound investment was restricted, and where it was encouraged by local companies. In 1996, the South Korean government decided to promote free outbound foreign direct investment, and launched an automatic approval system for outbound investment.

The Chinese government should take measures to centralize the multi-departmental administration of outbound investment that is present in China today, thereby promoting better regulation and guidance activities in this field. Today, China's outbound foreign investment administration system is highly decentralized, involving MOFCOM, NDRC, SAFE, GAC, SASAC, among others. A lack of unified planning and guidance is detrimental to the long-term growth of outbound FDI. It is therefore necessary to establish a single authority to be responsible for developing outbound investment strategies, providing local enterprises with outbound investment information and, at the macro level, administering and coordinating outbound investment activities in all sectors and industries across China. With regard to departmental functions in the field of outbound investment, MOFCOM focuses on administering daily operations, while the NDRC focuses on distributing resources at the macro level. In reality, however, the line between the NDRC and MOFCOM is blurred as a result of functional overlap. In order for China's outbound investment administration system to achieve healthy development, the responsibilities of the NDRC and MOFCOM must be clearly defined before an effective administration system can be established. Given the situation in China, NOIC should be established as the single administrative body for outbound foreign direct investment, responsible for controlling and operationalizing overseas investments at the macro level. Operating under the direct leadership of the State Council, NOIC should co-exist with other ministries/commissions/administrations such as MOFCOM, SAFE, NDRC, SAT, PBC and GAC. The NOIC should be legally granted the power to approve and investigate overseas investment projects and to punish non-compliant overseas investors. Together with corresponding administrative functions, this will enable NOIC to make unified guidelines, policies and strategic plans regarding outbound investment.

3.2 Improving Supervision/Administration

3.2.1 Simplify the Approval of Outbound Investment Projects

3.2.1.1 Overview of the Outbound Investment Approval System in China

To set up non-trading companies outside China, Chinese enterprises need to receive approval, including permits, from the competent authorities. MOFCOM has launched a pilot program aimed at granting lower-level authorities the power to approve outbound investment projects in 12 provinces and municipalities, including Beijing, Tianjin, Jiangsu, Shandong, Zhejiang, Guangdong, Fujian, Qingdao, Ningbo, Shenzhen and Xiamen. In these regions, local enterprises can receive approval for their non-trading outbound investment projects, including permits, from the competent province-level authorities regulating international economic cooperation and trade. In order for these enterprises to receive approval, the competent foreign exchange administrations must first provide their opinions on the sources of the foreign exchange funds for such projects. In other provinces and municipalities across China, local enterprises still need to receive approval, including permits, from MOFCOM in order to invest in and open non-trading companies outside China. In March 2009, MOFCOM issued the *Measures for Administering Outbound Investment* to allow the commerce authorities in all provinces, municipalities and autonomous regions to approve outbound investment projects worth less than $100 million USD.[1]

The approval procedures include:

Approval by the Competent Commerce Authority

Under the *Decision of the State Council on Reforming the Investment System*, MOFCOM issued the *Regulation on Approving Enterprises in the Chinese Mainland to Open Enterprises in Hong Kong and Macao Special Administrative Regions* on August 31, 2004 and the *Regulations on Approving Investment to Open Enterprises outside China* on October 1, 2004. Both documents provide that central SOEs shall receive approval from MOFCOM and local enterprises from the competent province-level commerce authorities. On March 16, 2009, MOFCOM issued the *Measures for Administering Outbound Investment* on the basis of the aforementioned two documents. This document further defines the power of approval. Under this policy document, outbound investment projects in the following five categories shall receive approval from MOFCOM: overseas investment in countries that have yet to establish diplomatic ties with China; overseas investment in particular countries or regions jointly identified by MOFCOM, the MFA and other relevant

[1] Liang Kaiyin: *Legislation Outlook on Chinese Overseas Investment*, Law Press China, 2009, p. 200.

authorities; overseas projects in which the Chinese organization(s) will invest at least $100 million USD; overseas investment projects that will involve the interests of countries and/or regions; and opening companies with special purposes outside China. On the other hand, outbound investment projects in the following three categories shall receive approval from the competent province-level commerce authorities: overseas projects in which the Chinese organization(s) will invest at least $10 million USD but no more than $100 million USD; overseas investments in the fields of energy and mineral resources; and overseas investments for which it is necessary to invite business partners to China. Additionally, the headquarters of central SOEs need to use the overseas investment management system to fill out and print application forms and submit them to MOFCOM for approval; local enterprises may submit these documents to the competent province-level commerce authorities. The new measures released by MOFCOM in 2009 have looser requirements for the approval of overseas investments than those released by MOFCOM and the NDRC respectively in 2004.

In addition to redefining the power of approval, the new measures released in 2009 come with two important modifications: first, receiving approval has become significantly easier; and second, the service functions and contents have been clarified for MOFCOM. There are four main facilitation measures among the new measures. First, the time has been reduced from 15–20 workdays to 3 workdays for MOFCOM and province-level commerce authorities to examine and approve overseas investment projects worth less than $10 million USD in fields other than energy and resources. Second, it is no longer necessary for most investment activities pending approval to receive the opinions of the economic and commercial counsellor's offices of Chinese embassies/consulates in relevant countries. Instead, the new measures only require that overseas investment projects worth at least $100 million USD, in the energy and resources fields or in other special areas, receive the opinions of the relevant Chinese embassies/consulates. Third, the measures simplify the examination items needed during the approval process, excluding examination of the environment and security of the host country, the distribution of investment by country, and the investment orientation policy. Fourth, Chinese enterprises may begin overseas reinvestment by their majority-owned overseas enterprises simply by reporting such projects to the competent commerce authorities for registration within 1 month after they finish relevant legal procedures. The clarification of MOFCOM's service functions and content can be regarded as the most important modification in the new 2009 measures. The clarified service functions suggest that MOFCOM is now not only an administrative body, but is also obligated to provide Chinese enterprises with support services for their outbound investment activities. Under the new measures, such support services mainly include: releasing the *Guide to Overseas Investment and Cooperation by Country/Region* to help enterprises understand the investment environment in the host country/region; releasing the *Catalog of Countries and Industries for Guiding Investment Overseas* to guide enterprises in making overseas investment in particular countries/regions; assisting enterprises in solving difficulties and problems through intergovernmental bilateral or multilateral economic, trade or investment cooperation mechanisms; establishing the outbound investment and cooperation information service system to provide enterprises with information such as statistics, investment opportunities, investment obstacles and warnings.

Approval by the NDRC

On October 9, 2004, the NDRC issued the *Interim Administrative Measures for Approving Overseas Investment Projects*, which has since become the primary document under which it administers overseas investment projects. The NDRC focuses on approving two types of overseas investment projects – those related to resources exploitation and those that involve the use of large amounts of foreign exchange. The latter refers to overseas investment projects outside the field of resources exploitation, in which the Chinese organization(s) plan to invest at least $10 million USD worth of foreign exchange. Under this document, the NDRC may approve projects that: comply with the state's laws, regulations and industry policies, will not damage China's sovereignty, security and public interests, and obey international law; are compatible with sustainable socioeconomic development and in favor of exploiting strategic resources needed for the growth of the national economy; satisfy national requirements for changing the industrial structure; promote the export of technologies, products, equipment and labor services where Chinese enterprises have comparative advantages, and the import of advanced technologies from abroad; meet national regulations on the administering of the capital account and foreign debts; and are carried out by investors that have all the required investment resources. In the meantime, this document also has detailed provisions regarding the power to approve projects that are in the field of resources exploitation or that involve the use of large amounts of foreign exchange.

Also, this document provides timing requirements to finish approval procedures, but they are not as stringent as the *Measures for Administering Outbound Investment* issued by MOFCOM. Since there are numerous issues that require further clarification, it is impossible to estimate the required time on the basis of this document. To support the *Interim Administrative Measures for Approving Overseas Investment Projects*, the NDRC released the *Policy for Guiding Investment in Industries Overseas* and the *Catalog of Industries for Guiding Investment Overseas* on July 5, 2006, identifying overseas investment projects that are encouraged or prohibited. Under the *Policy for Guiding Investment in Industries Overseas*, encouraged projects will receive policy support from the state in such respects as macro control, bilateral or multilateral economic or trade policies, diplomacy, finance, tax, foreign exchange, customs, resources information, credit, insurance, bilateral or multilateral cooperation and foreign affairs. In contrast, prohibited projects will not receive approval by the state, and the state will take measures to stop them.

Enterprises themselves should be responsible for considering the potential profits and losses of their outbound investments; the NDRC should only be responsible for the orientation and compliance of overseas investment projects. Under the new measures, therefore, the NDRC will no longer review feasibility reports on investment projects and will only review and/or approve project applications rather than both project proposals and feasibility reports. In this regard, the new measures contain significant improvements regarding areas requiring approval. Additionally, the new measures have clearer provisions regarding the approval procedures. The time required to finish these procedures is averaged to be 20 workdays or, at most, 30 workdays. However, this time period does not include the likely time required for advisory bodies to finish their assessments, which is not specified in the new measures. With regard to overseas acquisitions and projects for which invitations to bid (ITBs) are sent, the NDRC issued the *Notice on Issues Relevant to Improving the Administering of Overseas Investment Projects* on June 8, 2009. This document provides that Chinese organizations must submit project information reports to the NDRC and the competent industry authorities of the State Council before signing binding agreements with relevant foreign organizations. In the case of overseas acquisition projects, this includes making binding offers and submitting applications to the competent government authorities in the countries/regions of the other party. In the case of overseas projects for which ITBs are sent, this includes making formal bids.

3.2.1.2 Main Problems with China's Outbound Investment Approval System

Cumbersome Approval Procedures

To make outbound investment, Chinese enterprises must receive approval from at least two authorities, or even more if they are SOEs or insurance companies. The foreign exchange authority will assess risks regarding foreign exchange, which is required before China fully opens the capital account. The commerce authority, as the functional department that administers foreign economic affairs, including outbound investment, is also reasonably expected to play an administrative role in this aspect. This being said, approval by some departments is short of clear objectives. On the one hand, the competent government authorities spend excessive time and energy scrutinizing details of investment projects pending approval. On the other, they have yet to make sufficient efforts in making timely adjustments to relevant policies/measures, providing consulting services, and coordinating Chinese enterprises so as to avoid excessive investment in similar overseas projects and destructive competition. It is true that new relevant policies have granted lower-level authorities a certain degree of approval power, but this is insufficient when it comes to Chinese enterprises' ability to make their own investment decisions. The right to decide on investment for oneself with no need for approval is available only for small-scale investments by central SOEs (i.e., overseas investment projects in which Chinese enterprises will invest no more than $300 million USD, if the projects are in the field of resources exploitation, or no more than $100 million USD, if the projects are outside the field of resources exploitation). With respect to investment projects of local enterprises, the only change is that the power of approval once solely held by the NDRC has been granted to the competent province-level development/reform commissions.

Lengthy Approval Periods

Previous administrative regulations on outbound investment include the *Measures for Administering Outbound Investment* issued by MOFCOM, the *Interim Administrative Measures for Approving Overseas Investment Projects* issued by the NDRC, and the *Regulations on Administering Foreign Exchange in Outbound Direct Investment by Chinese Organizations* issued by SAFE. Only the first two documents specify the time required to finish approval procedures. Even so, the *Interim Administrative Measures for Approving Overseas Investment Projects* does not provide for the time required to finish certain intermediate steps, so the *Measures for Administering Outbound Investment*s the only document that explicitly provides the time required to finish approval procedures: 3–40 workdays. The approval period can be lengthy, as demonstrated by existing cases. Excessive intervention by the government has led to a distorted corporate behavior. In an attempt to grasp investment opportunities, some Chinese enterprises have even gone so far as to illegally remit their funds to other countries or regions because of the stringent approval system for outbound investment, cumbersome approval procedures, and lengthy approval periods. While these enterprises should be held accountable for their illegal actions, problematic government policies are of course a factor for distorted corporate behavior.

A Lack of Clear and Transparent Approval Criteria

In China, relevant government authorities never disclose whether or why they have approved or denied particular outbound investment projects. In particular, there is no platform for disclosing reasons for denial. Consequently, since some enterprises do not quite understand why their investment projects have been denied, the image of the government with respect to clear and transparent approval criteria has been weakened.

3.2.1.3 Streamline Outbound Investment Approval Procedures and Enhance the Service Function

In China, outbound investment approval procedures are complex, lengthy and insufficiently transparent, as mentioned above. It is therefore imperative to streamline the existing approval procedures in order to reduce the time required to finish them. It remains necessary, however, for the Chinese government to conduct certain examination and approval procedures for the use and outflow of foreign exchange, since China has not opened the capital account. Foreign exchange assets ensure China's access to global resources, and it is necessary to make proper use of such resources. From this perspective, guidance on the use of foreign exchange by means of industry policies is indispensable. As a result, outbound investment approval should focus on the assessment of risks in the use of foreign exchange and whether the use of foreign exchange complies with relevant industry policies of the state. With respect to other approval procedures, approval can and should be replaced by the registration for record system. That is, enterprises should register their approved outbound investment projects for record at the competent functional departments and industry authorities. To support this system, relevant approval procedures should be simplified. To achieve the main objectives of foreign exchange risk assessment and industrial policy guidance, MOFCOM and SAFE should co-establish the NOIC, which would focus on the key aims of determining whether outbound investment projects constitute foreign exchange risks and comply with relevant industry policies of the state. Regarding the approval procedures, the currently used four steps – early reporting, declaration, approval and post-examination per year – may be referenced. With respect to the approval step, very clear criteria should be in place, plus stringent time requirements for administrative approval. Approval by authorities other than MOFCOM and SAFE should be replaced by the registration system, and whether a project has been registered for record should be taken as one of the items for annual examinations. In short, the Chinese government should explicitly identify overseas investment projects that will not be approved, and focus its administrative efforts on large-scale projects while granting lower-level authorities, to a reasonable extent, the power to approve smaller investment projects.

In the meantime, the competent government authorities should enhance the service function to provide a better balance between regulation and the provision of services. Any approved outbound investment project is in accordance with the state's industrial policies and risk-assessment for foreign exchange assets. Therefore, the government should shift its focus away from administration and towards the provision of quality services to facilitate the overseas operations and internationalization of Chinese enterprises that implement these projects. Furthermore, to promote the implementation of the "go global" strategy and international operations of Chinese enterprises, the Chinese government should also make policies to establish an integrated service system that incorporates the use of funds, credit insurance, foreign exchange management, finance/taxation and service centers.

It is necessary to change the ways in which Chinese government agencies/departments, including the ones abroad, service enterprises. It is also necessary to rethink and identify services that governmental, quasi-governmental and commercial organizations are able to provide respectively. For example, governmental organizations should not provide services that commercial organizations or quasi-governmental organizations can provide, but instead should focus on services that it is uniquely capable of providing. Examples include: negotiating international investment treaties that require the host country to streamline approval procedures specific to Chinese enterprises; establishing bilateral dispute resolution mechanisms and joining multilateral dispute resolution mechanisms to reduce resistance against overseas investment and operations by Chinese enterprises and to protect their interests; using the overseas investment insurance system and other systems to reduce risks against overseas investment by Chinese enterprises; and, when necessary, providing credit support and assistance. On the other hand, commercial and quasi-governmental organizations should assume responsibility for services that they are well positioned to provide, such as investment negotiations, information services, and project support services. As mentioned at the beginning of this paragraph, the competent government authorities should enhance the service function to perfectly balance between regulation and services.

3.2.2 Improve Foreign Exchange Management

3.2.2.1 The History of China's Foreign Exchange Management System

China's foreign exchange management system has a long history. In March 1989, SAFE issued the *Measures for Administering Foreign Exchange Involved in Outbound Investment*, providing that outbound investment projects must receive examination by SAFE with respect to foreign exchange risks and sources before receiving approval from the competent authorities. The measures further stipulate that these projects must also be registered and go through the procedures for remitting foreign exchange at SAFE after they are approved. While these projects are undergoing the registration process, a guarantee for profits repatriation, which is equal to 5 % of the amount of the remitted foreign exchange, must be paid. Moreover, returns on overseas investments must be repatriated within 6 months after the end of the local accounting year, and must not be used for any other purpose without prior approval or be deposited outside China. These obvious tight and burdensome regulations remained effective until the end of 2003.

Later on, regulations on outbound investment gradually loosened in order to support the "go global" strategy, as well as due to the fact that China was by then no longer short of deposits or foreign exchange. SAFE first released a notice in November 2002 announcing that the guarantee regime for the repatriation of profits from overseas investments would be abolished beginning November 15 of that year, and announced in July 2003 that it would return to relevant investors the guarantees that had been charged. Second, SAFE released a notice in March 2003 that it would streamline examinations on the sources of foreign exchange, and in October 2003 it announced a pilot program that would grant local branches the power to examine the sources of foreign exchange for overseas investment projects worth less than three million USD. SAFE expanded this pilot program in May 2005 by: extending its coverage to the whole country from the first 24 pilot provinces, autonomous regions and municipalities directly under the central government; increasing the upper limit of the amount of foreign exchange available for outbound investment; and expanding the power of foreign exchange administrations in pilot areas to examine the sources of foreign exchange used for outbound investment projects of up to ten million USD from three million USD. In June 2006, SAFE further loosened foreign exchange regulations over outbound FDI, announcing that it would no longer verify with local foreign exchange administrations the upper limit of purchased foreign exchange from July 1, 2006 onward. SAFE's announcement also allowed domestic investors to use foreign exchange that they owned or purchased with renminbi and/or domestic foreign exchange loans to finance their overseas investment activities. This move meant looser examination on the sources of foreign exchange.

Following the 2008 version of the *Regulations of the People's Republic of China on the Administration of Foreign Exchange*, SAFE issued the *Regulations on Administering Foreign Exchange in Outbound Foreign Direct Investment by Chinese Organizations* in July 2009. Under this document, Chinese organizations were permitted to engage in outbound FDI using their own foreign exchange funds, compliant domestic foreign exchange loans, foreign exchange purchased with renminbi, tangible and/or intangible assets, and other foreign exchange assets approved by SAFE. Chinese organizations were also permitted to deposit outbound FDI profits outside China for the purpose of re-investing the funds overseas. Meanwhile, SAFE would conduct foreign exchange registration, instead of examination, on outbound FDI by Chinese organizations as well as the resulting assets and associated rights. With these policy directions, the regime greatly loosened foreign exchange administration over outbound FDI.

As of 2009, Chinese enterprises have been able to use foreign exchange for outbound FDI rather freely. This being said, their independence in using foreign exchange is mainly reflected in a company's use of its own foreign exchange funds and profits from overseas investments; they still need approval from SAFE before receiving foreign exchange loans or purchasing foreign exchange directly with renminbi. When it comes to needing foreign exchange for projects related to outbound FDI, capital regulation in China remains.

3.2.2.2 China Should Continue Appropriate Loosening of Its Foreign Exchange Management System

Foreign exchange management is a process of public choice; regulation of foreign exchange has the positive externality of increasing operating efficiencies within the overall economy. Nevertheless, regulation also always has its costs. Overly tight foreign exchange management can: restrict payment by foreign exchange instruments and other multilateral settlement methods; distort the supply and demand of foreign exchange; prevent exchange rates from reflecting supply and demand in the market; adversely affect foreign trade, outbound FDI, and the normal inflow and outflow of international capital; and reduce returns that could otherwise be available.

Today, SAFE focuses on examining the sources of foreign exchange and the risks of using foreign exchange in overseas investment projects:

Examining the Sources of Funds

With regard to examining the sources of funds, the primary applicable policy document is the *Notice of the State Administration of Foreign Exchange on Issues Relevant to Streamlining Examination on the Sources of Foreign Exchange Funds for Investment Overseas* [HF (2003) No. 43] issued on March 19, 2003. In this document, SAFE provides that, if an investor needs to purchase foreign exchange or remit foreign exchange from inside China in order to invest overseas, the investor should first submit an application to the local foreign exchange branch of SAFE, which then examines the source of their foreign exchange funds. Such examination does not apply to projects for which investment will be made completely in kind, foreign-assistance projects, and strategic investment projects approved by the State Council. Separate approval procedures are available for the use of foreign exchange funds owned by the enterprises, of commercial loans, and of loans for foreign assistance.

The Power to Examine the Sources of Funds

With regard to examining the sources of funds, SAFE issued the *Notice on Issues Relevant to Expanding the Pilot Program for Reforming the Management of Foreign Exchange for Outbound Investment* [HF (2005) No. 35] on May 19, 2005, which provided that local branches of SAFE may approve investment projects worth less than ten million USD. SAFE retains approval power for projects worth at least ten million USD and for outbound investment projects by central SOEs. SAFE's 2004 document required that enterprises include into their application materials the conclusion of the competent foreign exchange administration on the sources of foreign exchange to be used for outbound investment. The 2009 version not only removes this requirement, but also allows enterprises -after receiving approval of their overseas investment project and the Permit of Corporate Overseas Investment-to undergo relevant procedures at the competent foreign exchange administrations, banks, customs and foreign affairs institutions. These enterprises are also eligible for relevant policy support from the state.

Early Reporting and Annual Examination

In March 2005, MOFCOM and SAFE co-issued the *Notice on Printing and Issuing the Early Reporting System for Corporate Mergers and Acquisitions Overseas* [SHF (2005) No. 131]. This document stipulated that enterprises carrying out mergers and acquisitions (M&As) overseas must send timely reports to MOFCOM and the competent province-level commerce authorities as well as SAFE and the competent province-level foreign exchange administrations. Specifically, enterprises managed by SASAC shall send reports directly to MOFCOM and SAFE; other enterprises shall send reports to the competent province-level commerce authorities and foreign exchange administrations, which in turn shall forward these reports to MOFCOM and SAFE. This notice also provides that the competent government authorities and their relevant staff members shall keep secret all corporate confidential information accessed in the reporting process. The annual examination system for enterprises that engage in outbound investment was established under the *Interim Measures for Annual Joint Examination on Outbound Investment* co-issued by the then MOFTEC, the predecessor of MOFCOM, and SAFE on November 27, 2002. Under this document, MOFCOM and SAFE were responsible for conducting annual examinations on domestic investors engaged in overseas investment activities, and classifying the results of their examinations into Levels 1, 2 and 3. The levels indicated the examined enterprises' eligibility for relevant policy incentives or even for continuing outbound investment.

Foreign Exchange Services

On the side of foreign exchange management, the state has issued a series of policies including: cancelling examination of overseas investment risks and streamlining the foreign exchange source examination system; abolishing the guarantee regime for the repatriation of profits from overseas investments; allowing enterprises to purchase foreign exchange within the upper limit to make outbound investment; granting lower-level authorities the power of approval; and allowing Chinese enterprises operating overseas to use their profits for capital increases or reinvestment abroad.

Despite these reforms, the existing procedures for examining risks and sources of foreign exchange remain cumbersome and detrimental to overseas investment by enterprises.[2] Statistics show that, in order to receive examination on risks and sources of foreign exchange, enterprises must provide the competent foreign exchange administrations with 12 kinds of application materials that involve over ten domestic government departments. These materials include the feasibility report on the overseas investment project, the business license verified by the competent industry and commerce administration within the current year, the balance sheet and the income statement of the previous year audited by certain accountants, the permit for opening the foreign exchange account, the permit for providing financial services and the business license of the lender, as well as the documents most difficult to obtain, including the measures against foreign exchange risks recommended by the relevant intermediary in the investment destination, the evidence of credit standing of the investment partner(s), and the letter of opinion of the relevant Chinese embassy/consulate on this project, etc.

In the meantime, private businesses and FIEs receive obviously less support for overseas investment than SOEs, which hinders the further growth of China's outbound investment. Private businesses have been growing rapidly since China began

[2] Han Jiyun: "New thinking on China's foreign exchange administration system for outbound investment", *New Finance*, 2003 Issue 11.

reform and opening up. They are strongly willing to make investments overseas, and have become an important force in this field. Issued in 1989, the *Measures for Administering Foreign Exchange Involved in Outbound Investment* was designed for publicly owned enterprises, especially SOEs, despite the fact that it also applies to individual and private businesses. In reality, private businesses find it difficult to open foreign exchange accounts due to restrictions from China's foreign exchange administration policy. A lack of private foreign exchange funds and the unavailability of such funds for outbound investment have caused differences in treatment between SOEs and private businesses when it comes to outbound investment. Today, a polarity exists between Chinese enterprises in the process of conducting outbound investment: central SOEs typically have a large amount of money, and both policy and commercial banks are willing to offer loans; local and private enterprises have less money, and financial institutions are less willing to offer loans. Consequently, some Chinese private businesses are forced to circumvent domestic regulation to invest overseas, but they are faced with a series of problems such as small investment amounts, ruinous competition and managerial chaos. In addition, the *Measures for Administering Foreign Exchange Involved in Outbound Investment* does not cover FIEs, some of which, especially Sino-foreign joint ventures, also need to invest overseas in order to develop and internationalize their businesses. These enterprises strongly demand that SAFE loosen capital-account administration and allow greater freedoms in the outflow of foreign exchange funds to satisfy the needs for making outbound investment.

In July 2007, SAFE issued the *Notice on Issues Relevant to Returning the Guarantees for the Repatriation of Profits from Overseas Investments*. This measure sought to reduce the financial burden on overseas investors by cancelling guarantees for the repatriation of profits. The NDRC also officially announced in October 2007 that it would cancel the approval of the amounts of foreign exchange used by enterprises for outbound investment. Both moves were big steps by China to loosen foreign exchange regulation, although China's foreign exchange administration policy remains very tight when compared with those of developed and emerging industrialized countries.

With regard to foreign exchange management, therefore, the Chinese government should pay equal attention to costs and efficiencies, with both the importance of regulation and its potential effects on economic efficiency in mind. The Chinese government should further cancel unnecessary restrictions in such aspects as examination on the sources of foreign exchange funds, the purchase of foreign exchange, and the repatriation of profits. It should also allow enterprises to purchase larger amounts of foreign exchange with renminbi for outbound investment; facilitate the use and remittance of foreign exchange, thereby satisfying enterprises' need for making overseas investments. The Chinese government should change foreign exchange capital regulation into a legalized approval system in order to make capital administration more efficient. It should improve the capital payment and foreign exchange settlement system to enhance regulation over the flows of renminbi from the settlement of capital foreign exchange; further relax foreign exchange regulation over the outflow of capital in outbound FDI activities; allow enterprises to conduct entrusted foreign exchange lending inside China and to centralize foreign exchange management, reception and payment; make laws/regulations governing the follow-up management of overseas investments, relevant capital-account transactions of financial institutions, personal capital transactions, and derivatives transactions as soon as possible.

3.2.2.3 Combine Tight Control Over the Inflow of Foreign Exchange with Tight, or Loose, Control Over Its Outflow as Required

Foreign exchange administration in China has long been primarily characterized by encouraging exports while restricting imports in foreign trade, mainly because the foreign exchange administration system was designed during the period of a planned economy when foreign exchange was a rare resource in this country. All the cross-border payment systems in China were created to promote foreign trade and accelerate the accumulation of foreign exchange. As a result, inflow-relevant government policies are looser than outflow-relevant ones, leading to asymmetry in foreign exchange administration, especially with respect to the capital account.

China has seen a huge BOP surplus and a high net inflow of foreign exchange funds since 2005. Given that foreign exchange is no longer a rare resource in China, tight control over outflow combined with loose control over inflow no longer suits the current situation in this country. To address this, SAFE should make timely adjustments and innovations to its method of administration in order to replace the narrow focus on the outflow of foreign exchange with equal attention to both outflow and inflow. SAFE should administer capital flows in a balanced manner, and holistically view capital exchange inflow and outflow to achieve a unified planning and administration strategy. To achieve balanced administration, SAFE should maintain a good relationship between institutional stability and the cycle of capital flows. It should conduct administration to take into account the characteristics of capital flows in different periods. To make foreign exchange administration more future-oriented, it is advisable for SAFE to grasp opportunities to revise relevant policies according to an institutional framework of balanced administration.

The Chinese government should change its foreign exchange administration policy by replacing loose control over inflow vs. tight control over outflow with tight control over inflow vs. loose control over outflow. It should also continue relaxing restrictions on the holding and use of foreign exchange by individuals and businesses, and on the sizes and types of overseas financial investments made with foreign exchange funds.

With regard to “hot money” flows, the Chinese government must adopt a special policy of tight control over both inflow and outflow. Given expectations for the appreciation of the renminbi, the flow of hot money into China through various channels has become one of the major factors in the growth of China’s foreign exchange reserves. Accordingly, the Chinese government must take all possible measures to lower expectations for the appreciation of the renminbi in order to prevent the excessive inflow of foreign exchange. At present, this is already a top priority, necessitating tight control over the inflow and outflow of hot money. Proper institutional arrangements for tax refunds related to transactions that maintain a stable capital account within a certain period of time would best assure the normal functioning of compliant investment activities. The Chinese government may consider enacting the *Anti-Hot-Money Law* to make the aforementioned measure legal and authoritative.[3]

Also, to avoid the impact of international capital flows on China's financial system and real economy, the Chinese government should first prevent the massive outflow of capital while enhancing regulation over its inflow. Second, it should further open the capital account in a prudent manner.

3.2.2.4 Make Horizontal Divisions of Work and Decisions Depending on the Functions of Foreign Exchange Reserves

China's current foreign exchange administration system is effectively a single-level system. The MOF does not play a leading role; instead the People's Bank of China (PBC) is the sole body that makes strategic and operating decisions. Rather than a single-level system, China's foreign exchange administration should be organized into a dual system. First, the central bank should continue to be responsible for the liquidity of foreign exchange reserves, and focus its investments on monetary instruments and government debt with high liquidity and levels of safety in developed countries. These foreign exchange assets are functionally intended to provide an asset foundation for enforcing monetary and exchange-rate policies. Second, other economic authorities should manage some of the investment assets, with a focus on assets with higher returns. In order to match adjustments with the state's international development strategy, the competent authorities should purchase strategic overseas resources, equipment and technologies needed for national development, or engage in outbound FDI in order to find large-scale and stable non-financial uses of foreign exchange reserves, thereby achieving specialization and multi-level administration. From an internal vs. external perspective, it is necessary to identify the functions of the PBC and MOF in relevant aspects in order to address growing challenges related to balancing between domestic and foreign interests at a time when the Chinese economy is becoming increasingly open. This will improve coordination between monetary and fiscal policies.

Globally, the finance departments of the Japanese and Hong Kong governments play a leading role in foreign exchange management. The Japanese finance minister may initiate necessary intervention in the foreign exchange market in order to stabilize the exchange rate of the yen; the Japanese central bank conducts foreign exchange operations according to instructions from the finance minister. In comparison, the central banks of South Korea and Singapore play a leading role in the management of foreign exchange reserves in their respective countries. In South

[3]Yan Wei: "On adjustments to the policy for the reforming of exchange rates of renminbi", a doctoral thesis at the Central South University in 2010.

Korea, foreign exchange reserves are co-held by the Central Bank of Korea (BOK) and the exchange stabilization fund (ESF) run by the Ministry of Strategy and Finance (MOSF), which is also responsible for overall policy-making regarding foreign exchange reserves management. The Monetary Policy Committee of the BOK makes the operating decisions and thus plays a significant role in the management of foreign exchange reserves. In Singapore, foreign exchange reserves are co-managed by the Monetary Authority of Singapore (MAS) and the Government of Singapore Investment Corporation Pte Ltd. (GIC). Foreign exchange reserves held by the central bank are mainly used to intervene in the foreign exchange market and to act as the guarantee for currency issuance, whereas the GIC focuses on ensuring value maintenance and value appreciation for the managed reserves.

In order to strengthen the management of foreign exchange reserves, a new foreign exchange administration system is required. This system should be primarily designed to create the best possible economic and social benefits from foreign exchange, emphasize risk management for foreign exchange, and increase the operating efficiencies of foreign exchange reserves. For the future, the basic organizational structure of foreign exchange reserves management should mainly comprise two parts. First, the central bank should hold most of the foreign exchange reserves to satisfy transactional and preventive requirements, to handle the BOP deficit, to operationalize monetary policy, and to stabilize the exchange rate of the renminbi. Second, the foreign exchange reserves manager, or the foreign exchange investment company, should manage and operate part of the foreign exchange reserves for the purposes of investment and maximizing returns. Specialization and multi-level management are the two basic characteristics of this organizational structure.

In addition to opening a national foreign exchange investment company, the Chinese government should also consider making more aggressive outbound investment policies and combining foreign exchange reserves management with the internationalization strategies of SOEs and domestic banks. The government may also assist competitive Chinese enterprises in going global; develop more market-oriented, multi-level, diverse approaches to outbound investment; promote the shift of industry chains by opening businesses through outbound FDI; accelerate the optimization and improvement of the domestic industry structure; support balanced and sustainable economic growth, for example. In addition, the Chinese government may increase channels for outbound investment by Chinese residents and businesses; encourage investment in overseas capital markets to increase returns on foreign exchange investments; support the private sector in utilizing global markets to stabilize the supply of resources and investing in future-oriented industries.

3.2.2.5 Set Up an Independent Internal Auditing Department to Increase the Transparency of Foreign Exchange Management

To effectively regulate foreign exchange operations, it is imperative to set up an independent internal auditing department intended to examine the compliance of various businesses according to procedures specified under the foreign exchange operation and management regimes. Internal auditing targets all aspects of foreign exchange management, and contains compliance testing and substantive testing. Compliance testing refers to the assessment of the effectiveness of the internal control system, especially whether the internal control environment satisfies relevant managerial requirements and how efficient it is. Substantive testing refers to examination of the specific, main items within the internal control system. The principle of "clearly-defined managerial responsibilities" should be followed to set the internal regulatory structure of the foreign exchange reserves administration. Responsibilities and powers at the decision level should be clearly separated from those at the operations level in the field of foreign exchange management. Internal auditing should be independent from specific foreign exchange reserves operations, and be made at the central banking level. It is advisable to conduct internal auditing, either regular or irregular, to examine how the internal control system is running, thereby bringing continuous improvements to the internal control environment. Competent and well-trained persons are needed in all respects of foreign exchange reserves management; these persons must have solid knowledge of market practices and transaction instruments. Effective monitoring of international operations and relevant risks should be supported by a reliable, information reporting system and an independent auditing function. An effective and independent auditing department helps ensure that foreign exchange operations, internal control and the reporting system are properly functioning. It is imperative to establish workable remedies to alleviate risks in the management of foreign exchange reserves that may arise from failure of the operation system or other catastrophic events.

Increased transparency of foreign exchange management will bring benefits such as: helping the public and private sectors make decisions; influencing economic organizations such that they will adjust their activities in a market oriented fashion according to government policies related to foreign exchange reserves management; further increasing the efficiencies of foreign exchange reserves management in China through public monitoring; and ensuring that foreign exchange management transactions are based on the standards of justice and objectivity. For the purpose of confidentiality, however, the operating details of foreign exchange management should not be released. Otherwise, the administration may become less able to operate in the market. With regard to foreign exchange management, the transparency policy of a nation's central bank varies from country to country. In most countries, the foreign exchange reserves administration discloses its organizational structure, the categories of investable assets and risk tolerance through the annual report of the central bank. In some developed countries, investment benchmarks, including assets allocation, are also disclosed. The Reserve Bank of Australia, the Bank of Canada, the European Central Bank, the Bank of England and the Bank of Russia all disclose the currency structure of their reserves. Referring to this foreign experience, China should gradually improve its reserves information disclosure system, to include regular disclosure of basic information on the choice and flows of investment instruments for China's foreign exchange reserves as well as related parties in transactions. Such information may be released by referring to the IMF's Special Data Dissemination Standard (SDDS) as well as the data template for international reserves and foreign currency liquidity. Important reserves-relevant data such as the total value, currencies, forms and periods, and value increase/profits may be published in financial publications such as the *Financial Times* and, in China, the *Foreign Exchange* on a quarterly or yearly basis. External auditing may also be conducted, depending on the availability of relevant conditions, within the annual financial statements of the foreign exchange reserves administration regarding its reserves management activities. The external auditor may employ globally accepted standards and offer independent opinions on the truthfulness and justice of these statements; auditing results may also be published in other proper manners.[4]

3.2.3 Environmental Monitoring in Investment Destinations

China's FDI outflow is developing rapidly. Regarding regional distribution, Chinese investments are mostly made in developing countries in Asia, Africa and Latin America, namely, on the basis of South–South Cooperation. Regarding industrial distribution, Chinese investments are centered in mining (e.g., oil and copper), natural resources exploitation (e.g., water and electricity), processing/manufacturing, and infrastructure construction. Some Chinese overseas investment projects, such as a hydrological project in Sudan, a copper mining project in Chile, and a manufacturing project in Argentina, are leading to environmental problems. An environmental NGO in China, Friends of Nature (FON) cited the opinion of Daniel Ribeiro, aMozambique dam researcher, in an article that it published in June 2010, saying that "China should learn lessons from the West and should not turn a blind eye to the environmental damages and corruption arising from its foreign assistance projects." Since most enterprises seek the highest possible profits, corporate self-regulation is far from sufficient to ensure environmental protection in overseas investment destinations. In order to maintain long-term overseas investment growth, the Chinese government must strengthen regulations on overseas investment projects by Chinese companies, mainly in the following respects:

3.2.3.1 The Competent Government Authorities Should Be Responsible for Environmental Impact Assessments (EIAs)

The Chinese government may refer to the *Goals and Principles of Environmental Impact Assessment* published by UNEP, which provides that "States (including their competent authorities) should not undertake or authorize activities without prior consideration, at an early stage, of their environmental effects. Where the extent, nature or location of a proposed activity is such that it is likely to significantly affect the environment, a comprehensive environmental impact assessment should be

[4] Zhang Bo: "On the Optimization of Foreign Exchange Reserves Management in China", a doctoral thesis at Liaoning University in 2009.

undertaken in accordance with the following principles." It is necessary to note that EIA in this context should not only be made when an investor is about to invest overseas, but should be continuous throughout the lifecycle of the overseas investment project.

3.2.3.2 Follow the Principle of Transparency in Investment Projects

It is necessary to highlight the investor's obligation of disclosing and reporting investment project information (except for business secrets). Whether or not a project that will cause severe environmental pollution should be accepted is an issue that falls in the field of public decision-making. The public is most entitled to make the final choice between environmental pollution and economic development, and therefore public opinion should be taken into account. The practices and methods of the Global Reporting Initiative (GRI) in this field deserve a close study. The *Sustainability Reporting Guidelines*, which is the cornerstone of the GRI Reporting Framework, presents principles and indicators for measuring and reporting environmental performance. One difference between the GRI and our recommendation is that we recommend that reporting should be made both to China and the host country. The obligation of reporting is also continuous.

3.2.3.3 Establish the National Contact Point System

The national contact point system is a taxation method that has been proven effective by OECD member countries. We believe that this practice may be referred to for environmental protection in overseas investment destinations. Simply put, contact points should be established in overseas investment destinations to investigate alleged environmental problems or violations of environmental law caused by relevant investments. Moreover, complaints can still be filed at these contact points even if the pollution caused by overseas investors is not in countries under whose laws the contacts were established.

3.2.3.4 Be Subject to the Highest of Multiple Environmental Standards

Under the territorial principle, it is beyond any doubt that overseas investors should obey the environmental standards of the host country. This is also emphasized in Chinese administrative laws/regulations involving outbound investment. Since developing countries compete with each other for foreign investments, however, they have low environmental standards or do not even implement environmental standards in order to gain economic benefits. We recommend that overseas investors should be required to obey the highest environmental standards in the host country, the home country and the international community, thereby avoiding the phenomenon of the "Race to the Bottom". Indeed, the practice of following multiple standards is not our innovation, as the *Generally Agreed Principles and Practices for International Sovereign Wealth Funds (SWFs)* provides that SWFs must simultaneously obey applicable rules and disclosure requirements in the home and host countries.

3.2.3.5 Require Banks and Insurers to Directly Conduct Environmental Monitoring of Clients Who Make Overseas Investments

A direct provision that requires both banks and insurers to conduct environmental monitoring of their clients who invest overseas can help avoid the scenario in which only a few banks and insurers have environmental requirements on overseas investments. The World Bank Group, the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank (ADB), the African Development Bank (AFDB) and the Inter-American Development Bank (IDB) all have relevant environmental standards and practices that deserve study. The practice of the Overseas Private Investment Corporation (OPIC) is also worth studying. As a U.S. government organization, OPIC's mission is to help American companies invest overseas by underwriting possible political risks against their new overseas investment projects. In 1998, OPIC published the OPIC Environmental Handbook that presents information with respect to general environmental guidelines, assessment and monitoring procedures that OPIC applies, according to its own discretion, to prospective and ongoing investment projects. All OPIC projects must obey the environmental laws/regulations of the host country, and most activities must adhere to the environment standards of the World Bank Group. Moreover, the results of EIAs made by the OPIC are available to the public, according to U.S. domestic law. In particular, environmental monitoring of relevant projects by OPIC is continuous. In practice, OPIC cancelled an insurance contract it had signed with Freeport-McMoRan Copper and Gold Inc. for the latter's mining business in Irian Jaya, Indonesia, because the company's project had caused environmental damage. Banks and insurers, of course, should still develop detailed articles regarding green loans or insurance in light of advanced practices by the OECD, OPIC and other organizations, with their own actual conditions in mind.

3.2.4 Others

Improving the supervision/administration of China's outbound foreign direct investment involves a variety of tasks, including fiscal/tax/financial regulation, industry management, streamlined approval procedures, improved foreign exchange management, and environmental monitoring in overseas investment destinations. We will discuss each of these items in the following chapters. Given the length of this book, we can only present a brief, not detailed, introduction to numerous issues such as overseas investment statistics collection, the strengthening of joint annual examination on overseas investments, and the strengthening of state-owned assets management in overseas investment projects.

3.2.4.1 Strengthen Overseas Investment Statistics Collection

The current Chinese regulations on overseas investment statistics collection are detailed in the *Outbound Direct Investment Statistics System* that was promulgated by MOFCOM and SAC and implemented on January 1, 2007. The current statistics system apparently focuses on outbound *direct* investment; there is no policy or effective means of collecting statistics about outbound *indirect* investment. Moreover, there are even deficiencies in the outbound FDI statistics. As an example, Article 6 of the aforementioned document provides that "outbound direct investment statistics mainly cover various corporate and non-corporate enterprises outside China, of which domestic investors own or control at least 10 % of voting shares or equivalent interests by direct investment (hereinafter referred to as "overseas enterprises"). Overseas enterprises mainly include, overseas subsidiaries, affiliates and branches according to how they are established." Under this requirement, the statistics do not cover a substantial number of corporate and non-corporate enterprises outside China in which domestic investors own or control less than 10 % of voting shares or equivalent interests by direct investment. This does not satisfy statistical requirements under the global trend of an increasingly decentralized equity structure. Article 8 of the same document provides that "outbound direct investment statistical indicators mainly include: the agreed-upon amount of investment; the actual amount of investment; the amount of outbound FDI; the amount of net outbound FDI; capital stock; profits for reinvestment; the amount of reverse investment; repatriated profits; total value of assets; total value of liabilities; owner's equity; paid-in kind capital; sales (operating) income; gross profits; year-end headcount; the export value achieved by domestic investors through overseas enterprises; the import value achieved by domestic investors through overseas enterprises, etc." Such statistics focus on the home country and pay insufficient attention to indicators contributing to the economic development of the host country. This is a major flaw in which improvements are needed. As an example, the average compensation of employees in the host country, an indicator that compares it with the average income in the host country, etc., can be added.

3.2.4.2 Strengthen State-Owned Assets Management in Overseas Investment Projects

As for strengthening state-owned assets management in overseas investment projects, the current focus is on central SOEs. Since June 2011, SASAC has issued a series of documents such as the *Interim Measures for Monitoring and Managing Overseas State-Owned Assets of Central Enterprises*, the *Interim Measures for Monitoring and Managing Overseas State-Owned Property Rights at Central*

Enterprises and the *Interim Measures for Monitoring and Managing Overseas Investments of Central Enterprises*. All these documents target overseas central SOEs, however, the challenge remains how to regulate the large number of non-central SOEs. Several improvements can be made with reference to the aforementioned three documents. The scope of overseas state-owned assets should be clearly defined; the corporate governance structure should be improved; an accountability system for the loss of overseas state-owned assets should be established with a follow-up mechanism to make continuous improvements; and penalties for violations should be increased, etc.

Clearly Define the Scope of Overseas State-Owned Assets

The scope of overseas state-owned assets should be defined to include: state-owned assets created by overseas investments by domestic state-owned companies, enterprises and other economic organizations, including corporate enterprises in which state-owned companies/enterprises hold shares or even controlling shares, and set up corporate enterprises and/or branches; state-owned assets of trading companies registered in China and foreign trade branches registered outside China; overseas state-owned assets of corporate enterprises that contract projects outside China; state-owned assets of administrative authorities, institutions and their branches outside China; and other overseas assets that are state-owned.

Improve the Corporate Governance Structure

Strengthening regulation of overseas state-owned assets to prevent their loss requires a comprehensive effort by the Chinese government. The focus of regulation in this area should be on creating a modern corporate governance structure, making continuous follow-up improvements to the structure, and building in an intra-corporate mechanism related to benefits. A scientific corporate governance structure that accounts for the legal and regulatory requirements of both the home and host countries should be established, thereby institutionally preventing the loss of state-owned assets caused by poor corporate decisions, appropriation, etc. Specifically, centralized control over investment decision-making by the board of directors or the authorized state-owned assets manager should be strengthened through the articles of association or corporate managerial documents; the power and responsibility of the board of directors should be clearly defined; the board of directors should be empowered to effectively control overseas investments and supervise their management; the board of supervisors should have enhanced functions; the incompatibility between the behavior of a management team with diverse motives and the investors' goal of seeking the highest possible investment profits should be prevented; and failure of state-owned investors to control operating activities of relevant enterprises and insider control resulting from information asymmetry should be prevented.

Improve the Accountability System for the Loss of State-Owned Assets, and Increase Penalties

The accountability system should cover at least two scenarios: the loss of state-owned assets caused by wrong decisions on overseas investment arising from a breach by the investment decision-maker; and the loss of state-owned assets caused either intentionally or unintentionally by overseas enterprises or institutions in the course of daily operations. Relevant individuals and/or organizations shall be held civilly, administratively or even criminally responsible for either scenario.

Chapter 4
The Fiscal/Taxation/Financial Subsystem

An overview of the global history of outbound foreign direct investment shows that a state's fiscal and financial policies play a critical role in promoting outbound investment. With respect to the framework of China's fiscal, taxation and financial regimes, China has established a preliminary system oriented toward the market economy. Nonetheless, the existing fiscal, taxation and financial regimes and policies related to outbound investment by enterprises remain imperfect and require improvements to make them more systematic, scientific and implementable. This chapter is intended to offer basic ideas and recommendations on how to improve China's fiscal/taxation and financial support systems so as to promote overseas investment and cooperation by Chinese enterprises.

4.1 The Fiscal/Taxation System

4.1.1 Current Fiscal/Tax Incentives for Overseas Investment

Current fiscal/tax incentives for overseas investment focus on income and import/export taxes and support funds. The existing tax management system for outbound investment is mainly governed under the *Law of the People's Republic of China on Enterprise Income Tax* and its implementation rules, as well as policies/regulations promulgated by the competent ministries/commissions.

Under China's enterprise income tax law, tax credits may be applied to the income from equity investment, such as dividends and bonuses, which is derived outside China from foreign enterprises that are under the direct or indirect control of a Chinese domestic enterprise. In addition to direct tax credit, indirect tax credit has been introduced to further increase the modes and fields of outbound investment by Chinese enterprises. This is an important part of the existing income tax policy regarding outbound investment by Chinese enterprises.

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The State Administration of Taxation (SAT) began handling tax disputes in 2005. Chinese enterprises that invest in countries with which China has signed tax treaties may submit applications to SAT if they believe that measures taken by the host country have led to, or will lead to, taxation inconsistent with the tax treaty. SAT would then undertake negotiations with the competent tax authority in the host country to resolve the dispute. This has provided a new method for outbound investors to effectively deal with international tax disputes. SAT also promulgated the *Opinion on Providing Chinese Enterprises with Tax Services and Management for Outbound Investment* in March 2007, requiring that tax authorities at all levels further promote commercial outbound investment activities by improving relevant policies, management and services as well as strengthening cooperation.

On the other hand, SAT has also enhanced tax regulation over income from overseas investments. Article 45 of the enterprise income tax law provides that, for an enterprises which is controlled by a resident enterprise or by both a resident enterprise and a Chinese resident but which is established in another country (region) where the actual tax burden is lower than 12.5 %, if the enterprise does not distribute its profits or distributes the profits at a reduced rate for reasons other than reasonable business needs, the portion of the aforesaid profits that should go to the said resident enterprise shall be included in the income of the said resident enterprise during the current period.

In 2009, MOF and SAT promulgated the *Notice on Issues Relevant to Tax Credit for Overseas Incomes of Enterprises*, which contains important provisions concerning tax credits for overseas investments. It is one of the most important Chinese policy documents regarding outbound investment, providing that:

First, creditable foreign income tax refers to a corporate income tax that an enterprise shall pay and has paid for income derived from outside China under Chinese laws/regulations regarding foreign income taxes. But such taxes exclude: foreign income taxes that, according to the aforementioned laws/regulations, have been wrongly paid or levied; foreign income taxes that, according to relevant tax treaties, shall not be levied; interest, surcharges or penalties for underpayment or late payment of foreign income taxes; foreign income taxes that the competent foreign tax authorities have returned or indemnified the taxpayers or their stakeholders; foreign income taxes that have been exempted for the foreign incomes of Chinese enterprises under the enterprise income tax law and its implementation rules; foreign income taxes that, according to relevant regulations of the fiscal and tax authorities of the State Council, have been deducted from the taxable foreign income of enterprises.

Second, when calculating the creditable income tax that has been paid outside China as an indirect tax burden, the compliant income tax that has been paid in a foreign country as an indirect burden in the current year shall be deemed as the creditable foreign income tax and be deducted, on an as-is basis, from the total taxable income of the enterprise, if this tax is no more than the calculated creditable limit in the country; otherwise, this creditable limit shall be deemed as the creditable foreign income tax in the current year, and the portion beyond this limit may be offset, within five consecutive tax years immediately after the current year, by the remainder that equals the creditable limit less the taxable income in each year.

Third, with regard to operating profits that an enterprise makes outside China, including dividends that are eligible for indirect tax credit for foreign incomes, if it is impossible to truly and accurately determine, for objective reasons, the amount of foreign income tax that should be paid and has already been paid on the income. Even though the tax authority in the country of the income source typically issues a relevant tax payment receipt or evidence, there is a complicated system of credits and exceptions that cloud actual calculations. For example, income from operating profits made outside China is eligible for a creditable limit equal to 12.5 % of the taxable foreign income, except in the situation where the effective tax rate that shall be directly paid on this income in the aforementioned source country is at least 50 % lower than the tax rate specified in Article 4.1 of China's enterprise income tax law. In this situation the enterprise is eligible for a tax credit for the amount issued on a tax payment receipt or other evidence from the competent tax or government authority in the country. However, if this amount exceeds the aforementioned creditable limit, the portion of this amount is equal to this limit. With regard to investment incomes other than what is specified above in this paragraph, such as dividends, interests, rents, royalties and incomes from the transfer of assets, the tax credit shall be computed in accordance with the other provisions in this Notice.

Fourth, if the tax year in an investment host country is different than the tax year in China, and if the branch of a Chinese enterprise in that country does not have independent tax status, then the tax year for calculating production and operating incomes of that overseas branch should be the tax year in the host country which ends on any day within the corresponding tax year in China. The foreign income which is other than what is specified in the preceding paragraph, and for which the aforementioned enterprise has paid, or been indirectly burdened with, the foreign income tax, shall be deducted from its taxable income in the tax year in China that includes the day on which this foreign income is realized.

4.1.2 Increase Fiscal/Tax Support for China's Outbound Investment

4.1.2.1 Increase Fiscal/Tax Policy Support for Outbound Investment in Major Sectors

Increase Support for Outbound Investment in Outbound Investment in the Energy and Resources Sectors

First, the Chinese government should increase financial contributions to expand the size of overseas energy and mineral resources exploration funds and improve the management of such funds. This will allow the sharing of risks with Chinese enterprises in such sectors, especially in terms of taking on the early and highest exploration risks. Specifically, the Chinese government should bear all the costs and expenses for early resources exploration, before subsidizing relevant enterprises to take on prospecting in selected mineral deposits. Losses arising from risky exploration should be recovered by the government's risk fund, repayments to which should be made from corporate incomes after the exploration becomes successful. This risk fund may target either preparations (i.e. early project research, feasibility research and bids) or accidents that occur during operations after relevant projects are launched.

Second, the Chinese government should improve tax policies regarding overseas investment projects in the fields of energy and resources development. It is recommended that the Chinese government exempt the repatriated portion of foreign incomes of Chinese taxpayers resulting from investments in crude oil exploration and development, mining, timber, non-ferrous metals and other scarce resources, from domestic income taxation for a certain period of time -with approval from the competent tax authority. In other words, the taxation of foreign investment incomes in these sectors should be calculated with the so-called multi-layer indirect tax credit. With regard to tax incentives for companies in the energy and resources development sectors outside China, the China-made machinery, equipment, parts/components, and investments-in-kind should be deemed exports, and accordingly, should be eligible for the export tax rebate. With regard to value-added tax (VAT), primary products from overseas oil development by Chinese enterprises should be eligible for VAT reliefs. Income from overseas resource development by Chinese enterprises should be free from being re-examined and Chinese enterprises should not be liable for any payment of the difference between income tax paid in the source country and that of the domestic tax regime. In addition, the Chinese government should step up efforts to sign bilateral tax, investment protection and judicial assistance treaties with relevant countries with natural resources. Up to now, China has signed double taxation avoidance agreements (DTAs) with 96 other countries. China's competent fiscal and tax authorities should sign relevant agreements with all energy exporters as soon as possible.

Increase Fiscal and Tax Support for Outbound Investment in Strategic Emerging Industries

Strategic emerging industries mainly include energy conservation and environmental protection, new energy sectors, new-generation IT, biotechnology, high-end equipment manufacturing, new materials and new-energy vehicles. In order to promote outbound investment in these industries, relevant Chinese organizations need to understand the latest characteristics of economic globalization, aggressively explore new ways of cooperation, accurately position and orient themselves in relevant fields, and participate in international cooperation at higher levels, thereby increasing their capacity and core competitiveness in strategic emerging industries. In addition, the Chinese government must improve its fiscal, tax and financial policy support system, in order to better guide, support and encourage private capital to invest in these industries.

First, the government should increase fiscal support. With the goal of consolidating existing policy incentives and funding approaches, the Chinese government should use public money to set up funds specific to outbound investment in strategic emerging industries, establish a stable fiscal investment increase mechanism, and increase guidance and support. The central government should increase fiscal investment, provide support in innovative manners and focus on supporting outbound investment in areas such as major industrial innovation development projects, the industrialization of major innovations, and demonstrative projects regarding important applications. Also, the Chinese government should enhance performance assessment on fiscal policies and improve the fiscal fund management mechanism, thereby making more efficient and effective use of the aforementioned funds.

Second, the Chinese government should improve tax incentives. While still fully implementing the existing tax policies for the growth of high-tech industries, the Chinese government should conduct research on how to improve tax incentives for outbound investment in strategic emerging industries, with an orientation toward reform of the tax regime and tax categories. All seven of the strategic emerging industries have close ties with high technology, which in turn are characterized by high investment risks, especially when it comes to outbound investment. Accordingly, the Chinese government should focus relevant tax incentives on reducing risks against outbound investment in the high-tech field and in strategic emerging industries. To this end, the Chinese government should refer to the practice of the Japanese and French governments – they set up industry-specific risk provisions for overseas investments – and establish a risk provisions system for the potential losses of overseas investments in strategic emerging industries. Under this risk provision system, Chinese enterprises should be allowed to draw a certain percentage of their overseas investments in these industries, include them in their current period expenses, and deduct them before tax.

4.1.2.2 Improve the Corporate Income Tax Regime for Outbound Investment

Improve the Method for Calculating Taxable Foreign Income

With regard to the principle of calculating foreign income, current tax laws and accounting principles vary from country to country in terms of determining taxable income and deducting costs and expenses before tax. Chinese enterprises that invest overseas would be significantly inconvenienced if relevant taxation issues were handled solely under China's accounting principles and tax law. With respect to provisions on how to determine taxable corporate income, we recommend that the tax regime and accounting principles of the host country (i.e., the country in which branch organizations of relevant Chinese enterprises are located) be respected as long as it is not a tax haven or low-tax jurisdiction. The before-tax profits of overseas organizations should be used as the basis for taxable income, with adjustments allowed only for important provisions such as impairment of assets. In addition, the government of the host country may require the withholding of income tax in cases where Chinese companies sell and install mechanical equipment during the course of the outbound investment. From a tax-treaty perspective, the power of a host country to levy taxes depends on duration provisions of the tax treaty specific to whether construction businesses constitute permanent establishments. For the purpose of preventing double taxation on enterprises, the Chinese government should grant tax credit to enterprises that have had income tax withheld by the host country government -as long as they can provide evidence- on the precondition that the enterprise has made an application to initiate a mutual agreement procedure (MAP) or filed an administrative review action or lawsuit in the host country.

Taxable income should be limited to returns on overseas equity investments of resident enterprises, such as dividends and bonuses, as well as foreign income such as interest, rents, royalties and the transfer of assets, less reasonable costs and expenses relevant to the obtaining of these incomes that are calculated according to China's enterprise income tax law and corresponding implementation rules. The date on which returns on overseas equity investments -such as dividends and bonuses- are realized should be when the investee decides how to allocate relevant profits. The dates for when foreign income–i.e., interests, rents, royalties and the transfer of assets-is realized should correspond with agreed-upon dates for the payment of transaction prices, as specified in relevant contracts.

When calculating taxable foreign income, common expenses incurred by relevant enterprises inside and outside China in order for them to obtain domestic and foreign incomes, plus the reasonable portion relevant to the obtaining of taxable foreign income, should be apportioned between taxable domestic and foreign incomes on a reasonable pro-rata basis before being deducted. When calculating taxable foreign income, the losses of overseas branches set up in the same foreign country and without independent tax status, calculated according to China's enterprise income tax law and the implementation rules, should not be deducted from the relevant enterprise's taxable incomes inside or outside China, but should be allowed to be made up for, as required, with other income from the same country or with income realized in following years.

Further Increase Tax Incentives for Outbound Investment by Enterprises

First, the Chinese government should amend the provision in the current domestic tax law that taxes may be spared unilaterally. Instead, the government should adhere to the principle of mutually granting tax sparing in order to safeguard Chinese interests in terms of taxation. Second, the Chinese government can learn from the practice of the Japanese government and set up a risk provisions system for overseas investments, with a reduction in the percentage of provisions to 15 % for general overseas investments and 20 % for investments in resources development, for example. Any losses of overseas investments incurred by enterprises may be compensated under the provisions for risk; otherwise, the remainder of the provisions should be merged, from the 6th year onward, into taxable income annually for 5 years.

Further Refine Policies for Indirect Credit

First, with regard to operating profits earned by enterprises outside China and dividends eligible for indirect taxable foreign income credit, if the statutory and effective tax rates or indirect tax burden in the income source country are higher than the ones in China, then the amount of taxable foreign income and the creditable limit calculated under the tax rate specified in China's enterprise income tax law, should be used directly as the amount of creditable corporate income tax that has been paid outside China. Second, with regard to limitations on the percentage of shareholdings, it is recommended that the globally accepted 10 % be employed in China's domestic law so as to be consistent with tax treaties signed by the Chinese government. This will also help encourage Chinese enterprises to set up subsidiaries and pursue M&As outside China, in particular.

Lastly, with regard to the layers of indirect credit, fewer layers favor taxation, according to the current taxation capacity of the Chinese government. Given China's current outbound investment status, however, medium-size and large Chinese enterprises with overseas operations consist of multiple layers – as many as five in some large SOEs- for reasons such as foreign exchange management. To effectively reduce the tax burden on enterprises that invest overseas, it is recommended that no limitation on indirect credit layers be imposed. Instead, stringent limitations on the percentage of interest between the intermediate layers should be imposed – it must be 100 % and the final percentage of shareholdings must be at least 10 %. In terms of calculation methods, simple multiplication should be used if the holding percentage in an overseas subsidiary that is wholly owned through multiple layers does not exceed 50 %.

4.1.2.3 Improve Taxation Measures for Outbound Investment

To facilitate tax declaration by Chinese enterprise with overseas operations, the tax authority needs to continue improving specific taxation measures, with a focus on standardizing issues regarding foreign income earned by these enterprises. Such issues for standardization include content, modes, responsibility for providing evidence, the main tax return, schedules, attached documents, the CPA's report and penalty rules for failure to declare as required. The main tax return may be designed depending on the type of overseas investment; the schedules based on the type of foreign income; the attached documents based on the type of investment destination (e.g., tax haven or otherwise); and the country requirement for the CPA who issues the CPA's report based on the availability of CPAs for tax purposes in the investment destination.

It is necessary to impose reasonable regulations on overseas tax payments in accordance with domestic requirements for tax credit applications and the status of tax-relevant laws in the host country. Taxpayers should be allowed to provide photocopies of overseas tax payment receipts as the documents for applying for tax credit and, if they are truly unable to provide such receipts, declare taxable foreign income by means of deduction verification. Overseas tax payment receipts, or overseas tax payment itself, may be authenticated by means such as a CPA's report, international tax information exchange and mutual tax assistance. The Chinese government should establish a tax registration system specific to overseas investment activities. Chinese enterprises should take relevant documents, report to the competent local tax authority and go through procedures to change or cancel tax registration within 30 days of any equity change or other important tax-relevant change related to their subsidiaries or branches outside China. The required relevant documents should satisfy taxation requirements, on the one hand, but also be within the scope of what taxpayers are able to provide, on the other.

The Chinese government should establish a system to analyze and assess sources of taxes outside China. When major anomalies are discovered through this system, the competent tax authority should be allowed to initiate tax-auditing procedures. Specifically, this tax authority may conduct domestic auditing on its own and have a legal tax notary service provider, inside or outside China, carry out overseas auditing. There should be unified standards in China for how to initiate and carry out tax auditing relevant to the administration of tax sources outside China.

4.1.2.4 Enhance International Taxation Cooperation

It also is very important to enhance international cooperation so as to create a good external tax environment for enterprises with overseas operations. This is critical to promoting the growth of Chinese enterprises in the field of overseas investment and cooperation.

The Principle and Overall Arrangement for Enhancing International Tax Cooperation

The principles for enhancing international tax cooperation should be based on the following: enhancing mutual tax assistance to address discrimination against Chinese resident enterprises in the host country or other taxation behavior that does not comply with the tax treaty; preventing tax treaties from being misused; avoiding the negotiation or signing of tax treaties with low-tax jurisdictions or potential tax havens whenever possible; making timely modifications to tax treaties with these problems; and increasing information exchange to prevent international tax evasion.

The overall arrangement for enhancing international tax cooperation should include several initiatives. First, China should conduct new negotiations and sign treaties. Chinese enterprises already have a presence in a large number of countries and regions; Altogether, China has signed tax treaties or negotiated tax arrangements with 96 countries and regions to date. Going forward, China should focus on negotiating with African and Latin American countries of economic and strategic significance for China. Specifically, it should offer to negotiate with these countries, properly prioritize relevant negotiations, and make them more efficient and effective.

In addition to negotiating new treaties, China should also seek negotiations to amend select existing treaties in order to accomplish the following: modify provisions in these treaties that no longer suit China's current needs and requirements; update relevant content; introduce provisions against the misuse of treaties; and prevent situations that allow MNCs to take advantage of treaty provisions for tax planning or tax avoidance. The Chinese government should focus such amendments on adding provisions regarding tax sparing, tax categories eligible for tax credit, and non-discriminatory treatment. With respect to treaties it has signed with low-tax jurisdictions and potential tax havens, the Chinese government should redefine powers to levy taxes on the part of the source and home countries by negotiating and signing protocols or conducting additional negotiations. The Chinese government should also enhance information exchange to prevent the misuse of relevant treaties.

Third, the Chinese government should consider creating a multilateral tax cooperation mechanism to eliminate regional double taxation. In other words, the Chinese government should sign regional multilateral DTAs for particular tax categories highly relevant to the movement of production goods and factors, such as income, commodity, social security and property taxes. China and the ASEAN member states may develop methods of eliminating regional double taxation by referring to the practice in Northern Europe.

Deepen and Widen International Tax Cooperation, and Enhance Consultations and Enforcement Regarding International Tax Treaties

The Chinese government should study the possibility of conducting tax assistance in China, and negotiate and sign agreements on tax collaboration, simultaneous examination and visits of authorized representatives, in order to deepen and widen international tax cooperation. It should also sign regional multilateral treaties for preventing international tax evasion and avoidance, and establishing an intraregional multilateral tax information sharing mechanism. Such treaties should provide that the member states be liable for exchanging tax information and must establish a tax information exchange regime, thereby gaining a timely understanding of, and conducting enforcement against, intraregional tax crimes and avoidance. It is necessary to establish a mutual tax assistance mechanism and sign a draft agreement on regional mutual tax assistance to allow member states to conduct particular taxation activities on each other's behalf, such as sending tax notices, and taking tax preservation measures against relevant taxpayers and properties before tax liability is determined, thereby enhancing tax assistance between the member states. It is advisable to improve approaches to the resolution of tax disputes and make increased use of arbitration procedures. A consultation mechanism between the member states may be launched to address disagreements regarding taxation on international taxpayers, the identification of destructive tax competition, international double taxation, transfer pricing taxation, and thin capitalization.

It is necessary to enhance consultations on and enforcement of international tax treaties. The Chinese government should pursue the following: aggressively conduct consultations on international tax treaties; comprehensively analyze and sort through the signed treaties; conduct investigations and research in order to make interpretative provisions and clarify enforcement with respect to specific articles in relevant treaties/agreements; organize enforcement training of relevant treaties/agreements in order to avoid local differences in enforcement; research the applicability of and potential problems with articles in the signed treaties/agreements; make consultation plans to address specific problems; clarify China's position and principles and conduct negotiations with the other contracting states to modify and update the treaty/agreement; and enhance investigations on the misuse of international tax treaties through tax havens. Since Chinese tax authorities at all levels are far from having made enough efforts in examining foreign tax regimes, it is imperative to establish an efficient foreign tax regime examination system. It is recommended that the foreign income administration department of SAT be responsible for gathering information on the tax regime in relevant investment destinations, assessing and monitoring the characteristics of tax regimes and the levels of tax burdens in relevant countries or regions, and releasing examination results in a timely manner. In addition, there are now a wide variety of invoices in China, causing problems with their acceptance outside China. The Chinese government should therefore further standardize invoices to effectively solve this problem.

4.2 The Financial System

4.2.1 Current Financial Policies for China's Outbound Investment

In 2003, MOFCOM partnered with other ministries/commissions to promulgate the *Notice on Policy Issues Relevant to Furthering Support for Enterprises' Investment and Cooperation in the Field of Resources Development in Africa*, announcing that they would increase policy-based funds to support enterprises' investment and cooperation in the field of resources development in Africa. In October 2004, the NDRC and the China Exim Bank co-issued the *Notice on Providing Credit Support for Major Overseas Investment Projects Encouraged by the State* [FGWZ (2004) No. 2345], making clear that they will jointly establish a credit support mechanism for outbound investment in order to provide annual loans specific to outbound investment. Under the state's outbound investment program, the China Exim Bank will arrange credit funds of a certain size in its annual export credit plan to support major overseas investment projects encouraged by the state. Loans specific to outbound investment are also eligible for the Exim Bank's preferential export credit rate. This document also outlines the types of major overseas investment projects that these loans are intended to support and the application procedures for these loans.

On September 25, 2005, the NDRC and the China Development Bank (CDB) co-issued the *Notice on Issues Relevant to Furthering Financing Support for Major Overseas Investment Projects* in order to encourage domestic enterprises to further strengthen their financing capacity and to aggressively participate in major overseas investment projects by taking advantage of respective support measures. This document provides that, under the state's outbound investment program, the NDRC and CDB will make annual plans to provide financing support for major overseas investment projects and that the China Exim Bank will arrange loans of a certain size in its annual equity loan plan to provide support for an increase in the capital of major overseas investment projects encouraged by the state, and also for enabling relevant enterprises to strengthen their financing capacity.

In addition to the aforementioned documents, MOF and MOFCOM co-issued the *Notice on Issues Relevant to Providing Support for Early Expenses of Overseas Investment and International Economic Cooperation Projects in the Field of Resources Development* and a supplementary notice, which made provisions for early-expense support for international economic cooperation projects in the field of resources development.

To assist Chinese enterprises in addressing difficulties related to follow-up financing for overseas investment projects, SAFE launched a pilot external guarantee program under the Global Credit Line at the BOC in April 2001. SAFE then approved the ICBC to provide this service in March 2005, before rolling out the program across China based on the results of the pilot program.

In 2005, SAFE issued the *Notice on Adjusting the Way of Administering Domestic Banks' External Financing Guarantee for Overseas Investors*, which adjusted the way of administering domestic foreign exchange banks' external financing guarantee provided to Chinese overseas investors from an approval system on a per-case basis to a system of annual remainder management. There are four main aspects to this adjustment. First, following an application from a bank, SAFE determines an annual remainder target for an external guarantee based on the current guarantee status for Chinese outbound investment, the bank's financial indicators such as its balance sheet, and the status of the external guarantee service and contract performance in the previous year. Second, the bank may provide overseas investors with an external financing guarantee within the approved limit, instead of reporting to SAFE for approval on a per-case basis. Third, domestic banks qualified to provide the external guarantee service and their authorized bank branches are entitled to provide this service. Fourth, after providing an external guarantee, the bank as the guarantor should go to the local foreign exchange administration for regular external guarantee registration under the *Measures for Administering External Guarantee* *by Domestic Organizations* and its corresponding implementation rules. The performance of external guarantee contracts requires verification by the local foreign exchange administration. The bank needs to go through relevant purchase procedures if contract performance involves the purchase of foreign exchange with renminbi.

With regard to administering special funds for international economic and technological cooperation, MOF and MOFCOM co-issued the *Notice on Applying for Special Funds for International Economic and Technological Cooperation* in May 2011, which clearly outlined the focus of such cooperation projects as follows: overseas R&D center and equipment manufacturing projects implemented by Chinese enterprises through direct investment; projects implemented in overseas economic and trade cooperation zones; overseas agricultural, forestry and fishing cooperation projects; overseas contracted projects implemented by Chinese enterprises that are on a franchise basis, that employ Chinese project and technical standards, or that are priced in renminbi. Special fund support for international economic and technological cooperation includes direct subsidies and loan interest discounts:

First, direct subsidies mainly cover: early costs and expenses, including legal, technical and business consulting fees, survey and examination expenses, project feasibility research and safety/security assessment report writing expenses, and purchase and translation costs of standards/bid documents; transportation and insurance costs for transporting resources back to China, including agricultural products (i.e. soybeans, corn, wheat, natural rubber, palm oil, cotton and cassava), forestry (including logs, lumber and panels) and fish products produced within an overseas resource development project of a Chinese enterprise (subsidies will cover no more than 20 % of the actual transportation and insurance costs paid by these enterprises); accidental injury insurance for Chinese employees involved in the implementation of the "go global" strategy. For example, overseas Chinese employees of enterprises that carry out economic and technological cooperation outside China will receive subsidies for accidental injury insurance purchased from relevant insurers that have a limit of no more than 500,000 yuan worth of benefits per person and support no more than 50 % of the actual premium; expenses arising from the handling of sudden events outside China, including those related to passports, visas, international transportation and temporary overseas trips of corporate employees who handle such events; expenses arising from the registration of patents by overseas R&D centers of Chinese enterprises, with subsidies amounting to no greater than 50 % of the actual registration cost; and expenses related to adaptation training for workers sent abroad, with subsidies of no more than 500 yuan per worker.

Second, loan interest discounts refer to 1-year or longer term loans from domestic banks available to Chinese enterprises for the operation of overseas investment projects, overseas agricultural, forestry, fishing and mining cooperation, overseas contracted projects, and overseas design and consulting services. The discount rate for renminbi loans is no more than the benchmark interest rate released and enforced by the PBC or the actual interest rate, whichever is lower; the annual discount rate of foreign-currency loans is no more than 3 % or the actual interest rate, whichever is lower.

4.2.2 Improve the Financial Support System for China's Outbound Investment

4.2.2.1 Promote Bank-Enterprise Cooperation and Financial Innovation

In order to improve the financial support system for outbound investment, the Chinese government should first undertake the following: promote cooperation between enterprises that invest or have contract projects overseas and worldwide financial institutions; encourage relevant banks to engage in credit risk management for these enterprises; and establish an information sharing system between the banks and the enterprises, enabling the former to offer credit lines corresponding to the credit ratings of the latter. The banks should seek to provide enterprises with more convenient services, such as guarantee-free security and loans, within the credit limits. For select extra-large projects, a particular bank may take the lead in organizing syndicated loans, or the bank may team up with the enterprise to bid for overseas projects, co-manage the project and share relevant benefits/risks with the latter. This will allow the bank to participate in a prospective overseas project at an earlier phase than usual.

Second, the Chinese government should: capitalize on and disseminate knowledge learned from the experience of developed countries in project financing and guarantees; encourage financial institutions to make financial innovations; allow overseas investors to take rights/benefits in relevant projects themselves as security; encourage relevant banks to provide new financial products that suit outbound investment and project contracting; conduct worldwide pilot financing programs for large-scale projects eligible for state support; provide better policies with respect to security for loans, streamlined procedures and the purchase and use of foreign exchange.

4.2.2.2 Establish a Multi-level Overseas Investment Guarantee System

The Chinese government should undertake the following: accelerate the establishment of a multi-level guarantee system comprising public and private funds; enable the rapid development of small- and medium-sized financial institutions and new financial services; make comprehensive use of preferential fiscal policies such as risk compensation in order to encourage financial institutions to increase support for outbound investment by Chinese enterprises; and set up a risk fund and provisions for outbound investment in the energy sector in order to share risks with petroleum companies with respect to overseas investment and exploration, and to compensate them for project failures. Such a risk fund may target early project research, feasibility research, bidding and other preparations, or accidents after relevant projects are launched. In addition, the Chinese government should: further prevent overseas credit risks; help Chinese enterprises that invest overseas to become more aware of risks and prevent such risks in overseas investment activities; encourage relevant organizations to maximize the use of insurance instruments by providing a full range of risk protection and information management/consulting services for the development of overseas markets and outbound investment.

4.2.2.3 Combine Policy-Based Financing with Commercial Financing to Increase Financial Support for Outbound Investment

It is necessary to further utilize policy-based financial services to enable overseas investment, especially by more closely combining policy-based financing with commercial financing. The competent Chinese authorities should work to establish a system in which policy-based trade financing guides commercial financing, and in which policy-based credit services for outbound investment stimulate the growth of their commercial counterparts. Both policy-based and commercial financial institutions should continue to increase financial instruments to support overseas investment and to satisfy outbound investors' growing demand for financial services.

4.2.2.4 Focus Financial Support on Important Projects in Energy/Resources Development and Strategic Emerging Industries Outside China

Nowadays, China faces severe shortages of energy and resources, making it necessary to increase policy support for Chinese enterprises that explore and develop energy and resources outside China. The NDRC, MOFCOM and policy-based banks such as the China Exim Bank and the CDB should research and develop relevant policies to increase financial support for important projects.

Financial support for major overseas investment projects should focus on the following key areas: energy and resources development projects that help alleviate the shortage of resources in China; production and infrastructure projects that stimulate the export of technology, products, equipment and labor services from China; R&D center projects in which world-leading technology, managerial experience and human resources are used; M&A projects that enable Chinese enterprises to become more competitive worldwide and accelerate the development of the international market.

Overseas investors and contractors that implement important projects should be given proper preferential treatment in terms of loan interest and premium rates, or higher policy-based loan interest discount rates with extended discount periods. Additionally, the percentage of the government's special loans for outbound investment that enterprises are allowed to use should be further increased. The Chinese government should increase financial policy support for overseas investors in terms of loans, insurance, guarantees, the use of foreign exchange and tax rebates whenever possible. Unnecessary regulations should be abolished; the use and outbound remittance of foreign exchange should be more convenient; relevant organizations should step up developing products in the foreign exchange market to enable outbound investors to more easily avoid risks relevant to exchange and interest rates. The Chinese government should encourage domestic financial institutions to set up and develop overseas branches and make full use of regional financial platforms to provide Chinese enterprises with convenient financial services for their international operations. The NDRC and the China Exim Bank should co-establish a credit support mechanism for outbound investment. Under the state's outbound investment program, the China Exim Bank should arrange credit funds of a certain size in its annual export credit plan to support major overseas investment projects encouraged by the state in the energy, resources and strategic emerging industries. Investment projects in these industries should be eligible for preferential loan interest rates supplied by the export credit plan of the China Exim Bank. Domestic commercial banks and energy/resource companies should be encouraged to work more closely with each other in the development and utilization of overseas resources. As an example, they may co-establish companies to invest in such development activities. Various funds and insurers should be allowed to invest in overseas energy and resources development projects, and conversely, energy companies should be encouraged to find more sources of funds for their overseas energy and resources investment projects, including financing methods such as issuing bonds and going public. In the meantime, relevant financial institutions should be guided toward building credit management and loan assessment systems that suit the characteristics and needs of strategic emerging industries. It is also necessary to promote financial innovation such as IP-based and industry-chain financing.

4.2.2.5 Expand the Scope of Financial Institutions Permitted to Support Outbound Investment and Their Services

The China Exim Bank and the CDB are the current policy-based Chinese financial institutions responsible for promoting outbound investment by domestic enterprises. Both banks are wholly state-owned, but have limited loan sizes available for overseas investment, making it difficult for them to satisfy the corporate demand for increasing overseas investments. It is therefore recommended that the Chinese government enlarge the scope of financial institutions permitted to provide financial support by means of loans to include commercial banks, whether state-owned or otherwise. The Chinese government should also allow such financial institutions to enlarge the scope of their services in order to further strengthen financial support for outbound investment, in accordance with the success of the Japanese experience in promoting the growth of outbound investment.

4.2.2.6 Bring the Function of Capital Markets into Full Play

The function of capital markets with respect to financing and the development of equity investment funds should be maximized so as to fuel the growth of enterprises that invest overseas. Such enterprises should be encouraged to find more sources of funds for their overseas energy and resources investment projects, including financing methods such as issuing bonds and going public. The Chinese government should improve the growth enterprise board to support the public offering financing process for compliant outbound investors. The Chinese government should also: promote the development of the over-the-counter securities market to satisfy the needs of overseas investors in different stages of growth; improve the mechanism for shifting between different boards in order to gradually achieve organic linkage between capital markets at different levels; develop the bonds market by allowing overseas investors to issue more joint bonds and instruments; and assist insurance companies, social security funds, corporate annuity managers and other institutional investors in participating in Chinese MNC investment projects and equity investment funds, as long as risks are under control. Moreover, the Chinese government is far from providing sufficient financial support for outbound investment by small and medium enterprises (SMEs) compared to Western developed countries. The Chinese government should increase financial support for SMEs, and encourage and assist them in investing overseas.

4.2.2.7 The Internationalization of the Renminbi

The internationalization of the renminbi would facilitate China's outbound investment and reduce costs and risks for overseas investors. Outbound investment, in turn, helps further promote the internationalization of the renminbi. From a functional perspective, international financial transactions that are priced in renminbi and large-scale outbound FDI in the form of renminbi assets are important symbols of the internationalization of the renminbi. From an inflow vs. outflow perspective, having an efficient financial market for renminbi-priced assets as well as outbound investment in the form of renminbi assets are mechanisms that are mutually conditional and facilitative. To this end, it is necessary to enhance currency cooperation in East Asia, establish offshore renminbi markets, and promote the use of renminbi in international settlements, in order to gradually achieve the internationalization of renminbi.

Chapter 5
The IP/Standards Subsystem

In today's age where the knowledge economy and information technology play dominant roles, intellectual property rights and technical standards have become the focus of international competition and serve as strategic resources for the economic, technical, investment and trade development of each country. Developed countries are aggressively implementing IP- and standards-relevant strategies to maintain their leading competitive position in the technology field, which poses challenges for Chinese enterprises as they go global in terms of intellectual property and technical standards. With respect to IP, great changes are occurring to international IP rules – there is an apparently accelerating trend of IP internationalization. Global challenges such as the financial crisis and climate change also are posing new challenges for the IP system, and developed countries are further enhancing IP protection in an effort to turn advantages in innovation into competitive advantages in global markets. With respect to standards, developed countries have taken a competitive approach characterized by patented technologies, the conversion of patents into standards, and monopoly over standards, while also working to gain or hold a dominant position in the development of international standards, thereby maximizing their interests through a combination of IP with standards. At a time when China is becoming increasingly integrating into the international community in the field of IP and standards, researching how to define China's IP- and standards-relevant strategies will have important and far-reaching effects on promoting technological advancement, regulating markets, increasing the global competitiveness of relevant industries and products, and fueling outbound investment by Chinese enterprises.

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5.1 Enhancing International IP Protection

In 2010, China ranked second in the number of patent applications and first in the number of trademark registrations in the world. In 2011, ZTE Corporation became the world-leading company in terms of the number of patent applications, and Huawei ranked third. This indicates that Chinese enterprises have become aggressive in protecting their IP and that China is in urgent need of enhancing international IP protection. In May 2012, IP protection was the issue of focus at the Fourth Round of the U.S.-China Strategic and Economic Dialogue (S&ED). Unlike the past, IP protection is no longer an issue in which the United States presses China, but is a common concern for both countries.[1] In the process of going global, Chinese enterprises have faced increasing challenges related to IP protection in China, mainly including: the insufficiency of the Chinese IP system to satisfy the needs and requirements of developing sciences and technologies; a continued lack of an IP management system for coordination among enterprises, universities, research organizations and users that may have weak capacity for IP operations; gaps in the IP protection system, including insufficient law enforcement efforts; insufficient capacity of the IP service system and development of relevant human resource needs to meet the requirements for economic and social development; low IP awareness across society; and insufficient capacity with respect to international IP protection. To suit the situation and requirements of today's new information age, China must make breakthroughs and innovations in major fields in order to step up China's development into a world power in the area of IP. In order to increase the global competitiveness of Chinese enterprises and the core competitiveness of the country, relevant government authorities should make significant efforts in achieving the following: implementing a national IP strategy and continuously improving the legal system for IP protection; creating an atmosphere in which IP can flourish; improving IP creation, application and management; strengthening international IP protection; maximizing the use of the IP system to increase the global competitiveness of Chinese enterprises; and providing strong outbound support of Chinese enterprises.

5.1.1 Enhance the IP Management System

5.1.1.1 Raise IP Management to a Higher Level

With regard to IP management, the Chinese government made a significant move in 2008 by establishing an IP steering group led by a vice premier of the State Council, as part of the development of the *Outline of the National IP Strategy*. This being said, the annual *Promotion Plan for the Implementation of the National Intellectual*

[1] The *Economic Information*, May 4, 2012, p. 3.

Property Strategy, which was first made in 2009, is instead formulated by the Inter-Ministerial Joint Meeting for Implementation of the National Intellectual Property Strategy, which is at a lower level than the aforementioned steering group. This is in contrast with the situation in Japan, in which the annual IP promotion program is formulated by the Intellectual Property Strategy Headquarters, headed by the Japanese Prime Minister himself. With another state minister as the deputy head, all the other state ministers as well as persons appointed by the Prime Minister are able to contribute to IP creation, protection and application through this body. Accordingly, Japan's IP promotion program is made and implemented with legal support led by the Japanese Prime Minister. Given the lack of a basic law regarding IP, China's IP promotion plan would be implemented much more efficiently and effectively if it was made and implemented by a steering group set up by the State Council.

5.1.1.2 Create a High-Level, Authoritative Mechanism for Coordinating with IP Authorities

With regard to joint law enforcement and coordination efforts related to IP protection, organizations responsible for this mission in the United States, Japan and South Korea, for example, have something in common – they are all co-established by national IP authorities and, hence, are highly authoritative – despite having different names. In contrast, the existing IP administration system in China is fragmented and lacks a coordination mechanism, as exemplified by such problems as the coexistence of multiple authorities, functional overlap, inefficiency and conflicts of power. Such an IP administration system is prone to internal power struggles between central and local legislators, irresponsibility and low quality of legislation. In real-world operations, disagreements on issues such as legal grounds and law enforcement entities are very likely to bring about an administrative law crisis and higher social costs. This has become an institutional obstacle to IP administration and law enforcement in China. At this time, China is far from meeting its objective to "deepen the reform of the IP administration system" proposed in the *Outline of the National IP Strategy*. The Chinese government, therefore, needs to seek a method of coordinating IP authorities in terms of administration and law enforcement on the condition that the existing IP administration system cannot be changed. In other words, the Chinese government should address conflicts of power and buck-passing between relevant authorities and minimize law enforcement by multiple government departments, thereby achieving the goal of coordinating joint IP law enforcement. To this end, the Chinese government may set up a national IP administration coordination commission under the direct leadership of the State Council, and treat it as a national organization responsible for coordinating joint law enforcement activities by IP authorities. With authority from the top, such a high-level coordinator would be better able to unify and coordinate the joint law enforcement activities of IP authorities.

5.1.1.3 Set Up a Professional and Efficient Joint Law Enforcement Team

With regard to joint law enforcement teams, Western developed countries tend to set up such teams in order to consolidate law enforcement resources against violators of IP laws and counterfeiters nationwide, with very significant effects. This is in stark contrast to China, where IP administration and law enforcement entities include the IP, trademark, copyright, public security and customs authorities under a fragmented IP administration system. Each authority has its own law enforcement team with a full range of departments, despite the small sizes of some the agencies to warrant such resources. Due to a lack of communication and coordination with each other, these authorities find it difficult to tackle increasingly complex and hidden IP infringement and violation of IP laws worldwide. Such decentralized law enforcement is not only unable to effectively fight IP-related crimes and infringement, but also wastes limited, valuable law enforcement resources. The current setup significantly reduces the efficiency and effectiveness of joint law enforcement by IP authorities. The Chinese government should therefore consolidate the law enforcement teams of different IP administrations into a professional and efficient joint IP law enforcement team as part of its efforts to strengthen IP law enforcement.

5.1.1.4 Build a Smooth and Convenient IP Law Enforcement Information Sharing System

Efficient joint IP law enforcement requires a smooth and convenient information exchange and sharing mechanism. Currently, Chinese IP law enforcement entities generally exchange information through interdepartmental agreements or joint meetings only in the course of conducting joint law enforcement activities. Such an information exchange mechanism is only applicable in an extremely limited number of situations. Generally, there is a lack of deep, wide and timely information exchange and sharing in cases where it is necessary for multiple authorities to jointly fight IPR infringements and other relevant crimes. For example, the Chinese IP administrations collect information on IP rights holders, including registered patents and trademarks, but the public security authority has no regular or fast access to such information. Conversely, the public security authority has information on IPR infringements obtained through investigations, but the IP administrations in turn have no regular or fast access to this information. Such a poorly coordinated, fragmented information exchange mechanism has not only made it impossible for IP law enforcement to share information with relevant authorities, but also has led to duplicative efforts by different functional departments in handling a single case of IPR infringement, which of course lowers the efficiency of law enforcement. It is therefore imperative to use networking technologies in order to build a smooth and timely IP law enforcement information sharing mechanism, to facilitate digital information exchange between the IP administrations and other law enforcement entities, and to increase methods of sharing law enforcement information. These steps will thereby ensure that relevant information is transmitted in a timely, convenient and smooth manner and allow the advantages and resources of the various IP and enforcement authorities to be fully shared.

5.1.1.5 Improve the IP Legal System

Chinese legislators should accelerate efforts to make, amend and improve IP-related laws. Specifically, they should accelerate the process to amend China's *Trademark Law*, the *Law against Unfair Competition* and the *Regulations on Patent Commissioning*; make timely amendments to the *Copyright Law* and relevant administration laws/regulations, as well as the *Regulations on National Defense Patents*; amend the *Regulations on Protection of New Varieties of Plants*; and implement new laws including *Regulations on Protection of Copyrights to the Works of Folk Literature and Art* and the *Regulations on In-service Technological Achievements*. It also important for the Chinese government to further improve the IP legal system related to the Internet; strengthen research on laws regarding the protection of genetic resources and traditional knowledge; publish documents in a timely manner for the purpose of judicial interpretation or standardization, such as the criteria for hearing cases involving online copyrights or the granting or authentication of rights to patents.

5.1.2 Improve the IP Support System

5.1.2.1 Increase the Linkage Between IP and Other Policies

It is necessary to promote the creation and application of IP using fiscal, tax, financial, technology, investment and trade policy levers. The Chinese government should undertake the following: make IP policies that suit the growth of strategic emerging industries and traditional industries in important fields, thereby guiding innovators to gain strategic IP positions in these industries; enhance the capacity and build a relevant policy system for administering technological innovations and IP; improve the national technological development program, the IP administration system for major national technological projects, and the industrial IP work mechanism; prevent the misuse of IP so as to protect fair competition in the market and the public interest. Additionally, it is advisable for the Chinese government to improve region-specific IP policies and enhance category-specific guidance to fuel the development of regional economic innovation; research and develop rules and remedies for IP protection systems relevant to outbound investment and foreign trade; build and improve the IP statistical monitoring system; improve the IP review mechanism for major economic activities; enhance IP analysis and warning mechanism in the field of strategic emerging industries; improve and disseminate instructions to guide analysis and warning criteria to adapt to market demand; identify regions and sectors with strong demand as pilot areas for carrying out IP analysis, warning and review; promote the creation of an IP review mechanism for major economic activities, thereby preventing and reducing IP-related risks.

5.1.2.2 Encourage IP Creation and Application

The Chinese government should help enterprises and institutions to better use the IP system, encourage enterprises to implement an IP strategy, and provide SMEs with better guiding policies and information services related to IP. Moreover, the government should further improve corporate IP management specifications; promote the building of an IP asset valuation and accounting system; build an IP creation and operation system that covers enterprises, universities, research organizations and users; improve and implement tax incentives for IP transfer and licensing; implement financial policies that encourage innovation, such as the use of IP as security for loans, thereby facilitating the shift of funds, HR, technology and IP into enterprises; and support the formation of alliances between enterprises, universities, research organizations and users in important sectors and fields of technology, thereby stimulating IP creation and commercialization through technological innovation, IP cooperation and standards development. In addition, the Chinese government should set up funds specific to IP operations that are led by the state and include participation by various relevant organizations, thereby promoting the application of IP held by universities and research organizations; conduct pilot and demonstrative IP application projects; promote the commercialization of IP; assist in creating globally renowned brands; promote the growth of copyright-relevant industries; build industrial centers to encourage the conversion of IP into products; promote IP asset valuation and conduct pilot projects regarding the use of IP as security for financing; and protect and promote the development of time-honored Chinese brands.

In addition to the recommendations mentioned above, the Chinese government should also promote the growth of enterprises with IP-related advantages; develop and improve criteria for identifying such enterprises; identify a number of industry-leading enterprises, medium and large industrial enterprises, fast-growing high-tech companies, and competitive technology SMEs, and set up special phase-by-phase development plans for every IP-related field impacting these enterprises by means of creating mechanisms for contact with major enterprises, corporate IP workstations, and sending IP specialists. Governments at all levels and relevant authorities should prioritize fiscal/tax incentives and financial support for enterprises with IP-related advantages whenever possible.

5.1.2.3 Encourage Innovation in the IP Service Industry

To encourage innovation in the IP service industry, the Chinese government should undertake the following: improve the IP-based financing transaction system, promote IP asset valuation, and assist in building an IP-based investment/financing system led by financial institutions and venture capital firms; guide credit guarantee agencies in providing guarantee services for IP transactions; endeavor to create a risk sharing mechanism for hypothecation; support enterprises that own IP in issuing corporate bonds or going public for financing; standardize IP review, tracking and information disclosure in securities markets; and build platforms for exhibiting, trading, incubating and converting IP.

In addition, the Chinese government should develop the IP service industry; urge relevant authorities to develop fiscal, tax and financial incentives for the growth of this industry; encourage the private sector to provide IP commercialization services; promote the development of IP agency, consulting, valuation, management, training, information retrieval, data processing and financial services, thereby providing society as a whole with high-quality IP services; allow industry associations play a significant role in the IP service industry; standardize employee qualification management in the IP service industry; and assist in enhancing self-regulation and integrity of this industry.

It is advisable to support service providers that deliver value-added services such as IP software, special IP databases, IP consulting as well as IP-based loans and other investment/financing services; support and guide private capital in entering the field of IP services; encourage and support exchange and cooperation between excellent overseas IP service providers and their Chinese counterparts; assist IP service providers in providing high-end consulting services relevant to IP strategies, analysis/warning, intangible asset acquisition, and international IP disputes; support public IP service providers in transforming into companies; and develop a number of well-known IP-themed exhibitions.

5.1.2.4 Develop an IP Culture and IP Professionals

It is important for China to develop innovative ways of promoting IP; build authoritative and efficient IP communication platforms; conduct a number of influential IP-centric cultural activities; carry out widespread IP education; include IP education as part of the national education system; promote ethical values that favor innovation and integrity and discourage against counterfeiting and infringement; conduct external promotion to allow the international community to gain an objective, impartial and comprehensive understanding of IP protection efforts underway in China, thereby maintaining a positive image of China; continue holding publicity activities such as the National IPR Publicity Week, the China Patent Week, the China Trademark Festival and the Green Bookmark Action; hold events on hot IP topics in such forms as forums, salons, classrooms and exhibitions; publish books and make film/TV programs about typical IP cases; strengthen IP-related legal education; make comprehensive use of education and media coverage to improve the IP environment and to help the public become more aware of IP rights, thereby creating an IP culture characterized by respect for knowledge, innovation, integrity and obedience of law.

Currently three problems exist with regard to the development of IP professionals. First, academic IP education is still lacking in quality and direction. A major in intellectual property has not been classified as a Level 2 subject in academic education in China. Only three Chinese universities offer a masters or doctoral program in IP, including Peking University, the Renmin University of China and the Zhongnan University of Finance and Economics. Only a few universities even try to provide academic IP education in subjects such as law, business administration, public administration and economics. As such, teachers tend to feel that focusing on the development of IP professionals has yet to become legitimate. Statistics show that, up to now, fewer than 3,000 IP professionals have graduated from Chinese universities, suggesting that the development of IP professionals in China is far from sufficient to satisfy the need for their expertise in the process of socioeconomic development in this country.

Second, the team of educators in the field of developing IP professionals needs to expand and become more competent. Chinese universities already have a team of teachers specializing in IP education since the specialization began nearly two decades ago. However, there is a lack in the numbers and competence of these teachers to satisfy the need to develop a large number of IP professionals in the foreseeable future. Statistics show that there are now fewer than 500 teachers specializing in IP education in the dozen of Chinese universities that have set up IP schools, among which only a small number of teachers have received comprehensive IP education or studied IP outside China. The number of theorists and teachers who are experienced in handling IP issues is even smaller.

Third, IP training is decentralized and lacks a unified plan. Today, more than ten authorities provide IP training, including the State Intellectual Property Office (SIPO), the National Copyright Administration (NCAC), the State Administration for Industry and Commerce (SAIC), the MOFCOM and the Ministry of Education (MOE). While all of these authorities appear to be responsible for IP training, in practice, none of them is really responsible for it. There is a lack of coordination and collaboration, not to mention unified planning and deployment. The quality of training varies widely, and most of the training is general, rather than specialized. In all, it is necessary to improve the knowledge mix of IP professionals and the way in which they receive relevant training and education.

Since IP professionals are supposed to be multidisciplinary, the subject of IP should develop into an interdisciplinary one. Cooperation among scholars in multiple disciplines inside and outside the university is especially important in the early period of this subject. Since most (or at least 80 %) of professionals in IP practices work on IP relevant to technology, they are supposed to be legal professionals who have a science and/or engineering background, a solid understanding of the fundamentals of law, as well as certain business administration and economic knowledge (i.e. knowledge related to intangible asset valuation and licensing).

The IP education system must be set up to comply with pedagogical requirements. Under the education system in China, students may pursue IP legal education after they finish a bachelor degree program. Examples of post-grad academic education in this field include IP education as a second major or a masters of IP program that last about 3 years (i.e., basic law education plus special IP education).

Studying science/engineering programs before studying law enables students to acquire knowledge, as it is easier to study natural sciences when one is young and to understand social sciences such as law when one can apply experience to their education. The aforementioned education method is fundamentally consistent with legal education in the United States but differs greatly from general legal education in China, where Chinese undergraduates who major in law come directly from high school. In addition, those who conduct research into IP education and particular high-end IP professionals should have doctoral degrees, which typically require at least 4 years of education.

The aforementioned discussion focuses on how academic education for IP professionals should be structured. However, given the shortage of IP education resources in China, radically changing the education situation within a short period of time will be very difficult. Therefore, concurrent to improving academic IP education, it is necessary to enhance in-service training and education for IP professionals.

5.1.3 Strengthen International IP Protection

5.1.3.1 Guide Enterprises in Internationalizing IP Operations

Become Aware of the Need to Register IP

The primary internationally accepted principle with regard to IP certification is the principle of "first to register." This being the case, Chinese enterprises should pay close attention to IP registration and certification when they have a technological innovation or a new trademark. Enterprises with innovative technology that go global should carefully study the IP laws/regulations of the host country and find out how they differ from their Chinese counterparts before they enter this country. Meanwhile, Chinese enterprises should familiarize themselves with IP application procedures and protections and pay attention to the current status of IP registration and authorization in the host country. When entering global markets, enterprises should actively apply for or register IP rights in the host country that concern their survival and core competitiveness, such as relevant patents and trademarks. Until they receive approval, Chinese enterprises should keep relevant technology a closely guarded secret to prevent losses arising from the leakage of proprietary information. Last but not least, enterprises should endeavor to gain a full understanding of the international IP protection treaties in which China is a member. In the process of internationalization, enterprises should take advantage of the "first to register" principle and other rules conducive to their IP registration to ensure their rights/benefits regarding IP. They must also stay alert to principles detrimental to their growth and competitive advantages, such as compulsory patent licensing, and endeavor to minimize the harms from such policies. It is for this reason that enterprises should fully consider the positive and negative effects of relevant international treaties and make choices that most favor their growth when deciding whether to register their patents or to keep secret their proprietary technology.

Resist Infringements on Relevant Rights

When their IP rights are infringed, Chinese enterprises should make efficient use of the law to protect their interests. Unlike general properties, intangible IP rights are granted and protected by law. As a result, enterprises should rely on the law when their IP rights are infringed upon and damages occur. Enterprises should ensure that all their employees are strongly aware of IP protection, gather and keep IP-related evidence as part of their daily operating activities, and prepare measures against possible infringement on their IP rights. They may also set up a legal department specializing in tackling such infringement. Once an enterprise decides that infringement has occurred, it should immediately send a request to the competent legal authority for rights protection, and fight the infringement per the law, thereby showing their determination to protect their rights and interests. In the meantime, enterprises should keep in touch with relevant domestic organizations, such as domestic industry associations, the chamber of commerce and the trade promotion committee, to learn about the latest changes in domestic and international laws governing IP protection. More importantly, the support of these organizations can help enterprises to tackle infringements more effectively and reasonably.

Strengthen the Ability to Create IP

The process of internationalization has positive and negative effects on IP creation. On the one hand, Chinese enterprises face tougher challenges with respect to seizing early opportunities in more markets. On the other, global markets provide enterprises with unprecedented opportunities and ample resources for innovation and growth. The creation of IP goes hand in hand with talent. Accordingly, enterprises should endeavor to retain talent by means of a mature corporate culture and rules; provide talent with financial, technical and mental support for their development and innovation; and offer employees proper incentives to guide fair competition in the field of technological innovation. In the meantime, enterprises should introduce foreign talent to expand their team of technological innovators and learn about latest technological developments worldwide, with the goal to develop technologies that will fuel their corporate growth and adjust their innovation programs to international markets. The creation of IP also requires massive inputs of resources and certain technological foundations. Chinese enterprises need to continuously strengthen cooperation with industry-leading MNCs in order to achieve a win-win situation through combining resources and advantages, thereby making great strides forward in technological development. In addition, Chinese enterprises should consider mergers with and/or acquisitions of foreign companies or their business units with certain technological advantages whenever possible. This will allow Chinese enterprises to benefit from the latter's technologies, solidify their own technological foundations, and pave the way for their technological leadership and dominance.

Emphasize the Development of a Corporate IP Strategy and System

Chinese enterprises should prioritize IP creation and protection in their strategic goals, and add the concept of IP into their systems and cultures. An enterprise's corporate culture directs corporate growth. Only after an enterprise has established an innovative, aggressive corporate culture and creed that suits internationalized management will it have strong creativity and cohesion to meet challenges around the world. Moreover, an enterprise will be able to mobilize all possible resources and effectively use the law to protect its IP rights from infringement only after the entire staff is strongly aware of IP protection. With respect to system building, an enterprise should set up an IP management department specializing in collecting statistics on corporate IP, registering and managing IP, and conducting follow-up rights protection and monitoring. In the meantime, Chinese enterprises should extend the function of their information management departments to play a desirable role in gathering IP information.

5.1.3.2 Improve IP Information Retrieval and Warning/Emergency Response Systems

As international IP protection becomes increasingly integrated and standardized, and with China assuming the role as a manufacturing power, Chinese producers are facing a growing number of accusations from foreign enterprises with respect to IP infringement. For example, the DVD6C Licensing Group enforced its patent rights against Chinese producers, causing the decline of China's entire DVD industry. As another example, Wenzhou-based private company General Protecht Group Inc. spent 3 years and a large sum of money to defeat a malicious IP-related lawsuit filed against it in U.S. court by Leviton, North America's leading producer of electrical and electronic wiring devices. Chinese enterprises and industries have always been faced with potential threats from foreign IP rights holders who hold a large number of critical patents. With enterprises facing such a plight, the Chinese government must act to assist domestic enterprises in achieving victories in the war for IP.

Chinese government authorities can produce effects in two respects – prevention and assistance. On the side of prevention, the competent authorities should create an IP information retrieval and warning/emergency response system to avoid the occurrence of international IP disputes. On the side of assistance, they should assist relevant enterprises in protecting their IP rights outside China. An effective overseas IP rights protection system should cover responding to accusations from foreign IP rights holders against Chinese enterprises with respect to IP infringement, in the first place, and effective rights protection for Chinese enterprises with overseas operations when they suffer such infringement outside China, in the second place. The aforementioned IP information retrieval and warning/emergency response systems should be built under the leadership of the Chinese government; the competent government authorities should include MOFCOM, which should take charge of foreign investment and trade affairs, and SIPO, which should take charge of IP affairs, as well as SAIC, NCAC and others.

The IP information retrieval system and the IP warning and emergency response system complement each other and constitute an important part of the IP public service system. Emphasizing mutual support between the two systems is important to enable Chinese government authorities and enterprises to strengthen international IP protection and competitive advantages with respect to IP.

Establish an Effective IP Information Retrieval System as Soon as Possible

An effective IP information retrieval system provides early preparation and serves as the foundation for an IP warning and emergency response system. Effective access to information and records on applications, licensing and registration of IP such as patents and trademarks allows Chinese enterprises to avoid technologies in which IP ownership already exists as they develop their IP strategies and carry out new technology R&D projects. This information access also enables them to adopt a proper brand strategy to fight trademark squatting and dilution by other enterprises. Public information on patent applications available from the IP information retrieval system also enables enterprises to build their IP R&D upon higher and newer technologies. In addition to the aforementioned prevention of international IP disputes, an effective IP information retrieval system plays a positive role in disseminating knowledge/information, promoting knowledge innovation and avoiding the waste of R&D resources.

In order to establish an effective IP information retrieval system, Chinese government authorities and organizations should undertake the following: strengthen efforts to build an IP information consulting service platform to guide IP rights protection by creating IP administration and law enforcement information databases and country-specific patent and trademark databases; and make full use of Internet and database technologies to provide Chinese enterprises with public services, such as information retrieval and consulting, to help them tap into international markets and effectively protect IP for their technological innovations. The SIPO patent retrieval system serves as a good model for building the IP information retrieval system. A retrieval system corresponding to information on trademarks registered in China should also be built. The competent authorities should also further emphasize cooperation with the World Intellectual Property Organization (WIPO) in the field of information retrieval systems in order to include information on international patent applications and trademark registrations into China's IP information retrieval system. Chinese IP authorities should also conduct information exchange and communication with foreign IP authorities in order to gather information on IP registrations in relevant countries and to lay a solid information basis for the IP warning and emergency response system.

Establish the IP Warning and Emergency Response System as Soon as Possible

The competent Chinese government authorities should establish an IP warning and emergency response system, which identifies key warning and monitoring points for China's major industries and for major products, thereby reducing IP disputes and protecting relevant rights holders' interests. The *Outline of the National IP Strategy* has prioritized the building of an IP warning and emergency response system in the national IP strategy, and the competent authorities have already set about researching this issue. To engage in international competition and establish an international IP protection system in China, the current top priority is to establish a national-level integrated IP warning and emergency response system based on the results of government research and the experience of other countries in building such a system.

The IP warning and emergency response system should include, as is implied by its name, warning and emergency response. Both should be carried out at the government and enterprise level. With regard to the warning mechanism, relevant government authorities, enterprises and intermediary organizations should pay close attention to the latest economic developments, retrieve and analyze relevant IP information, and consolidate their relevant resources to provide and gain a timely and dynamic understanding of IP developments and information in particular global industries. From a government perspective, providing relevant organizations with such information is intended to help enterprises avoid infringing the IP rights of other organizations and better direct R&D activities and industrial development. The warning mechanism also includes timely monitoring and understanding of worldwide changes and adjustments to IP policies or systems, and timely provision of relevant information to particular enterprises and other organizations. On the side of the emergency response system, relevant organizations should take proper countermeasures in the event of IP conflicts and disputes according to predefined contingency plans. At the state level, the Chinese government should support the establishment of an IP consulting service organization that provides individuals or enterprises with relevant services, especially consulting services, when they are not familiar with governing laws or how to deal with relevant issues. In the meantime, the Chinese government should guide and support relevant enterprises and institutions in making their own contingency plans.

The Chinese government should play a leading role in building the IP warning and emergency response system and consolidate its resources together with intermediary IP service organizations and enterprises so as to accelerate this process. As an example, the U.S.-based CHI Research Inc. provides patent data analysis and research results, which serves as a unique data resource for the government to research and make macro-level policies, and for enterprises to make and implement IP strategies that in turn become an important part of the U.S. IP strategy. The Chinese government should make great efforts to support and guide intermediary IP service NGOs in providing IP consulting services; help Chinese enterprises determine the direction of IP development, define IP strategies, and respond to IP disputes, thereby increasing the global competitiveness of Chinese enterprises in relevant industries. The competent patent, trademark and copyright administrations and other government authorities should become more aware of service provision, strengthen industry-specific guidance on IP development, and help enterprises accumulate IP-related advantages. Enterprises are both service users and implementers in the national IP warning and emergency response system, and are an integral component to the effective working of such a system.

China's IP warning and emergency response system should serve five main functions. First, gathering IP information. In addition to gathering IP information through the IP information retrieval system, this function should also encompass the gathering of IP law/policy information, such as the making and enforcement of international IP-relevant treaties, the main content of IP laws in every country, the direction and objectives of, and policy instruments for, the IP strategy of each country, etc. Second, analyzing IP information. This function entails a qualitative and quantitative analysis of obtained information using mathematical/statistical and other tools. Statistics collection and analysis with regard to IP information will help relevant organizations determine technological development trends, potential markets, main competitors, the status of technological development in foreign companies, the lifecycles of particular technologies and industries, as well as the current status and trends of the trademark and copyright industries. Third, defining IP warning indicators. This function is at the core of the entire IP warning and emergency response system. IP warning indicators should be defined according to the current status of IP development in China and international IP protection. A proper indicator system should be built on a country-specific, industry-specific and IP type-specific basis. The number and quality of IP ownership by relevant enterprises in particular industries should be the most important indicators. Fourth, assessing crises according to the results of IP information analysis. Warning reports should be sent against enterprises and industries that exceed IP warning indicators. While sending such reports, relevant government authority researchers, intermediary organizations and enterprises should work together to propose IP crisis response plans. Fifth, making contingency plans and enforcing countermeasures to address IP crises. The enforcement of countermeasures is the final safeguard of the IP warning and emergency response system and is critical for reducing IP disputes and crises.

5.1.3.3 Strengthen International IP Cooperation

With the rise of economic globalization, IP protection today is more than the responsibility and duty of any single country. Instead, global collaboration and cooperative efforts by all countries is required. In light of this, the Chinese government should undertake the following: continuously deepen exchange and cooperation with WIPO; actively participate in the development of, and discussions on, international rules led by WIPO; engage in the WIPO Development Agenda in areas such as the protection of genetic resources, traditional knowledge and folk literature/art, patent law harmonization and Patent Cooperation Treaty (PCT) reform; conduct consultations and negotiations on issues such as the modification of the International Patent Classification (IPC); play a constructive role in establishing impartial and reasonable international IP rules and systems that enable mutual benefits.

With respect to regional and bilateral IP cooperation, it is necessary to aggressively promote cooperation between China and the Asia-Pacific Economic Cooperation (APEC), the Organization for Economic Cooperation and Development (OECD) and ASEAN, and strengthen cooperation between China and the United

States, Europe, Japan and South Korea. Relevant government authorities should guide this cooperation in a pragmatic, strategic and forward-thinking way. To date, China has signed several IP-related cooperation agreements, including the ones with ASEAN via the *Memorandum of Understanding on China-ASEAN Cooperation in Intellectual Property Rights*, with the European Patent Office (EPO) via a strategic partnership agreement, and with the German Patent and Trade Mark Office (DPMA) via a future-oriented strategic relationship agreement. For the future, Chinese authorities should focus on increasing mutual trust, seeking agreements, and making clear, comprehensive bilateral cooperation plans under these agreed-upon frameworks in order to achieve better cooperation in major international IP affairs. It is also necessary for Chinese authorities to deepen cooperation and maintain high-level dialogue with the United States Patent and Trademark Office (USPTO); enhance high-level communication with IP authorities in developed European countries such as the United Kingdom, Germany and France; and strengthen cooperation with special-purpose IP organizations such as the International Union for the Protection of New Varieties of Plants (UPOV).

SIPO should be the state authority that conducts foreign IP training and HR development. Under the current circumstances, it is critical to strengthen cooperation with other developing countries and provide foreign IP assistance by various means. This will help cement and extend China's achievements in this area and build its image as an active and responsible developing country. China should actively implement cooperation agreements with the African Intellectual Property Organization (OAPI), the Cooperation Council for the Arab States of the Gulf (GCC) and other countries such as Mongolia, North Korea, Vietnam and Thailand, and deliver on its commitments. It should continue providing individuals or relevant organizations in developing countries with IP training through the Asian Foundation, the China-ASEAN Fund on Investment Cooperation, or other funds aimed at cultivating HR in developing countries as well as bilateral and multilateral cooperation. Such training should cover fields including patents, copyrights, trademarks and others. In the meantime, China should increase opportunities to send its nationals to other countries such as the United States, Japan, South Korea, Germany and France for the purpose of HR development.

5.2 Engaging in International Competition in the Field of Standards

To cope with fierce international competition, China should actively participate in international competition in the field of standards. To this end, the Chinese government should define a standards development strategy that aligns with its "go global," trade, industrial/technological development, and scientific development strategies, as well as that enables China to make great strides forward in the field of standards development. Making and enforcing a standards development strategy will facilitate China's transformation from a planned to a market economy, from following technology standards to setting them, and from confinement to its domestic market to expansion into global markets. It will also enable significant progress in enabling China to make globally accepted standards and develop advanced technologies under these standards. This will ultimately raise standards development in China to new heights while fully harmonizing relevant standards within the market environment and the legal system. To this end, the Chinese government should build a new, effective standards system that aligns with the socialist market economy, as well as corresponding administration and operation systems; undertake efforts to increase the percentage of scientific and technological R&D results that lead to higher productivity under relevant standards; lay the groundwork for future standards to fully reflect China-developed technology and be adaptable to domestic and international markets; establish China as major contributor to the development of international standards – after Europe, the United States and Japan- thereby providing strong support for Chinese enterprises that "go global."

5.2.1 The Competitive Strategy

5.2.1.1 Positioning

The economic and technological power of a country is the foundation on which a country selects a competitive strategy in international standardization. With their strong economic and technological power, major developed countries have adopted a competing and/or controlling strategy. For example, the United States utilizes a competing and controlling strategy, the EU a controlling strategy, and Japan a competing strategy. Specifically, the United States has controlled the development of particular international standards, but has yet to achieve its objective of controlling all standards development. It will further compete for control over international standards, in addition to maintaining its current control in specific areas. The EU has adopted a controlling strategy. It already holds significant control over the making of international standards through the "one country, one vote" principle of international standards development, and by the signature of the *Vienna Agreement* (ISO-CEN) and the *Dresden Agreement* (IEC-CENELEC). The EU seeks to maintain its control in the face of intensifying competition in the field of international standards development. Despite its status as a major economic power, Japan has had a relatively insignificant impact on the field of standards development to date. It has therefore adopted a strategy of competition for influence in the development of international standards, that is, competition for leading managerial and/or technical positions in international standards bodies.

Given the state of China's current position, and, especially, its economic and technological power, China should adopt a competitive international standards strategy that focuses on "making breakthroughs in important areas." This refers to identifying areas and industries in which China has marked advantages and competing for a favorable position with regard to international standards development such that future standards better reflect China's technical requirements. This will help China gain a dominant position in international competition in these areas and industries. As part of this strategy, China should track and adopt international standards, participate or even take the lead in the development of these standards, and hold leading managerial and/or technical positions in international standards bodies.

5.2.1.2 Principles

Adapt to the Objectives of the State's "Go Global" Strategy

China's competitive strategy in international standardization should focus on supporting Chinese high-tech MNCs and high-tech product exporters, especially industry leaders and enterprises in central and western China, in increasing their global competitiveness in this field.

Combine with the Objectives of the State's Scientific Development Strategy

The Chinese government should continuously improve the national innovation system and lay an institutional foundation, in terms of scientific and technological development, to transform China into an innovative country. In the process of building a technological innovation system, China should prioritize the development of standards in which enterprises are at the core and effectively interact with universities, research organizations and users. It should also focus on conducting innovation by combining military and civil applications, and build an innovation service system consisting of technology-specific intermediary organizations. China is entering a stage of faster scientific and technological development and will likely match medium developed countries in terms of scientific and technological competitiveness and high innovative capacity. This is the stage in which China should strive to make breakthroughs in the international standards process and achieve objectives including: elevating a number of Chinese MNCs to join the ranks of the Global 500 as a result of technological innovation; establishing several high-tech development zones as globally influential centers of technological innovation; transform private companies into active innovators; establish excellent innovation systems in a number of international research organizations.

Align with the Objectives of the State's Industrial/Technological Development Strategy

The Chinese government should provide strong support for building a technological innovation system in which enterprises play a dominant role. It should do this by developing select large enterprises and groups that are innovative and globally competitive with world-leading technologies in particular fields, and improve the technological innovation system so that Chinese enterprises are able to carry out technological development and innovation in important industries and areas. According to the objectives of the state's industrial/technological development strategy, the competitive strategy in international standardization should focus on supporting large enterprises and groups, which are able to conduct innovation on their own and are globally competitive, in actively participating in the development of international standards and other relevant activities. This will enable Chinese high-tech companies, which make and sell world-leading technologies in particular fields, to gain dominant positions in making relevant international standards.

Obey and Seek Fair and Reasonable International Rules

As a WTO member, China should actively fulfil its obligations and make technical laws/regulations, standards and conformity assessment procedures under existing international standards. In the meantime, given that China is a country with a huge population of about 1.4 billion people and has widely varying geographic conditions, the Chinese government should effectively use WTO incentives for developing countries. It should also actively participate in shaping the development of international standards to reflect China's technical requirements.

Keep in Mind Product Advantages When Making Relevant International Standards

Because China is significantly behind developed countries in terms of economic and technological power, relevant Chinese organizations must identify technologies and products with good market prospects as the focus of competition. They should centralize advantages and resources to make breakthroughs in major areas such that a breakthrough in any single international standard will bring economic benefits to China.

5.2.1.3 Objectives

Relevant Chinese government authorities and organizations should make great efforts such that the global competitiveness of Chinese standards and China's capacity to substantially participate in international standardization activities satisfies the requirements of China's scientific development, outbound investment, foreign trade and industrial/technological development strategies. Additionally, international standards development should support China's development from simply a country with a large amount of foreign trade into a world power that is able to effectively protect its economic interests abroad. The Chinese government should improve Chinese standards as quickly as possible such that these standards become comparable, as a whole, with their international counterparts and globally competitive in fields where China has advantages, thereby making China a major contributor to the development of standards in Asia. Moreover, the Chinese government should strive to make Chinese standards in fields where China has strategic advantages become the dominant, competitive international standards as soon as possible, thus transforming China into a major contributor to international standardization.

Improve the Entirety of Chinese Standards

It is necessary to improve the entirety of Chinese standards such that they are comparable with their international counterparts. Additionally, China should actively localize more international standards that apply to China and gradually synchronize the development of domestic standards in major sectors such as health, safety, environment and energy with international standards in these areas.

Achieve Global Acceptance of Major Standards

Relevant Chinese government authorities and organizations should endeavor to develop and promote standards in fields where China has advantages or is unique, in which domestic organizations hold IP rights, which can be widely applied across particular industries and/or can become globally accepted, and which concern China's national interest. China should also work to turn domestic standards in these fields into international ones, and increase the total number of international standards in which China plays a leading drafting role or which are built upon China's domestic standards.

Improve Participation in the Development of International Standards

The Chinese government should build a mechanism whereby government authorities, industry organizations, universities, research organizations and, especially, enterprises can substantially participate in the development of international standards. With regard to discussions on drafts of international standards that concern important Chinese interests, joint teams comprised of government, industry organizations, universities, research organizations and, especially, enterprises should be organized to provide the full scope of Chinese feedback on these drafts at international conferences, in accordance with international rules. With regard to shaping the aforementioned standards, such teams should also carry out joint PR events. Such efforts will ensure that China's economic interested are properly protected in the course of standards development. The Chinese government should also prioritize the development of major high-tech companies so that they form internal international-standards development systems to cover issues regarding high-tech industry development, standards R&D, and integrated trade and investment, and become substantially involved, or even taking the lead, in the development of international standards or de facto international standards.

Set Up a Team of Competitive Experts in International Standards Development

It is necessary to build a team of international standardization experts who have a good command of particular foreign languages and excel in their respective areas. Led by domestic enterprises, this team is expected to play an important role in the development of international standards. Specifically, relevant Chinese government authorities and organizations should identify standards experts and individuals capable of leading managerial and technical positions in international standards bodies and make them members of the ISO Council/Technical Management Board or IEC Council Board/Standard Management Board for consecutive terms whenever possible. These experts and individuals should also hold positions in ISO or IEC technical committee (TC)/subcommittee (SC) secretariats or as working group (WG) conveners whenever possible and wherever the interests of China are concerned. China should strive to take the lead among developing countries in terms of the total number of positions in the TC and SC secretariats, and seek appointments of Chinese nationals as presidents or vice presidents of the ISO, the IEC or the ITU whenever possible.

Ensure Funding

It is necessary to establish a funding mechanism to support a variety of engagement channels with respect to competition in international standardization, and ensure stable investment from across society in such engagement. Funds for this purpose should mainly be used by or for: international-standards development teams that cover issues regarding high-tech industry development, standards R&D, and integrated trade and investment; training of international standardization experts; the Asian standardization exchange and training center; and the making of international standards in major sectors such as safety, environment, health and information.

The ultimate goal is to ensure that the losses suffered by China as a result of standards setting related to international economic activities decreases; that Chinese standards become well-known around the world and are recognized or employed by some countries, especially developing ones; that Chinese standards are able to effectively support enterprises in major industries and products from famous brands in competing in international markets; and that China becomes a major force in international standards setting and is able to work with other countries to promote the development of Asian regional standards or even international standards.

5.2.1.4 Mission

With regard to the competitive strategy in the field of international standards, the primary mission is to increase the global competitiveness of Chinese standards. This mission can be divided into three tasks – effective adoption of international standards, substantial participation in the development of international standards, and achieving breakthroughs in major fields through leadership in international standards development concerning the interests of China. Effective adoption is intended to improve the entirety of Chinese standards and to align them with the international standards system; substantial participation is intended to increase the global competitiveness of Chinese standards in major sectors and to address international standards that fail to fully reflect China's technical requirements; achieving breakthroughs in major fields is primarily intended to turn Chinese standards in high-tech fields and China-unique industries into international standards. These three tasks are mutually supportive– effective adoption forms the basis for substantial participation and achieving breakthroughs in major fields, both of which, in turn, facilitate the former.

Effective Adoption – Improving the Entirety of Chinese Standards

To improve the entirety of Chinese standards, effective adoption of international standards and advanced foreign standards is an important policy for China as a developing country. This policy aims to let Chinese standards catch up with their international counterparts. Effective adoption of international standards refers to only adopting international standards that are identical to relevant national standards and that are applicable to China. The content of international standards that do not apply to China should be modified before being adopted and, when necessary, be reasonably integrated with Chinese standards or technologies. It is necessary to engage, as early as possible, in international standards that apply to China and develop the Chinese counterpart of these standards at the same pace, thereby achieving timely and rapid conversion. Effectiveness and efficiency are critical for effective adoption, and should be emphasized over the mere adoption rate when it comes to the adoption of international standards. "Effectiveness and efficiency" herein refer to the adoption of international standards that are technically reasonable and applicable, that favor economic, investment and trade development, and that are adopted in a timely manner on the basis of tracking international standards. In addition to effective adoption, it is necessary for the Chinese government to rapidly identify international standards content that is unfavorable to China and send proposals for modification to the relevant international standards bodies in order shape international standards development in China's favor.

Substantial Participation – Increasing Competitiveness Through Standards in Major Sectors

The ability of China to substantially participate in international standardization activities has an important effect on the development of China's outbound investment. Given that China is significantly behind developed countries in terms of economic and technological power, and in light of the difficulties it faces in leading international standards setting, substantial participation in international standardization activities is a cost-effective approach to shaping international standards to reflect China's technical requirements.

Substantial participation in international standards development will enable the gradual accumulation of experience so as to lay a solid foundation for China's eventual leadership in this activity. Substantial participation refers to actively participating in the development of international standards that concern the interests of China, as well as in corresponding international standardization activities. Substantial participation embodies: having a substantial voice and vote in the comment and voting phases of international standards setting; expressing detailed opinions at international standards conferences that reflect the interests of China; participating in the drafting of international standards that concern the interests of China; and seeking appointments/elections of Chinese nationals to president/vice president positions or other leading managerial positions in international standards bodies whenever possible, especially in the TC secretariats bodies responsible for international standards that concern China's economic interests.

Achieving Breakthroughs in Major Fields – Gaining Dominant Positions in Technical Standards in Fields Where China Has Advantages or Is Unique

Making breakthroughs in major fields refers to centralizing China's economic, technical and human resources to make international standards, whenever possible, in fields where Chinese organizations have innovation advantages, where there is the potential to create a large industry and market, and where these standards will directly influence China's economic interests. Achieving breakthroughs in major fields is an important objective of China's competitive strategy in international standardization. Relevant Chinese government authorities and organizations should follow the principle of "act in a selective manner" and identify major fields where there is the most potential to make breakthroughs.

Standards setting breakthroughs in major fields are mainly achieved in four ways. First, technical standards made for industry-leading technologies of major enterprises are taken up as proposed international standards. Such standards are generally those that specify product quality requirements. With a focus on high technology, these standards are adaptive to and orient markets. Second, forum standards created in high-tech fields are taken up as proposed international standards in order to grasp relevant opportunities. Third, standards are created on the basis of technological R&D results, before being taken up as proposed international standards. In this case, R&D activities generally are carried out in parallel with standardization activities, with multimedia and nano technology as examples. Fourth, a state initiates an important technical standard project to make a major technical standard that concerns national interests and then proposes it as an international standard. This approach mainly embodies the will of a nation. In the case of a proposed strategic international standard aimed at dominating international markets, organizations in the industry that are expected to benefit from this standard typically play a dominant role in making the proposal, backed by policy and funding support from the state. In the case of international standards in sectors such as the environment, safety and health, the government should play a leading role, according to the overall global trend of competition in international standardization. As a developing country that faces competition from developed countries in the field international standardization, in the near-term, China should refer to the Japanese experience of using government investment and leadership to help domestic enterprises become more competitive and compete in international standardization. The Japanese government invested 3 billion yen in the first 3 years of the enforcement of its competitive strategy, with focused support on 30 research projects prioritized under its strategy with the aim of making targeted international standards.

5.2.1.5 Key Points of the Strategy

Key Points of Effective Adoption

1. Basic international standards, such as those on fits and tolerances and mechanical drawings, belong to globally-accepted common standards. Chinese organizations should adopt these standards by making the respective Chinese standards identical in order to align China's basic technical system with the international technical system. Such alignment is conducive to introducing technology and trading goods, and communicating in the same technical language enables the removal of foreign technical investment and trade barriers. Otherwise, Chinese enterprises would find it more difficult to go global.
2. International product standards should be carefully analyzed before they are adopted. International standards generally are advanced and reasonable without deliberate technical barriers. They represent the mainstream market and the direction of technological development. If the existing Chinese standards are not as good as their international counterparts and it is technically feasible to adopt the latter, then relevant government authorities and organizations should actively adopt the international standards in order to improve China-made products and make them more competitive around the world. Nevertheless, an international standard should not be adopted if some of the requirements are unfavorable to China, if it is technically impossible to satisfy the requirements, or if the standard contains patent traps.
3. It is advisable to make a domestic standard and then turn it into an international standard whenever possible, especially in cases where one or more products are unique to China and feature proprietary technology and IP belonging to Chinese organizations. Alternatively, China may encourage other countries, by such means as product exports and technical exchange, to adopt its standard.

Key Points of Substantial Participation

1. General participation: The principle in this case is to gain access to international standards information and trends in order to provide information for effective adoption and substantial participation alike. Such information is obtained mainly by attending international conferences and forums.

2. Prioritized participation. Participation in international standardization projects that will have a significant impact on Chinese product exports and market competitiveness should be prioritized, especially if the project can be shaped to reflect Chinese interests and requirements. Relevant Chinese government authorities should regularly research the aforementioned projects and prioritize support for them in terms of human and physical resources. The Chinese government should fully prepare, before conferences on these projects are held, to ensure that China's interests and requirements are truly reflected in relevant international standards.

   International standardization projects for which participation should be prioritized include: international standards for high-tech electromechanical products and other areas where Chinese enterprises face numerous technical barriers in outbound investment and foreign trade; international standards that relate to the global competitiveness of China's agriculture industry, such as those regarding food safety and measurement methods[2]; and international standards in the health, safety, environmental and energy sectors. A full understanding of these standards will allow China to better tackle technical barriers set by developed countries by means of safety, quality and environmental standards.
3. China's proactiveness and leadership. Relevant Chinese government authorities and organizations should undertake efforts to establish Chinese nationals in leadership positions within the ISO or IEC TC/SC secretariats or as WG conveners whenever possible and wherever the interests of China are concerned. In particular, Chinese nationals should seek to become presidents or vice presidents of the ISO, the IEC or the ITU and/or other managerial positions whenever possible.

Key Points of Achieving Breakthroughs in Major Fields

The technologies that drive international economic development in today's knowledge economy include digital, networking, nano and genetic technologies. Breakthroughs in any one of these technology fields will bring huge benefits to a nation's economy. Networking technology, in particular, is the technology field that has the closest ties with standards development. Likely to be the focus of future international competition, networking technology has the potential to bring high profits and is a major area for Chinese outbound investment. China should strive to make breakthroughs in major fields, focusing on the following:

1. Technologies in industries most important for the national economy. Now that the electronics and IT industries have become the most important industries for the Chinese economy, the Chinese government should prioritize its support for

[2] Although agricultural products represent a small percentage of Chinese exports, they are important to the interests of China's 800 million peasants and to social stability. They are also a major industry for Chinese overseas investment.

technical standards in these two industries and seek international acceptance of Chinese developed standards as international standards.

2. Sectors where China has world-leading technologies. The fields of sciences and technologies are developing at an unprecedented rate; new disciplines keep emerging, and the life-cycles of high-tech products are rapidly decreasing. Accordingly, China is closely following behind –and in some areas has caught up to- developed countries in numerous high-tech sectors, such as IT, biotechnology and superconductor technology. China may very soon make breakthroughs in certain high-tech fields where it has comparative advantages and where there is large market demand. Having international standards that correspond to China's technology breakthroughs will greatly increase the global competitiveness of Chinese organizations in relevant industries and promote their overseas operations.
3. Industries unique to China. Traditional Chinese medicine, tea, and Chinese character encoding, among others, are typical Chinese industries in which China has comparative advantages in making international standards. Having international standards in these fields will help fuel the growth of these industries.
4. Major high-tech products. These high-tech products include computers and peripherals, communications equipment, audiovisual devices and software.

5.2.2 Policies and Measures

5.2.2.1 Adjust Policies Regarding the Adoption of International Standards

The Chinese government should modify the current administrative measures regarding the adoption of international standards. With respect to existing international standards, it should emphasize effective adoption after sufficient verification, testing and analysis. With respect to international standards that are being developed, it should emphasize effective adoption on the basis of substantial participation in the development of these standards.

Create an Effectiveness Measurement System for the Adoption of International Standards

It is necessary to create this system in order to assess the latest developments related to international standards, the applicability of international standards to China, the compatibility between domestic and international standards, and the extent to which international standards reflect China's technical requirements. It is advisable to determine the principles under which China adopts international standards and, when necessary, to make timely adjustments to them in order to ensure the effective adoption of international standards.

Make Effective Use of WTO Policies for Developing Countries with Respect to the Adoption of International Standards

The WTO provides developing countries with different and preferential policies regarding their enforcement of the *Agreement on Technical Barriers to Trade*. China as a developing country should make full use of such policies. This agreement provides that "although international standards, guides or recommendations may exist, in their particular technological and socio-economic conditions, developing country Members adopt certain technical regulations, standards or conformity assessment procedures aimed at preserving indigenous technology and production methods and processes compatible with their development needs." It also provides that members granted exemptions from relevant international standards "because of fundamental climatic or geographical factors or fundamental technological problems."

5.2.2.2 Create a Mechanism for Competing in International Standardization

Create an International/Foreign Standards Tracking System

1. It is necessary to undertake the following: build a well-coordinated tracking system that is under the leadership of the national standardization administration, that is comprised of national standardization research organizations and technical committees focusing on standardization in particular fields, and that comes with a clear division of work; build a national-level international standards information platform to provide updates on the latest developments in the field of international/foreign standards in a timely manner; publish a quarterly international standards analysis report; and publish an annual international/foreign standards development report. This will enable relevant Chinese government authorities and organizations to gain a comprehensive understanding of the major trends in international/foreign standards, while providing the foundation and direction for prioritized participation, or even leadership, in international standardization.
2. The national standardization research organization should be responsible for the following: tracking and researching international/foreign standardization strategy policies and international/foreign standards trends in major fields, particularly the trends of international standards bodies and those of major developed countries and emerging industrialized countries; regularly publish research reports on the developments of international/foreign standardization; maintain the daily operation of the national standards information platform; and provide relevant industries with important international standards information.
3. Relevant technical committees should be responsible for: gathering information on international/foreign standards that their respective member companies and associations are tracking; track and research international/foreign standards in

their respective technical fields that are being developed or modified; and analyze the impacts of these international/foreign standards on China.
4. The national standardization administration should be responsible for: building a national information service platform for tracking international/foreign standards; ensure that government administrations, industries and the public have access to timely information on the latest developments related to international/foreign standards.
5. The state should encourage industries and enterprises to actively track international standards and advanced foreign standards.
6. It is advisable to send standardization experts, who are responsible for tracking foreign standards and sending timely reports back to China, to Chinese embassies, consulates or relevant departments of Chinese organizations in Europe and major developed countries such as the United States and Japan.

Create an Assessment Mechanism for Participation in International Standardization Activities

1. It is necessary to have a mechanism to assess China's participation in international standardization activities with respect to the following: whether China has substantially participated in reviewing and voting on international standards; whether a standardization technical committee has voted, with substantial opinions, on draft international standards in different stages; whether experts have been convened to discuss relevant issues prior to participation in international conferences; whether extensive opinions have been gathered from relevant parties; whether speeches made at the conferences have been prepared and conference attendance have been registered with the competent foreign affairs authority; and whether solutions to relevant issues have been recommended after an official has attended an international conference, to be used as the basis for that individual's participation at future conferences.
2. It also is necessary to assess the performance of Chinese nationals who hold positions in the secretariats of international organizations in terms of their performance in organizing participation in the development of international standards and in organizing relevant international activities. Individuals with poor performance in these respects should be replaced.
3. China should encourage enterprises to actively participate in the development of international standards by giving tangible or intangible rewards to enterprises that actively participate in international standardization and produce positive results in this area.
4. A system for continual participation by experts in international standardization should be created. To assure the effectiveness of participation in prioritized international standards development, the Chinese government and enterprises should work together to ensure that relevant Chinese experts continually participate in the review of international standards in the same field going forward.

Create a Mechanism for Assuming Leadership in the Development of Major International Standards

1. Procedures should be developed in making major international standards. The national technology and standardization administrations should be responsible for: developing procedures to propose major international standards; developing methods to assess standards in major fields; conducting unified assessment and prioritization of major projects; organizing unified proposals for international standards so as to achieve breakthroughs in major fields.
2. China should establish approaches to taking leadership role in international standardization. It is advisable for China to propose the following types of standards as international standards: technical standards based on the advanced technologies of industry leaders, forum standards developed in high-tech fields, and standards based on national research results. The Chinese government should initiate projects specific to major technical standards; organize relevant organizations in proposing standards that concern the national interest as international standards; encourage domestic industry organizations to rapidly propose de facto, forum and consortium standards as international standards; encourage research organizations, universities, non-government associations and, especially, enterprises to substantially participate in the development of international standards; support enterprises and non-governmental associations in selectively participating in the development of de facto international standards and forum/consortium standards outside China, and in activities of foreign standards forums.
3. Entities most likely to achieve breakthroughs in major fields should be identified. Organizations in industries that are expected to benefit from proposed strategic international standards intended to help Chinese organizations dominate in international markets should play a dominant role in the development of these standards; the state should provide the proposers of these standards with policy and financial support. The Chinese government should take the lead in proposing international standards in the environmental, safety, health and other sectors.
4. The Chinese government should establish a mechanism that allows Chinese organizations in high-tech fields to take the lead in developing international standards related to technological development, standards R&D, and integrated trade and investment. This mechanism should cover the following: consideration -early in the stage of high-tech development- whether to pursue making international standards or de facto or forum/consortium standards; consideration of which international market sectors a particular high-tech product should dominate; effective utilization of international standards based on high-tech innovations produced by Chinese organizations; establishment of a standards system for new technologies in which Chinese organizations are the IP rights holders; and effective support for raising Chinese outbound investment to new levels and shifting the focus of foreign trade from size to quality and profits.
5. The state should provide policy support for the development of international standards bodies in industries where China is unique or has advantages. It should also encourage these standards bodies to make and publish de facto international

standards and/or forum/consortium standards, and work toward global acceptance of these standards. The World Federation of Chinese Medicine Societies (WFCMS) is a typical example of international industry-specific federations established by China. It has begun making and releasing standards.

5.2.2.3 Create an External Environment for Competing in International Standardization

Take Leading Positions in International Standards Bodies Whenever Possible

The Chinese government should assist Chinese nationals in taking critical positions in international standards bodies, such as the roles of president and vice president, WG conveners, and positions in TC/SC secretariats, whenever possible and wherever the interests of China are concerned, in order to ensure proactive leadership in international standardization.

Shape Policies of International Standards Bodies to Reflect the Interests of Developing Countries

The Chinese government should make the following recommendations to international standards bodies: future positions established in ISO and IEC TC/SC secretariats should first be held, in principle, by developing countries that lack sufficient representation and that are able to make substantial contributions; the existing ISO and IEC TC/SC secretariats should have a 5-year term instead of a permanent one; international standards bodies should actively seek ways to improve participation of developing countries in the development of international standards and/or serve as their secretariats.

Sign Cooperation Agreements with International Standards Bodies to Jointly Develop International Standards

Relevant Chinese organizations should endeavor to sign cooperation agreements with international standards bodies to jointly develop international standards whenever possible, just like the European Committee for Standardization (CEN), the European Committee for Electrotechnical Standardization (CENELEC), ASTM International, and the Institute of Electrical and Electronics Engineers (IEEE) have done. While contributing to international standardization, this will pave the way for China to take the lead in the development of relevant international standards.

Actively Establish Strategic Partnerships with Foreign Standards Bodies

Competition and cooperation coexist in international standardization. With regard to competition in this area, China and most other Asian countries have common interests, which should form the core of potential strategic partnerships. China may also use resources in Europe and the United States whenever possible. It is therefore advisable for China to establish Asia-centric strategic partnerships that target key countries, in order to create a favorable environment for China to substantially participate in standards development and achieve breakthroughs in major fields, while winning support from strategic allies.

1. China should establish a strategic Asian regional standardization alliance centered on China, Japan and South Korea. To this end, it is necessary for China to create a regular consultation conference mechanism across Asia in order to discuss common concerns and reach agreements related to standards, thereby creating a mechanism for joint competition in international standardization; develop methods of rapidly sharing information within Asia; effectively communicate and conduct consultations, whenever necessary, about major international standards issues that concern the interests of Asia; partner with relevant Asian countries to develop standards based on common concerns, and seek to gain acceptance for these standards as international or de facto international standards; set up an Asian standardization exchange and training center to develop human resources for developing countries in terms of standardization; and establish close emotional ties with other Asian countries through HR training in order to lay a solid foundation for China's output of standards in the future.
2. China should actively establish exchange and cooperation relations with standards bodies in major developed countries such as the United States, Germany, the United Kingdom and France, which are the de facto leaders in international standardization, as exemplified by the fact that the majority of international standards are drafted by them. By exchanging and cooperating with these countries, China will have an early, necessary influence on the international standards currently being developed, and secure support for the eventual development of international standards spearheaded by China.

5.2.2.4 Reinforce the Development of Basic Resources

Create a Mechanism for Developing and Introducing HR in International Standardization

The national standardization administration should work with the MOE and the Ministry of Human Resources and Social Security (MOHRSS) to make policies for developing and introducing HR in international standardization. The focus should be on setting up international standardization and management of technology (MOT) subjects in several universities in order to provide research organizations and industries with excellent HR in international standardization. The Chinese government should also open international standardization HR training centers within national standardization research organizations to provide industry employees who participate in international standardization activities with regular training. As part of this process, the Chinese government should define criteria for assessing student qualifications for admittance to international standardization programs; introduce excellent HR in international standardization from other countries and employ their participation in relevant tasks; create international standardization HR databases; establish a system for qualifying professionals in international standardization; and set up the position of senior international standardization specialists and improve their benefits.

Provide Financial Support for Increasing the Global Competitiveness of Technical Standards

The Chinese government should continue to increase expenditures on competition in international standardization while inviting private capital to participate in such competition, thereby gradually diversifying sources for funding. The Chinese government should first provide stable financial support for basic and critical projects in international standardization. It should ensure that sufficient funds are available to domestic organizations for tracking and researching international/foreign standards, for developing HR in international standardization, for the operations of international organization secretariats in major fields, and for projects specific to making breakthroughs in major fields. These funds should be incorporated into the national fiscal budget. Second, the Chinese government should create activity funds for competing in international standardization. Such funds should be in the range of 200 million yuan per year, and focus on providing necessary subsidies for substantial participation in international standardization in major fields. Third, the government should increase efforts to raise money in a market-oriented manner, by encouraging enterprises to become stakeholders and their consortiums/associations to increase financial inputs into the development of international standards in relevant fields. This will gradually create a mechanism for raising money in a market-oriented manner and, consequently, establish a positive financial cycle of participation in international standardization.

Establish a Deliberative Assembly System for National Projects Focused on Efforts to Make Breakthroughs in International Standardization

The deliberative assembly system plays an important role in a market economy to promote decision-making on a scientific, democratic and equitable basis. A deliberative assembly should be established to be responsible for assessing national projects focused on efforts to make breakthroughs in international standardization and offer relevant recommendations. Members of the deliberative assembly should include experts and representatives of relevant government authorities, enterprises, academic organizations and intermediary organizations.

Set Up a Special Standardization Technical Committee

To implement national projects focused on making breakthroughs in international standardization with respect to technologies, standards and integrated trade/investment, it is recommended that a standardization technical committee specializing in these areas be created. This committee should be co-led by MOST, MOFCOM, the Ministry of Industry and Information Technology (MIIT), and the General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ). Its secretariat should be organized by the Standardization Administration of the People's Republic of China (SAC).

Develop Webpages for Projects Specific to China's Efforts to Make Breakthroughs in International Standardization

To implement national projects focused on efforts to make breakthroughs in international standardization with respect to technologies, standards and integrated trade/investment, it is advisable to create a section specific to these efforts on SAC's official website. This will facilitate the timely release of information on the latest efforts by the special standardization technical committee mentioned in the preceding paragraph, and raise public awareness and support for these efforts.

Chapter 6
The Risk Prevention and Control Subsystem

The international situation has become increasingly complex and changeable in recent years. With their growing size of outbound investment, Chinese organizations face increased investment risks, which have resulted in growth losses in their overseas operations. In addition to traditional operational risks, outbound investment risks generally include: political risks, such as political changes, wars, armed conflicts, terrorist attacks or abductions, social turmoil, ethnic/religious conflicts and crimes in a host country; economic risks, including macroeconomic changes due to economic crises, financial market turbulence and sovereign debt crises, inflation and interest/exchange rate fluctuations; policy risks, which refer to adjustments to the fiscal, monetary, foreign exchange, tax, environmental, labor and resources policies of the government of the host country and nationalization/expropriation risks; natural risks, such as earthquakes, tsunamis, volcanic eruptions, hurricanes, floods, debris flows and other natural disasters as well as pandemics; and other overseas risks that may damage or threaten China's outbound investment and cooperation. To guide enterprises in reinforcing overseas investment risk prevention and to ensure the smooth enforcement of China's outbound investment strategy, the Chinese government urgently needs to build a set of overseas investment risk prevention and control systems.

6.1 The Prevention and Control System at the Government Level

Building a prevention and control system at the government level mainly includes improving the investment law, support system and relevant information services, reinforcing safety/security monitoring and management, and improving the safety/

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security risk emergency response system. No further discussion on how to improve China's investment law and support system will be provided in this chapter, since it has been detailed in the preceding chapters.

6.1.1 Improving Information Services

Outbound investment comes with various high risks and complexities that need to be managed. Studying the political and economic risks in a host country is, in effect, the first step toward making decisions on whether or how to carry out international operations. Chinese government authorities and enterprises should gather relevant information and intelligence to the greatest extent possible in order to gain a comprehensive understanding of potential investment destinations. Only by so doing can they make the right decisions, grasp business opportunities and avoid pitfalls.

With regard to risks outside China, MOFCOM and the MFA both release timely information on country-specific safety/security status, tourism, commerce, labor services and other sectors through their official websites and other media. It is especially noteworthy that, as China becomes stronger and engages more deeply in international affairs, Chinese nationals face a lower level of overseas security than in the 1990s, meaning that they may suffer more dangers than before. To address this issue, the relevant Chinese government authorities should track and analyze security information for Chinese nationals and enterprises outside China, conduct dynamic assessments of the security status by country/region, and send timely warnings via the official websites of the MFA and relevant Chinese embassies/consulates. In 2000, MFA issued the first ever *Guide to Consular Protection and Services Outside Chinese Territory*; it also has "Special Reminders to Outbound Travelers" on its official website, which provides country-specific information on an ad hoc basis in order to caution Chinese nationals about visiting countries or regions in turmoil. Chinese authorities such as MOFCOM and MFA work closely with Chinese embassies/consulates in monitoring the security status of hotspots and sending timely warnings about overseas security. In 2006, SINOSURE published China's first ever *The Handbook of Country Risk*, which was the first formal establishment of a country risk analysis system in China. This handbook provides certain reference information and identifies and assesses political risks for Chinese enterprises seeking to invest overseas. In 2010, MOFCOM issued 67 warnings regarding overseas security risks and suggested that domestic enterprises reinforce risk prevention. In 2011, MFA officially launched the website cs.mfa.gov.cn in order to provide Chinese nationals and enterprises with one-stop overseas security information and consular services as part of continuously enhanced preventive consular protection. This website covers country-specific information, consular news, security warnings and emergency hotlines.

In addition to current efforts, the relevant Chinese government authorities should strive to make further progress in learning more about the needs and requirements of domestic enterprises; encouraging the growth of investment promotion organizations; providing domestic enterprises with consulting services in areas relating to outbound investment such as information, law, finance, IP and certification; and, in particular, refining and sorting through information to ensure its timeliness and accuracy. All the relevant information held by the government should be made public as long as it does not involve national secrets or corporate business secrets, thereby improving corporate access to timely overseas investment information. The Chinese government should also enhance ties with Chinese enterprises and nationals outside China; increase public awareness of the services the government is able to provide and how it provides them; improve the expatriate registration system; establish direct contact with Chinese expatriates, and provide them with efficient and effective services. In addition, Chinese embassies/consulates should create relevant mechanisms to regularly provide Chinese companies with the latest information on the security status of their host countries, and to convene them to discuss security issues.

Major improvements should include the following:

6.1.1.1 Create an Integrated Environment Assessment System for China's Outbound Investment

From May 2008 onward, MOFCOM has been organizing the economic and commercial counsellor's offices of Chinese embassies and consulates, its International Trade and Economic Cooperation Research Institute, its Investment Promotion Agency and relevant Chinese experts in co-writing the *Guide to Outbound Investment and Cooperation by Country/Region* ("the Guide"), with country-specific updates made available periodically. The 2010 edition of the Guide contained investment and cooperation information on 165 countries and regions in areas such as politics, economy, society, law and customs, plus issues that Chinese enterprises should consider in outbound investment and cooperation. Based on corporate feedback, the 2011 edition of the Guide added introductions to policies and laws/regulations of relevant countries/regions regarding land and employment, plus risk prevention information, in addition to updates on relevant data, policies and laws/regulations. Today, the Guide has become an authoritative approach to learning about the investment environment in relevant countries and regions. This being said, the Guide does have a major deficiency – it lacks a comprehensive assessment of these countries and regions as investment destinations. It is therefore necessary to create an overseas investment environment assessment system to provide a comprehensive assessment on all investment destinations.

Chinese scholars spend a great deal of time and energy researching methods to assess the investment environment, but they focus on presenting foreign methods from a western investment perspective. Very little research is focused on investment environment assessment methods for China's outbound FDI. These assessment methods fall under quantitative scoring and qualitative judgment, and usually emphasize general and macro-level factors when it comes to the selection of assessment indicators. Every method has certain applications and limitations. Since investment environments are very complex and vary around the world, no single assessment method applies to all countries. Zhang Biqiong (2012) developed a comprehensive assessment method (see Table 6.1), which combines quantitative

Table 6.1 The comprehensive scoring indicator system for overseas investment environments

Investment environment factor	Points	Investment environment factor	Points	Investment environment factor	Points
I. Capital repatriation	0–12	II. Foreign ownership allowed	0–12	III. The extent of regulation over foreign investors	0–12
No restrictions	12	Full foreign ownership is allowed and welcome	12	Foreign and domestic enterprises are equally treated	12
Only time restrictions	8	Full foreign ownership is allowed but is not welcome	10	Foreign enterprises are slightly restricted but are not regulated	10
Capital restrictions	6	More than 50 % foreign ownership is allowed	8	Foreign enterprises are slightly restricted	8
Capital and dividend restrictions	4	No more than 50 % foreign ownership is allowed	6	Foreign enterprises are restricted and regulated	6
Various restrictions	2	Only less than 50 % foreign ownership is allowed	4	Foreign enterprises are tightly restricted and regulated	4
Capital repatriation prohibition	0	Foreign capital must not exceed 30 % of the interests	2	Foreign enterprises are restricted and regulated	2
				Foreign investment is prohibited	0
IV. Currency stability	4–20	V. Political stability	0–12	VI. Willingness to protect enterprises through tariff	0–8
Fully convertible	20	Stable for a long time	12	Full protection	8
Difference between official and non-official exchange rates is less than 10 %	18	Stable but on a ruler-specific basis	10	Considerable protection	6
Difference between official and non-official exchange rates is between 10 % and less than 40 %	14	Internally divided but the power is held by the government	8	Slight protection	4
Difference between official and non-official exchange rates is between 40 % and less than 100 %	8	Strong opposition forces inside and outside the coconut	4	Little protection	2

Difference between official and non-official exchange rates is within 100 % or more	4	Coups or turmoil is likely	2	No protection	0
Tight capital regulation	0	Coups or turmoil is extremely likely	0		
VII. The availability of local capital	0–10	VIII. The inflation rate in the past 5 years (%)	2–14	IX. Infrastructures	2–8
A mature capital market with open securities exchanges	10	<1	14	Convenient and well maintained	8
A small amount of local capital with speculative securities exchanges	8	1–3	12	Convenient but old	6
Limited local capital with a small amount of external capital	6	3–7	10	Inconvenient	4
Extremely limited short-term capital	4	7–10	8	Few infrastructures	2
Very tight capital regulation	2	10–15	6		
Massive capital outflow	0	15–35	4		
A scarcity of capital	0	>35	2		
X. Labor supply	0–8	XI. Market demand	6–12	XII. Business costs*	2–8
Skilled labor, undersupply, low wage	8	High local consumption level, undersupply	12	Sufficient supply, low costs	8
Pretty skilled labor, reasonable wage	6	High local consumption level, pretty sufficient supply	10	Pretty sufficient supply, pretty low costs	6
Unskilled labor, sufficient supply, low wage	4	Local consumption level is average	8	Overall price equal to the international average	4
Undersupply of labor, pretty high wage	2	Local consumption level is low	6	Undersupply, slightly high price	2
				Undersupply, expensive price	0

Source: Zhang Biqiong (2012)

* Business costs include water/electricity/gas, land and housing prices and environmental protection expenses

and qualitative judgments to comprehensively assess an investment environment. This method is practical and therefore is worth being used by China's commerce authority in order to round out the Guide.

Zhang Biqiong (2012) read the 2010 and 2011 editions of the Guide, before calculating the scores of investment environments in 165 investment destinations using the 12 indicators of her comprehensive assessment method (see Table 6.2).

Table 6.2 Overall scores of environments in host countries/regions of China's outbound FDI (2011)

Country	Score	Country	Score	Country	Score	Country	Score
Portugal	128	Cape Verde	114	Angola	104	Ukraine	94
Estonia	126	Qatar	114	Lesotho	104	Chad	94
Japan	126	Australia	114	Laos	104	Iraq	94
Romania	124	Hungary	114	Kyrgyzstan	104	Guinea-Bissau	94
Singapore	124	Switzerland	114	Zambia	104	Liberia	94
U.K.	124	Indonesia	114	Maldives	103	Sierra Leone	94
France	124	Israel	114	Samoa	102	Tanzania	94
Canada	124	Peru	114	Jamaica	102	Cote d'Ivoire	92
Albania	122	Tunisia	114	Tonga	102	Mauritania	92
Finland	122	Botswana	114	Georgia	102	Mozambique	92
Barbados	121	Malta	112	Armenia	102	Kenya	90
Sweden	121	Belarus	112	Macedonia	102	Papua New Guinea	88
Argentina	120	The United Arab Emirates	112	Vietnam	102	Vanuatu	88
EU	120	Cyprus	112	Namibia	102	Azerbaijan	88
Morocco	120	Saudi Arabia	112	Ethiopia	102	Madagascar	88
Ireland	120	Bahrain	112	Guyana	102	Iran	88
Poland	120	Italy	111	Uganda	102	Equatorial Guinea	88
Norway	119	Uzbekistan	110	Dominica	101	Guinea	86
Uruguay	118	Antigua and Barbuda	110	Oman	100	Pakistan	86
Costa Rica	118	Bosnia and Herzegovina	110	Benin	100	the Philippines	86
Trinidad and Tobago	118	Slovakia	110	The Czech Republic	100	Senegal	86
Spain	118	Serbia	110	Iceland	100	Gabon	84
Slovenia	118	Rwanda	110	Turkmenistan	100	Mali	84
Austria	118	Sri Lanka	110	Central Africa	98	Burundi	84
Moldova	118	South Korea	110	Seychelles	98	Afghanistan	84
Jordan	118	Turkey	110	Comoros	98	Venezuela	84
Malaysia	118	Chile	110	Brunei	98	Bangladesh	82

(continued)

Table 6.2 (continued)

Country	Score	Country	Score	Country	Score	Country	Score
Luxembourg	118	New Zealand	109	South Africa	98	Niger	82
Mauritius	118	Mexico	109	Egypt	98	Nepal	80
Bulgaria	116	Libya	108	Brazil	98	Malawi	80
Lebanon	116	Syria	108	India	98	Congo-Kinshasa	78
Hong Kong	116	Greece	107	Russia	98	Zimbabwe	78
Macao	116	Micronesia	106	Fiji	98	East Timor	74
U.S.	116	Grenada	106	Cuba	98	North Korea	74
Germany	116	Bahamas	106	Congo-Brazzaville	98	Myanmar	72
Holland	116	Tadzhikistan	106	Surinam	98	Togo	68
Belgium	115	Lithuania	106	Bolivia	96	Eritrea	68
Denmark	115	Thailand	106	Kazakhstan	96	Sudan	66
Colombia	114	Cameroon	106	Yemen	96	Algeria	84
Latvia	114	Mongolia	106	Ghana	96		
Djibouti	114	Cambodia	106	Nigeria	96		
Kuwait	114	Croatia	104	Ecuador	94		

Source: Zhang Biqiong (2012)

6.1.1.2 Improve the *Risk Warning and Information System for the Safety of China's Outbound Investment and Cooperation*

In August 2010, MOFCOM formulated the *Risk Warning and Information System for the Safety of China's Outbound Investment and Cooperation*, which stipulated that the economic and commercial offices of Chinese embassies/consulates, local commerce authorities and relevant chambers of commerce or industry associations should undertake the following: gather overseas safety/security risk information involving their respective host countries, regions and enterprises in their respective industries; sort through and analyze relevant information and assess the effects of relevant issues on China's outbound investment and cooperation; send timely warnings, when necessary, to Chinese-controlled enterprises in the host countries as well as their respective regions and industries, and report relevant issues to MOFCOM, which in turn will send warnings nationwide, when necessary, on the basis of overseas safety/security risk information sent by relevant organizations or obtained in other manners.

This system has a deficiency in that the gathering of overseas safety/security risk information is based on active efforts by economic and commercial offices of Chinese embassies/consulates, local commerce authorities and relevant chambers of commerce/associations. It overlooks the importance of Chinese enterprises with overseas operations in gathering such information and sending warnings. Enterprises happen to be the fastest in identifying and responding to risk information since they have important interests in their respective host countries. For example, on February

8, 2011, the head of the Libyan project department of the CCCC Fourth Highway Engineering Co., Ltd. learned through talking with local people that large-scale demonstrations or even armed conflict would break out in cities such as Benghazi and Beda. They made advance preparations, and the CNPC and the Libya-based branch, the Zhongnan Engineering Corporation, HydroChina Corporation also set about taking countermeasures against this crisis as early as February 13 and 16 respectively. In contrast, the official MOFCOM website did not warn individuals and enterprises in Libya of this security risk until February 22, half a month after the first aforementioned project department. It is therefore necessary to modify the *Risk Warning and Information System for the Safety of China's Outbound Investment and Cooperation* by including Chinese-controlled enterprises, especially affiliates of central SOEs, in foreign countries as important "organizations that should gather overseas safety/security risk information," in addition to the economic and commercial offices of Chinese embassies/consulates, local commerce authorities and relevant chambers of commerce/associations.

Launch an Efficient and Practical Security Warning System as Early as Possible

It is advisable to build a security warning system based on visual signs that are consistent with Chinese recognition and memorization habits. A five-level terrorist attack warning system was built in the United States after the September 11 attacks. Under this system, green, blue, yellow, orange and red represented different terrorist attack warning levels in ascending order. It turned out that this warning system was rather complex and ambiguous and was unable to provide accurate information. From April 20, 2011 onward, therefore, a new dual-level warning system was implemented in the United States to replace the five-color system. The new system included only two alert levels – "elevated threat" and "imminent threat." The first refers to the existence of a credible terrorist threat against the United States and the second of a credible, specific, and impending terrorist threat against the country. Under this new system, the appropriate intelligence agency will issue an alert depending on its assessment of the credibility and specificity of the threat. Such an alert will contain the alert level, a concise summary of the potential threat, information about actions being taken to ensure public safety, and recommended steps that individuals, communities, businesses and governments can take to help prevent, mitigate or respond to the threat. Alerts under this new system are only valid for a certain period of time and will automatically become invalid after that. But they may be extended once new intelligence becomes available or relevant threats have changed. It is advisable for Chinese authorities to learn from the American experience and lessons in building a security warning system – it should provide alerts against credible and specific threats. This does not mean that a larger number of alert levels are necessarily bad, but the key is to make them suit actual needs and requirements and facilitate recognition and memorization by Chinese nationals.

6.1.2 Enhance Security Regulation

To prevent and reduce overseas human security risks against domestic enterprises, MOFCOM should make higher requirements for the safety of their international operations in four respects. First, enterprises should always establish a security assessment system for overseas commercial projects that they seek to implement. The security status of overseas projects should be divided into different levels depending on the situation in the countries/regions where these projects are based; security risks should be an important factor in making decisions regarding overseas investment. Second, enterprises must develop sufficient security measures for the selected projects and carry out category-specific management. For a project involving government assistance, the competent government authority and the enterprise that will implement this project should assess the security environment in the country to receive the assistance. They should require the local government and police to provide security measures depending on security risks; the enterprise must buy insurance against security risks to overseas employees. Third, the Chinese government should review and approve standards for security costs as a percentage of the enterprises' overseas bid (this percentage may be determined depending on security risks in different countries and regions), for the development of internal security measures (e.g., the percentage of security personnel, and employee security training) and contingency plans, and for security insurance for overseas employees. Regulation by the government will help enterprises improve risk assessments before they carry out overseas operations. Fourth, the Chinese government should consider conducting investigations into projects in high-risk regions and enforce a requirement that a project be denied as long as there is one dissenting vote with respect to security issues.

Management should be further enhanced in the commerce sector; MOFCOM, the economic and commercial offices of Chinese embassies/consulates, local commerce authorities and relevant industry organizations should jointly build a sectoral management system under which all the foreign assistance projects, important outbound investment projects, contracted projects and labor service cooperation projects will be tracked and managed in a comprehensive manner. In 2005, MOFCOM issued the *Overseas Chinese-Controlled Enterprise/Organization Reporting and Registration System*, which required all Chinese-controlled enterprises approved by MOFCOM or the competent province-level commerce authorities and that have obtained the Overseas Investment Permit to report to, and register at, the Chinese embassies/consulates in their respective host countries. Unfortunately, however, many Chinese investors are unwilling to report to relevant Chinese embassies/consulates after they go abroad, because they have more freedom being out of regulation by relevant domestic authorities and are afraid of restrictions that would appear after they report. However, as a consequence, they seldom receive effective protection in the face of security risks. Overseas Chinese enterprises and nationals therefore are obligated to report information, in a timely manner, to relevant Chinese embassies/consulates in order to assist the Chinese government in gathering relevant information. The competent Chinese commerce authorities are obligated to urge individuals and enterprises to report truthful, relevant information to, and register at, Chinese embassies/consulates in their respective host countries on a timely basis.

6.1.3 Improve the Security Risk Response Mechanism

Chinese enterprises have been facing growing security risks in recent years. To address this issue, the Chinese government has set up a preliminary emergency response mechanism for overseas security incidents.

First, the relevant government authorities will launch the emergency response mechanism immediately after the occurrence of heavy casualties or asset losses outside China that involve Chinese nationals or juridical persons. This mechanism mainly includes: setting up an emergency response team and making an action plan; working out a contact scheme to assure unimpeded information exchange; open hotlines to gather information from various sources; and coordinate the work of relevant domestic organizations. In November 2004, the inter-ministerial meeting system to provide for the safety of overseas Chinese nationals and organizations, led by MFA and comprised of MOFCOM and other ministries, was established with approval from the State Council. Under this system, major consular protection issues involving overseas Chinese nationals and/or enterprises are handled under unified direction and coordination in order to accelerate effective solutions to major crises by diplomatic means. The inter-ministerial meeting system has led to the proper handling of multiple serious, sudden consular protection issues such as those related to the emergency rescue operation after the Indian Ocean tsunami, the Lebanon-Israel conflict, the evacuation of Chinese expatriates amid a civil unrest in the Solomon Islands, an attack on a Sinopec project team in Ethiopia and the evacuation of Chinese expatriates from Libya.

Second, the Chinese government has established a diplomatic consultation mechanism to assist Chinese enterprises and nationals in dealing with relevant issues after crises occur, thereby minimizing losses. The Chinese government may hold regular bilateral or multilateral consultations or emergency negotiations, or send special representatives of the head of the MFA or government workgroups to the sites of relevant incidents, in order to urge relevant countries to protect the rights and interests of Chinese nationals by taking effective measures. After a series of crimes against Chinese nationals in South Africa, for example, the MFA sent representatives to South Africa in September 2004 to talk with the Department of International Relations and Cooperation (DIRCO) and the local police about the safety of Chinese nationals and Chinese South Africans, while offering condolences to families of the victims and meeting the representatives of Chinese organizations and Chinese South Africans.

The existing mechanism should be improved mainly as follows:

6.1.3.1 Make the Emergency Response Mechanism Permanent

The Chinese government has established ad hoc groups in recent years to provide on-site assistance after sudden incidents occur to overseas Chinese enterprises or individuals. During the turmoil in Libya, for example, the Chinese government sent three multi-ministerial workgroups to several major Libyan cities to organize evacuations; MPS and the Ministry of Transport (MOT), in addition to the MFA, sent staff members to carry out investigations into the Mekong River massacre since it also involved crimes and water transport security; SASAC and MFA co-led assistance to Chinese enterprises, including SINOHYDRO Corporation regulated by SASAC, amid the crisis in Sudan. Such multi-ministerial workgroups are able to work with clear division of work and high specificity, however they have deficiencies. Sending ad hoc workgroups to tackle relevant issues means that China has yet to establish a permanent overseas emergency response mechanism to better handle risks.

To this end, the Chinese government should accelerate legislation for the protection of overseas Chinese nationals and organizations. Consular protection is at the core of assuring the safety of overseas Chinese nationals. The existing legal grounds for consular protection by the Chinese government mainly include: bilateral consular conventions and international treaties of which China is a member; domestic laws such as the *Nationality Law*, the *Inheritance Law*, the *Law of the People's Republic of China on the Control of the Exit and Entry of Nationals*, the *Maritime Law* and the *Emergency Response Law*. As an example, the *Emergency Response Law* focuses on handling emergencies in China, but it should also take a global view and include the protection of overseas Chinese nationals as part of its emergency response mechanism. The Chinese government should urgently start legislative procedures to make special laws/regulations to standardize the management of overseas security issues and provide for the protection of overseas Chinese nationals and enterprises. This will bring substantial benefits, including the address of overseas security issues- both minor and major- by legal means, thereby avoiding handling them by political means; a clear definition of relevant roles when such a security issue occurs; and cost-savings through effective handling of such issues under the law.

6.1.3.2 Formulate the *National Contingency Plan for Overseas Emergencies* as Soon as Possible

By the end of February 2012, the Emergency Management Office of the State Council had formulated 18 special-purpose national contingency plans such as the *National Contingency Plan for Natural Disaster Relief*, the *National Contingency Plan for Flood and Drought Relief*, the *National Contingency Plan for Sudden and Severe Animal Epidemics* and the *National Contingency Plan for Food Safety Incidents*. However, it has yet to make the *National Contingency Plan for Overseas Emergencies*. The lack of such a contingency plan leaves China in a very passive position with regard to handling overseas emergencies.

In February 2011 when the crisis broke out in Libya, the Chinese government had no idea who the employees of Libya-based Chinese-controlled enterprises were and where they were located. After the crisis, SASAC required relevant central SOEs to immediately provide employee statistics, before acquiring access to relevant data. Given the lack of a contingency plan, recommendations on evacuation were mainly proposed by Chen Zhijie, Deputy General Manager of the China Civil Engineering Construction Corporation (CCECC), who was at the time attending a meeting in China on behalf of the China Railway Construction Corporation Limited (CRCC). In a report presented to MFA and MOFCOM, he proposed recommendations based on his years of work experience in Libya plus previous evacuation cases from countries such as Iraq and Uganda. It was Chen's recommendations that spurred the relevant authorities to first start evacuating Chinese nationals in Libya to third countries by means of renting vehicles such as passenger ships from Libya's neighboring countries on an ad hoc basis, before evacuating them back to China in batches. As the crisis escalated, the Chinese air force responded rapidly thanks to a predefined contingency plan. The contingency-based response was in stark contrast to the ad hoc efforts when the crisis first broke out. According to a newspaper report, on the evening of February 27, the Chinese air force launched a Level 1 action plan for severe emergencies immediately after it received an order from the Central Military Commission (CMC) to send military aircraft to Libya and evacuate Chinese nationals. The Chinese air force also set up two commands, one at headquarters and one at the front line, both with accompanying coordination teams. Under the contingency plan, the transport aviation division of the Chinese airforce performed rapid preparations, including setting up facilities such as bunk bed-like structures on which one could sit or lie in the cabin overnight, plus makeshift lavatories, to provide the evacuees with a safer and more comfortable trip back to China. Due to the joint efforts of the two command headquarters and the transport aviation division, a fleet of aircraft carrying food, medicine and other basic necessities departed from the Urumqi Diwopu International Airport on February 28. The entire evacuation preparations took less than 24 h. As can be seen, having a contingency plan is critical to the success of an emergency response. It is therefore critical for China to formulate the *National Contingency Plan for Overseas Emergencies* as early as possible.

6.1.3.3 Increase International Transport Capacity

Libya, a North African country, has been in turmoil since February 2011. Expatriates began fleeing this country as riots and bloodshed have escalated. In the midst of the crisis, the Chinese government sent 91 civil charter aircraft, 12 military aircraft, 5 cargo ships and 1 military ship, along with 35 rented foreign charter aircraft, 11 rented foreign passenger ships and over 100 rented buses within 12 days to evacuate Chinese nationals by sea, land and air. A total of 35,860 Chinese nationals were safely evacuated and repatriated back to China in the country's largest overseas evacuation action since 1949. Under the international humanitarian law (IHL), China also assisted 12 other countries, including Greece, Italy, Bangladesh and Nepal, in evacuating about 2,100 foreigners from Libya, thereby displaying its role as a responsible global power.

However, the evacuation actions also revealed several deficiencies in China's international transport capacity. For example, the largest aircraft used to evacuate Chinese nationals from Libya were four Ilyushin Il-76 military transport aircraft imported from Russia. Given the limited number, only 12 trips were made by these aircraft, transporting a mere 1,655 persons to Khartoum, the capital of Sudan, and 287 to Beijing. Additionally, China was short of large maritime ships – an aircraft carrier would be able to safely transport about 5,000 expatriates at one time. Lacking in these resources, the Chinese government was forced to rely on foreign resources for its evacuation actions in Libya, highlighting the urgent need to develop critical equipment like large aircraft as a top priority.

A larger international transport capacity of course requires improvements to the cross-border mobility of the Chinese military. To this end, China should encourage domestic universities, research organizations and enterprises to partner with military research organizations and enterprises, and coordinate joint efforts to enhance the ability to repair and maintain high-tech equipment, thereby building an integrated military and civil equipment repair/maintenance system. This system will enable comprehensive equipment support, including multifunctional examinations, emergency repairs and remote technical support. This in turn will enhance the long-distance, cross-border mobility of Chinese military forces, their ability to provide high seas escort, and adaptation of equipment to complex environments.

6.1.3.4 Build Overseas Military Supply Bases

To evacuate Chinese expatriates from Libya in 2011, the Chinese air force fleet had to fly over Pakistan, Oman, Saudi Arabia and Sudan, plus the Arabian and Red Seas. Altogether, flights had to pass through six time zones and eight air-traffic control zones before landing in Libya. Moreover, the lack of overseas military supply bases meant that Chinese military aircraft had to fly over 12 h in a single trip, which was a heavy test of the pilots' willpower and ability to fight fatigue. This would have been alleviated if China had a greater number of military supply bases along major transport lines worldwide.

To address this issue, it is now necessary for the Chinese government to break free from its traditional mindset.

When it comes to building overseas military supply bases, China is now in a period different from the eras of Western colonization and the Cold War. In the era of Western colonization, overseas military bases were built primarily to occupy the territories of other countries, to impose colonial rule, and to seize resources. In the Cold War, the United States and the former Soviet Union built overseas military bases to expand their respective presence, spread their values and political systems, and coerce the host countries into desired actions. In contrast, China now is an era of globalization and free trade. The building of overseas military bases is intended to protect international economic activities, and has nothing to do with colonization, seizure of resources, revolution or even the waging of wars to overturn other governments. It therefore would be welcomed by the host countries/regions.

China builds overseas military bases mainly to perform non-traditional security tasks, such as fighting pirates, maintaining the safety of maritime transport, conducting emergency evacuations, and assisting in maritime emergencies and natural disaster relief. Non-traditional security threats are a problem for all countries and, accordingly, joint efforts are required to eradicate such threats. As a result, overseas military bases built by China for this purpose should be recognized and accepted by the international community.

As part of its responsibilities as a global power, China should participate in providing resources for international public security. The ability to provide a large number of international public security resources is one of the most important symbols of a global power. U.S. and Indian naval forces rescued Chinese ships that were attacked by pirates on many occasions. China has been criticized for long enjoying "free rides" provided by the United States with respect to the safety of maritime transport, rather than assuming its corresponding responsibility as a global power. Such criticism happens to justify China's building of overseas military bases. Seychelles has reportedly invited the Chinese government to open a military supply base on Mahé in order to further fight pirates. This is a great opportunity for China to begin building overseas military supply bases.

6.1.3.5 Allow Central SOEs to Play a Leading Role in Emergency Response Outside China

China's outbound investment is characterized by a large amount of central SOEs with overseas operations. This generally is an important advantage in terms of emergency response. In the evacuation of Chinese expatriates from Libya in 2011, for example, Chinese-controlled enterprises in Libya included 13 central SOEs with a combined headcount of over 25,000 Chinese nationals. It turned out that these central SOEs conducted effective and efficient evacuation procedures.

First, they were able to respond rapidly with unified coordination. SASAC immediately set up an emergency response group for evacuating overseas employees of central SOEs. It divided Libya into four areas, and assigned responsibility to China State Construction Engineering Corporation Ltd. (CSCEC), China Communications Construction Company Limited (CCCC), SINOHYDRO and China Gezhouba Group Corporation (CGGC) for evacuation actions in their respective areas. In addition to evacuating their own employees, these four central SOEs systematically coordinated the evacuation of other Chinese-controlled enterprises and Chinese individuals in their respective areas. Relevant central SOEs also set up command centers at multiple levels back in China and evacuation workgroups in Libya, along with efficient communication and coordination mechanisms between the two countries.

Second, these SOEs demonstrated dedication to mutual assistance. Central SOEs such as COSCO, China Shipping, Air China, China Eastern and China Southern Airlines made rapid adjustments to their normal operations in order to deploy transport resources for emergency rescues, despite business losses resulting from these adjustments. CPC members and corporate officials were the last ones to remain behind after the evacuation of other employees, as were the employees of central SOEs after the departure of other Chinese nationals. The central SOEs also did what they could to help 12 foreign countries evacuate a total of 2,100 employees, winning the respect and gratitude of these countries for China's spirit of mutual assistance.

For the future, central SOEs with a presence in high-risk areas should share their experiences and collaborate with each other, and also consider establishing a predefined coordination mechanism. This will allow them to play a significant role in any future security event. Integrating SOEs as part of China's emergency response system will be a significant, China-unique advantage in responding to overseas investment risks.

6.1.3.6 Handle Security Issues Involving Chinese Expatriates in a Low-Profile Manner

Attacks against Chinese expatriates in recent years have aroused the indignation and attention of the Chinese government and public. Senior Chinese leaders have given personal attention to many such incidents and urged relevant authorities to properly deal with public concerns over the overseas security of Chinese nationals. Chinese enterprises do need support from an increasingly powerful China, however, Chinese enterprises should not excessively rely on diplomatic intervention by the Chinese government to handle such security incidents. In some cases, excessive pressure on host country governments may lead to results opposite than what was expected or desired, and exacerbate, rather than lessen, the security risks to Chinese enterprises and nationals based in the host country.

As the political and economic value of Chinese enterprises and nationals outside China increases, there is a greater likelihood that China will become the target of terrorist attacks or even political backlash by host country governments if the Chinese government and Chinese enterprises respond to attacks against overseas Chinese enterprises and nationals in a high-profile manner or exert excessive diplomatic pressure. Such a response can mire overseas Chinese organizations and nationals in political issues in the host country, leading to higher security risks. Several international security incidents, such as the attacks against Chinese enterprises and nationals by the Justice and Equality Movement (JEM) in Sudan, and by the Ogaden National Liberation Front (ONLF) in Ethiopia, can be attributed to local discontent over the growing value of Chinese enterprises and individuals overseas. Consequently, Chinese enterprises and nationals face significant security risks even in countries that have good diplomatic ties with China, due to targeting by opposition forces in these countries.

As a result, it is necessary for China to be prudent in using diplomatic means to respond to security incidents outside China. Relevant Chinese government authorities and organizations should handle many such incidents in a low profile and pragmatic manner, and avoid becoming involved in local political conflicts, or being used or coerced by opposing parties in such conflicts. Getting involved in political conflicts only subjects Chinese enterprises and nationals to greater risk of attack by opposition forces of a host country. The Chinese government should conduct analysis of security risks against overseas Chinese enterprises and nationals on a case-by-case basis. General crimes should be distinguished from terrorist attacks, and dealt with under normal legal procedures whenever possible, rather than through frequent exertion of diplomatic pressure on the host country government. Only by maintaining a low profile and reinforcing prevention can China effectively reduce the risk to Chinese enterprises and nationals when local political conflicts arise. To this end, the Chinese government should guide media coverage so that relevant incidents are properly, not excessively, reported.

6.2 The Prevention and Control System at the Enterprise Level

6.2.1 Improve Risk Cost Accounting

Chinese enterprises tend to pay insufficient attention to costs related to risks against their international operations. Most Chinese enterprises focus on short-term economic benefits and bidding via low prices, with no in-depth understanding of the significant differences in the cost calculation between overseas and domestic investments. Costs related to overseas investment risks are much higher than those for domestic investments. These costs include, among others, hiring strategy consultants, making risk assessments, providing security protection, handling legal affairs, and buying insurance. As a result, enterprises can no longer simply compete on the basis of low prices when making offers. Otherwise, they would be at great risk of suffering financial crises, and would be unwilling to spend on the safety of their employees, which in turn poses numerous potential problems. It is advisable for enterprises to fully consider all the complexities involved in investing overseas, and factor in various costs associated with risk prevention.

6.2.1.1 Hiring Strategy Consultants

Intensifying competition in international markets heightens the need for effective corporate strategies. A key question Chinese enterprises must address when establishing overseas operations is how to formulate a timely competitive strategy that matches the situation of the investment environment and their own resources. Hiring strategy consultants is an important approach. A Chinese enterprise that wants to enter the developed European and American markets, for example, generally must hire a strategy consultant to guide and establish government relationships and handle other relevant issues. The strategy consultant will help the enterprise identify objectives, make an implementation strategy and achieve a "soft landing" in those markets.

6.2.1.2 Risk Assessment Costs

Chinese enterprises have yet to gain an in-depth understanding of the effects of risk assessment, so they often try to reduce or even avoid costs in this field. In light of this, Chinese enterprises have experienced a fair share of misfortune in the process of internalizing risk assessments into their project design. Attempts to save costs by downplaying risk assessment or conducting insufficient research will lead to poor decisions that will ultimately hinder the operations of MNCs, and which cannot be remedied with ten or even a hundred times as much as it would have cost to conduct the risk assessment in the first place. Chinese enterprises with a presence outside China still lack experience in international operations risk management, not to mention a lack of awareness of such risks. Some smaller enterprises even enter international markets with a gambler's mindset. The lack of awareness of risk prevention in international operations constitutes the primary obstacle to Chinese enterprises' ability to go global and must be overcome by better assessing risks in such operations. Chinese enterprises should enhance business ties with international risk assessment service providers when they enter overseas markets. They should also place special emphasis on conducting international M&As, as overseas organizations are much more familiar with the situation overseas than Chinese enterprises. However, Chinese enterprises should take care to avoid excessive reliance on the opinions of Western assessment service providers, which may be biased toward pro-Western values and interests. Chinese enterprises should therefore base their decisions upon assessment reports made by Chinese organizations whenever possible.

6.2.1.3 Protection Costs

Chinese outbound investment projects take place in various regions around the globe, including countries and regions that have a high degree of security risks, such as terrorism, ethnic/racial/religious conflicts, political turmoil and poor public security, and therefore are subject to frequent security incidents. Some projects are located in remote areas, where project team members are scattered, or in hotspots with high risks. Faced with heavy workloads and long project cycles, the implementation staff is often prone to physical and mental fatigue, which in turn causes slower response to emergencies. Chinese workers sent abroad generally lack self-security and self-protection awareness, as well as experience with responding to emergencies. It is therefore recommended that Chinese enterprises include protection costs into project costs, establish a protection cost accounting system, and synchronize overseas security management with business development in the planning and implementation process. When doing business in areas with high security risks, Chinese enterprises should hire professional international security consultants to provide risk assessment and professional consulting services. They should also hire local security guards, and include risk protection costs into their bids and offers.

As Chinese enterprises go global, worldwide private security companies play a growing role in protecting overseas assets, especially in the event of blackmail. When investing overseas, Chinese enterprises should make full use of security resources such as private security companies and intermediary organizations, employing them to manage overseas security risk prevention, provide 24/7 security assistance, etc. As an example, a number of enterprises from China's Jiangsu Province have established a security coalition in South Africa. These enterprises jointly hire local security guards when necessary. In fact, there are already a large number of proven security companies in China that specialize in handling emergencies and protecting the overseas interests of enterprises. China City Guard Security Service Co., Ltd. is one such private company that works with local partners to provide security services in accordance with the overseas security needs and requirements of Chinese enterprises. This company generally provides bodyguards, and works with its local partners to provide security forces.

Additionally, Chinese enterprises should increase resources devoted to employee security training. A basic precept of security risk prevention for Western MNCs is a focus on training on-site employees. Active prevention and timely response by employees themselves make protection efforts much more efficient and reduce the probability of risk occurrence. According to Western experience, Chinese enterprises should pay more attention to employee security training and emphasize security and protection education as a top priority in their overseas business education programs. The more aware and knowledgeable workers are of risk prevention and basic security, the better they will beat dealing with emergencies and reducing or avoiding the occurrence of security incidents. After arriving at an overseas site, employees should be given information on their surroundings and on the local security status and requirements. Chinese coworkers should be encouraged to establish good relationships so that they can help each other and work together in the event of a crisis. Additionally, before entering a high-risk country or region, Chinese enterprises should include provisions in relevant contracts or other formal documents specific to security assurance. These contracts should provide that the Employer shall take all necessary measures to ensure the safety of Chinese staff and normal construction, and that the Employer shall provide emergency response equipment and other necessary assistance in the event of emergencies.

6.2.1.4 Legal Costs and Expenses

There are huge differences between Chinese and foreign laws, and it is generally impossible for Chinese enterprises to gain a sufficient understanding of all foreign laws before investing overseas. Since business opportunities may open up and disappear quickly, the leaders of Chinese enterprises usually have to make risky overseas investment decisions with limited access to information, as was exemplified in the case of China-based TCL Corporation, which failed to consider France's worker protection law when acquiring the French company Thomson SA. In comparison, Western MNCs generally work to ensure that sufficient efforts are made in preventing legal risks. Statistics show that the costs of legal affairs management account for about 1–3 % of the annual profits of large foreign MNCs, including 1 % in the United States and 0.7 % in Europe. It remains difficult for Chinese enterprises to devote the same amount of resources in this field as their foreign counterparts–the annual budget for the legal affairs department in a Chinese enterprise is about 1/50 of the budget in a foreign MNC; the number of legal professionals, only about 1/4. Chinese enterprises therefore should consider increasing resources devoted to legal risk prevention and incorporate these expenses into their annual budget, rather than have them as a miscellaneous item with a small amount of allotted funds.

6.2.1.5 Insurance Expenses

Enterprises with overseas operations, especially project contractors, must buy overseas accident insurance for overseas employees. This will ensure sufficient financial support for timely medical care in the event of an accident or emergency. This will provide benefits to employees while reducing the financial burden of employers.

6.2.2 Optimize the Mechanism for Making Risk Prevention Decisions

MNCs should have a risk management department responsible for making risk prevention decisions related to international operations. Today, Chinese enterprises typically make decisions under a vertical application-for-approval pattern. Starting from the bottom, the applicant first seeks approval from the head of the department, who seeks approval from the vice president, who then seeks approval from the company's president. A major flaw in this pattern lies is that research and justification efforts tend to be insufficient, despite the fact that the project has been studied at multiple levels up to the top management. In comparison, international giants make similar decisions in a more scientific manner; the project report stays at certain lower levels to allow for interdepartmental discussions and the opportunity to receive opinions from external experts. Such a process allows for a more comprehensive assessment of risk information and facilitates risk management. The aforementioned vertical application-for-approval pattern makes it easy to clearly define responsibilities, but is too simple and hasty a process to adequately avoid risks. Several failed decisions have resulted from such a pattern. The risk management department should be allowed to extensively participate in internal discussions on business decisions. To enhance risk prevention for international operations, MNCs should each build an internal risk management system to carry out risk prediction, prevention and control. It is necessary in some respects to enhance internal regulation and prevent non-compliant operations under the regulatory principle of “keep a close eye on juridical entities, risks and internal control, and increase transparency”. In other respects, however, Chinese enterprises should learn to use globally accepted practices in risk management, thereby accurately identifying, preventing and controlling business risks. In light of the fact that Chinese enterprises with an overseas presence typically pay insufficient attention to legal risks, granting more power to the legal department as an advisor and watchdog, and standardizing the procedures and processes of legal affairs should be a high priority for Chinese enterprises as they seek to optimize the mechanism for making risk prevention decisions.

6.2.2.1 Grant More Power to the Legal Department as an Advisor and Watchdog

Strengthening the legal advisory service system is a basic measure Chinese enterprises can take to prevent legal risks. Chinese enterprises should strengthen the position and function of the legal department within its organizational structure by improving the corporate legal advisory service system, setting up a team of general counsel, legal advisors and contract managers/clerks, and hiring local lawyers as legal advisors for overseas projects. The position of general counsel is a common and high position within the organizational structure of Western MNCs. The general counsel is in charge of making implementation plans for the company’s legal risk management strategy, and guiding and coordinating the division of work and collaboration between the legal department and relevant business departments. Large Chinese MNCs should develop a legal advisory service system led by the general counsel. In the meantime, the legal affairs sub-department should be elevated as an important part of a Chinese company’s risk management department. With regard to overseas subsidiaries, the legal department of the parent company may send legal advisors.

Enterprises should also establish an interactive mechanism between the legal affairs and business departments so that legal risk prevention is integrated as an important part of the company’s overall internal control system. This will enable the entire company to act as a single whole in addressing legal risks. Under such a system, legal risk management will be elevated in importance to corporate financial management. It is known that the management of every company values the financial quality of the company; managers pay close attention to monthly and quarterly financial indicators. By building a legal risk management system, the legal department will enable the senior management of the company to pay as much attention to legal risks as they do corporate finance.

6.2.2.2 Standardize the Procedures and Processes of the Legal Affairs Department

Enterprises should effectively engage their legal advisors and legal departments in the decision-making process and improve their internal legal monitoring systems in order to prevent legal risks at the source. To do so, enterprises should first implement a legal justification system for business decisions in order to include business behavior as part of the legal risk control system for management. Legal advisors should pre-justify important business activities and give legal recommendations and opinions in writing. In turn, corporate management should make a habit of consulting with its legal advisors before carrying out important business activities. Second, the legal department should center its work on production operations and reforms in the company. It should make regular, in-depth analysis of legal risks facing the company, and assess the priorities of legal risks and relevant management measures based on this analysis. Third, enterprises should consider rejecting major business decisions if the legal department is opposed to them. Fourth, the legal department should be granted unlimited access to internal corporate information.

6.2.3 Effectively Integrate into the Society of the Host Country

6.2.3.1 Establish Good Ties in the Host Countries Across All Sectors

Chinese MNCs should always respect the governments and societies of the host countries, and seek to establish good ties across all sectors and integrate into the host country on the basis of mutual benefit. First, Chinese MNC's should establish good relations with its host country partners. This will not only facilitate the company's performance, but also its ability to tackle emergencies. It was through talking with local friends that Yang Yuemin, the secretary general of the CPC committee at the Libya Department of the CCCC Fourth Highway Engineering Company, learned on February 8, 2011 that a massive demonstration was likely to occur in Benghazi. The department then began preparing for an emergency response. Chinese expatriates evacuated from Libya that year said that, before getting in touch with the Chinese embassy, they largely relied on protection from the local people. Their local friends offered to help them or hired armed locals to offer protection. Second, Chinese enterprises should establish good relations with local employees. Chinese nationals should strive to work with local employees and avoid unnecessary disputes and their consequences. Third, Chinese enterprises should establish good relations with the nationals of the host countries. Local religions, customs and government regulations should be respected. Chinese expatriates should deal with local residents in a friendly manner. In Islamic countries, for example, Chinese expatriates must take care to never drink or trade in alcohol, or smoke or eat in public spaces during the fasting period. Interactions between people from different countries are often subject to misunderstandings as a result of information asymmetry. Chinese nationals in areas where religious extremists are active should always keep in mind local religious customs and traditions in order to avoid unnecessary disputes.

6.2.3.2 Implement Localization Strategies

Chinese enterprises should strengthen interest-based ties with stakeholders in the host countries, to reduce the likelihood of societal risks. First, they should properly increase the shareholdings of local employees in the company. This will increase local employees' sense of belonging and enhance the mentality of "corporate interests come first." It will also help prevent local government actions against corporate growth. Second, Chinese enterprises should, to a reasonable extent, rely on host country financial institutions for financing. This will not only reduce financing costs and increase the efficiency and convenience of financing, but will also enhance ties and strategic alliances with local financial institutions. Third, Chinese enterprises should properly prioritize the use of local suppliers for materials and components. Although this may increase purchasing costs, it will fuel the growth of relevant industries in the host countries, increase local jobs and add to the goodwill toward Chinese enterprises. It will also help bond the interests of relevant local industries with that of Chinese enterprises, better enabling them to deal with risks. Fourth, Chinese enterprises should always endeavor to achieve an all-win outcome with respect to the interests of local alliances in which they are members. An all-win transactional structure allows stakeholders to secure benefits and is conducive to eliminating societal risks. Fifth, Chinese enterprises should avoid spending a large amount of their own funds on buying equipment, and instead focus on renting when possible. Chinese enterprises should seek to maintain a low stock of raw materials as well as semi-finished and finished products, thereby maintaining strategic flexibility and avoiding irreparable losses caused by local political and economic changes.

6.2.3.3 Pay Close Attention to Local Public Opinion

Establishing good media relations is a strategic mission of MNCs, as media coverage can play an important role in winning public support. Chinese enterprises are generally not good at dealing with mass media – they tend to focus on commercial advertising and publicity via commercial media. This makes it difficult for them to become well known among the local public and subject to trust issues. In comparison, the rivals of Chinese enterprises are typically able to dominate public opinion and media coverage when a crisis occurs, and can create local public distrust of Chinese enterprises. It is worth noting that some Chinese enterprises have taken the strategy of staying silent in the media, however, this silence has been interpreted, according to the Western perspective, as disdain for or arrogance toward public attitudes, and only adds to the public's mistrust. Chinese enterprises with an overseas presence therefore must learn to properly use local mass media to win favorable public opinion and dispel possible crises.

Paying close attention to the local public opinion in a host country is a critical factor in reducing or eliminating political and societal risks. Many Chinese investors overlook changes in local public opinion in the aftermath of an attack, or, they simply do not know how to guide public opinion through media coverage and improve public relations. This ignorance can ultimately lead to unfavorable public opinion and hostility against Chinese enterprises in host societies. In September 2009, for example, a shoe warehouse owned by investors from Wenzhou City, Zhejiang Province, China was burned down by protestors in Elche, Spain. This heavy loss was partly due to the failure of the Chinese investors to pay sufficient attention to leaflets circulated by the protestors prior to the arson. Similar incidents would likely be avoided if Chinese investors improved their public relations image and effectively used media coverage to guide public opinion.

6.2.3.4 Improve the Risk Warning System

Chinese enterprises with overseas operations should actively work with the Chinese government to establish a joint risk response system. They should increase human, physical and financial resources to accelerate the development or improvement of their respective emergency response systems for overseas disputes or incidents in accordance with the state's requirements. Chinese enterprises should make the development of such systems an indispensable part of their overseas development plans; set up a department responsible for preventing and tackling overseas emergencies; monitor and handle relevant conflicts and problems; report potential crises to the appropriate authority as early as possible; and predefine countermeasures against different risks.

Risk management should be focused on prevention. Chinese enterprises should develop standardized and comprehensive warning management procedures. First, they should set up an internal risk management team. Team members should preferably be senior managers and experienced professionals who are innovative, communicative, careful, calm and amiable. They should also be familiar with environments inside and outside of the company and the company's industry. Second, Chinese enterprises should conduct regular risk identification and analysis, build a sensitive and accurate external environment monitoring system, and set up a risk warning system. The monitoring system will help Chinese enterprises keep a close eye on the situation and trends in host countries. In terms of the risk warning system, it is necessary to first make scientific predictions and analysis of possible risks. Corporate managers should follow and analyze the changes and trends of factors connected with their companies, such as environmental, technical, objective and institutional factors, before predicting possible risks against their companies. Third, Chinese enterprises should establish a warning management plan and conduct risk management exercises. It is advisable to regularly identify possible sources of conflict or crisis, and carry out anti-conflict exercises. This will not only increase responsiveness and crisis management, but will also help determine whether a predefined management plan is practicable or not. Fourth, Chinese enterprises should provide risk education and training. Chinese enterprises should develop a risk education system to enhance their employees' risk awareness and relevant crisis-management skills. This will help improve the ability of employees to handle and endure crises, if and when they arise.

Responding to human security risks requires the making of contingency plans. It is necessary to establish a clear organizational structure for crisis management, including roles, responsibilities and requirements, contact information, and evacuation routes/sequence. Contingency plans should include a sufficient degree of detail, such as the types and amounts of items that should be contained in an emergency backpack. Information should also be visualized wherever possible to increase ease of use.

Chapter 7
The Overseas Economic and Trade Cooperation Zone Promotion Subsystem

From the mid-1990s onward, the national leaders of many developing countries, and even some developed countries, have expressed the hope of introducing China's experience with reform and opening up, and its development zone or industrial park model, into their countries. It was in this context that China began setting up overseas economic and trade cooperation zones in 2006. This not only allowed China to spread its successful model to other countries to help them develop, it also guided Chinese enterprises in going global. Under the guidance of the state, Chinese enterprises have built, on their own or as participants, various overseas economic and trade cooperation zones, such as processing zones and technical/industrial parks, which possess good infrastructure, complete industry chains and strong ripple effects. Today, overseas economic and trade cooperation zones have become an important springboard for Chinese enterprises to go global, and have had significant international influence and social benefits. Countries such as Zimbabwe have made requests to the Chinese government to develop cooperation zones there. Of course, this is an overseas investment method for which there is little international experience that can be referred to. Problems such as unreasonable zone plans, unclear industry positioning and insufficient support for private company needs have occurred, and require specific support from the state to alleviate.

7.1 Promote the Development of Cooperation Zones

7.1.1 Overview of Overseas Economic and Trade Cooperation Zones

To date, MOFCOM has given the greenlight to 19 overseas economic and trade cooperation zones, divided into two batches. The first batch of eight zones was approved at the end of November 2006. The remaining 11 zones were approved at

C. Pei, W. Zheng, *China's Outbound Foreign Direct Investment Promotion System*, Research Series on the Chinese Dream and China's Development Path,
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the end of 2007. As of August 2011, 16 of these overseas economic and trade cooperation zones were operational with a total of over $4.50 billion USD in investments. Although only 18 km^2 of the allocated 132.75 km^2 of land has been developed,[1] the 16 zones are already home to about 250 companies. To enhance the strategic overseas deployment of technology companies, the Chinese government already has plans for a third batch of cooperation zones featuring high-tech industrial parks, and is in the process of sending information technology branches (ITBs) and approving these zones.

The overseas economic and trade cooperation zones built by China have six main characteristics. First, these zones are mostly located in underdeveloped regions such as Southeast Asia, Africa and Latin America as well as with China's neighbors that have close economic and trade ties, such as Russia and South Korea. Second, the largest share of investments is devoted to the manufacturing industry, mainly in traditional sectors such as energy, resources, construction, agriculture, light industry, smelting and electronics. Third, companies that take the lead in entering these zones tend to be highly internationalized and financially strong, such as Haier, China International Marine Containers (Group) Ltd. (CIMC), and the Hongdou Group Co., Ltd. Fourth, investment sizes vary but all exceed $100 million USD. For example, $1.57 billion USD (or about 10 billion yuan) was invested in the Sino-Russian Tomsk Wood Industry and Trade Cooperation Zone. The physical area of planned zones range from just over 1 km^2 (i.e. the Hair Home Appliance Industry Zone in Pakistan has an area of only 1.03 km^2) to 165 km^2 (Lekki Free Trade Zone in Nigeria). Fifth, all the existing overseas economic and trade cooperation zones operate according to market-oriented principles, with the Chinese government providing guidance but Chinese enterprises playing a dominant role. In brief, these zones are the result of outbound investment by Chinese enterprises, with support from the Chinese government. Sixth, there is no fixed model for the form these zones take, although they can be functionally categorized into industrial parks (the market-seeking type), export processing zones (the export-oriented type), technical parks (the tech R&D type), overseas resource development cooperation zones (the resource development type) and FTZs (the integrated type).

Regarding the overall status of overseas economic and trade cooperation zones built by China, as a whole, infrastructure construction is progressing as planned. The construction of the Thai-Chinese Rayong Industrial Zone began in March 2006, and so far 1.50 km^2 of land has been developed. The original Phase I parts of the plan, covering utilities, drainage, road and telecommunications systems as well as land levelling, has even been implemented earlier than expected. The construction of the China-Russia Ussuriysk Economic and Trade Cooperation Zone began in the second half of 2006, with 538,100 m^2 of land expropriated for Phase I. To date, factory, office, dormitory and warehouse buildings with a total area of 50,000 m^2 have been purchased and three brick-concrete factory buildings with total floor space of 8,954 m^2 and one brick-concrete office building with a total floor space of 2,740 m^2

[1] The 2nd China Society of World Economics (CSWE) Forum on International Investment, http://finance.qq.com/zt2011/global/

have been constructed. Infrastructure construction for the Long Giang Industrial Park began in May 2008, and already 20 ha of land has been leveled, with water/electricity supply and road systems built, for factory construction and production purposes. A temporary office building has also been constructed and is in use. The construction of the Yuemei (Nigeria) Textile Industrial Park began in 2008. The road hardening project and water/electricity supply and drainage systems have been completed and 12 standardized factory buildings totaling 100,000 m^2 in area and some dormitory buildings have been constructed. While the total number of enterprises that have entered and operate in these overseas economic and trade cooperation zones is smaller than expected, all of the enterprises are performing well. The Thai-Chinese Rayong Industrial Zone was identified by MOFCOM as the best industrial park in terms of the number of enterprises that have entered so far. Under the original plan for this project, a total of 50 Chinese enterprises were to operate in this zone, with 25 entering in Phase I (2009), 15 entering in Phase II (2010), and 10 in Phase III (2012). As of October 2009, however, only 17 Chinese enterprises had entered the zone, or 68 % of the Phase I plan. Notwithstanding, all the enterprises have been performing well thanks to the policy, service and environmental advantages of this zone. The China-Russia Ussuriysk Economic and Trade Cooperation Zone now houses seven enterprises, which have combined fixed and current assets worth 375 million yuan. Due to good production and business performance, these enterprises saw total sales revenues of $58 million USD, and paid $12 million in taxes in 2007, for example. Most enterprises in the Thai-Chinese Rayong Industrial Zone specialize in manufacturing automotive parts, machinery, metals, electronics and home appliances, and perform well at present. The Hailiang (Vietnam) Copper Manufacturing Co., Ltd. was the first company that entered the Long Giang Industrial Park. This company invested $47.18 million USD in Phase I to build a 36,000-ton high-quality copper alloy production facility. Hailiang will increase its investment to $120 million USD and move its 35,000-ton capacity facility from China to ultimately build a 71,000-ton copper alloy production facility at this site. The company has already begun production as planned.

7.1.2 Main Problems with Overseas Economic and Trade Cooperation Zones

7.1.2.1 Problems with Enterprises

Enterprises themselves play a dominant role in the construction of overseas economic and trade cooperation zones. Nonetheless, investment in such a zone is usually started off by a single leading enterprise under the guidance of the government, and then more enterprises are gradually invited to participate. This approach has led to four main problems. First, the leading enterprise will receive government subsidies and loans, which may encourage excessive development and construction. Second, these overseas economic and trade cooperation zones mostly target Chinese

SMEs. Since these enterprises are less competitive, it is doubtful whether they are able to support and collaborate with each other in terms of business functions, in order to get the maximum benefit from outbound investment and cooperation, and ensure sustainable development of the zone and its leading enterprise. Third, since there are no new, assets-based ties between the leading enterprise and the SMEs, the question of how to coordinate the international operations of the SMEs in the zone and to properly control overseas processing and production remains unanswered. Fourth, a good external governance mechanism intended to encourage and bind local enterprises to supply diversified, stable and reliable energy and resources has yet to be established among the enterprise clusters in the zone. In general, problems with enterprises themselves have posed tough challenges for the sustainability of overseas economic and trade cooperation zones.

7.1.2.2 Unclear Industry Positioning

Several problems plague the first two batches of approved cooperation zones, including similar industrial choices, excessive industries, unreasonably high positioning and unclear future development plans. With regard to industrial choices, for example, all the cooperation zones are meant to cover all possible industries, and each is planned, with the exception of the nonferrous industrial park in Zambia, to integrate manufacturing, commerce, logistics, services and recreation in one area. Such a plan may look ideal, but it ignores zone-specific characteristics and industrial advantages. This type of plan also does not reflect the situation in, and needs and requirements of, the host country in which the zone is located.

7.1.2.3 Unscientific Zone Plans

An excessive amount of similar zones have been planned and built. There was a very short construction interval between the first two batches of cooperation zones approved by MOFCOM. Before the experience and lessons from the first batch could be assessed and summarized, the second batch had been initiated and construction had started in an almost identical manners the first batch. As such, there were only quantitative, not qualitative, differences between the first two batches. A continued lack of proper guidance and improvement may cause potential problems for future development.

The plans and investments themselves also faced high risks. The current approach of having a leading investor establish a zone and then invite other enterprises to enter the zone is likely to lead to unreasonably large cooperation zones and one-off investments. Great losses will occur if the investment environment in the host country changes for the worse, or the defined investment plan finds no market or demand in the host country. In addition, most host country investment destinations are underdeveloped and possess certain deficiencies with respect to the economic environment, infrastructure, institutional arrangements and credit environment. These deficiencies greatly increase the risks to China's outbound investments.

Additionally, many of the cooperation zones are limited to a few, similar locations. In Southeast Asia, for example, China has built overseas economic and trade cooperation zones in Cambodia, Vietnam and Thailand. Cambodia and Vietnam are very similar, small countries, and two cooperation zones have been built in Vietnam, in particular. This practice is prone to causing vicious competition and is counter to the original intention of building such zones. Lastly, security issues were overlooked in the planning and construction of several cooperation zones, resulting in a high degree of potential security threats.

7.1.2.4 Disadvantages of the Host Countries

The host countries of particular economic and trade cooperation zones have been slow to deliver the incentives that they originally promised. For example, the Pakistan Haier-Ruba Economic Zone is in a country with an unstable political situation. The lack of political stability adversely affects both parties in terms of economic benefits, the implementation of relevant incentives and the progress of construction and entrance of enterprises into this zone. The China-Russia Ussuriysk Economic and Trade Cooperation Zone also faces several problems, including the lack of special incentives, Russia's cumbersome project approval procedures, difficulties in getting work permits and finishing customs clearance procedures for equipment, and even the weather. Due to the climate of Russia's Far East, only 6 months of the year is suitable for construction conditions. As for the Mauritius Tianli Economic Trade and Cooperation Zone, the Mauritius government still has yet to provide the incentives that it promised long ago. The Taihu Cambodia International Economic Cooperation Zone is located in an environment with poor utilities and telecommunications infrastructure that far from satisfies the needs and requirements of this zone.

7.1.3 Recommendations for Furthering the Growth of Overseas Economic and Trade Cooperation Zones

7.1.3.1 Provide Incentives to Make Enterprises More Willing to Go Global, and Strongly Support Promising SMEs

Improving corporate conditions is of primary importance for transforming overseas economic and trade cooperation zones from being government-led to enterprise-led, as well as strengthening the micro-level foundation for the sustainability of such zones. Only by fueling corporate growth and providing strong support for promising SMEs can the Chinese government encourage enterprises to go global, and ensure that the right number of financially strong enterprises establish themselves in overseas economic and trade cooperation zones. The Chinese government needs to provide incentives with respect to industry support, production/consumption, investment, international economic cooperation and foreign trade. It should strongly support promising SMEs, in particular, and guide them in focusing internal resources on improving the main business, rather than on increasing business types and sizes, to enhance their core competitiveness. Additionally, overseas economic and trade cooperation zones should develop their respective entry/exit criteria in order to attract compliant enterprises while eliminating non-compliant ones. The China-Egypt Suez Economic and Trade Cooperation Zone, for example, has developed such criteria. In 2011, 6 of the 27 enterprises that entered this zone in 2010 exited, and four new enterprises entered. The average profits of these enterprises rose from $83,800 USD in 2010 to $92,000 USD in 2011. This indicates that the selectivity criteria of a zone can be conducive to increasing the profit margins of enterprises in the zone.

7.1.3.2 Make Proper Adjustments to Industry Positioning and Promote the Growth of Zone-Typical Industries

Unreasonably high industry positioning and excessive industries are two general problems facing existing overseas economic and trade cooperation zones. In particular, the intent to build all the zones into integrated service zones is inconsistent with both the conditions of Chinese enterprises and with the regional economic and geographic conditions of the host countries. It is therefore necessary to change the industry positioning. To this end, the Chinese government should properly assess the main industries in the cooperation zones and identify zone-specific advantages from an industrial economics perspective. It should analyze and understand the zones in terms of transportation, resources, supply chains, industrial characteristics, market coverage and benefits available to the zones. The Chinese government should also guide Chinese enterprises such that they fully consider the situation in the host countries. Additionally, the Chinese government should clearly and specifically position the overseas economic and trade cooperation zones to reflect the future direction of industries and their business functions, after considering factors such as the technological, managerial, and HR advantages of the Chinese enterprises, their experience in international business, as well as the potential domestic resources that would attract enterprises into these zones. Also, the cooperation zones should be built to create business ecosystems conducive to economies of scale and complementary effects. For example, the cooperation zones should provide efficient services and systems with respect to forwarding agencies, customs clearance, logistics, banking, legal, financial, employee training, chamber of commerce, catering, security, sanitation and repair/maintenance services. In other words, these zones should provide public products and services to help enterprises reduce costs and expenses, on the one hand, and increase overall productivity in the zones, on the other.

7.1.3.3 Build an Integrated Indicator Assessment System to Enable Reasonable Planning and Development of Cooperation Zones

To effectively promote the healthy and systematic development of overseas economic and trade cooperation zones, which harmonizes and reflects the needs of society, the economy, culture, and the environment, it is necessary to build a scientific, quantitative and standardized indicator system. The appropriate Chinese government authorities should devise a system of standardized indicators to assess the construction and development of cooperation zones. This indicator assessment system should be based on the geographic, economic and societal conditions of the country in which the cooperation zone is located, and should also refer to criteria pertaining to similar development zones in China. Additionally, it should focus on the long-term development and overall benefits of the cooperation zones, not just the short-term profits of the enterprises in the zones. It should also factor in the external economic benefits of the cooperation zones, not just in terms of the benefit to the host country (i.e., the contribution to the local economy), but also in terms of attracting overseas expansion of other enterprises into the host country. The China-Egypt Suez Economic and Trade Cooperation Zone has carried out effective tests in this field (see Table 7.1).

7.1.3.4 Develop and Enhance the Government's Steering, Service and Support Functions

Today, MOFCOM is in the process of approving the third batch of overseas economic and trade cooperation zones. It is in this approval period that the Chinese government should learn from its previous experience in promoting the development of cooperation zones, and change its mentality from one focused on providing a leadership function to one that focuses on orientation, services and support functions. This will enable the government to effectively promote the healthy and systematic development of all cooperation zones.

As part of this change in mindset, the relevant government authorities should focus on providing necessary coordination and guidance to address the problems plaguing the development of cooperation zones, such as a lack of rational investment, an excessive amount of similar projects and excessive focus on only a few select locations. This guidance will allow enterprises in the zones to differentiate their businesses and overseas operations to complement one another, thereby preventing vicious competition and waste of resources. Second, the relevant government authorities should develop various information access methods to provide the enterprises with information services regarding the host countries' policy environments, customs, etc., as well as guidance and recommendations on investment and business decisions. Third, the appropriate government authorities should establish necessary support systems, such as a risk avoidance system and a warning system, to help inform investors of the investment environments in the host countries. The Chinese government should also provide policy and financial support to enterprises

Table 7.1 The integrated performance assessment system for overseas economic and trade cooperation zones (with the China–Egypt Suez Economic and Trade Cooperation Zone as an example)

	Item	Unit	2009	2010	2011
Contribution to local economy	The number of enterprises in the zone		20	27	25
	Agreed-upon investment	USD 1,000,000	180.04	216.82	283.62
	Annual output value	USD 1,000,000	30.8261	46.9166	46.3484
	Annual tax	USD 1,000,000	0.8364	1.3229	1.0007
	Import/export value	USD 1,000,000	18.868	29.0184	34.4591
	The number of Egyptian employees		1,102	835	675
	The total amount of wages of Egyptian employees	USD 1,000,000	1.4425	1.9665	1.0091
Contribution to China's "Go Global" strategy	Accumulated total of actual outbound FDI	USD 1,000,000	9.722	69.48	104.82
	Accumulated total of attributable equipment exports from China	USD 1,000,000	13.4082	15.15	34.231
	Accumulated total of attributable raw-materials exports from China	USD 1,000,000	10.986	22.9434	30.7001
	Total profits	USD 1,000,000	1.43	2.2618	2.30
Business Benefits Of The Zone	Profits of Egypt TEDA (Tianjin economic-technological development area)	USD 1,000,000	0.429	0.399	0.425
	Profits of Central Africa TEDA	RMB 1,000,000	29.74	51.43	40.07
	Accumulated total infrastructure investment in previous years	USD 1,000,000	26.54	32.611	49.405

Source: Feng Weijiang (2010)

with overseas operations in order to help them secure investment opportunities and reduce investment risks. It should send timely warnings and, if an enterprise's rights and interests are damaged, protect them through all the above-mentioned support systems. Fourth, the Chinese government should enhance consultations with the host countries regarding the development of the cooperation zones. Since setting up an overseas economic and trade cooperation zone requires high-level economic and trade cooperation, the Chinese government should coordinate with the government of the host country, enhance high-level meetings and consultations, and establish intergovernmental cooperation, coordination and dialogue mechanisms to discuss issues such as open market access, industry cooperation options, bilateral coordination regarding industrial policies, incentives for enterprises in the zone, national treatment and the human and asset safety of enterprises. It is necessary to keep consultation mechanisms efficient and effective so as to facilitate the development of the cooperation zones.

7.1.3.5 Improve the Risk Prevention/Control and Safety/Security Systems for the Cooperation Zones

Become More Aware of Risks

All the cooperation zone administrative boards should develop a global and strategic view to further guide the enterprises in the zone and help them understand the current safety/security situation, become more aware of risks, and identify the risks they may face in carrying out economic activities in the host countries. The enterprises should understand the relationship between development and safety – development is possible only when safety is ensured. Only with higher awareness of risks can the enterprises focus on prevention and pay equal attention to risk prevention and management. This will allow the enterprises to avoid or minimize the losses of overseas investment assets, assure the safety of overseas employees and protect the interests of China.

Build and Improve the Safety/Security Responsibility System

Under the principle of "the investor/sender is responsible for safety/security", the enterprises that participate in a cooperation zone must be directly responsible for risk prevention/control and safety/security in the zone. As such, they must assume responsibility for providing employees with safety/security education and conduct safety/security management, monitoring and examination. The head of every enterprise in the zone should take primary responsibility for overseas safety/security and must efficiently and effectively perform his/her function in this respect.

Make and Improve Internal Safety/Security Contingency Plans and the Internal Emergency Response Mechanism

In order to nip potential problems in the bud, the lead enterprise that implements a cooperation zone must make and improve safety/security contingency plans and the emergency response mechanism according to the situation in the host country. This enterprise should conduct reasonable coordination and direction and take effective measures in accordance with the current division of work and role arrangements.

Contingency plans specific to different scenarios should be made, released to all relevant individuals and organizations at the earliest possible time, and enforced whenever necessary.

Make Project Risk Assessment and Build the Safety/Security Cost Accounting System

Every cooperation zone administrative board must make or improve risk assessment for every investment project. Making judgments according to safety/security factors allows the board to effectively conduct daily management and operations. With respect to budgets and expenses, safety/security measures may be included as part of the existing public services in the zone.

Develop Practicable Risk Prevention/Control and Safety/Security Measures

First, it is necessary to identify the locations in the cooperation zone that require major safety/security measures. Such locations generally are in the production, living, office and central areas, and should include financial offices, warehouses, master control rooms, substations, electricity control rooms, water treatment facilities, confidential document storerooms, chairperson's and general manager's offices. Multi-level management, prevention and control measures should be taken. Second, safety/security techniques and equipment must be in place. Overseas Chinese-controlled organizations and their premises must be equipped with necessary safety/security measures, including electronic monitoring/control and warning systems, INMARSAT telephones, standby power supplies, emergency materials such as food, medicine, water and petrol, and required rescue equipment and vehicles. Third, full-time security guards must be hired. Every cooperation zone must have a team of full-time and part-time security guards with clear division of work and role arrangements. Local armed police or security guards may be hired depending on security risk levels and the security situation in the host country. Former members of special police or military forces may be hired as leading security guards to train their local colleagues, thereby enhancing protection in the zone.

Build and Improve the Safety/Security Risk Warning and Information Reporting Systems

In the event of an emergency, relevant information must be reported to the Chinese embassy/consulates in the host country, relevant investors back in China, and higher authorities at the earliest possible time. Contingency plans must be launched immediately to effectively manage the crisis and/or carry out relevant PR activities.

7.2 Assist Private Companies in the Cooperation Zones

7.2.1 Overview of Private Companies in the Overseas Economic and Trade Cooperation Zones

MOFCOM awarded contracts to private companies for 8 of the 19 overseas economic and trade cooperation zones approved in the first two batches. Private companies based in Zhejiang Province won contracts for four of these zones, including the Sino-Russian Tomsk Wood Industry and Trade Cooperation Zone and the Thai-Chinese Rayong Industrial Zone. Some other private companies have built industrial parks or FTZs on their own, such as an FTZ built by the Daheng Group in Botswana and an industrial park built by General Protecht in the City of Atlanta, GA. Overseas economic and trade cooperation zones set up by Chinese private companies can generally be categorized by industry; research and gathered data show that the main industry categories fall in the production and sales of home appliances, electromechanical equipment and automotive/motorcycle components; textile/shoemaking and textile technology R&D; tree felling and processing; and mineral resources exploitation. These zones are mostly located in Russia, ASEAN countries and, especially, Africa. When compared with SOEs that implement overseas economic and trade cooperation zones, Chinese private companies need more specific government support due to limitations in human, physical and financial resources.

7.2.2 Main Problems Facing Chinese Private Companies That Implement Overseas Economic and Trade Cooperation Zones

7.2.2.1 Insufficient Understanding of the Investment Environment in the Host Country

Chinese private companies are generally smaller and have limited resources compared to SOEs. As such, it is difficult for them to gain a comprehensive understanding of the legal and policy environments, business models and cultures in the host countries. Some private companies have nothing to rely on but themselves when they first arrive in a strange country. For their part, securing economic benefits can be a lengthy process, with low efficiency, frequent mistakes, high costs, and wasted time. Both the Chinese government and relevant chambers of commerce are seldom able to provide effective assistance to enterprises that go global. The Chinese company Geelyis such an example of a private company that suffered difficulties in building an economic and trade cooperation zone in Mexico due to a lack of understanding of the political and legal systems of the country.

7.2.2.2 Scarcity of Versatile Professionals Familiar with the Legal and Policy Environments in the Host Countries

One study has shown that Chinese private companies that build and manage cooperation zones outside China tend to be short of professionals in the fields of international business management and marketing, who have a good command of foreign languages, and are familiar with the local legal and policy environments and business models in the host countries. This lack of qualified professionals in these fields has hindered corporate growth and advancement. The reason for the lack is partly because these economic and trade cooperation zones are mostly in underdeveloped regions such as South Asia, Africa and Eastern Europe, which are generally not attractive employment destinations for the needed professionals. In addition, the lack of necessary supportive policies and laws makes it more difficult for these zones to recruit qualified individuals in the fields of international business management and marketing. Some private companies have reported that, due to restrictions and a lack of effective management, they have lost valuable human resources that they developed by themselves as a result of better offers from the local competition. Such losses typically cause a crisis of trust within the companies, and as a result, these companies have reasons to worry about the implications of recruiting locals as managers.

7.2.2.3 The Government Pays More Attention to Approval than to the Provision of Services

Cumbersome and lengthy approval procedures for overseas investment are detrimental to the ability of Chinese enterprises to seize business opportunities. Today, private companies must receive approval for overseas investment projects from multiple government authorities, including the local reform and development commissions, foreign economic and trade cooperation authorities, and customs and foreign exchange administrations. Companies with very large overseas investment projects also have to receive approval from the NDRC and MOFCOM. For example, in order to build an industrial park in the United States, the Tong Ling Group spent more than 1 year going through the approval procedures at the foreign economic cooperation, foreign trade and foreign exchange authorities ranging from the provincial/departmental level to the national level. This not only wasted a huge amount of time, labor, and physical resources, but more importantly, caused the company to miss out on numerous potential business opportunities. Some enterprises do not receive any reply within 1 or even 2 years after they submit applications for approval. Some authorities also do not give an explanation for why a project has been denied, unless they receive a specific request to do so. No authority is held accountable for the loss of business opportunities that result from these cumbersome and lengthy approval procedures.

7.2.2.4 Difficulties in Receiving Approval for Buying Needed Foreign Exchange and Becoming Eligible for Incentives

Today in China, there still remains tight limitations on buying foreign exchange for investment, making it difficult for Chinese enterprises to invest overseas. With respect to the foreign-exchange administration, SAFE requires that projects with a total investment of over two million USD be approved by the relevant provincial branch; projects with a total investment of over ten million USD, must be approved by SAFE itself. Additionally, the *Interim Administrative Measures for Approving Overseas Investment Projects* issued by the NDRC provides that the NDRC must review, and the State Council must approve, the following types of projects: resource development projects with total investments of over $30 million USD, projects that require more than $10 million USD in foreign exchange, resources development projects in which Chinese organizations invest at least $200 million USD, and other projects in which Chinese organizations invest at least $50 million USD. This has made it impossible for Chinese private companies to gain timely access to foreign exchange needed for their respective overseas investment projects, and constitutes a severe obstacle to the growth of Chinese companies outside China. For example, the total investment in the aforementioned industrial park built by the Tong Ling Group was $136 million USD. Unfortunately, the Tong Ling Group could only apply for up to $9.99 million USD since the relevant provincial department for foreign economic cooperation and trade was only allowed to approve applications for less than $10 million USD. The company had no choice but to secure the needed $136 million USD by submitting more than ten applications, each with a complete set of project reports. In brief, the existing regulations have imposed severe difficulties on Chinese enterprises seeking to invest overseas.

7.2.2.5 Delays in Granting Government Subsidies

Delays in granting government subsidies have caused extra difficulties in financing the construction of overseas economic and trade cooperation zones. Most Chinese private companies are SMEs and cannot match SOEs in terms of internal financial resources. Investments in overseas economic and trade cooperation zones are largely raised by Chinese private companies responsible for the construction of these zones. Some of these companies have invested nearly all their funds, although these funds may only cover the early stages of zone development. Chinese companies generally factor in government subsidies as part of their total budget for a project; unfortunately, these subsidies sometimes take a long time to be delivered. Moreover, it is very difficult for Chinese private companies to receive bank loans. To benefit from relevant policies and government subsidies, Chinese private companies must submit complex application documents and go through cumbersome and lengthy application procedures. Many policies are seldom effectively implemented. In 2006, when it began planning the construction of overseas economic and trade cooperation zones, the Chinese government said that it would grant each zone up to two billion yuan in loans. Later on, the Chinese government said that for every approved overseas economic and trade cooperation zone, the state would provide two to three hundred million yuan in financial support and up to two billion yuan in mid- and long-term loans. The ineffective implementation of this policy and slow granting of these loans was very detrimental to Chinese private companies seeking to finance their overseas operations. Take the industrial park built by Geely for example. Geely estimated that the total investment for their project would require 10.60 billion yuan, an amount that would have been very difficult for Geely to raise by itself. The Holly Group also factored in government subsidies as part of its budget for building an industrial park, but later on found out that government subsidies were granted too slowly to satisfy its financing needs.

7.2.2.6 A Lack of Effective Integration of Information Resources

Chinese private companies lack an in-depth understanding of relevant foreign laws, policies and investment environments. Relevant websites fail to provide sufficient usable information, yet there is an excess of relevant research organizations and consulting service providers. Due to limited size and competence, it is expensive for Chinese private companies to obtain accurate information all by themselves. As a result, various information resources should be effectively integrated to provide comprehensive and usable information to Chinese enterprises at a reasonable cost.

7.2.2.7 A Shortage of Incentives for Investment in Resource Development

Resource development projects in overseas economic and trade cooperation zones can reduce the consumption of China's domestic resources and environmental pressure, promote the export of equipment, labor services and building/construction materials, and avoid technical barriers. Resource development projects require huge amounts of capital investment, have long implementation cycles and industry chains, operate under harsh environments, and suffer from insufficient government support. As an example of some of the difficulties faced, Xilin Group, a Chinese enterprise based in Yantai City, Shandong Province, needed to buy equipment critical for a Russia-based industrial park project from a third country, because such equipment was unavailable in China. The Xilin Group encountered a problem during customs clearance. Such equipment would be regarded by Russia as imported equipment from the third country, and hence would not be eligible for tax exemption for investments in kind. Xilin could get around this if it increased its investment in the Russia-based subsidiary by means of cash before buying the equipment from a third country. However, this solution ran into another problem; the direct import of the equipment from a third country before turning it into investment in kind in Russia would be inconsistent with the investment destination approved by the Chinese government. The relevant Chinese authority required that Xilin ship the equipment to China before going through investment increase procedures. Such a solution added a significant burden on the company and caused a huge waste of time.

7.2.3 Recommendations on How to Support Chinese Private Companies in Overseas Economic and Trade Cooperation Zones

7.2.3.1 Provide Chinese Private Companies with More Incentives

The Chinese government should offer policy incentives depending on the form, size and type of overseas investments made by enterprises. It should focus policy support on outbound investors that carry out resource development and manufacturing/processing projects. The Chinese government should not categorize loans according to whether the enterprise is private or state-owned, but instead provide financial support according to business size in order to help private companies of different sizes go global more easily.

7.2.3.2 Set Up Overseas Investment Development Funds for SMEs

The Chinese government should use its huge foreign exchange reserves to set up multiple small- and medium-sized funds to serve as equity capital for corporate growth. With these funds, the Chinese government may provide direct financial support to private companies that create industrial parks outside China, including subsidized loans for infrastructure construction in these parks. It is advisable to financially reward outbound investors on a pro-rata basis according to the amounts of their actual investments, thereby reducing relevant risks and costs. The Chinese government should grant such rewards to private companies that invest in overseas economic and trade cooperation zones, in particular, so as to encourage enterprises to go global in the form of business clusters.

7.2.3.3 Open a Semi-official Outbound Investment Promotion Center

The Chinese government may refer to the practices in Singapore and Hong Kong and open a semi-official outbound investment promotion center with overseas offices to facilitate the provision of services to Chinese enterprises. Such a center should provide enterprises with assistance regarding information and, especially, project negotiations and feasibility research. In the meantime, it may provide enterprises with one-stop services by going through required procedures at the competent customs, financial institutions, inspection and quarantine bureaus, SAT offices and foreign-exchange administrations on behalf of enterprises.

7.2.3.4 Chinese Embassies/Consulates Should Enhance Services for Chinese Private Companies

Chinese embassies/consulates should expand management and services to cover Chinese private companies. They should provide Chinese private companies with local political, economic, policy and legal information and provide timely updates on developments that may affect these companies. In countries and regions where there are many Chinese private companies, the economic and commercial counsellor's offices of Chinese embassies/consulates should increase the number of employees that come from federations of industry and commerce. Chinese embassies/consulates should actively guide Chinese private companies in utilizing international resources such as bilateral investment guarantee agencies to reduce operating costs and better prevent risks.

7.2.3.5 Encourage the Federations of Industry and Commerce to Act as a "Bridge"

The Chinese government should make full use of the federations of industry and commerce to act as a "bridge" in enhancing communication and coordination with the relevant government authorities. These federations should provide policy, legal, business and HR consulting and training services to enterprises that have invested or are preparing to invest in overseas economic and trade cooperation zones to build and open factories. It is important for the federations of industry and commerce to further enhance connections and establish cooperation mechanisms with trade organizations, chambers of commerce and industry associations in the investment destinations or the host countries in which cooperation zones are located. The federations should actively assist Chinese enterprises in responding to issues such as anti-dumping investigations and technical barriers. By addressing difficulties facing Chinese private companies, the federations will become their strong supporters. Lastly, the All-China Federation of Industry and Commerce (ACFIC) should take the lead in establishing organizations in overseas economic and trade cooperation zones, such as associations of enterprises with international operations. These organizations should play the role of coordinating relevant affairs and protecting the interests of overseas Chinese enterprises, on the one hand, and guiding them in self-management, self-regulation and self-education, on the other. These efforts will help maintain desirable competition.

Chapter 8
The Overseas Securities Investment Promotion Subsystem

Overseas securities investment is an important part of China's outbound investment strategy. It is very significant for three reasons. First, due to the fast growth of the Chinese economy and an increasing amount of foreign exchange reserves, China has a strong material foundation for outbound investment. The need to maintain and increase the value of China's foreign currency assets has become the internal driving force for making outbound investment. Second, overseas securities investment and capital operations will both become necessary for the success of China's ongoing transformation. Third, overseas securities investment is a good supplement to the few investment approaches in China, as it provides domestic investors with an effective way of reducing investment risks. The Chinese government should build the overseas securities investment subsystem around improving the Qualified Domestic Institutional Investor (QDII) system and standardizing Sovereign Wealth Funds (SWFs).

8.1 Improve Main Systems in the Field of Overseas Securities Investment

With China's capital account not yet fully open and its currency not yet fully convertible, the primary system for overseas securities investment in China today is the QDII system, under which Chinese nationals may indirectly trade in securities such as stocks and bonds in foreign capital markets through financial institutions approved by the domestic regulators. The launch of the QDII system was a test in institutional innovation intended to provide domestic capital with more possibilities for investment. The QDII system has been able to increase the efficiency of China's financial assets allocation and transformation of domestic deposits into investments.

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In the first half of 2001, the government of the Hong Kong Special Administrative Region submitted a report to the State Council, recommending that licensed institutional investors be set up in the Chinese Mainland. In September 2004, the China Insurance Regulatory Commission (CIRC) and the People's Bank of China (PBC) co-issued the *Interim Measures for Administering the Overseas Use of Insurance Foreign Exchange Funds*. In 2006, the relevant Chinese government authorities issued the *Interim Measures for Administering the Provision by Commercial Banks of Overseas Wealth Management Services*, the *Operational Procedures of Administering Foreign Exchange in the Provision by Commercial Banks of Overseas Wealth Management Services*, the *Notice on Issues Relevant to the Provision by Commercial Banks of Overseas Wealth Management Services*, the *Notice on Issues Relevant to Administering Foreign Exchange in Overseas Securities Investment by Fund Management Firms* and the *Interim Regulations on Administering Overseas Investment by Domestic Social Security Funds*. On November 2, 2006, the Hua An International Balanced Fund was officially launched as the first ever domestic fund to invest in overseas capital markets. On June 18, 2007, the China Securities Regulatory Commission (CSRC) issued the *Trial Measures for the Administration of Securities Investment outside the Territory of China by Qualified Domestic Institutional Investors* and the *Notice on Issues Relevant to the Enforcement of the Trial Measures for the Administration of Securities Investment outside the Territory of China by Qualified Domestic Institutional Investors*. On June 28, the CIRC issued the *Interim Measures for Administering Outbound Investment with Insurance Funds*. All these documents indicated that a preliminary legal system regarding the QDII system had been established in China.

Unfortunately, however, China's QDII system has produced far from satisfactory results. Since the QDII system began overseas operations, the net value of funds managed by QDIIs is often embarrassingly low, according to Wind Information Co., Ltd (Wind Info). As of September 19, 2011, only about 10 % of products from QDIIs had made profits. Forty-four QDII funds had suffered a total loss of about 45 billion yuan. Thirty-nine QDII funds each had a net value below zero. The China International Fund Management (CIFM) Asia-Pacific Advantage founded in October 2007 saw the heaviest loss with net value of only 0.554 yuan. China's first ever QDII fund, the Hua An International Balanced Fund was already returned to its holders on November 2, 2011 at its original face value, after the first investment period ended. Investors were refunded about $3 million USD and the fund ended operations. The above-mentioned figures show that Chinese financial institutions and investors have performed very poorly since they entered global capital markets. One of the most important reasons for this poor performance lies in the institutional flaws in the QDII system.

8.1.1 Flaws in China's QDII System

8.1.1.1 The Regulatory Method

Excessive Regulators

Chinese QDIIs fall under commercial banks, insurance companies and securities companies (including fund and securities firms), each of which is regulated by a different authority. The *Trial Measures for the Administration of Securities Investment outside the Territory of China by Qualified Domestic Institutional Investors* provides in Article 4 that "The CSRC and the State Administration of Foreign Exchange (hereinafter referred to as SAFE) shall implement surveillance on the securities investment outside the territory of China by QDIIs." Under Articles 3 and 4 of the *Interim Measures for Administering the Provision by Commercial Banks of Overseas Wealth Management Services*, the CBRC has the power to approve commercial banks to provide overseas wealth management services and regulate such services, whereas SAFE administers foreign exchange limits on such services. The *Interim Regulations on Administering Overseas Investment by Domestic Social Security Funds* provides in Article 8 that "The CIRC shall make policies concerning, and regulate, overseas investment by insurance funds, whereas SAFE shall administer such foreign exchange issues as payment limits, remittance and conversion with respect to overseas investment by insurance funds." It can thus be seen that the CSRC, the CBRC and the CIRC regulate QDIIs in the categories of securities companies, commercial banks and insurance companies respectively, as opposed to the fact that SAFE is the single regulator in the field of foreign exchange. While such a regulatory method does follow the basic principle of "industry-specific administration" in China's financial sector, there are obvious flaws in the coexistence of multiple regulators. In 2004, the CSRC, the CBRC and the CIRC co-issued the *Memorandum on the Division of Work in the Field of Financial Regulation*, establishing the regulators' meeting mechanism and the information exchange and cooperation system. However, the traditional divided regulation system has led to "spheres of influence" unique to each regulator, resulting in the failure of either of the aforementioned systems from producing significant effects.

Pay More Attention to Qualification than to Monitoring

Today in China, the current practice of securities regulation pays more attention to review and approval than to investigations and penalties. As such, issues that should be regulated by market rules are instead regulated by the Chinese government. With this practice, regulatory activities such as review and approval of securities investment by QDIIs before or during such investment activities are carefully carried out. However, routine monitoring of investment activities is insufficient. This practice has considerable adverse effects on the creation of a market mechanism, as it creates a phenomenon in which investors only passively receive regulation, which in turn usually leads to attempts by these investors to circumvent the law.

8.1.1.2 The Legal System

Low Levels of Relevant Laws with a Lack of Unified Provisions

Laws governing Chinese QDIIs mainly include regulations promulgated by the CSRC, the CBRC and the CIRC. These are low-level regulations, which are not very authoritative. Moreover, there is often inconsistencies or even conflicts between the contents of these regulations, some of which differ widely from globally accepted practices. Specifically, the *Trial Measures for the Administration of Securities Investment outside the Territory of China by Qualified Domestic Institutional Investors*, the *Interim Measures for Administering Outbound Investment with Insurance Funds* and the *Interim Measures for Administering the Provision by Commercial Banks of Overseas Wealth Management Services,* which form the main body of law governing QDIIs, are inconsistent with one another in many aspects.

1. The aforementioned three regulations differ from one another in terms of the concepts of outbound investors and the forms of outbound investments. The *Trial Measures for the Administration of Securities Investment outside the Territory of China by Qualified Domestic Institutional Investors* employs “qualified domestic institutional investors” and “overseas securities investment;” the *Interim Measures for Administering the Provision by Commercial Banks of Overseas Wealth Management Services*, “commercial banks” and “overseas wealth management services”; the *Interim Measures for Administering Outbound Investment with Insurance Funds*, “investors who make outbound investment with insurance funds” and “outbound investment with insurance funds.”
2. The aforementioned three regulations also differ from one another in terms of provisions regarding investment instruments. The *Trial Measures for the Administration of Securities Investment outside the Territory of China by Qualified Domestic Institutional Investors* employs the concept of “securities”, and the *Notice on Issues Relevant to the Enforcement of the Trial Measures for the Administration of Securities Investment outside the Territory of China by Qualified Domestic Institutional Investors* exhaustively enumerates all the allowable “financial products or instruments” that can be invested in. The *Interim Measures for Administering Outbound Investment with Insurance Funds* only enumerates the allowable types of investments without using the concept of “financial products” or “securities”. The *Interim Measures for Administering the Provision by Commercial Banks of Overseas Wealth Management Services* provides that qualified commercial banks may invest in financial products outside China, although it does not enumerate the types of such financial products. The *Notice on Issues Relevant to the Provision by Commercial Banks of Overseas Wealth Management Services* provides in Article 6 that “Commercial banks

must not invest directly in stocks or their structural products, commodity derivatives or securities at levels lower than BBB in cases where these banks provide overseas wealth management services as part of their integrated wealth management services."

Unclear Legal Responsibility

Although the *Trial Measures for the Administration of Securities Investment outside the Territory of China by Qualified Domestic Institutional Investors*, the *Interim Measures for Administering the Provision by Commercial Banks of Overseas Wealth Management Services* and the *Interim Measures for Administering Outbound Investment with Insurance Funds* have provisions regarding regulation over QDIIs, none of them clarifies specific legal responsibility. The *Trial Measures for the Administration of Securities Investment outside the Territory of China by Qualified Domestic Institutional Investors* provides in Article 43 that "The CSRC and/or SAFE shall impose administrative punishment on domestic institutional investors and custodians that have violated these Measures." The *Interim Measures for Administering the Provision by Commercial Banks of Overseas Wealth Management Services* provides in Article 43 that "SAFE shall impose administrative punishment on commercial banks and their custodians inside China that have violated these Measures. In severe cases, both the CBRC and SAFE are entitled to require the aforementioned commercial banks to replace their custodians inside China, or even to cancel the quota of foreign exchange purchase for their overseas wealth management services. Both the CBRC and SAFE are entitled to require the replacement of the overseas agents of the custodians if these agents refuse to provide relevant information." The *Interim Measures for Administering Outbound Investment with Insurance Funds* specifies in Articles 57 through 59 a principle that "the CIRC shall impose administrative punishment under law" against wrongdoing by clients, trustees and custodians, but with no provision on relevant civil responsibility of QDIIs.

8.1.1.3 Information Disclosure

The concept of financial regulation that focuses on information-based regulation is reflected, to a certain extent, in the system of QDII-relevant rules. The *Trial Measures for the Administration of Securities Investment outside the Territory of China by Qualified Domestic Institutional Investors* provides in Article 32 that "Such people with the obligation to make information disclosure as the QDII, and the custodian shall reveal the information in strict accordance with related laws and regulations." The *Interim Measures for Administering the Provision by Commercial Banks of Overseas Wealth Management Services* specifies information disclosure in nine articles in Chapter 5, titled "Information disclosure and risk management". In addition, the *Interim Measures for Administering Outbound Investment with Insurance Funds* specifies information disclosure in 13 articles in Chapter 7, as is exemplified by Article 47: "The investor who makes outbound investment with insurance funds shall disclose information on important issues to relevant parties on a true, accurate and complete basis in accordance with applicable regulations issued by CIRC and must not have any material omissions or make false, misleading and/or disparaging statements." Despite the quantity of provisions on information disclosure, careful analysis of the aforementioned provisions easily reveals their deficiencies:

The Lack of a Review/Monitoring/Authentication System for Information Disclosure

Information disclosure should obey rules such as truthfulness, accuracy, completeness and timeliness, which should apply equally to information released by individuals or organizations. However, there are no clear definitions regarding how to determine whether information is true, accurate, complete and timely. In securities markets, disclosed information is generally authenticated through certain mechanisms, and is generally trusted by investors since accounting, law and securities firms engage in information disclosure. In comparison, Chinese QDIIs do not yet disclose sufficient information on their products. For example, they do not explain the percentages of investment instruments in their asset portfolios, nor do they provide accurate information on relevant rates and return mechanisms, or clear information on provisions of guarantees against product risks or issues that relate closely to the interests of investors. In an advertisement, China Minsheng Bank (CMBC) claimed that its *Analysis Report on the Investment Value of the "Direct Access to Hong Kong-Based Funds" Product* included an automatic termination mechanism that featured advantages such as a scientific product structure and a combination of better-than-expected returns with risk control. Such a claim actually mislead investors. It is difficult to avoid misleading information due to the lack of a review/monitoring/authentication system for information disclosure.

No Requirement for Continuous Information Disclosure

The existing provisions regarding information disclosure by QDIIs only cover pre-transaction information disclosure, with no requirement for continuous information disclosure after a transaction occurs. In securities markets, information disclosure is continuous and includes information disclosure both before and after securities products are issued, as well as regular and irregular information disclosure. This being said, the regulations mentioned in the preceding paragraphs prioritize disclosure during issuance, and neglect disclosure after issuance, i.e., continuous disclosure. In reality, it is only after securities products are launched into the market that investors focus their attention on information disclosed on a continuous (e.g., annual financial statements and mid-year reports) or ad-hoc (e.g. major changes in issuers, insider trading reports and early warning disclosure during acquisitions) basis, rather than on information released by issuers during issuance.

No Requirement on Legal Responsibility for Information Disclosure

Individuals or organizations that are obligated to disclose information should disclose, as required, information on investments made by QDIIs, or they will be held responsible under governing civil and/or administrative laws. Unfortunately, this requirement is not made clear in the existing system of QDII-relevant rules in China.

8.1.2 Improve China's QDII System

8.1.2.1 Improve the Regulatory Method

Identify a Leading Regulator and Improve Regulatory Measures

Now that Chinese organizations typically invest in foreign securities markets, the Chinese government should develop a regulatory method with the CSRC as the leading regulator. All the regulators should have clearly-defined responsibilities and power, and coordinate with each other to monitor and supplement each other's responsibilities. It is necessary develop and improve regulatory measures that suit the current stage of capital markets, thereby increasing regulatory efficiencies. The regulators should make great efforts to achieve effective regulation, increase fairness, transparency and efficiency in capital markets, reduce systemic risks in these markets, and protect the interests of investors.

Improve Regulatory Ideas and Enhance Self-Regulation

It is necessary to improve regulatory ideas and combine government-led regulation with self-regulation. The regulators should seek to gradually achieve regulation over QDIIs -which are among the most important investors in securities markets-through market mechanisms. They should also gradually employ a looser approval system to qualify domestic institutional investors. It is advisable for the regulators to standardize their regulatory behavior, clarify their responsibilities, reduce administrative review and approval, and gradually transition to a market-based administration, in order to comply with the principles of efficiency and moderation in QDII regulation. For example, regulations over fundraising and fund issuance by QDIIs may be achieved mainly through pre-issuance review and information disclosure. Regulation over overseas securities investment activities by QDIIs may be achieved mainly through cooperation with securities regulators in the investment destinations. Regulation over the inflow and outflow of foreign-exchange funds may be achieved by monitoring special QDII accounts. Regulation over participants in overseas securities investment activities by QDIIs, such as fund issuers, custodians and investors, may be achieved mainly by combining government-led regulation with self-regulation.

Enhance International Regulatory Cooperation

Investing outside China is the basic business characteristic of QDIIs. Accordingly, effective regulation over QDIIs necessitates a dynamic process of collaborative regulation that combines domestic regulation with international regulatory cooperation. Chinese regulators must enhance cooperation with foreign financial institutions and international financial organizations, including by establishing an effective cooperation mechanism. Collaboration should first be enhanced with Hong Kong. QDIIs tend to first focus investment in Hong Kong in their early stages, plus, since Hong Kong and the Chinese mainland are both within a single sovereign state, regulatory cooperation between the two will be more direct and effective than general international regulatory cooperation. On this basis, financial regulatory laws/regulations on each side should be amended to gradually reduce or even eliminate legal differences in securities regulation between the Chinese Mainland and Hong Kong, thereby increasing regulatory efficiency. Second, the Chinese government should enhance regulatory cooperation with other countries by signing judicial assistance agreements and memorandums of understanding (MOUs) to seek mutual assistance with the governments of other countries and their securities regulators to investigate wrongdoing by QDIIs and enforce relevant verdicts. This will allow domestic securities laws to be applied in other countries, and achieve the goal of regulating global securities markets. Judicial assistance agreements have legal force since they are signed through formal diplomatic negotiations. Regulators of relevant countries should consult and communicate with each other in terms of the regulatory goals, principles, standards, contents and methods, as well as issues discovered during regulation.

8.1.2.2 Improve the Legal System

Today, Chinese QDII-relevant laws are low-level and not very authoritative. It is necessary to change this situation and unify the regulatory provisions promulgated independently by the CSRC, CBRC and CIRC. The workable method to achieve this goal is to have the three regulators co-issue a regulatory document similar to the *Interim Measures for Administering Outbound Investment by Domestic Financial Institutions*, which unifies the contents of the existing regulations separately issued by these three regulatory authorities. In the meantime, it is advisable to add QDII-relevant provisions into the *Securities Law* and its implementation rules. The Overseas *Securities Investment Law Governing Qualified Domestic Institutional Investors* should be duly made to provide for qualifications, approval procedures, fund raising and management, information disclosure, supervision/administration and legal responsibility with respect to various QDIIs.

8.1.2.3 Improve Information Disclosure

Only by improving the information disclosure system will it be possible to enhance investor protection, build public trust and increase market efficiencies. Information disclosure is primarily intended to provide all investors with equal access to relevant information, enabling them to weigh risks and benefits regarding securities investment. In order to improve the information disclosure system in QDII legislation, efforts should be made in three main respects. First, the authentication system for QDII information disclosure should be improved. Law and accounting firms and other intermediary organizations should be required to authenticate and monitor disclosed information. Second, improvements should be made with regard to establishing a continuous information disclosure system. It is necessary to form both regular and ad-hoc information disclosure mechanisms based on specific fundamental principles and modes of information disclosure. Third, improvements should be made with regard to the legal responsibility system for information disclosure and, particularly, the civil responsibility system for QDII information disclosure.

8.2 Standardize Sovereign Wealth Funds (SWFs)

China has a huge amount of foreign exchange reserves. Before SWFs were set up, SAFE invested foreign exchange assets in government and corporate bonds in developed countries for the purpose of asset protection and liquidity. At present, the majority of China's foreign exchange reserves are invested in US national debt. Influenced by the global economic situation, it is expected that the RMB will appreciate while the US dollar continues to depreciate. As a result, investing foreign exchange reserves in government and corporate bonds in developed countries, especially the United States, is not only unlikely to make profits but risks having a negative ROI. In contrast, Middle Eastern countries with huge amounts of foreign exchange reserves -thanks to the continuous inflow of money from oil sales- have long benefited from SWFs as an active asset management method. Pioneers among emerging markets, such as Singapore, also have seen a remarkable increase in national strength through the success of SWFs like Temasek Holdings (Private) Limited and the Government of Singapore Investment Corporation (GIC). These countries all deserve close study by China. Setting up SWFs that differ from traditional assets in which SAFE has invested is, in a sense, a way to offset against excessive investment in US-dollar assets.

It is in this context that setting up SWFs to actively manage foreign exchange reserves has become an important choice for China. In September 2007, the China Investment Corporation (CIC) was officially founded with approval from the State

Council. The CIC is a wholly state-owned company formed under the *Company Law* that specializes in managing foreign exchange investments. It has 1.55 trillion yuan -which was used to buy about $0.2 trillion US-dollar foreign exchange reserves-as its registered capital. The CIC mainly invests these foreign exchange assets in foreign financial portfolios. Instead of being run by the government, the CIC independently manages its business in a commercial manner and aims to achieve the highest possible long-term returns within the limits of acceptable risk, according to an official statement. The CIC marked the creation of China's first ever SWF, and has provided a brand new approach for China to manage its huge foreign exchange reserves. The CIC has since carried out a series of investment activities; however, given its newness, it has experienced some difficulties, which may be addressed as follows:

8.2.1 Organizational Governance: Pay Equal Attention to Standardization and Professionalism

Establishing scientific, standardized and efficient internal organizational and governance structures, as well as building professional management teams that are familiar with market rules, are critical for the success of China's SWFs. CIC's current governance structure is obviously biased toward the government, making it very difficult to avoid government interference in making corporate decisions. Most members of the CPC committee and the boards of directors and management at CIC come from the State Council, the social security fund and ministries/commissions such as the MOF and the PBC, which gives the CIC as an organization an excessive political nature that makes it difficult to overcome bureaucratic flaws inherent in a government department. The close ties between CIC and relevant government authorities create restrictions and interference from stakeholders in daily investment management and operations. Consequently, internal disagreements over investment decisions may evolve into interdepartmental conflicts of interest. On the other hand, CIC has a governance structure typical of a wholly state-owned Chinese company, including the boards of management, directors and supervisors, and the CPC committee. The division of functions and roles between the board of supervisors and the CPC committee is always a headache for the governance of wholly state-owned companies. In China, the CPC committee is an organization that partially influences the daily business decisions of SOEs. Now that CIC possesses a large amount of funds, the CIC must deal with host country partners and their governments in seeking global investment opportunities. Making these partners and governments believe that the CIC acts according to market rules rather than the will of the Chinese government's remains a serious challenge.

For the future, CIC must pay equal attention to standardization and professionalism in organizational operations. Standardization refers to building an organizational structure in accordance with globally accepted standards. The senior management of such a company should never consist of anybody but government officials. However, successful SWFs, such as the Abu Dhabi Investment Authority (ADIA), the GIC and Temasek, and the Government Pension Fund in Norway, are all dedicated to employing the organizational structure of private investment firms in global financial markets, not that of government administrative agencies. These SWFs emphasize autonomy and ensure that the core decision-making power is in the hands of the board of directors and the investment committee. They prioritize organizational simplification and efficient decision making. Professionalism refers to introducing senior professionals with various backgrounds into the boards of directors, management and supervisors at CIC. The board of directors at Temasek, for example, consists of government officials, senior officials from affiliated enterprises and professionals. Temasek prioritizes recruiting people from private companies and other sectors such that both governmental and non-governmental opinions can be heard at the board of directors, bringing about a high degree of professionalism.

8.2.2 Clear Positioning: A Commercial Organization that Acts Under Market Rules

In order to succeed in global financial markets, CIC must clearly position itself as a commercial organization that makes decisions on its own and acts independently and professionally under market rules. Based on the original intention for establishing the CIC, it is clear that there are a series of conflicts in its strategic positioning. On one hand, CIC is required to achieve strategic control at the macro level, a mission tasked by the state, to assist the PBC in absorbing excessive liquidity in the domestic financial sector, and to support Chinese enterprises in going global. This is a political mission that CIC needs to complete first of all. However, it is this requirement that makes CIC so prone to political interference in carrying out overseas investment activities and, hence, to limitations set by foreign governments against China's SWFs. On the other hand, CIC was set up with clear objectives including alleviating excessive liquidity in China. This being said, its wholly owned subsidiary Central Huijin Investment Ltd. (Central Huijin) uses over 50 % of its capital on investing in domestic financial institutions. This practice has largely offset efforts to alleviate excessive liquidity in China. If CIC is unable to effectively separate its investment in domestic enterprises and its own business, then foreign governments will likely think they are a single business and, hence, magnify the asset size and energy of CIC. An expanded perception of the size and energy of CIC could serve as grounds for their claim that Chinese investment is a threat.

From a long-term perspective, enforcing a single investment strategy will become a necessary choice in order for CIC to develop into a commercial organization that acts under market rules. To this end, CIC and Central Huijin must be separated such that neither side has any equity in the other or any other substantial relations. The

Chinese government should closely study the practice of the Singaporean government and consider simultaneously setting up two independent SWFs that focus on different investment objectives. For example, CIC may focus on investing in overseas portfolios (similar to the GIC), and Central Huijinon domestic strategic investments (similar to Temasek). Such a structure, in which CIC and Central Huijin act as two parallel entities, will be conducive to reducing the political resistance against CIC in making outbound investment.

Because CIC and Central Huijin will be independent from each other, the state should be responsible for all the capital in CIC in order to reduce the financial burden on this company. As a result, freedom from having to pay relevant interests will make CIC more likely to enforce an aggressive, market-oriented, commercial investment strategy, consistent with the globally accepted practice that SWFs act with no liabilities. *The Economic Observer* reported good news on November 5, 2011 that CIC and Central Huijin already had a plan to become independent entities. According to the news report, the Chinese government would set up the CIC International Investment Limited to specialize in outbound foreign direct investment, with CIC, MOF and PBC serving as shareholders. It therefore seems that this issue will likely be solved in the near future.

8.2.3 Institutional Improvements: Fund Legislation and International Cooperation

CIC was set up as an SWF under the *Company Law of the People's Republic of China*; however, it did not receive review at the NPC, making it likely that CIC will face a series of legal challenges with respect to its status and future development. At present, CIC does not belong to the MOF or PBC. Moreover, SASAC and NDRC, both of which are in charge of large-sized SMEs, are unable to decide on its investment business. Under the leadership of a team consisting of officials from multiple government agencies/departments, CIC has yet to clarify issues such as its strategic mission, managerial power, long-term goal (i.e. focus on only commercial returns or a multidimensional, macro-level strategic goal?), investment portfolio strategy, additional sources of funds, corporate governance structure and the method of distributing relevant earnings (i.e., regularly included into public money or be held by CIC to increase its capital?). From a long-term perspective, if these issues are left unresolved, then CIC will always be riddles with challenges and restrictions from multiple fronts. In order to facilitate the healthy growth of Chinese SWFs, therefore, the Chinese government should improve fund legislation as soon as possible and, in particular, should issue basic legal documents with respect to these funds.

Nowadays, SWF-relevant international rules and principles are mostly embodied in the Sovereign Wealth Funds and Recipient Country Policies developed by the OECD, the Generally Accepted Principles and Practices (GAPP), also known as the Santiago Principles, developed by the IMF, and the Kuwait Declaration developed by the International Working Group of Sovereign Wealth Funds (IWG). A newcomer in the SWF market, China should first of all gain experience from developed European countries and the United States and study the market rules in order to improve its own systems. Second, China should make full use of its growing role in international organizations in order to engage in making SWF regulatory rules and actively express its opinions. Chinese SWFs should work with other SWFs to establish a trade dispute resolution mechanism similar to the WTO. The home and host countries of SWFs should negotiate with each other to sign agreements intended to achieve win-win situations, thereby facilitating the resolution of relevant disputes.

8.2.4 Obey Certain Practices: Become More Transparent and Seek Win-Win Situations

Almost all the satisfactory investments made by existing SWFs in Western countries are made under the following principles: never seek to become a majority shareholder; focus on investments in open markets; and duly release information on changes in the investment portfolio. In order for CIC to minimize the negative effects of political influence in outbound investment, it must emphasize increased transparency through the release of information online and improvements to the system of regular financial information reporting and announcement. In addition, the relevant Chinese government authorities should clearly define and release the investment objectives of Chinese SWFs; build and improve the legal framework, governance structure and risk management system of these funds; enhance the accountability system for SWF management; and make Chinese SWFs more independent. This will address the doubts of Western governments, reduce ethical risks for investors and fund managers, improve the reputation of Chinese SWFs, and reduce resistance in the investment destinations.

Lastly, CIC should seek win-win situations. Instead of seeking to become a majority shareholder, CIC should enhance cooperation with private companies to make outbound investment, especially strategic investment in major sectors. CIC must first of all learn from the failure of the China National Offshore Oil Corporation (CNOOC) to acquire Unocal Corporation and of the Aluminum Corporation of China (Chinalco) to invest in Rio Tinto. Based on the experience of these failed bids, CIC should always obey the principle of not seeking to become a majority shareholder and make investments in a low-profile manner, thereby reducing protectionist pressure in the recipient countries. Second, Chinese SWFs should aggressively partner with overseas private companies with good credit standings and qualifications in the home and host countries to obtain support. When it comes to overseas investment, large companies like CIC are subject to attacks because of their government background and huge funds, on the one hand, and lack of sufficient technical support in daily investment activities on the other. In comparison, domestic and overseas private companies with good qualifications and foreign experience are able to solve technical challenges facing SWFs and circumvent political barriers, and can also assist excellent private Chinese companies in going global. As a result, enhancing cooperation with private companies is one of the most important approaches to developing Chinese SWFs. Such cooperation will have significant effects for Chinese SWFs, especially with regard to investments in regions like Southeast Asia where the Chinese community has a long history, is large in size and has important political and economic influence.

Chapter 9
The Service Subsystem

The steady progression of outbound investment presupposes services at a certain level of quality. The steady increase in the size of outbound investment requires the comparable steady improvement of services at the same pace. Chinese enterprises began going global at a time when services were underdeveloped. The outcome is imaginable. Of all overseas investments made by Chinese enterprises, only one third were successful, and the others broke even or failed, according to the *Survey on Current Conditions and Intention of Outbound Investment by Chinese Enterprises* published in 2009 by the Economic Information Department of the China Council for the Promotion of International Trade (CCPIT). An important reason for such a low success rate lies in the underdeveloped, low-quality system of services in China. In order to provide Chinese enterprises with effective support for outbound investment, it is necessary to step up building the service subsystem as an important part of China's outbound investment promotion system. The Chinese government should take measures to accelerate the growth of industry associations and prioritize the development of credit rating services.

9.1 Encourage Industry Associations to Develop on Their Own

The government, enterprises and industry associations share the same objective of maintaining national and corporate interests, although they play different roles in the context of economic globalization. The government generally acts as the representative of the public interest and assumes responsibility for contributing to global development. Accordingly, its image and public trust would be severely affected if it spoke too much for one or several enterprises in international investment disputes or trade conflicts. In comparison, an industry association does not have this concern because it represents the interests of all enterprises in the industry and is not

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associated with the national image when addressing investment disputes or trade conflicts. Accordingly, industry associations have the opportunity to speak and handle particular issues more boldly than the government could. Developed countries have long made full use of industry associations when employing their right to discourse as the primary means of handling investment disputes or trade conflicts. This practice provides the government with strategic depth in economic and diplomatic affairs, allowing it to handle issues much more easily.

Industry associations as intermediary organizations play a growing role in the context of economic globalization. They especially and urgently need to play a significant role in such fields as the resolution of international investment disputes, IP protection, market access, assisting the government in making relevant laws, and promoting information communication between enterprises and relevant authorities.

Nonetheless, Chinese industry associations have not played this critical role because of China's imperfect legal system and excessively administrative nature. In a country where the government dominates industry affairs, industry associations seldom engage -or play a very limited role when they do engage- in quality management and monitoring, making group and industry rules, resolving investment disputes, and protecting IP. This is in stark contrast to their counterparts in Europe, Japan and the United States, which are very active in these respects. There are two main reasons for this phenomenon. First, Chinese industry associations are excessively administrative. The government has yet to grant relevant powers to these associations, and as a result, Chinese industry associations cannot really represent the interests of relevant enterprises. Second, Chinese industry organizations have limited capacity for self-government, and rely heavily on the government. Now that Chinese enterprises are unlikely to win, on their own, in intensified competition in global markets, relevant industry associations should consolidate resources across their respective industries and mobilize to protect industry growth. In order for Chinese industry associations to play a better role in assisting enterprises in making outbound investment, the following approaches must be taken.

9.1.1 Enhance Relevant Systems

Since industry associations differ in area scope and functions than other NGOs, the Chinese government should reform the existing legal system, make laws and corresponding institutional frameworks specific to different types of NGOs, and adopt different regulatory policies. It is necessary to amend and improve the existing regulations on NGOs and non-profit NGOs, and to promulgate administrative regulations specific to specialized NGOs such as industry associations, thereby gradually establishing a system of sector-specific administrative laws and regulations. The Chinese government should guide the behavior of industry associations via tax relief/exemption and government procurement, and establish effective assessment and regulation mechanisms to control the activities of industry associations, their processes, and results. In order to improve the legal and policy environments to promote the growth of industry associations, the Chinese government should amend or make relevant laws/regulations to develop or improve relevant systems, such as new and more effective incentives, the social security system and the income tax allowance system. These new systems should be built under the principles of sector-specific regulation, resources-oriented guidance and behavioral control, in order to assist industry associations in conducting self-governance and control of the creation, use, protection and management of intellectual property.

9.1.2 Reduce Administrative Control

The Chinese government should properly handle its relations with industry associations and reduce administrative intervention. While reducing direct intervention in the activities of industry associations, the Chinese government should enhance regulation and monitoring to ensure the integrity of industry associations and encourage self-regulation. The Chinese government should gradually stop direct control over activities such as assessment, notarization and arbitration while granting industry associations the power to manage relevant industries and economic activities on behalf of the government. Today, China is in the process of reform toward what is termed "small government, big society." To help NGOs develop the capacity for self-governance, the Chinese government should grant them certain powers; allowing industry associations to assume desirable governing roles is not only the right path, but an unavoidable one. To do this, the Chinese government should do five things: First, it should change its mindset toward the belief that NGOs have the potential for self-governance and that industry associations have the ability to effectively manage activities in their respective industries. Second, it should improve relations between industry associations and relevant authorities, and change its current functions to gradually establish a tripartite administration model consisting of the government, industry associations, and enterprises. Under this model, the Chinese government should rely on industry associations to manage issues that it cannot manage well or at all, such as making industry-specific technical standards, collecting industry-specific statistics, assessing and comparing technology R&D results, and comparing brands and releasing industry information. Third, the Chinese government should set up industry association development funds to reward industry associations that play a demonstrative role. Fourth, the Chinese government should maintain the non-governmental nature and independence of industry associations, and ensure that they are thoroughly independent from government agencies and departments in terms of human, financial and physical resources. For example, the Chinese government should prohibit government officials from becoming the heads of industry associations. Fifth and lastly, when helping industry associations become fully independent from government agencies and departments, the Chinese government should maintain effective information communication channels with industry associations to communicate clear objectives and policy orientations. These five measures will establish the normalcy of industry leadership and management of industry associations, and gradually reduce reliance on the government.

Reducing government control over industry associations does not mean, of course, that the government will no longer pay attention to industry associations. Instead, the government will change its focus from administration of industry associations to regulation, guidance, coordination and organization. Article 18 of the *Opinion of the General Office of the State Council on Accelerating the Reforming and Development of Industry Associations and Chambers of Commerce* [GBF (2007) No. 36] makes it clear that local governments and other competent authorities should actively take measures to guide industry associations in providing industry services and conducting self-governance and coordination; that the NDRC should work with ministries such as the Ministry of Civil Affairs (MCA) to step up developing relevant measures; and that local governments should develop implementation methods that suit local conditions. In the field of outbound investment, the government may regulate, direct, guide and support industry associations as follows: work with them to define industry-specific outbound investment strategies; monitor the enforcement of these outbound investment strategies; work with industry associations to train human resources in outbound investment in order to make industry associations better able to handle issues in the field of outbound investment; guide industry associations in making policies for cooperation among industry players, universities and research organizations; monitor to make sure that industry associations act within the legal framework; handle administrative issues that industry associations are unable to handle.

9.1.3 Enhance the Capacity of Self-Governance

Industry associations may develop industry rules for the purpose of self-regulation, thereby enhancing the capacity for self-governance. IP management, which is an important task of industry associations, is one example of how industry associations can enhance the capacity for self-governance. Industry associations may take IP management measures that include developing industry regulations, adding IP protection as a condition of industry entry, strengthening the management of industry entry permits, and taking punitive measures against non-compliance. Industry associations may provide that "an enterprise should sign a self-regulation agreement and promise not to make rights-infringing products before it applies for an industry entry permit". If it is discovered that an enterprise has infringed on another's IP rights, the enterprise should be willing to accept corresponding penalties. An enterprise that is found to have made products that infringe particular patents may be penalized in multiple ways. The industry association could issue a public criticism, or revoke the enterprise's industry entry permit. The infringing enterprise could also be required to apologize to the enterprise(s) whose patents it infringed, compensate the affected enterprise(s) for the resulting losses, and cease production of patent-infringing products. If the infringing enterprise refuses to accept these penalties, the industry association may conduct an investigation to obtain evidence, and request or urge relevant authorities such as the State IP Office and Administration of Industry and Commerce to handle relevant issues. An industry will become more competitive if its industry association can effectively manage IP, enhance IP protection, and create a favorable research and development environment for technologies in which industry players hold IP.

For example, the Wenzhou Razor Industry Association (WZRIA) has taken three measures to manage and protect IP. First, it developed an industry agreement to protect the rights of its members and maintain a healthy environment for competition in the industry. Second, it promotes the development of patents and innovation in the industry. Third, it launched a patent-centric strategy across the industry. This industry association issued the *Razor Industry Regulations on Rights Protection* shortly after it was founded, specifying the conditions, scope, methods and punitive measures for rights protection. This document states: "A product for which a member asks for rights protection by this Association must be the first of its kind in global markets and be designed and made by the member itself. This product, if confirmed to satisfy certain conditions, will be recognized and made public in relevant newspapers, be issued a rights certificate, and be immediately patented in the industry. Where this Association confirms IP infringement of any and all products that this Association protects (to the extent that they remain valid), this Association will destroy the molds of the counterfeit products at the sites where they are found, confiscate the counterfeit products and relevant components/parts, and, in severe cases, will request the relevant administration of industry and commerce to revoke the business licenses of the maker(s) of the counterfeit products."

Thanks to self-regulation and fair competition enabled by the industry regulations issued by the WZRIA, counterfeiting has been under effective control in the razor industry of Wenzhou City. The number of cases of rights violations in the local razor industry is also much smaller than in the lock and smoker's device industries, according to an analysis of reports on rights protection published by WZRIA in recent years. Other industry associations in China may learn from WZRIA and make respective industry regulations to supplement national law, thereby enhancing their capacity for self-governance.

9.1.4 Assisting the Industry in Going Global

9.1.4.1 Act as a Spokesperson for the Industry and Respond to International Disputes

An industry association may act as a negotiator that responds to various international investment disputes in the market. In other words, it may act as the spokesperson for enterprises to protect the interests of the industry. Globally, there are only a very small number of cases in which a government or a single enterprise is the respondent; in the vast majority of cases an industry association protects the interests of the industry and acts as the respondent. Having an industry association speak for enterprises is perfectly justifiable and is conducive to building the image of China as a market economy. To fulfill this role, industry associations should create rights protection mechanisms and prioritize the protection of IP held by member enterprises in their respective industries, thereby preventing products -particularly those of Chinese high-tech companies that may be less aware of IP protection- from being counterfeited and infringed in host countries. Industry associations should also actively assist members in filing or responding to lawsuits, and make full use of applicable provisions to protect the interests of their members and minimize relevant losses.

In international operations, Chinese enterprises face a growing number of international disputes. Accordingly, one of the major tasks of Chinese industry associations is to enhance collaboration between relevant industries and actively respond to disputes. Statistics show that, for more than a decade, China has been the country with the largest number of anti-dumping actions taken against it each year. It has also become a primary target of Section 337 investigations conducted by the U.S. International Trade Commission (USITC). Almost all trade investigations against China are launched by foreign companies under the organization of a relevant industry association. In the Unites States, there are industry associations for all types of industries, and their staff members gather information and intelligence worldwide in order to provide their members with thoughtful and convenient services and facilitate the filing or response to lawsuits regarding international trade and investment. Today, there are over ten million enterprises in China, the vast majority of which are SMEs. Despite their large numbers, Chinese enterprises lack synergy and lose most lawsuits regarding international trade and investment disputes. In addition to the prohibitively high cost of lawsuits that are too expensive for most Chinese SMEs to afford, and distractions caused by relevant lawsuits, an important reason for the inability of Chinese enterprises to win lawsuits lies in the failure of Chinese industry associations to play a significant role in helping Chinese SMEs win such lawsuits. For the future, Chinese industry associations should enhance collaboration in relevant industries and play a leading role in tackling international investment disputes.

How can Chinese industry associations better handle IP disputes? Take the success of the WZRIA in tackling international IP disputes for example. Wenzhou became the center of China's razor production in September 2001. Royal Philips of the Netherlands (Philips), the leader of the global razor market at the time, has since routinely charged Wenzhou-based razor makers of patent infringement. In turn, the Wenzhou-based razor brands also were targets of counterfeiting in the cities of Yuyao and Yiwu, Zhejiang Province and in the city of Putian, Fujian Province. The Wenzhou razor industry faced the significant challenge of tackling domestic and international IP disputes at the same time. In April 2002, Philips filed lawsuits with the Zhejiang Provincial Intellectual Property Office (ZJPIPO) against multiple Wenzhou-based razor makers for IPR infringement. On May 3, WZRIA organized the involved local enterprises in responding to the lawsuits. They separately requested that SIPO's Patent Reexamination Board annul the two design patents claimed by Philips. These lawsuits lasted three and half years, and in the end, the seven Wenzhou-based razor makers jointly won six lawsuits involving seven authorities. Four patents claimed by Philips were annulled. More recently in March 2010, Wenzhou Ridian Electrical Appliance Co., Ltd. won a 3-year razor patent lawsuit case filed against it by Philips.

An important reason for the victory of Wenzhou's razor makers in domestic and international IP disputes lies in the fact that WZRIA played a crucial role. Most Wenzhou-based razor makers are SMEs with limited financial strength, low awareness of IP and lack of relevant professionals, which makes them poorly equipped to handle disputes. The relevant razor enterprises initially had no idea how to respond to the lawsuits filed by Philips in April 2002, but WZRIA made efforts in consolidating the resources of various parties, conducting information communication and guiding the involved enterprises. It took three main measures. First, WZRIA worked closely with local government authorities such as the Wenzhou Science and Technology Bureau (WZSTB) and the patent office, reported relevant information to the NPC patent law enforcement inspection team, the SIPO and the ZJPIPO, and proposed recommendations, thereby seeking their attention and support. Second, WZRIA consolidated the resources of the involved enterprises. WZRIA held regularly scheduled meetings -such as the association director's work meeting and the council meeting to reach agreements on relevant issues- before helping the involved enterprises centralize their respective human, physical and financial resources to hire senior patent agents to actively and legally respond to the lawsuits. Third, WZRIA started researching patent strategies specific to the razor industry. It set up a research project team, held workshops and established an IP department and a warning system within the association. Prior to identifying a patent strategy, WZRIA gathered and analyzed information on razor patents from China, the United States, Japan, Germany, Russia and France, researched advanced technology trends in the industry, and analyzed the common strategies and competitive methods of the competition. The victory of Wenzhou's razor industry in the lawsuits was a clear demonstration of the improvements in WZRIA's ability to tackle international patent disputes while underscoring the effects of industry associations in the growth of relevant industries.

The aforementioned example is a good instruction manual in how Chinese industry associations can manage and protect the IP of enterprises in their industry. First, in an environment where Chinese SMEs are unable to tackle disputes on their own, it is imperative for industry associations to consolidate resources throughout their respective industries to conduct IP self-regulation in China and handle international IP disputes outside China. Second, industry associations should build IP strategies, including patent and trademark strategies, in their respective industries, and guide enterprises in building IP warning systems. Third, industry associations should guide industry players to form IP alliances for the purpose of resource sharing and achieving economies of scale. Fourth, industry associations should conduct extensive promotion to help enterprises become sufficiently aware of IP, protect their IP from infringement, and avoid infringing the IP of others. Fifth, industry associations must organize enterprises involved in international IP disputes to actively and calmly respond to relevant lawsuits, carrying out active defense and effective offense in order to protect the interests of these enterprises under law.

9.1.4.2 Consolidate Information Resources in the Industry, Use Information to Produce Supportive Effects

A Chinese enterprise once invested in a large power plant in eastern Malaysia. However, due to the limited size of the local economy and low electricity rates, the power plant did not perform well after it was put into operation. The area in which the power plant is located happens to be abundant in nonferrous metallic mineral resources. The power plant stands to significantly increase its profits if it shared this information with a Chinese smelting enterprise, and joined forces to co-exploit the local mineral resources on the basis of providing low electricity rates. Another Chinese enterprise was awarded a contract for a high-quality mineral resource project in South America, which required an investment of only $1.5 billion USD. Unfortunately, it turned out that, given the harsh natural environment, this enterprise would have to spend over $5 billion USD to build the power supply systems and railroads to operationalize the project. As a result, the company abandoned the project, leaving its equipment in South America due to high transport costs. A huge investment has been made with no return.

These two examples highlight the importance of information resources. Corporate sensitivity to information varies widely due to different business types and scopes. Information that some companies think is of no value may be exactly what others companies need. Chinese enterprises with overseas operations frequently encounter this type of fragmentation and shielding of overseas market information. Chinese enterprises that have gone global are beginning to have access to a great deal of information, but they continue to need even more. Industry associations also receive a great deal of information through communication with enterprises or foreign industry associations. Accordingly, industry associations are well positioned to serve as the urgently needed platforms for information consolidation and exchange.

Industry associations should make full use of their role as information platforms to assist enterprises seeking to carry out overseas operations in researching markets in potential host countries and providing them with information on supply and demand, competition, resources, technologies and local cultures in these markets. This practice will allow enterprises to identify and start overseas businesses in countries and regions with good market potential. Industry associations should release timely information on changes in product supply and demand in regional markets, creating more international business opportunities for enterprises. It is also advisable for industry associations to gather and research information on major foreign competitors and to identify areas in which their members are lagging behind foreign rivals, thereby helping their members narrow the competitive gap.

9.1.4.3 Regulate Competition in the Industry and Help Enterprises Achieve an All-Win Situation

There is already fierce competition among overseas Chinese enterprises just as there is for domestically based companies, which is one of the major challenges for Chinese enterprises that have gone global. Ruinous competition has even occurred among central SOEs bidding for overseas projects; Chinese enterprises are now most afraid of competition from other Chinese enterprises, not foreign competitors, when bidding for overseas projects. When buying iron ore in Australia, for example, Wuhan Iron and Steel (Group) Corp. (WISCO), Anshan Iron and Steel Group Corporation (Ansteel), Baosteel Group Corporation (Baosteel), Sinosteel Corporation (Sinosteel) and other central SOEs all wanted to invest in a mine in Pilbara. As a result of this intense competition among these Chinese enterprises, the deal was ultimately closed at a price one third higher than the original ask. Fierce competition results in higher prices of the investment targets, on the one hand, and also damages the image of Chinese enterprises, on the other. One of the immediate consequences of ruinous competition is poor performance of contracts. The resulting lack of quality and rise in labor disputes has damaged the image of Chinese enterprises in overseas markets and created obstacles for other Chinese enterprises in going global. A key factor underlying this situation is the current weak position of Chinese industry associations. To address these issues, Chinese industry associations should improve industry rules, implement strict industry entry regulations and endeavor to act as authorities in their respective industries. Industry associations should conduct self-regulation in their respective industries in order to enable Chinese enterprises to support and partner with each other in overseas markets. In light of the fact that some enterprises compete by cutting prices, industry associations should conduct regular surveys, release the resulting information and talk with these enterprises in order to stop harmful actions aimed at short-term benefits. In addition to preventing destructive competition among Chinese enterprises in overseas markets, industry associations should also help enterprises in their industries achieve an all-win situation.

9.1.4.4 Consolidate Internal Resources and Encourage Members to Form Technology Alliances

Industry associations may make full use of their role as contact points and coordinators to consolidate, facilitate distribution and utilization, and, to a certain extent, achieve the sharing of member resources, to make the industry more competitive as a whole. Industry associations should promote cooperation among their members and, when necessary, encourage them to form technology alliances or industry clusters in order to carry out international operations and reduce relevant risks at the same time. Given the extreme importance of technical standards, industry associations should actively organize the translation of domestic standards into foreign languages while introducing international standards. Such efforts will help eliminate bottlenecks in the internationalization of Chinese standards, spread Chinese standards outside China, and increase the competitive advantages of Chinese enterprises.

9.1.4.5 Conduct Training, Consulting, Market Introduction and Promotion

Industry associations should provide their members with training on international operations, technology and human resources. They may publish newspapers and hold meetings to conduct information exchange, and provide consulting services regarding business, technology, management, financing, accounting, law, quality inspection and measurement. They should publish journals, hold fairs, exhibitions, seminars and workshops outside China and invite embassy officials, relevant experts and entrepreneurs to attend these events, which will increase the reputation of their industries and members, create business opportunities, and help their members develop foreign markets.

9.2 Build a Credit Rating System

Western credit rating agencies (CRAs) have long dominated credit rating activities. They usually give high credit ratings to Western developed countries and their companies, while adjusting, or even deliberately lowering, the credit ratings of the other countries and their companies depending on how well they relate to the United States. These organizations attempt to reduce the international competitiveness of particular countries and their companies by damaging their image. In the 2008 financial crisis, Lehman Brothers Holdings Inc., which had an AAA credit rating, collapsed nearly overnight. This incident is a clear example of how the so-called authoritative American credit rating agencies have vested interests in some of the rated companies and thus have lost the impartiality that they should otherwise have. Western CRAs have designed rating criteria in favor of the interests and ideologies of Western developed countries and apparently underestimate China's sovereign credit rating. They keep the credit ratings of all financial institutions and companies connected with China at lower levels. This practice has added to the overseas investment costs of Chinese enterprises. Today, Chinese CRAs are much smaller and weaker than the established global giants, and have a narrower range of credit rating services. Their credit ratings are not authoritative, widely used or influential, which makes it impossible for them to compare with their international counterparts. China urgently needs to build an independent credit rating system in order to promote outbound investment by Chinese enterprises.

9.2.1 *Problems with Credit Rating in China*

Chinese CRAs are licensed by the Chinese government in order to develop mature capital markets. The selected credit rating model relates to the distinctiveness of credit activities in China. China lacks a good environment for the growth of the credit rating market since market players lack awareness and skills in using credit products. Credit activities have begun to take shape, but the percentage of the credit economy in the overall national economy remains low, and there still is no solid basis for the growth of the credit rating market. The risks in credit transactions remain high, and the Chinese government has not yet made further efforts to stimulate demand in the crediting market. The policy orientation and credit intermediation of the banking sector greatly influences the size and structure of the credit rating market. As a result, China's credit rating industry is not driven by the market, but by government authorities. Consequently, rating activities have a rather strong administrative nature, and their results are not widely recognized in the market. China's credit rating industry is plagued by a variety of problems, primarily including the lack of a sufficient legal support system, an effective regulatory system, a unified accreditation mechanism, a basic market entry and exit mechanism, an effective code of conduct for practitioners, and scientific credit rating metrics and methodology, among others.

9.2.1.1 Lack of Sufficient Legal Support

Chinese laws and regulations governing credit rating activities are underdeveloped and unable to effectively control the behavior of CRAs. First, relevant legislation is extremely low level. The current legal grounds for regulating the credit rating industry only include two legislative measures, the *Guiding Opinion on Credit Rating Administration* issued by the PBC in 2006 and the *Interim Measures for Administering Credit Rating Services in the Securities Markets* issued by the CSRC in 2007. The first is an internal document of the PBC and has no binding effects. The second is only effective at low levels and has a limited scope of applicability, making it difficult for this document to effectively bind upon credit rating activities. Second, there are a lot of gaps in the legislation. For example, there remain no provisions regarding the market entry and exit mechanism for CRAs, compliant operations, and unfair competition. Moreover, there are few compulsory rating requirements. Deficiencies in legislation have exacerbated non-compliant operations by CRAs and created ruinous competition. Third, there is a lack of an investor protection system. CRAs hold important positions, yet are only subject to light punishment for mistakes. There are no remedies and compensation mechanisms corresponding to investors' losses arising from wrongdoing by CRAs. This is of course detrimental to protecting the interests of investors.

9.2.1.2 Lack of an Effective Regulatory System

Administrative regulation is a necessary supplement to legal regulation and is especially important until legislation regarding China's credit rating industry is improved. Today, China's credit rating industry lacks an effective regulatory system; there are multiple authorities that each regulate particular aspects of CRA business. Specifically, the CSRC regulates credit rating services in securities markets, the PBC regulates credit rating services in the interbank bond and credit markets, and the NDRC regulates credit rating services regarding ITB/bidding and corporate bond issuance. These authorities work on different regulatory grounds and have different regulatory requirements. The lack of a single government authority and an effective regulatory system for CRAs has created large regulatory gaps, including the lack of basic practitioner requirements and service standards. Also, because no single government authority reviews and regulates rating results across China, many CRAs compete for business opportunities at the expense of quality, severely hindering the healthy growth of the credit rating industry.

9.2.1.3 Lack of a Unified Accreditation Mechanism

When compared with foreign countries, China lacks a reliable and unified CRA accreditation mechanism. First, the coexistence of multiple regulators results in the possibility of one organization being accredited more than once. Five Chinese CRAs, including the China Lianhe Credit Rating Co., Ltd., were accredited by both the NDRC and the PBC. Second, there are no clear, unified provisions regarding the accreditation of CRAs. Neither the NDRC nor the PBC has clarified criteria for accrediting CRAs. Only the CSRC specifies the criteria for accrediting CRAs for providing credit rating services in the securities markets, as stipulated in the *Interim Measures for Administering Credit Rating Services in the Securities Markets*, issued in 2007. However, when compared with similar criteria in other countries, this document does not reflect one core factor – whether rating results are widely accepted by main investors. The lack of unified accreditation criteria is detrimental to improving the quality of credit rating services provided by CRAs, makes it difficult to assess the credit levels of enterprises on a fair and objective basis, and makes it impossible to increase public trust in CRAs.

9.2.1.4 Lack of a Basic Market Entry and Exit Mechanism

Entry limitations on CRAs were cancelled when the *Administrative Licensing Law* came into effect. CRAs are now registered in accordance with relevant commercial service industry standards. Given the lack of a single competent authority that conducts industry entry examinations on CRAs and annual inspections on their business activities, the entry barriers for CRAs are extremely low, and the competence of CRA employees vary widely. These problems have significantly reduced the authority of and public trust in CRAs. The lack of an effective exit system has also caused ruinous competition in the credit rating industry. In order to gain market share, some CRAs have resorted to unfair competition via non-market means, and in some cases even compete for business by offering unreasonably low prices and promising credit ratings that are otherwise undeserved. An immediate consequence of this ruinous competition is the severe damage to the image of the credit rating industry and to the authoritativeness of rating results.

9.2.1.5 Lack of an Effective Code of Conduct for Practitioners

Credit rating services in China perform poorly in terms of compliant operations due to the lack of basic laws/regulations governing CRAs and flawed internal control systems. There are numerous problems with the general administration of credit rating services, operational procedures and quality control. First, substantial conflicts of interest exist; some CRAs have had close ties with government agencies/departments or commercial banks since their founding. Accordingly, these organizations are subject to the influence and requirements of relevant government agencies/departments and/or service recipients, which have led to non-compliant operations, the lack of objectivity and independence, and even adverse effects on the impartiality of credit rating services. Second, there are problems with service rates. Today, Chinese CRAs charge issuers at randomly varying rates. Some CRAs promise to refund service fees on a proportional basis, or even determine credit ratings according to the amount of service fees, which essentially leads to the de facto purchasing of credit ratings. Third, there are problems with information disclosure. Today, Chinese CRAs are only required to release rating results, with no requisite for disclosing rating methods and processes. The non-compliant use of credit information makes it impossible for market players to fully assess and monitor the quality of credit rating services.

9.2.1.6 Lack of Scientific Credit Rating Metrics and Methodology

There are certain problems with how corporate credit rating indicators are set in China. Today, rating results lack objectivity, impartiality and accuracy since there are no unified service standards, scientific rating methods, sufficient historical credit data or efficient and effective tracking and inspections in China's credit rating industry. Take the common growth rate of net profits for example. This indicator only takes into account the net profit growth rates of the past couple years, described in financial statements provided by enterprises. The calculated results would be consistent with reality if enterprises experienced continuous, steady growth over the past few years. Otherwise, the results of these calculations would make no economic sense. CRAs should not assign corporate credit ratings based merely on analyzing the financial status of enterprises, but should also take into account such factors as industry growth and managerial competence.

9.2.2 *Build a Good Credit Rating System in China*

9.2.2.1 Build an Independent Credit Rating System

The 2008 financial crisis revealed that in the context of economic globalization, the one who holds power over credit ratings holds financial power in the international community. At a time when the debtor-creditor relationship has become increasingly globalized, the right to discourse on credit ratings has unprecedented influence on the core interests of a country. Accordingly, the global credit rating landscape is changing quietly. There is already a consensus on the need to enhance regulation over credit rating, and a growing number of countries are tightening legislation governing credit rating, beginning to support the growth of local CRAs, and relying on independent efforts to protect their financial security. In February 2009, the then Russian Prime Minister Vladimir Putin called for setting up local CRAs. The South Korean government has strengthened credit rating regulation on the basis of dual CRAs, requiring that bond issuers must select the National Information and Credit Evaluation Inc. as one of the two CRAs. The Japanese government funded and controls the Association of CRAs in Asia (ACRAA), designed to increase the influence of Japanese CRAs in Asia. These moves signal that credit rating has been elevated to the level of national strategy, and that there is a megatrend of resisting the current unfair international rating system. This trend has created a rare, historic opportunity for China to engage in making international rating rules and securing the right to discourse on international ratings in the aftermath of the financial crisis.

Support Domestic CRAs

The Chinese government should make a policy to accelerate the growth of domestic CRAs, which includes measures to integrate the development of CRAs into national economic and financial development programs, promote the development of the national credit system, and match the pace of credit rating industry growth with socioeconomic development in China. In doing so, China should adhere to the principle of combining unified regulation with special regulation in the regulatory system. It should first identify the administrative and regulatory bodies for CRAs, and set stringent market entry and daily regulation criteria. Second, China should combine the pilot RMB cross-border trade settlement program and RMB offshore financial services with supporting domestic CRAs in the effort to rate national credit risks, thereby assuring these organizations' right to discourse regarding overseas RMB sovereign debt instruments. Third, China should make special policies and measures to support the growth of domestic CRAs. Two or three domestic CRAs with great growth potential should be identified and given special support in the form of state-owned shareholdings. This will allow selected CRAs to become more globally competitive and grow faster, enabling them to engage in international financial activities and assure China's right to discourse in global financial markets.

Prevent the Penetration and Dominance of American CRAs

Foreign CRAs may engage in rating services that do not involve national economic or technical security, but to protect China's financial and national security, they should never be allowed to dominate in China's rating market. The Chinese government must immediately improve legislation regarding credit rating in order to address the phenomenon where American CRAs engage freely in the credit rating of Chinese government authorities and enterprises (including those in the financial and defense sectors). First, the Chinese government should explicitly restrict foreign CRAs from entering economic sectors that involve national security, such as large SOEs, major financial institutions and the defense sector (e.g., weaponry, aerospace, aviation, nuclear industry and shipbuilding). Second, China's credit rating market must be opened under the principle of equality. While allowing foreign CRAs to enter China's credit rating market, the Chinese government should require foreign governments to promise market entry approval of Chinese CRAs. Foreign CRAs will have their qualifications for providing credit rating services in China revoked if they are found to have provided intelligence to foreign intelligence agencies.

Limitations on the Percentage of Foreign Investments in Chinese CRAs and Rating by Dual CRAs

The same provisions regarding the shareholdings of foreign financial institutions in Chinese banks may be applied to Chinese CRAs. In addition to limiting the share of foreign organizations' interest in Chinese CRAs to no more than 25 %, foreign organizations also must not control, directly or indirectly, the management right of joint ventures. Rating by dual CRAs should be employed in rating activities that do not involve the financial, economic or technical security of China. In other words, in rating activities that do not involve China's economic or technical security, a Chinese CRA must also issue a rating report in addition to the rating report from a foreign CRA, thereby ensuring that major Chinese enterprises receive fair treatment when entering international markets.

Support Chinese CRAs in Entering the American Rating Market

The right to discourse regarding international rating activities has a significant impact on national interests. Although China is the largest creditor of the Unites States, it is unable to protect its interests as a creditor due to the lack of the right to discourse regarding international ratings. Although China enjoys rapid economic growth and increasing national strength, it is unable to determine prices in RMB in international markets due to, again, the lack of the right to discourse regarding international ratings. Consequently, China is unable to protect its national interests in the process of RMB internationalization. In April 2010, Dagong Global Credit Rating

Co., Ltd., an independent Chinese CRA, was prohibited by the U.S. Securities and Exchange Commission (SEC) from entering the American market. This incident demonstrates that the Chinese government needs to include support for Chinese CRAs in securing the right to discourse on international ratings into its national strategy, thereby providing stronger support to facilitate their entry into the American rating market. The Chinese government should support domestic CRAs by releasing rating results of other countries, especially with regard to American sovereign debt, in order to reveal American debt risks and to protect the core interests of China as the largest creditor of the United States.

9.2.2.2 Build a Unified Regulatory System for Credit Rating

Improve Legislation Governing Credit Rating

It is recommended that the *Regulations on Credit Management* be promulgated as early as possible in order to unify provisions regarding market access and personnel qualifications of credit organizations (including CRAs). In the meantime, it is necessary to identify a single competent authority that oversees the credit investigation industry, the responsibilities of this industry, and regulatory measures/methods. The *Measures for Administering Credit Rating Agencies* should be issued in addition to the *Regulations on Credit Management* as early as possible in order to identify a single regulator and coordinator of the credit rating industry and to clarify conditions for market access and regulatory accreditation of CRAs, the code of conduct for practitioners in the credit rating industry, and regulation over conflicts of interest, information disclosure, etc.

Build a Unified Regulatory System

Since indirect financing plays a leading role in China's financing field, banks bear investment and business risks arising from information asymmetry. The *Regulations on Credit Management (the Draft for Opinions)* makes it clear that the PBC is the competent authority under the State Council that regulates the credit investigation industry. This provision suits the need for preventing risks in the credit market and enhancing the capacity of financial risk-based pricing. It should be made clear in the implementation rules of the *Regulations on Credit Management* and the *Measures for Administering Credit Rating Agencies* that the PBC is the leader and coordinator in regulating the credit rating industry. The PBC should be granted the power to communicate and coordinate with other authorities and take the lead in developing the main regulatory systems for the credit rating industry. Other authorities may develop special-purpose regulations as needed in accordance with these main systems.

Unify Market Access Conditions and Accreditation Mechanisms

It is necessary to establish standard, transparent and unified CRA access and accreditation systems in order to ensure that credit rating services are provided in a compliant manner. The access conditions should reflect the core content of credit rating norms. Incompetent profiteers must be barred from entering the market, although conditions for regulatory accreditation should be slightly looser to satisfy the market need for diversified credit rating services. Conditions for regulatory accreditation should mirror the actualities of credit rating regulation in the bond and credit markets. The main conditions should include whether regulatory requirements are satisfied, the ability to avoid conflicts of interest, and acceptance by investors or borrowers, among others. Special conditions may be set by the competent regulators in light of specific administrative requirements.

Enhance Practitioner Regulations

Administrative regulations should be refined to avoid conflicts of interest, and CRAs should be urged to establish compliant and effective international control systems. Clear requirements should be made on the qualifications of CRA personnel, the quality of information on which credit rating is based, credit rating procedures, improvements in the credit rating methodology, etc. Lastly, CRAs should be explicitly required to disclose their credit rating methods and procedures, the sources of information on which credit rating is based, major risks that they are unable to assess during credit rating, and the track record in credit rating activities, among other items.

Effectively Perform Regulatory Responsibility

In addition to improving relevant legislation, the regulators should conduct more active supervision and administration of the credit rating industry. First, under the guidance of a team of experts, regulators should establish a rating quality review mechanism based on probability-of-default statistics, which will compel CRAs to improve the quality of credit rating services. Second, regulators should conduct regular onsite and offsite inspections of CRA business activities and impose penalties on non-compliant CRAs under the law. Third, they should establish a CRA assessment mechanism that focuses on the quality of credit ratings, independence, practitioner performance, and inspection and assessment results, to serve as grounds for the approval or denial of market access to CRAs, and for regulatory accreditation.

Promote Self-Regulation by the Industry Association

It is necessary to set up a national credit rating industry association in order to promote self-regulation in the credit rating industry. Regulators should promote the establishment of such an industry association as soon as possible to allow for industry self-regulation as a supplement to government-led regulation. The industry association should issue administrative measures for industry self-regulation, and clarify requirements regarding professional ethics, competence, and professional responsibility of practitioners. The industry association should build a testing system for qualifying practitioners and follow-up educational systems in order to improve the competence of practitioners. It is advisable that this industry association build a robust self-regulation system to urge CRAs and their personnel to fulfil their responsibilities to the public, clients and peers, and to prevent threats to public trust and unfair competition.

9.2.2.3 Develop the Credit Rating Metrics and Methodology

Information on Which Credit Rating Is Based

A large, scientific information support system underpins credit rating activities. Since relevant information comes from various sources, extra attention should be paid to the quality of information. Relevance, timeliness, reliability and comparability are important measures for assessing the quality of information on which credit ratings are based.

1. Macroeconomic information. When analyzing the external environments of enterprises, CRAs need to monitor critical economic variables including economic transformation, availability of loans, the level of disposable income, consumer tendencies, interest rates, inflation rates, economies of scale, market rates, government budget deficits, GDP trends, unemployment trends, the value of the US dollar in international markets, stock market trends, import/export factors, changes in products and demand by category, price fluctuations, monetary policies, fiscal policies, tax rates, etc.
2. Information on industry trends. Industry trends include industry characteristics, competitive status, lifecycles, etc. It is necessary to make reasonable predictions about the future of enterprises by correctly evaluating the sustainability of corporate operations.
3. Financial and non-financial data. Such data falls under two categories – the first category refers to financial statements and relevant information disclosure; the second category covers business data and performance indicators at the same level that the competent authorities use to administer enterprises.
4. Information derived from analysis by regulatory authorities of financial and non-financial data. Analytic information generated by the relevant authorities is critical to understanding the reasons for changes in corporate data. The relevant

authorities directly administer the business activities of enterprises, and regularly analyze corporate data for administrative purposes. Annual business summaries, for example, not only explain data and changes in financial statements, business data and performance indicators, but also analyze uncertainties in future business activities of enterprises. The relevant authorities therefore are the best sources of analytic information.

5. Information on future growth. Such information refers to business opportunities and risks, the plans of the relevant authorities, and predictions about business and finance.
6. Information on the relevant authorities and shareholders. Such information encompasses the identities, backgrounds and professional ethics of shareholders and administrative officials, the identity of the majority shareholder and his/her shareholdings, factors causing changes in shareholdings, related parties, and the relationships of the majority shareholder, directors, managers, suppliers, customers/clients and competitors to the rated enterprise.

Assessment Content

Corporate ratings should focus on corporate competitiveness, the capacity of business management, accounting policies, the quality of financial statements, financial indicators and special analysis.

1. Corporate competitiveness. Competitiveness is reflected mainly through market share, product leadership and the ability of the enterprise to influence the market price. Market share mirrors the position of the enterprise in the market, and is the primary measure for corporate competitiveness. Product leadership refers to whether an enterprise's product leads among all competing products in the market. A market-leading product is very competitive in the market. Since the ability of an enterprise to influence the market price typically reflects a monopoly in the market, an enterprise with influence on prices has a very strong competitive advantage. Although market share and product leadership can reflect corporate competitiveness, most enterprises have small market shares or products that are similar to those of the competition. As a result, market share is generally unable to truly reflect the competitiveness of these enterprises. A more workable method is to evaluate the ability of an enterprise to maintain strong business performance. Such evaluation mainly involves assessing the capacity of product segmentation, the degree of market fragmentation, and the degree of fragmentation among main customers/clients and suppliers.
2. Business management capacity. Evaluation of business management capacity mainly includes the analysis of management's responsiveness to change, business strategies, the management's risk tendency, managerial effectiveness, management changes, the rationality of the product mix, operating efficiencies and changes in corporate competitiveness.

3. Analysis of accounting policies and the quality of financial statements. Analysis of accounting policies mainly includes the rating of factors such as the grounds used for consolidating financial statements, the principles of depreciation, policies for confirming incomes, policies for retaining earnings, the valuation of goodwill and intangible assets, and the revaluation of fixed assets. Analysis of the quality of financial statements refers to analyzing the truthfulness and reliability of financial data.
4. Analysis of financial indicators. Generally, financial indicators are able to objectively reflect business performance and risks, which is why their analysis is always the main focus of credit assessment. Financial indicators include cash flow, asset size and quality, profitability, capital structure, business development, etc.
5. Special analysis. Some special resources of an enterprise may have a significant effect not on the competitiveness of the company, but on its credit level. These special factors include contingencies, financing approaches, public relations, etc. Contingencies refer to external guarantees provided by the enterprise, commitments to product quality, and litigation matters, which are generally not reflected in an enterprise's balance sheet because of their uncertain nature, but which may produce significant effects on its normal operations.

Credit Rating Metrics

Credit rating metrics should include operating efficiencies, growth potential, debt-paying ability, profitability, financial structure and cash flow.

1. Operating efficiencies. How efficiently an enterprise manages its businesses can be analyzed based on changes in long-term and current liabilities and sales revenue, or, based on the comparison between operating assets and the growth rate of the ratio of current assets to total assets.
2. Growth potential. The rationality of an enterprise's asset structure can be analyzed according to three main indicators – the ratio of current assets to total assets, the ratio of total liabilities to owner's equity, and the ratio of long-term liabilities to owner's equity. The average of these three indicators is first calculated for each of the company's businesses, and then reasonable values of the three indicators are determined based on this average. It is possible to determine the business type of an enterprise and estimate its growth potential according to how it compares to the determined values of these three indicators. Companies whose businesses are ahead of the times are typically characterized by a higher-than-average ratio of current assets to total assets; companies whose businesses are shrinking typically have a lower-than-average ratio of current assets to total assets. Companies that have unsafe investment liability structures are primarily characterized by a higher-than-average ratio of total liabilities to owner's equity; companies that have latent potential in their liability structure typically have a lower-than-average ratio of total liabilities to owner's equity. Independent com-

panies are primarily characterized by a higher-than-average ratio of long-term liabilities to owner's equity; non-independent companies have a lower-than-average ratio of long-term liabilities to owner's equity.

3. Debt-paying ability. The ability of a company to pay off its debts can be measured by its debt/asset ratio and the return on net assets (RONA). The debt/asset ratio is one of the major measures for the long-term debt-paying ability of a company. It is widely accepted that 60–70 % is a reasonable range for the debt/asset ratio. A debt/asset ratio of lower than 30 % suggests that the company is financially strong, has low debts, and has sufficient availability of funds. On the other hand, a debt/asset ratio of higher than 70 % is too risky to be acceptable for creditors. Consequently, a company with a debt/asset ratio of greater than 70 % will find it difficult to raise money and face higher financing risks. A company's debt-paying ability can also be measured according to its current ratio and quick ratio, or by its current assets and current liabilities. It is usually believed that an increase in current assets at the same rate as any increase in current liabilities, plus an increase in total profits, is ideal for a company.
4. Profitability. Profitability is the ability of a company to make profits. There are several ways to measure the profitability of a company, including gross margin, net margin, return on total assets (ROTA), RONA, the ratio of operating cash flow to sales revenue, and the ratio of net operating cash flow to operating profit.
5. Financial structure. Analysis of a company's financial structure is primarily intended to study the purpose and rationality behind the use of corporate funds. Such analysis is generally made according to three measures, including equity ratio, the ratio of equity to fixed assets, and the capitalization ratio.
6. Cash flow. In a company's cash flow statement, the net cash flow is the sum of net operating cash flow, net investment cash flow and net financing cash flow. Since cash is the foundation for the survival of a company, it is possible to obtain a great deal of valuable information on the business status of a company by analyzing the cash makeup of each item on its cash flow statement. Such analysis is critical for gaining a deep understanding of how well a company is managing its businesses.

Analysis of Credit Records

To assess the credit level of a company, attention should be focused on important credit records, including that of the relevant administration of industry and commerce, main records at the competent tax authority, credit records at the competent goods inspection and quarantine administration, credit records at commercial banks and import/export policy-based banks, credit records at the competent foreign exchange administration, credit records at customs offices, preparations for responding to lawsuits and insurance, and credit records at relevant customers/clients and suppliers. Records for the previous 3 years should be studied as the standard duration.

Corporate Credit Rating Procedures

Basic credit rating procedures include preparation, field research, preliminary assessment and recommendation, re-rating, reception of feedback on rating results, announcement of the rating result, archiving and providing follow-up services. A complete project rating process generally should take 2–3 weeks.

1. Preparation. A CRA begins preparing for a credit rating after a company or client submits a credit rating application and signs the Credit Rating Service Agreement. The CRA first sets up a rating team, and the project lead establishes working relations with a representative designated by the company. The CRA rating team informs the company of credit rating procedures so that the latter knows how to work with the rating team. The CRA also provides the company with a list of materials needed for the credit rating. The company prepares the necessary materials and submits them to the rating team within the agreed-upon period of time.
2. Field research. It is possible to gather first-hand data/information needed for credit rating through field research. Field research begins with onsite interviews with relevant company officials, primarily the company's executives, members of the management, and the heads of the sales and finance departments. Such interviews mainly cover the company's current key issues related to business, management and finance, including decision makers' analysis of the external environment and understanding of the company's internal strength, the corporate vision of the future, corporate decision-making procedures, the stability of decision makers, detailed information on the main decision makers, credit records of the company, and other information relevant to the credit rating project. The second step in field research is a visit to the company to acquire perceptual knowledge on its production environment and business status. Lastly, the members of the rating team will conduct surveys and interviews with the competent authorities, relevant NGOs, financial institutions, main creditors and debtors, and other enterprises or organizations connected with the company.
3. Recommendation after preliminary assessment. After completing field research, the rating team enters the preliminary assessment stage. The members of the rating team first create summaries of their findings and the information provided by the company. They then sort through quantitative and qualitative data under the credit rating metrics, before entering the data into computers for processing. After conducting a static and dynamic analysis of the company's data and information, the rating team then makes a comprehensive rating of the company according to dimensions such as business environment, position in competition, management level and financial status. The rating team then determines the initial score for each dimension, and provides a full and proper explanation for the score. Based on this comprehensive analysis, the rating team then drafts the preliminary Credit Rating Report which includes the determined credit rating of the company. It then submits the Credit Rating Report, the attached tables and the working papers to the corporate credit rating board for review.

4. Re-rating. The corporate credit rating board checks, reviews and questions the preliminary Credit Rating Report, the proposed credit rating, the attached tables and the working papers, before voting on them. Based on the comments and credit rating determined by the board, the rating team will modify the Credit Rating Report and the credit rating. In order for a credit rating to become valid, it must be approved by at least two thirds of the corporate credit rating board members.
5. Reception of feedback on the rating results. The rating team will send the Credit Rating Report and the Feedback Form on the Rating Result to the client within 3 days after the result is determined. If the client does not raise an objection to this result within 5 days after receipt, then the team prepares to announce the result.
6. Announcement of the result. The credit rating result is typically announced through the national media. The announcement generally includes the name, credit rating and brief description of the rated company and the main supportive data. The CRA then issues the Credit Rating Certificate to the rated company.
7. Archiving. The rating team categorizes the original data of the rated company and all written materials generated during the credit rating process, and archives them as working papers for future reference.
8. Provision of follow-up services. After the credit rating process concludes, the members of the rating team contact the rated company on an ad hoc basis and provide consulting services. They also track changes in the credit level of the rated company based on the information that the company discloses. If the credit status of the rated company changes in a way that affects its credit rating, then the CRA will re-rate the company under its rating tracking procedures, and announce the result according to the aforementioned announcement procedures.

Determining Corporate Credit Ratings

Corporate credit ratings fall under five levels, AAA, AA, A, B and C. “AAA” is the highest possible rating and indicates an extremely high degree of corporate credit worthiness and low debt risks. Enterprises at this level are financially strong, and have excellent assets, good indicators and business status, high profitability, outstanding economic benefits, immense growth potential, high solvency and ability to pay debts. Business uncertainties have little effect on the operation and development of these enterprises, and it is extremely unlikely that these enterprises will experience a financial crisis. “AA” indicates a good corporate credit level and fairly low debt risks. Enterprises at this level are relatively financially strong, and have good assets and indicators, good business status, fairly high profitability, steady economic benefits, good growth potential, and pretty high solvency and ability to pay debts. Business uncertainties have small effects on the operation and development of these enterprises. Uncertainties have slight effects on the operation and development of these enterprises. “A” indicates that an enterprise has a good corporate credit level and generally is able to repay debts. Enterprises at this level have acceptable financial strength and quality of assets, average or above average economic indicators and pretty good business status. However, they are somewhat susceptible to adverse economic conditions and changes in circumstance that might affect the operation and development of these enterprises and their profitability and ability to pay debts. “B” and “C” ratings indicate average and poor credit levels, respectively.

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