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China’s Critical Issues for 2018

Discussion Summary

This paper captures the discussion at IMA Asia’s China CEO Forum in Shanghai, 11 December 2017.

Chair: Richard Martin, MD, IMA Asia

Commentator: Andrew Browne, senior correspondent, Wall Street Journal

Writer: Shannon Ellis
Editor: Richard Martin

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The Process

Critical issues management has been done by MNCs for decades. It helps firms develop a fast response to events that can upend business plans. Shell kicked it off in the early 1970s with a team that explored the potential impact of oil exporters forming a cartel to drive up prices. Shell was ready when OPEC drove the oil price up from $3/barrel to $12 in 1973.

The basics are simple:

- A title that captures the issue
- Brief background for clarity
- Key players involved
- Flags that warn when an issue is about to go live
- Impact assessment on markets and the company
- Mitigation plans

There are two steps to making the process pay-off. The first is making it the responsibility of line managers. The goal is to improve discussion of the business plan, risk management, and delivery of results. The critical issues are updated on every presentation of the plan, and are discussed in every review of performance. It works between front-line execs running BUs and the China CEO/CFO, and between China HQ and Global HQ. It turns a rigid process for producing results into a flexible and responsive process. It enables a fast response to events, which is central to risk mitigation.

The second step is developing a better understanding of the environment. Our guest commentator, Andy Browne, of The Wall Street Journal in China, is a classic resource for understanding the China environment. He has met many times with top politicians and officials from China and the US, and understands what makes them tick. He started in 1982 at the South China Morning Post before moving to Reuters News Agency, where he spent 20 years running bureaus around Asia before becoming Asia Pacific News Editor. He joined the WSJ in 2004, and was a member of Beijing team that won the Pulitzer Prize for International Reporting in 2007. Andy opened the session with his version of China's "Grey Rhinos" (easily seen risks but you must act); the term is taken from the title of a 2016 bestseller in China.

Richard Martin started working on critical issues management at the Heads of Asia Pacific Operations (HAPO) conference run by Business International in Guilin, China in 1982. Hans Dumoulin of Shell (a leader of the team that picked the 1973 oil price hike) and Dan Sharp of Xerox led the critical issues sessions at the 1982 HAPO. Mark Michelson (IMA's HK Chairman) and Rick Payne (IMA's editor) also attended.

With the help of Andy and 31 China CEO Forum members we came up with the following five China Critical Issues for 2018.

Critical Issue — A US-China trade war (and rising nationalism and protectionism on both sides)

Background

Trump won't flip-flop on trade with China as he has done on other issues. For decades, he has attacked the World Trade Organisation (WTO, formed in 1994 to replace trade wars with a global system of rules and a dispute settlement system). He believes that having let China enter it, flout the rules, and rise to become the second largest economy globally has been a huge mistake. In August, he authorized the US Trade Representative (USTR), Robert Lighthizer, to investigate China's IP practices, and the unfair burden it places on US businesses under Section 301 of the US Trade Act of 1974. This pre-WTO system enables retaliation for perceived unfair trade.

Key Actors

Robert Lighthizer is the author of Trump's 'America First' policies. He is critical of the WTO, and has signed an agreement with Japan and the EU to end subsidies for SOEs and technology transfer requirements for foreign companies, which is widely seen as aimed at China.

The Committee on Foreign Investment in the United States (CFIUS), is the US body responsible for reviewing inbound foreign investment for national security risks. A bipartisan bill to increase its power is working its way through Congress (the Foreign Investment Risk Review Modernisation Act or FIRRMA).

MOFCOM, China's Ministry of Commerce.

The Department of Trade under the National Development and Reform Commission (NDRC).

Flags

- Follow Robert Lighthizer on Twitter.
- See if FIRMMA gets passed by the US Congress.
- Monitor Chinese social media for rising anti-US sentiment, particularly any linked to your industry or products.
- Watch for a Section 301 ruling in the US; China would regard any penalties imposed as the first shot in a trade war.

Impact

Trade wars start as a tit-for-tat that can escalate. Some US firms will see it as a chance to block competition from China. The question is who gets hit in return. Retaliation can be broad (e.g. a new levy on all US imports) or specific to high profile sectors, as Korean and Japanese firms recently discovered. If specific to a sector or firm, it can devastate business. Non-US firms should watch for the impact on US suppliers, customers, and competitors.

Mitigation

US firms need a comprehensive public affairs/marketing strategy that focuses on links to the broad Chinese community, alignment with Beijing's policies, and possibly downplays US origins. Good access to regulators and policy influencers will help. Alternative supply channels for key inputs from the US should be assessed. Some may even consider restructuring (like McDonalds) to give local owners a prominent position.

Critical Issue — War on the Korean peninsula

Background

There has been a worrying shift in the narrative coming out of the White House. The notion of containment has been scrapped. The new narrative -- that North Korea is pursuing an offensive strategy – implies that the US cannot live with a North Korean nuclear threat, and may strike first. At a minimum, the threshold for military action under Trump is lower than in prior administrations. However, it is unclear if the ramping up of tensions is part of a US effort to simply spur China to tougher sanctions on North Korea.

Key Actors

Korean leaders. In the North, Kim Jong-un. In the South, newly elected President Moon Jae-in and his party want good relations with the North.

The UN Security Council is where the US, China, South Korea, and others will signal whether sanctions are working or not.

In the US administration watch statements by John Kelly (White House Chief of Staff) and H.R. McMaster (National Security Advisor).

In the Chinese administration watch statements by Wang Yi, China's minister of foreign affairs.

Flags

- Watch the UN sanctions. If China tightens, the North's fragile economy will quickly slump, and Pyongyang will likely de-escalate.
- Watch for a brief détente during the Winter Olympics (Feb in S Korea).
- Watch Pyongyang's missile launches and bomb tests. Washington has signalled that an atmospheric bomb test would trigger US military action.
- Watch for signs of preparation for conflict (e.g. in mid-December China reportedly started building refugee camps along its Korean border).

Impact

Actual war. Less likely, but accidents happen. Although brief, it would be devastating for North & South Korea. While the US and China would avoid direct conflict, US firms may find their China operations frozen or confiscated. US citizens in China may be at risk from a spike in anti-US sentiment.

A major escalation in tension. Quite possible. Flights and shipping would be disrupted as airspace and shipping lanes are closed. In China, there could be runs on banks, hording & shortages. A boycott of US products would be highly likely.

Mitigation

Start with the mitigation options for a China-US trade war (our first critical issue). US firms should also lobby the US administration to highlight the collateral damage to China operations, which may not be fully appreciated. Plan for increased security for US staff and families in China, and special consideration for PRC staff who will be in a difficult position. Careful realignment of marketing plans and avoidance of knee-jerk reactions (including in the US). Other foreign firms may want to clarify they aren't US-owned and to look for alternative suppliers.

Critical Issue — Market dislocation and social unrest due to President Xi's reforms and stringent implementation of regulations

Background

Companies have dealt with this issue through 2017, and it is set to continue in 2018. One major aspect is rigorous implementation of environmental regulations, which has forced the closure of some local firms in sectors like chemicals. More recently, it saw the expulsion of migrant workers and families from Beijing, which triggered unrest. At the 19th Party Congress, Xi Jinping declared that China's 'principal contradiction' (Marxism for get on the right side of the issue or you are toast) is the desire for a better quality of life and unbalanced, inequitable social conditions. That provides the philosophical underpinning for a crack down on corruption and for the stringent application of environmental and safety rules, as well as residency permits. Xi's centralisation of power in his first 5-year term allows him to force such change across ministries and provinces.

Key Actors

Xi Jinping. Xi has unilaterally launched and led this process from the start, and it has been critical to his political dominance.

The Communist Party. Party organs have seen their authority over every aspect of government re-emphasised. Track party statements (often prominent in the local press) as much as ministry statements.

Flags

- Campaigns. China relies on campaigns to drive action, and they are prominently reported in local media.
- Official reaction to accidents and consumer scares. Beijing aims to respond to popular concerns. Accidents and scares that gain prominence in social media will almost always trigger a regulatory response.
- New regulations. Like all governments, Beijing generates a stream of new rules. Watch for those in your sector.

Impact

The broadest impact is slower growth as environmental risks are curbed and decision making in government slows. The risk is often sector specific (e.g. targeting chemical and steel firms). It can be specific to foreign firms, either as a warning to local players or due to overzealous local officials inspired by nationalist sentiment. It can require immediate remediation (repacking and relabelling product or briefly closing a plant until new equipment is installed) or relocation of a plant (to new designated industry zones) or closure. The impact can quickly escalate if a response is slow or judged as inadequate.

Mitigation

Be compliant. In the past, compliance was seen as an extra-cost of business for foreign firms. Now, it ensures continued operations despite a wave of inspections, while non-compliant local firms are closed. Look for alternative sources if some key local suppliers are closed. Stay close to the regulators and track the development of new regulations. As discussed in our Sept 2017 session with China Policy, China has an open process for policy evolution if you track the local press, industry conferences, and think tanks.

Critical Issue — A China financial crisis

Background

A financial crisis has been brewing in China since the 2008-09 stimulus saw non-financial sector debt jumped from 150% of GDP to 275% by late 2017. As a top Chinese regulator commented, it is difficult to lend so much, so fast without a lot going bad. The bad borrowers are mostly SOEs and local governments; the latter hiding their debt in off-balance sheet vehicles. The bad lenders are mostly state-owned banks. Risk arbitrage has played a worrying role, along with an explosion of murky products (China's wealth management products or WMP look a lot like the CDOs that were central to the 2008 US crisis). So far, a crisis has been avoided, as Beijing has enough control over the economy (it owns most of the bad lenders and borrowers), enough money, and a mitigation strategy (views on this range from extend-and-pretend for dud loans to a viable path for growing/inflating China's way out of the mess). The potential for a crisis declined over 2017, but the risk remains large, and steps to de-risk the financial system could hurt some sectors and firms, or even trigger brief consumer panics in 2018.

Key Actors

The Financial Stability and Development Committee (FSDC). Set up in 2017 under the State Council to oversee all financial risk and to end risk arbitrage.

The Peoples' Bank of China (PBOC). Of the four existing regulatory agencies, the PBOC will retain a central role, and will house the FSDC.

Flags

- Bond defaults and bankruptcies. Beijing has played wack-a-mole over the last five years, stepping in to halt all but a handful of bond defaults and bankruptcies. Yet, this could snowball out of control.
- Bank runs and stock market plunges. Beijing has contained these so far, but sometimes after missteps that have aggravated the crisis.
- Popular protests. Consumers are quick to mobilise physical or social media protests over dud financial products.
- Supplier delivery holdups and customer payment problems. Like popular protests, these can warn of big underlying problems about to surface.

Impact

Provided Beijing's de-risking strategy works, the impact will be restricted to specific local firms. If Beijing's strategy fails, a financial crisis like that in the US in 2008 could be expected.

Mitigation

MNCs are not directly exposed, as they have little if any involvement in the informal lending and borrowing practices that are high risk. However, some local suppliers, customers, partners, and competitors for foreign firms will be hurt. Assessing the funding sources for such firms will help lower risk, as will watching the stability of their non-core ventures. Good political connections have helped local firms manage financial risk in the past, but may be less important in 2018 as Xi realigns political power across China.

Critical Issue — Cybersecurity and internet sovereignty

Background

Beijing sees control over the internet as central to control over society. President Xi often talks of the need for "Internet Sovereignty", which means allowing any state absolute control of its bit of the Web to the detriment of international connectivity. A strict new cybersecurity law came into effect in June 2017, and in mid-January 2018, China will close unauthorised VPNs. Large MNCs with approved connections to their oversea HQ should not be affected. However, their ability to connect to third-party cloud services outside of China may deteriorate. A new law on encryption is also being drafted, and it could limit the extent to which companies are permitted to scramble sensitive communications. Within China, the June 2017 cybersecurity law requires firms to reveal to authorities the content of their communications. In addition, citizens have been urged to report any internet communications that fail to align with national policy.

Key Actors

The Cyberspace Administration of China (CAC, set up in 2014) is the central internet regulator, censor, oversight, and control agency. It reports to the Central Leading Group for Internet Security and Information, which, like many key leading groups in the party, is headed by Xi Jinping.

Ministry of Industry and Information Technology (MIIT) is responsible for ensuring IT infrastructure is compliant with the law.

VPN operators. Leading foreign ones have usually found work-arounds as China has erected its Great Firewall. Will this continue?

China's telecom firms may be the main beneficiaries as providers of official VPN services and leased lines.

Flags

- Impact of closing independent VPNs Jan 2018. Although imminent, there's uncertainty about how big an impact this will have.
- New implementation guidelines in Q1'18. As a lot is unclear in the new rules, a wave of guidelines on implementation can be expected.

Impact

Foreign MNCs are being pushed to establish IT systems in China that are independent of their global system. It is likely that considerable time and money will need to be spent in 2018 to ensure effective communications within China and between China operations and the world.

Mitigation

In early January, Chinese ISPs will be required to block TCP port 80 (used for HTTP traffic), and ports 8080 and 443 (used for carrying HTTPS traffic). To retain access to these ports, ISP customers must register or apply to re-open the port through their local ISP. Companies should also assess whether their ISP piggybacks on the (lower cost) local internet to reach data centres outside of the country, as such systems will quickly degrade.

Other critical issues

At our dinner with Andy we canvassed a number of other critical issues that might upset business plans in 2018:

- Digital disruption as the BAT crowd use their scale, data skills, and cash to enter new industries and reshape them.
- An epidemic, such as bird flu. Most MNCs already have contingency plans for such events.
- A collapse in the housing market, likely linked to the collapse of one of the major developers.
- A battle in the leadership.

All are possible, but none presently fit the "grey rhino" requirement of being highly visible and requiring immediate safety precautions. However, it would be worth reviewing the list every quarter (we may make this a brief aside in the quarterly forecast update). Companies may also spot some grey rhinos that are specific to their sectors. We'll reconvene in December 2018 to pick new critical issues to add to the list and those to drop.

Our China CEO Forum participants represented

AIG
Ascendas-Singbridge
Atlas Copco
Bacardi
Becton, Dickinson and Company
Best Buy
Danfoss
Davis Wright Tremaine
DKSH
Emerson
FedEx Express
FMC
Genus Asia
Glanbia Nutritionals
Glaston
Henkel
Hormel Foods
Kellogg
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