PAMIR

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PAMIR Executive Brief

China Update

2 October 2023

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PAMIR

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Our analytical teams provide deep insight on geopolitical impact, risk landscape, and competitive strategies in foreign markets.

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Despite the lukewarm business prospects voiced by foreign firms in Shanghai, the sharp increase in the number of foreign-invested companies indicates some sectors – and a pool of punters – continue to see the Chinese operating environment as a manageable risk.

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Executive Summary

- China invested RMB 3.782 trillion ($519 billion) in R&D in 2022, up 10.1% YoY and the seventh year of double-digit growth.
- FDI in China for the first seven months of 2023 dropped 4% YoY, but 28,406 new foreign-invested companies were registered, up 34% YoY. FDI from Europe rose sharply, but the percentage of companies optimistic about the five-year business outlook in China fell to 52%.
- China's new Foreign State Immunity Law will increase Chinese court jurisdiction over the commercial activities of foreign sovereign states.
- A draft "Patriotic Education Law" is part of the Chinese government effort to rally nationalism as China's security environment deteriorates.
- Chinese consumers' record-setting online purchases of iPhone 15 eclipsed fanfare over Huawei's new Mate 60.

China's Economy

R&D Investment

China invested RMB 3.782 trillion ($519 billion) in technology R&D in 2022, up 10.1% YoY and the seventh year of double-digit growth, according to Chinese government data released on 20 September.

This accounted for 2.54% of Chinese GDP, 0.11% more than in 2021. China is the world's second largest R&D investor after the US.

Provinces/ Cities (Top 6)	
Guangdong	441.19B
Jiangsu	383.54B
Beijing	284.33B
Zhejiang	241.86B
Shandong	218.04B
Shanghai	198.16B

Funding Source	Investment (RMB)	Info date	Investment (Billion RMB)
Enterprises	2.387T	+11%	77.6%
Hi-Tech Enterprises	650.77B	+14.5%	22
Government	381.4B	+2.6%	12.4%
Central	34.2%		
Local	65.8%		
Universities	241.24B	+10.6%	7.8%
Other Entities	67.75B	+22.3%	

Chinese enterprises are the biggest drivers of R&D (77.6% of total input), matching that of US enterprises (77.6% in 2022) and approaching Japan (78.6%) and Korea (79.1%).

Government tax breaks and matching financial incentives motivate enterprises to invest more in R&D. Chinese analysts believe US-led technology export restrictions will compel China to invest even more in domestic R&D.

Foreign Investment

On 18 August China's Ministry of Commerce reported on FDI in China for the first seven months of 2023:

- FDI was RMB 766.7 billion, down 4% YoY (in US dollar terms, the drop was 9.8%).
- 28,406 new foreign-invested companies were registered, up 34% YoY.
- FDI in the manufacturing sector increased 0.1%, high-tech 3.8%, and high-tech manufacturing 25.3%.
- Investments jumped YoY from France (213.7%), UK (159.9%), Canada (113.3%), and Switzerland (61.2%).

CHINA INVESTED $519 BILLION IN TECHNOLOGY R&D IN 2022

China Internal

Foreign State Immunity Law

On 1 September the Standing Committee of the National People's Congress (NPC) approved the Foreign State Immunity Law (FSIL), to go into effect on 1 January 2024. The law has 23 articles that cover six major areas and limit exemptions for foreign actors:

CHINA'S FOREIGN STATE IMMUNITY LAW PROVISIONS:

1. **Foreign state immunity:** Chinese courts can exercise jurisdiction over non-sovereign actions by foreign sovereign states, such as their commercial activities and their faults for personal and asset damages.
2. **Asset seizure by Chinese courts:** Assets of foreign sovereign states, such as diplomatic assets, are exempted from distraint by Chinese courts, but their commercial assets are NOT exempt under certain conditions.
3. **Definition of foreign sovereign states:** A foreign sovereign state includes the state itself, its government organizations, and individuals and entities that exercise sovereign actions on behalf of the sovereign state.
4. **Role of China's Ministry of Foreign Affairs in FSIL cases:** MFA should provide courts with necessary documents to handle FSIL cases and recommendations on cases and issues related to China's key national interests and diplomacy, giving MFA substantial sway in FSIL cases.
5. **Principle of reciprocity:** China offers reciprocity to countries that give China similar immunities.
6. **Legal process for FSIL cases.**

Ma Xinmin, Director General of the MFA Treaty and Law Department cited two reasons for introducing the FSIL:

- Before the introduction of FSIL, China gave total immunity treatment to foreign sovereign countries, meaning Chinese courts could not prosecute cases against foreign governments. Now, when Chinese enterprises or individuals have commercial disputes with foreign governments, the Chinese courts can take their case.
- The FSIL responds to cases where foreign courts have ruled against China, taking away China's sovereign state immunity. Ma emphasized the principle of reciprocity and said FSIL follows international practices.

A scholar from the Chinese Academy of Social Sciences' Institute of International Law says that FSIL is directed against the US, which passed its own Foreign Sovereign Immunities Act in 1976. In recent years US courts have taken several cases against the Chinese government, particularly after Covid. In May 2020, 20 NPC delegates jointly petitioned to formulate an FSIL for China's protection.

- As with all Chinese laws, FSIL is very vague. Some legal experts noted that FSIL says it is applicable within the territory of PRC but does not specify if it covers Hong Kong and Macau, which are PRC territories with separate legal systems. Moreover, China has always claimed Taiwan as part of the PRC, but Taiwan has its own government and legal system.

> *Government tax breaks and matching financial incentives motivate enterprises to invest more in R&D. Chinese analysts believe US-led technology export restrictions will compel China to invest even more in domestic R&D.*

Patriotic Education Law

On 26 June the draft China Patriotic Education Law (PEL) was submitted to the NPC Standing Committee for its first reading. The draft has five chapters and 37 articles that would serve to "foster love for country, for the CCP, and for China's socialist political system." Once finalized, PEL is intended to define the scope of education, which covers communist/socialist ideology, Chinese and CCP history, Chinese culture, national symbols, Chinese geography, national solidarity and ethnic unity, deeds of national heroes and government model workers, and awareness of national security.

- PEL will delegate the lead to education departments at all levels of the government and requires other government agencies and media platforms like newspapers, radio, TV publication houses, and social media to cooperate in education. Enterprises, industry associations, and social groups are required to provide conveniences for education, such as offering venue and time slots. PEL authorizes the military to institute its own patriotic education programs.
- PEL will call for a variety of education methods tailored to different age and social groups, particularly in schools.
- PEL requires various occasions to use the national flag, national anthem, and oath to the Constitution.
- PEL will prohibit actions "humiliating" to Chinese national symbols or "distorting" the history of foreign aggression against China.
- PEL will call for enhancing national identity among residents in Hong Kong, Macau, and Taiwan.

The formulation of this law is part of the Chinese government effort to rally nationalism as China's security environment deteriorates. There is no information on when a final version of the law will pass.

- Hong Kong Chief Executive John Lee said the HK government is following the PEL process in the NPC. Once PEL becomes law, Hong Kong will adopt its own version in compliance with the law.

…the US also highlighted the cyber threat from China. On 12 September the Department of Defense (DoD) released an unclassified summary of its 2023 Cyber Strategy, which notes "Using cyber means, the PRC has engaged in prolonged campaigns of espionage, theft, and compromise against key defense networks and broader US critical infrastructure…

Cybersecurity

More than 10 Chinese government agencies, including the ministries of Public Security and State Security, sponsored a nationwide cybersecurity awareness campaign, “2023 Cybersecurity Education Week,” from 11 to 17 September. The campaign focused on telecom-based electronic device security, financial information security, personal data security, and awareness of various Chinese cybersecurity laws and regulations. All government agencies, enterprises, schools, and villages were required to devote time to the campaign.

- On 10-16 September the government held a cybersecurity exhibition in Fuzhou that displayed some of China’s latest technology achievements in cybersecurity protection. According to the exhibition, China’s national power grid has three layers of cyber protection, and all chips and operating systems used by the grid are made in China.
- Some local governments are enforcing their own requirement that cellphone users must download an anti-fraud application developed by the Ministry of Public Security. Some users fear the app could help the police trace their personal information.
- On 15 September the government-run Xinhua News Agency carried a long report that accused the US of being the world's largest “hacker empire,” repeating that China is the biggest victim of cyberattacks in the world and that most of the attacks originate from the US.
- On 20 September China’s Ministry of State Security published an article on all state media detailing supposed “major cyber theft” methods by the US intelligence apparatus, particularly the operations of the Office of Tailored Access Operations (TAO) of the US National Security Agency. The article accused some US IT companies of conspiring with US intelligence organizations to leave “backdoors” in their operating systems and apps.

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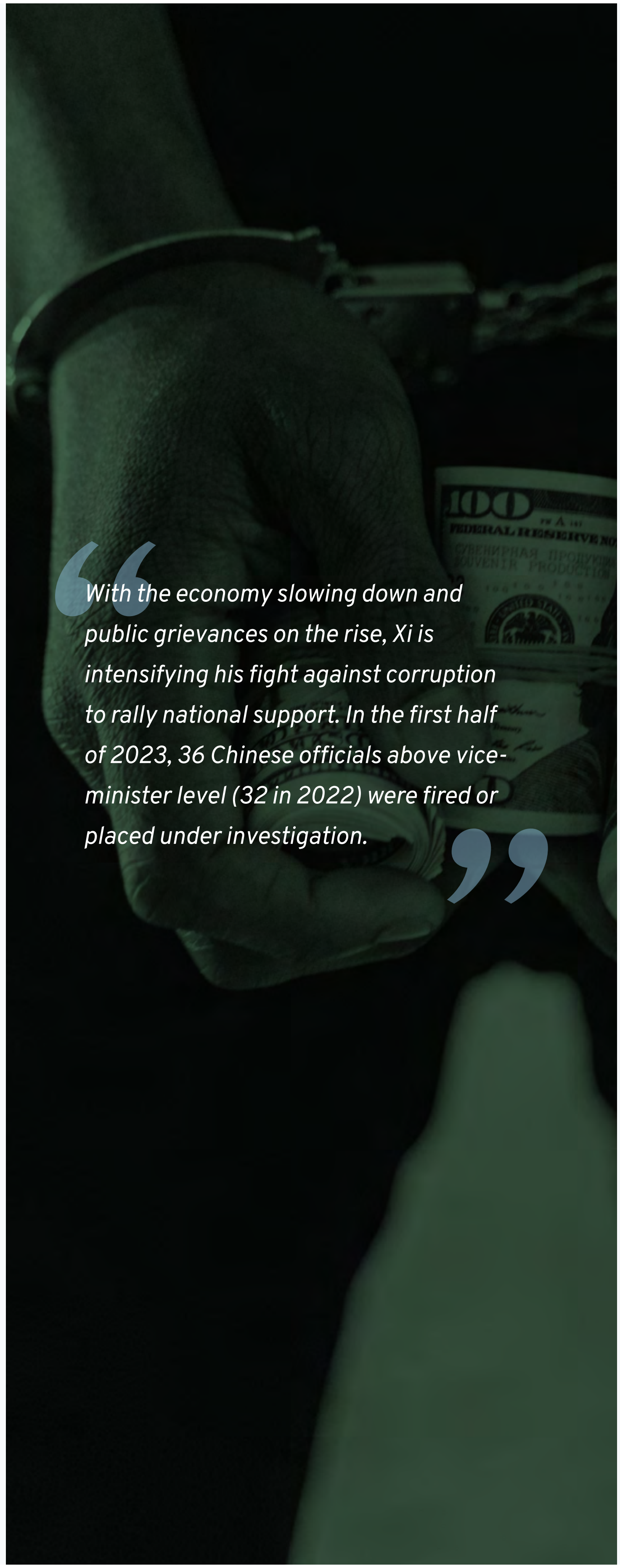
Corruption

US officials and media believe that Defense Minister Li Shangfu, who disappeared from public view in late August, is under investigation for corruption. If so, Li would be the second senior Chinese government official removed from office in the last three months for alleged corruption.

Before his promotion last March, Li had served since 2017 as Director of the PLA Equipment Development Department (EDD), which oversees R&D and procurement. EDD and the Chinese defense industry have been cradles of corruption – several former top defense industrial executives for aviation, shipbuilding, and army armaments are in jail for corruption. In July 2023 the PLA discipline inspection authority asked the public for leads into EDD corruption. It is speculated that Li's predecessor, General Wei Fenghe, and eight more EDD senior officers also are under investigation.

Chinese sources believe Li's removal for corruption would indicate:

- Xi Jinping's control over the Chinese military is weaker than it appears. Since becoming Chairman of the Central Military Commission (CMC) in 2012 and taking over the Chinese military, Xi has reportedly removed nearly 100 active and retired general officers for corruption. Although some of these removals had political considerations, they showed that the PLA has been plagued by corruption. Despite heavy-handed measures, high-level corruption continues under Xi's leadership. In July, the commander and political commissar of the PLA Strategic Rocket Force were removed for alleged corruption.



"With the economy slowing down and public grievances on the rise, Xi is intensifying his fight against corruption to rally national support. In the first half of 2023, 36 Chinese officials above vice-minister level (32 in 2022) were fired or placed under investigation."

- The corruption investigation against Li may lead to General Zhang Youxia, Politburo member and 1st Vice Chairman of the CMC. This CMC position actually runs the PLA, unlike the largely ceremonial defense minister position. Zhang preceded Li as EDD Director from 2012 to 2017, and several of the now jailed Chinese defense industry leaders committed their offenses under Zhang's watch. Zhang, 73, has been one of Xi's close confidants with a relationship rooted in friendship between their fathers from Chinese revolutionary war times. Xi kept Zhang on the Politburo last year even though Zhang was well past the mandatory retirement age of 68. In his position as 1st CMC vice chairman, Zhang is one of few Chinese military officers who could initiate a coup.
- Xi's decision to take down senior officers like Li came at some cost to his political prestige for poor personnel choices but shows concern that widespread corruption by senior officers has seriously undermined PLA morale and combat effectiveness at a critical moment. Xi has repeatedly warned Chinese leadership and the PLA about the deteriorating security environment for China and the pressing urgency of the Taiwan issue. While touring a PLA unit on 8 September, Xi emphasized that senior officers must care more about the rank and file and address their difficulties.

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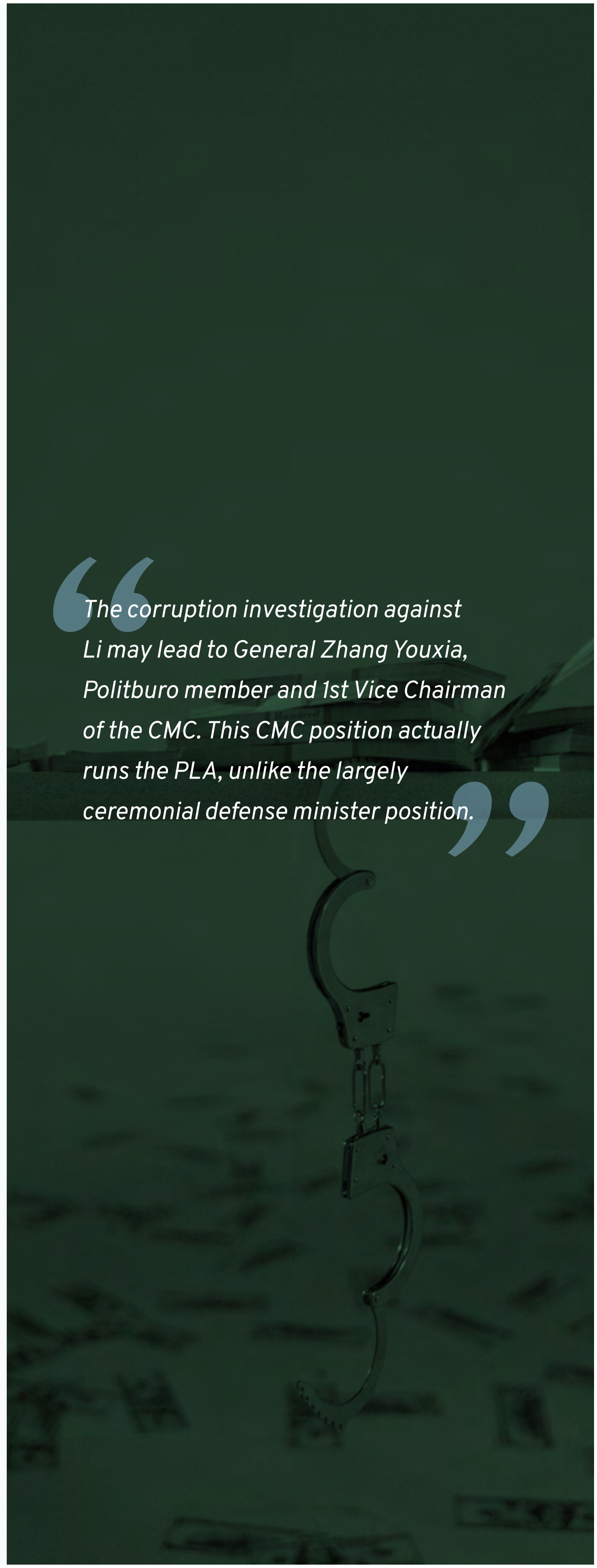

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US-China Relations

Business and Trade

Although some Chinese websites had called for a boycott of the new iPhone 15, claiming that it is made in India, Apple's China website was overwhelmed and crashed within 10 minutes once sales officially launched on 22 September. Before sales opened, buyers had lined up at midnight outside the Apple Store in Beijing and other major cities.

- Online retailer Meituan reported that its first day sales were 13 times greater than first day sales of the iPhone 14, exceeding RMB 200 million within the first 30 minutes, and Jingdong reported record cellphone sales.
- Chinese media reported that demand for iPhone 15s from smaller cities jumped six times, indicating that Apple is making greater inroads in interior China. This reception shows that Huawei's Mate 60 did not undermine Apple's popularity in China.

AmCham Shanghai's 2023 China Business Survey of its 325 members, released on 19 September, indicates that two-thirds of companies face pressure to decouple, but most blame US government policy rather than the Chinese government. The percentage of companies optimistic about the five-year business outlook fell to 52%, the lowest in the survey's history.

> *After several high-level visits, the US and China have taken steps to stabilize the bilateral relationship and a series of reforms announced in August signal the Chinese government's desire to improve the investment climate.*

AMCHAM SHANGHAI'S 2023 CHINA BUSINESS SURVEY

Key findings include:

- **52%** of companies **expect greater revenue in 2023 than in 2022**. 74% of retail companies expect higher revenues.
- **68%** of respondents **reported profits** in 2022 (**75% in 2021**).
- Over the next three to five years, **40% of respondents expect revenue growth in China to outpace their companies' worldwide growth** — a 7% drop from last year.
- **31% of respondents, 6% more than 2022, see market growth potential** and are increasing investment in China.
- **22% of respondents are decreasing investment in China**, the top reasons being uncertainty about the US-China trade relationship, followed by expectations of slower growth in China.
- **40% of respondents, up 6% over 2022, are redirecting** or planning to redirect **investment originally planned for China**. Most are looking towards Southeast Asia.
- **19% of respondents are considering moving some current operations out of China** over the next one to three years, largely due to uncertainty about US-China relations.
- **17% of companies ranked China as number one** in their company's global investment plans — **down from 27% in 2021.**
- **One-third of respondents reported that policies and regulations towards foreign companies had worsened** in the past year.
- **Only 33% considered the regulatory environment to be transparent**, the 3rd straight year of deterioration.
- **70% labeled data localization and other cybersecurity requirements as a hindrance to their business**.

A survey conducted in June-July among the 117 members of the US-China Business Council found responses similar to the AmCham Shanghai report.

AmCham Shanghai's chairman Sean Stein noted that, "China is becoming more challenging for foreign investors. What businesses need above all else is clarity and predictability, yet across many sectors, companies report that China's legal and regulatory environment is becoming less transparent and more uncertain.

- Similarly, after years of slow improvement, more companies are reporting IP challenges are hindering their business, and companies saying that geopolitical tensions are adding to uncertainty and making operations more challenging.

Recent developments are more encouraging. After several high-level visits, the US and China have taken steps to stabilize the bilateral relationship and a series of reforms announced in August signal the Chinese government's desire to improve the investment climate. If implemented, those reforms could reduce uncertainty and help restore investor confidence, according to Stein.

On 22 September the US and China simultaneously announced the launch of Economic and Financial working groups headed by vice-minister level officials that will meet on a regular basis and report to Secretary Janet Yellen and China's Vice Premier He Lifeng.

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Sanctions & Restrictions

On 22 September the US Commerce Department issued "guardrails" for using the $52.7 billion authorized by the US CHIPS Act to promote domestic semiconductor industry development. The rules prohibit recipients of CHIPS funding from expanding more than 5% of their existing semiconductor manufacturing capacity in foreign countries of concern for 10 years, and from engaging in joint research or technology licensing efforts with foreign entities of concern.

As of 9 August, 490 US and foreign companies, including TSMC and Samsung, reportedly had applied for the US grant; the guardrails will significantly restrict their operations in China.

- China has repeatedly criticized CHIPS as "a typical act of economic coercion out of geopolitical considerations," saying that it violates market and international trade rules and will damage the global chip supply chain.

China's Foreign Ministry and Ministry of Commerce denounced additional US trade sanctions:

- On 25 September the US added 11 Chinese companies to its Entity List for providing drone parts used by Russia against Ukraine.
- On 26 September the US sanctioned three Chinese companies for alleged forced labor practices in Xinjiang. This brings to 27 the number of Chinese companies sanctioned under the 2021 Uyghur Forced Labor Protection Act.

Anecdotal reporting suggests that China may be becoming more restrictive when issuing visas. In one case, a foreign businessperson received a work permit, while the non-working spouse inexplicably was denied an entry visa.

In another incident, a parent sought to visit an adult child employed in southern China but was granted only a three-day visa.

> *Observers believe the Malta meeting was part of preparations for a possible Xi-Biden summit during the November APEC meeting in San Francisco, but some Chinese experts see US sanctions against Hong Kong Chief Executive John Lee Ka-Chiu as an obstacle.*

Diplomatic Relations

During secret talks in Malta with US National Security Advisor Jake Sullivan on 16-17 September, China's Foreign Minister Wang Yi emphasized that the Taiwan issue is "the foremost inviolable red line in China-US relations" and urged the US to "faithfully fulfill its pledge to not support Taiwan independence."

- Wang pointed out China's development "enjoys a strong, self-driven impetus, and it aligns with the logic of history, and cannot be averted." Wang asked the US to lift its high-tech restrictions and sanctions against China. A White House press release particularly mentioned, "The United States noted the importance of peace and stability across the Taiwan Strait."

Observers believe the Malta meeting was part of preparations for a possible Xi-Biden summit during the November APEC meeting in San Francisco, but some Chinese experts see US sanctions against Hong Kong Chief Executive John Lee Ka-Chiu as an obstacle. Lee was sanctioned by the US in August 2020 for his role in "undermining Hong Kong's autonomy" when he was Hong Kong's police chief. As a member of APEC, Hong Kong's Chief Executive has always attended previous APEC summits, but US media reported in July that the Biden administration would not invite Lee this year due to US sanctions. China's Foreign Ministry has urged the US to "fulfill its due responsibility as the APEC host, invite Chief Executive Lee to the meeting according to customary practice…China will firmly safeguard the legitimate and lawful right of Hong Kong, China to attend the APEC meeting."

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Strategic Outcomes

Pamir Position

Despite the lukewarm business prospects voiced by foreign firms in Shanghai, the sharp increase in the number of foreign-invested companies indicates some sectors – and a pool of punters – continue to see the Chinese operating environment as a manageable risk. Pamir expects that successes resulting from steadily increasing Chinese R&D investment will be an attractant for FDI as long as investments are not in conflict with Western restrictions or are hampered by China's suspicions against and burdens on foreign actors.

Business Impact

The Foreign State Immunity Law does not appear to have immediate ramifications for the foreign business community, but firms with contracts to any diplomatic missions should seek clarification of what might constitute a "commercial asset." Pamir foresees the high likelihood of divergences between central and local government interpretations of the new law.

Business Opportunity

With FDI totals shrinking but turning up in a larger number of presumably smaller scale start-up firms, Pamir reminds investors to conduct thorough checks on company backgrounds and government connections.

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