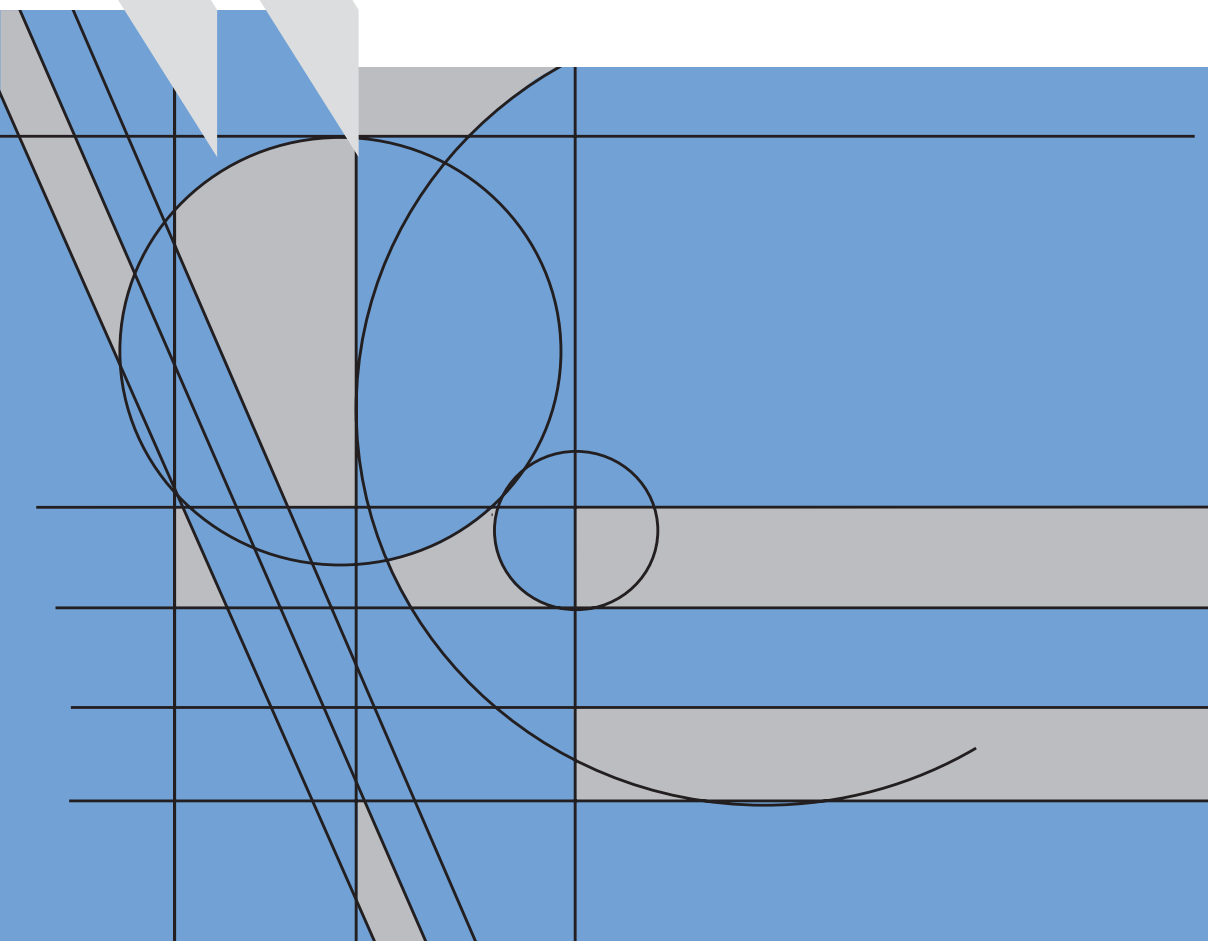




OECD Investment Policy Reviews

CHINA

**ENCOURAGING RESPONSIBLE
BUSINESS CONDUCT**

OECD Investment Policy Reviews

China

ENCOURAGING RESPONSIBLE BUSINESS CONDUCT

2008



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Foreword

This third Investment Policy Review of China forms part of the continuing programme of OECD-China co-operation on investment policies which began in 1995 and has benefited from the policy dialogue between the OECD Investment Committee and the People's Republic of China. This programme focuses on developing a mutually beneficial exchange of experiences to promote open and transparent policy frameworks for investment. A rules-based framework can encourage more and better foreign investment in China and sustainable outward investment by Chinese enterprises overseas, stimulating economic growth and development and facilitating the country's further integration into the global economy.

The 2008 Review assesses the impact of major changes in China's legal and regulatory framework for investment and improvements in China's FDI statistics methodology since the 2006 Review. It describes motivations for and the development of China's outward direct investment in recent years, including recent Chinese investment in Africa. The Review then outlines the case for encouraging responsible business conduct in China and by Chinese companies operating abroad, highlighting efforts to strengthen environmental protection and respect for core labour standards by enterprises.

The chapter on responsible business conduct is based on the background report discussed at the Multi-Stakeholder Symposium on Chinese and OECD Approaches to Encouraging Responsible Business Conduct held at the OECD in Paris on 26-27 June 2008. The Symposium brought together a wide variety of stakeholders, including the Chinese government, OECD member governments, the Business and Industry Advisory Committee to the OECD (BIAC), the Trade Union Advisory Committee to the OECD (TUAC), OECD Watch, Chinese and international NGOs, and the OECD Secretariat. The report has been revised to take account of this discussion. The chapter on environmentally responsible business conduct was presented and commented on at the Seminar on Promoting Environmentally Responsible Business Conduct in China held back-to-back with the Multi-Stakeholder Symposium at the OECD in Paris on 27 June 2008.

The Review is based on studies prepared by Kenneth Davies, Senior Economist, Misuzu Otsuka, Economist, and Ayse Bertrand, Lead Statistician, in the Investment Division of the OECD's Directorate for Financial and Enterprise Affairs, with input from its Competition and Corporate Affairs Divisions, from the Centre for Tax Policy and Administration, and from the OECD's Environment Directorate.

Table of Contents

Executive Summary	9
Chapter 1. Recent Developments in China's Investment Policies	11
Overview	12
1. Current trend of FDI inflows	12
2. Regulations on the acquisition of domestic enterprises by foreign investors effective from 2006	15
3. Enterprise Income Tax Law effective from 1 January 2008	19
4. Property Rights Law effective from 1 October 2007	23
5. Anti-Monopoly Law	27
6. Revised catalogue for guiding foreign investment industries, effective from 1 December 2007	32
Notes	40
Annex 1.A1. Differences between the 2003 Interim Provisions and the 2006 Regulations	43
Annex 1.A2. Statistical Tables	51
Chapter 2. China's FDI Statistics	57
Notes	63
Chapter 3. China's Outward Direct Investment	65
Overview	66
1. Overview of China's outward foreign direct investment	68
2. The government's policy on OFDI	81
3. Motives for China's OFDI	93
4. China's direct investment in Africa	103
Notes	119
Annex 3.A1. Statistical Tables	130
Chapter 4. Encouraging Responsible Business Conduct in China	143
Overview	144
1. Background	146
2. The case for encouraging responsible business conduct in China	150
3. China's policies for promoting responsible business conduct	165
4. Remaining challenges	213
Notes	215

Annex 4.A1. Guidelines for State-owned Enterprises Directly under the Central Government on Fulfilling Corporate Social Responsibilities	225
Annex 4.A2. Shenzhen Stock Exchange Social Responsibility Instructions to Listed Companies	230
Annex 4.A3. Speech by the OECD Secretary-general at the Global Corporate Social Responsibility Forum in China	236
Annex 4.A4. OECD Visit to Textile Factories in Guangdong.	243
Annex 4.A5. Summary of Discussions at Multistakeholder Symposium.	249
Chapter 5. Environmentally Responsible Corporate Conduct in China .	257
Overview	258
1. The regulatory framework for the environment in China.	260
2. Role of the business sector in environmental protection	267
Notes	275
Annex 5.A1. A List of Environmental Laws, Regulations and Policies in China	283
English Glossary	285
Chinese Glossary.	286

List of Boxes

2.1. OECD Benchmark Definition of Foreign Direct Investment, 4th edition	62
3.1. Measurement of China's OFDI	71
3.2. The Largest Chinese MNEs	78
3.3. Major OFDI deals by Chinese enterprises (2004-07).	95
3.4. MNEs seeking resources – China National Petroleum Corporation (CNPC).	96
3.5. MNEs seeking new markets – ZTE Corporation	99
3.6. MNEs seeking strategic assets – China National BlueStar (Group) Corporation	101
3.7. The trade relationship between China and Africa	105
3.8. China's Resource-seeking OFDI projects in Africa	112
3.9. Case study: A Chinese construction SOE in Africa: COMPLANT . .	116
4.1. The OECD <i>Guidelines for Multinational Enterprises</i>	147
4.2. OECD members and China face similar challenges in encouraging RBC.	148
4.3. How the OECD <i>Guidelines</i> already apply to companies in China and to Chinese enterprises	151
4.4. A major challenge: How to combine growth with equity	153
4.5. Global responsibilities of Chinese corporations: A Chinese view . .	157

4.6. Corporate donations	169
4.7. A Chinese academic view of RBC	170
4.8. The 2007 government work Report: Re-orienting China's growth strategy	184
4.9. Environmental Conditions in the Lending Policies of the Export-Import Bank of China	190
4.10. China's adoption of United Nations conventions	203
4.11. Chinese oil company activity in Peru	211

List of Tables

3.1. M&As vs. China's OFDI	75
3.2. China's OFDI in Africa – flow and stock	107
4.1. ILO Conventions ratified by China	206
4.2. Domestic and foreign-invested enterprises reportedly publishing RBC reports in 2007	209

List of Figures

1.1. FDI inflow as % of capital formation and GDP	13
1.2. FDI inflow by type	14
3.1. China's OFDI – flow: 1982-2006	69
3.2. China's OFDI – stock: 1982-2006	72
3.3. Trade value between Africa and China: 1982-2006	105
3.4. China's OFDI in Africa – flow: 1991-2006	107
3.5. Top African recipients of China's OFDI stock	109

Executive Summary

China's regulatory framework for investment has been developed further since 2006

The OECD reviews the five landmark laws and sets of regulations promulgated since the publication of the 2006 *OECD Investment Policy Review of China*. It finds that these changes improve the tax and competition elements of the regulatory environment within which businesses, including foreign-owned enterprises (FIEs), operate in China, but tighten restrictions on inward direct investment, including cross-border mergers and acquisitions. The review also takes stock of developments in China's inward and outward FDI statistics methodology.

China's increasing outward investment is prompting calls for responsible behaviour

China has been rapidly becoming an important source of outward foreign direct investment (OFDI) in recent years. Government policy was initially the main determinant of OFDI, but it is now increasingly driven by commercial motivations. In the context of China's growing role as an investor in Africa in particular, concerns over China's investment behaviour are being raised and Chinese enterprises are under increasing pressure to be more responsible global players.

China is adopting policies to encourage responsible business conduct (RBC)

The OECD supports the Chinese government's efforts to promote high standards of corporate behaviour and develop further the framework conditions that enable responsible business conduct (RBC). The Chinese authorities are striving to ensure corporate compliance with laws relating to RBC and are also promoting RBC in overseas operations of Chinese enterprises. China has signed and ratified international agreements relevant to promoting RBC. Chinese companies are seeking to learn about RBC standards.

More can be done to encourage RBC

While the Chinese government has made efforts to encourage responsible business conduct, many Chinese enterprises are still largely unaware of what RBC entails and have not organised themselves to promote it. The lack of co-ordination of government agencies' approaches hinders communication of the government's expectations to Chinese companies. The OECD offers policy options to help implement at local level legislation and regulations establishing framework conditions for responsible business conduct.

China has made progress, but still faces challenges, in encouraging environmental RBC

China's rapid economic growth has been accompanied by negative environmental impacts. The Chinese government has accelerated its efforts to develop the legal framework and standards for environmental protection. The OECD offers policy options to meet the formidable challenges faced by the Chinese authorities in enforcing and implementing these.

Chapter 1

Recent Developments in China's Investment Policies

This chapter assesses the extent to which China's legal and regulatory framework for investment has been improved since the publication of the 2006 OECD Investment Policy Review of China, including new cross-border mergers and acquisitions regulations, the Enterprise Income Tax Law, the Property Rights Law, the Anti-Monopoly Law and the latest revision of the Catalogue for Guiding Foreign Investment Industries.

Overview

Five landmark laws and sets of regulations have been promulgated since the publication of the 2006 *OECD Investment Policy Review of China*: expanded regulations on cross-border mergers and acquisitions; an Enterprise Income Tax Law that sets a single tax rate for domestic and foreign-owned enterprises; a Property Law giving equal protection to private and public property; the People's Republic of China's first Anti-Monopoly Law; and a third revision of the Catalogues for Guiding Foreign Investment Industries.

The overall effect of these measures is to add essential building blocks to the regulatory structure within which businesses, including foreign-owned enterprises (FIEs) operate in China, especially the new laws on property and competition. The unification of business tax rates is positive in that it increases incrementally the transparency of the tax regime for domestic and foreign investors, as, in some ways, do the new cross-border M&A regulations. Similarly, the Anti-Monopoly law fills a major gap in China's competition legislation; it does not discriminate between domestic and foreign-invested enterprises except insofar as it allows for a national security review to be applied to the latter. On the other hand, an opportunity appears to have been missed in regard to the Foreign Investment Catalogues, which remain less than wholly transparent. The revised M&A regulations, which in other respects provide the potential for increased transparency, also introduce an extra and opaque screening barrier to cross-border acquisitions.

1. Current trend of FDI inflows

China's policies towards FDI are developing as a response to the new situation in which the country finds itself after nearly three decades of openness towards foreign investment and trade. China remains the largest recipient of FDI among developing countries (see Table 1.A2.1), a position it attained in the 1990s. The challenge perceived by the Chinese government is no longer one of simply attracting FDI, but rather one of meeting the needs of a rapidly developing economy. The result is a more selective approach, as is evident in the revised Catalogues for Guiding Foreign Investment Projects. This selectivity is made more affordable now that the economy has become less dependent on FDI as economic growth, largely driven by domestic investment, has accelerated. This decreased dependence on FDI has also allowed a further move toward full national treatment with the ending of the

special tax regime for foreign investment. As the trend in FIEs away from Sino-foreign joint ventures towards wholly-foreign-owned enterprises has continued, and as FIEs have maintained their dominance of China's export trade, fears of foreign investment have been voiced on behalf of domestic business in recent years. In response to such fears, and to perceived negative reactions abroad to China's own overseas investments, broadly-defined national security concerns are being included in new legislation.

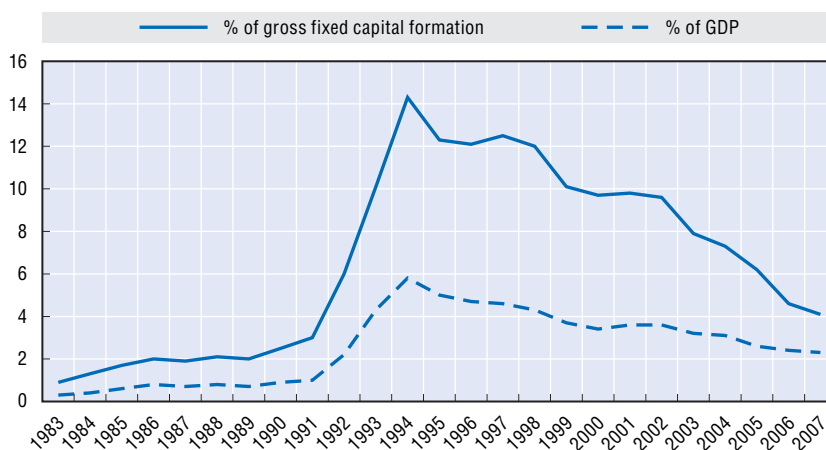
1.1. FDI inflows continued to increase in 2006 and 2007

Total FDI inflow rose from USD 60.3 billion in 2005 to USD 69.5 billion in 2006 and USD 82.7 billion in 2007, measured in terms of value of actually utilised investment (Table 1.A2.2). Non-financial FDI reached USD 65.8 billion in 2006 and USD 74.8 billion in 2007 (figures for financial and non-financial FDI were not published in earlier years).

1.2. FDI inflows are a declining proportion of fixed investment and GDP

Economic growth has been more rapid than FDI inflow growth, so the shares of FDI in gross fixed capital formation and GDP have fallen to 4.1% and 2.3% respectively after peaking in 1994 at 14.3% and 5.8% (Table 1.A2.3). FDI has always accounted for a minority of capital formation in China (Figure 1.1). As noted in earlier reviews, China has throughout the period of economic reform enjoyed a high saving rate which has enabled it to finance fixed investment from domestic resources.

Figure 1.1. FDI inflow as % of capital formation and GDP

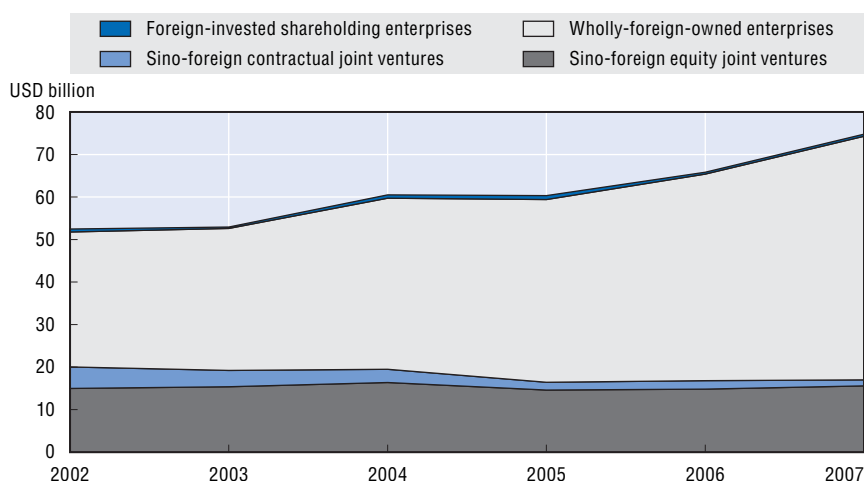


Source: OECD calculations from National Bureau of Statistics GDP data and MOFCOM FDI statistics.

Wholly-foreign-owned enterprises have continued to increase their dominance in non-financial FDI, rising from 60% of inflow value in 2002 to 76% in 2007. The share of joint ventures, both equity and contractual, which predominated in the 1980s and 1990s, continued to contract, respectively from 29% to 21% and from 10% to 2% in 2002-07 (see Figure 1.2). With improvement and maturing of the business environment, foreign investors, many of whom now have long experience of operating in China, have become less dependent on local partners.

Figure 1.2. **FDI inflow by type**

Non-financial FDI only



Source: MOFCOM yearbooks and FDI website www.fdi.gov.cn.

The largest source of China's FDI remains Hong Kong, China (Table 1.A2.5), although it remains uncertain how much of these inflows originates in Hong Kong, China itself, how much is pass-through FDI from other sources such as OECD countries using the territory as a convenient base for operations in China, and how much is "round tripping" capital from China taking advantage of tax incentives available there because Hong Kong, China is treated as a separate customs territory from the rest of China. The removal of these incentives is dealt with below in the section on the unified business tax. The proportion of FDI recorded as emanating from Hong Kong, China has been in secular decline since the 1980s, when it ranged between two-thirds and three-quarters of the total, but is now stable at around one-third and in 2007 the proportion rose to 37.1% of actually utilised FDI from 32.4% in 2006 as FDI from other major providers, including the EU, Japan, Korea, and the United States, fell in absolute as well as relative terms.

A major difficulty in calculating inflows from major sources remains the high proportion of FDI routed through tax havens. In 2007, there was a sharp increase in such inflows coming through Mauritius, the Cayman Islands, the British Virgin Islands and Samoa, which together accounted for 29.2% of the global total. The British Virgin Islands alone contributed 22.1%, more than combined recorded FDI inflows to China from Europe, North America and Japan. Recent co-operation between the OECD and China on improving the international comparability of China's FDI statistics is dealt with in the next chapter.

2. Regulations on the acquisition of domestic enterprises by foreign investors effective from 2006¹

The OECD's 2003 and 2006 *Investment Policy Reviews of China* recommended more open policies towards cross-border mergers and acquisitions (M&As). The 2006 Review analysed *inter alia* the 2003 *Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, hitherto the most comprehensive set of regulations on cross-border M&A. It welcomed the additional transparency they brought and proposed further measures to liberalise cross-border M&A regulations, including: further relaxation of foreign ownership restrictions; increased regulatory transparency; adopting internationally-standard and transparent merger notification procedures; further improving corporate governance; and fully opening capital markets to foreign investor participation.

On 8 August 2006, the Ministry of Commerce (MOFCOM) announced a new set of *Regulations on the Acquisition of Domestic Enterprises by Foreign Investors* (hereafter the 2006 Regulations), to take effect on 8 September 2006.

The new policy towards cross-border mergers and acquisitions is explained in the 11th five-year plan for utilising foreign investment, announced by the National Development and Reform Commission (NDRC) on 9 November 2006.² This states that priority will be given to quality rather than quantity of foreign investments, that emerging monopolies by foreign-invested enterprises are posing a potential threat to China's economic security and that foreign businesses are harming Chinese enterprises' capacity for independent innovation. The plan sets forth a clear industrial policy prioritising geographical areas, industrial sectors, levels of technology, environmental protection and efficient use of natural resources. In response to perceived rising concern over foreign acquisitions of leading Chinese firms in critical sectors (so-called "dragon head" enterprises), the plan provides for increased supervision of sensitive acquisitions to ensure that what are termed "critical industries and enterprises" remain under Chinese control and to prevent the "abuse of intellectual property".

2.1. Foreign investors may use shares to pay for Chinese companies

The 2006 *Regulations* represent a further opening toward cross-border mergers and acquisitions (M&As) in line with standard international practice in that they allow for the first time the acquisition of equity interests held by shareholders of a Chinese domestic company by payment of equity interests held by shareholders of an overseas company or new shares issued by an overseas company.

The 2006 *Regulations* increase corporate transparency by requiring parties to a cross-border acquisition to disclose whether or not they are affiliated with each other and, if they are under the common control of the same entity, to provide additional information regarding the purpose of the acquisition and whether the appraisal results conform to fair market value. They also make specific and detailed provision for the use of special-purpose entities overseas by Chinese domestic firms making acquisitions in China – an important addition in view of the generally unrecorded but widespread practice of “round-tripping” by Chinese companies seeking to benefit from incentives offered to foreign investors.

2.2. The Regulations add a new screening requirement for cross-border M&A transactions

On the other hand, the 2006 *Regulations* add a new screening requirement on cross-border M&A transactions in which the foreign investor obtains controlling rights of a domestic enterprise if the acquisition: involves a major industry; has or may have an impact on national economic security; or may result in the transfer of famous trademarks or traditional Chinese brands.

The lack of definition of terms including “major industry”, “impact” on “national economic security”, “famous” trademarks and “traditional” Chinese brands appears to render the new screening requirement less than wholly transparent. Foreign investors seeking to merge with or acquire domestic Chinese enterprises, the domestic enterprises targeted for merger or acquisition, and the Chinese government agencies charged with implementing the new regulations may not have enough information to be able to apply these terms to an actual transaction. Pending the publication of detailed implementing regulations, if any, the new screening process may have a serious unintended discouraging effect on investments.

The new screening measures covering cross-border acquisitions which have or may have an impact on “national economic security” appear to go beyond measures to safeguard essential security interests.³ This also raises an issue of compatibility with international commitments.

Since the extra layer of screening is added after the merger or acquisition, it amounts to an *ex post* restriction which can substantially impede the stability of cross-border merger or acquisition transactions.

“Famous trademarks” can be certified by a People’s Court and also by Chinese administrative agencies, including the Trademark Office of the State Administration for Industry and Commerce (SAIC). Since People’s Court certifications are not listed publicly, it is difficult for foreign investors to see whether a trademark falls into the category of “famous trademarks”. It is not usual for developed countries to restrict cross-border mergers or acquisition by reason of “famous” trademark or “traditional” brands.

The creation of a new layer of screening is in addition to the examination and approval process based on the *Catalogues for Guidance of Foreign Investment Industries*, which the Chinese authorities have been invited in both the 2003 and 2006 OECD Reviews to make more transparent and eventually replace with a closed list. It does not appear consistent with the repeatedly expressed intention of the Chinese authorities to streamline foreign investment approval procedures.

The law concerning the control of strategic investment in listed companies by foreign investors was promulgated on 31 December 2005 and came into force on 30 January 2006. This law provides the relevant procedures for merger and acquisition of domestic listed companies by foreign investors. However, the relationship between the 2006 *Regulations* and this law is unclear, and therefore it remains uncertain whether the 2006 *Regulations* should be applied to a foreign investor merging with or acquiring a Chinese listed company.

2.3. Merger notification discrimination against foreign investors has been retained

The OECD’s 2006 Review also noted that “the 2003 *Interim Provisions* contain regulations on premerger notification that appear to discriminate against foreign investors and others that are based on unquantifiable premerger notification thresholds”. The Review welcomed the Chinese government’s intention to promulgate a non-discriminatory anti-monopoly law and meanwhile recommended changes to the merger notification procedures in the 2003 *Interim Provisions* to increase their transparency. It was understood informally from the Chinese authorities that they intended to replace the discriminatory merger notification procedures in the 2003 *Interim Provisions* with a merger notification procedure in the anti-monopoly law that did not distinguish between domestic enterprises and foreign investors. This reassurance was needed in view of recent calls from some officials for the new anti-monopoly law to block undesirable cross-border acquisitions, following a

report by the State Administration for Industry and Commerce (SAIC) in 2004 that foreign companies were building monopolies in China (an allegation that MOFCOM has since publicly refuted).⁴ The merger notification procedures in the 2006 *Regulations* do not reflect the OECD's recommendations and are essentially the same as those in the 2003 *Interim Provisions*. The new Anti-Monopoly Law does not in general discriminate against foreign-invested enterprises (see Section 3 on the law below), so it remains to be determined to what extent the provisions of the 2006 *Regulations* on merger notification procedure still apply and whether or not they will be rescinded.

Drawing on practices which OECD members have also encouraged each other to adopt, policy options for consideration include:

- Clarifying the conditions of application of the new screening procedures, in particular by listing sectors qualifying as “major industry”, defining “national economic security” and “impact”, and explaining the criteria for identifying “famous” trademarks and “traditional” Chinese brands.
- Reducing the number of stages required in examination and approval procedures. The 2006 *Regulations* appear to introduce new complexities to the examination and approval process for cross-border M&As. Any implementing regulations adopted to clarify the 2006 *Regulations* would be more encouraging to investment in China if they moved in the direction of greater transparency, clarity and simplicity.
- Using existing remedies which may be less restrictive than the additional procedures in the 2006 *Regulations* while still achieving the legitimate objectives which may underpin the introduction of the new screening process.
- Reconsidering the merger notification procedures in the 2006 *Regulations* in the light of the 2006 OECD *Investment Policy Review*, including the possibility of rescinding them to ensure consistency with the new Anti-Monopoly Law.

2.4. SASAC December 2006 Directive on “strategic” industries

The State Assets Supervision and Administration Commission (SASAC) in December 2006 issued a *Guiding Opinion Concerning the Advancement of Adjustments of State Capital and the Restructuring of State-Owned Enterprises*.⁵ The Opinion recommended that state-owned capital be concentrated in “major industries and key areas”, defined to include “industries involving national security, significant basic infrastructure and major mineral resources, industries supplying important public goods and services, and major backbone enterprises in ‘pillar’ industries and high and new technology industries”. The industries referred to are not further defined in the Opinion, which makes reference to generalised national security concerns, but in presenting it to the media, SASAC Director Li Rongrong said that central state-owned enterprises (SOEs) in electrical power and distribution, oil and

chemicals, telecommunications and armaments should either be solely owned by the state or else the state should have a majority shareholding, while the state must always have a controlling stake in coal, aviation and shipping SOEs. At the same time, he said, central SOEs in the downstream oil and chemical sector and in value-added telecommunications services could continue to bring in private or foreign capital.⁶ Mr. Li also proposed that central SOEs should become dominant in other sectors, including machinery, automobiles, information technology, construction, iron and steel, and non-ferrous metals.⁷

2.5. Implicit restrictions on FDI in industrial equipment manufacturing

In January 2007, the Chinese government responded to the State Council's earlier *Opinions on Revitalisation of Industrial Machinery Manufacturing Industry* (which proposes encouragement of an increase in the market share of domestic enterprises in 16 sectors) by announcing preferential import tax incentives to "raise the core competitiveness and capacity for independent innovation of domestic industries". These incentives include refunds of previously levied import tariffs and value-added taxes for key parts and accessories imported for development and manufacture of such equipment. The refunded money is to be used as "national investment in research and development of new products and the cultivation of capacity for independent innovation". The Ministry of Finance is charged with deciding which enterprises meet the conditions for such refunds. The refunded money is to be transferred to "national capital", e.g. SOEs take the refund as registered capital, while enterprises without state-owned shares shall have the state-owned assets operation company authorised by local government hold the shares.⁸

3. Enterprise Income Tax Law effective from 1 January 2008⁹

On 16 March 2007, the National People's Congress promulgated an Enterprise Income Tax Law¹⁰ which for the first time applies to all enterprises established in China, regardless of whether they are domestic or foreign-owned. This law replaces the Foreign-Invested Enterprise Income Tax Law¹¹ and the Interim Enterprise Income Tax Regulations¹² that applied to domestic enterprises.¹³

Enterprises are divided in the new law into resident and non-resident enterprises. Resident enterprises are those established in China, or established in accordance with the law of a foreign country (region) but having their actual administrative institutions in China. Non-resident enterprises are those established outside China but with organisations or establishments in China, or else having organisations or establishments outside China that

derive income from China. Resident enterprises are taxed on their worldwide income, non-resident enterprises only on their income from within China.

The Enterprise Income Tax Law, by setting a single 25% tax rate for all resident enterprises without distinguishing between domestic and foreign ownership,¹⁴ ends the uncertainty that has surrounded this policy since China's accession to the WTO at the end of 2001 and establishes a level playing field for all enterprises in regard to taxation of income.

Up to end-2006, foreign-invested enterprises (FIEs) paid an average of 15% of their income in enterprise income tax, while domestic enterprises paid on average 25%. The standard concessions for an FIE included top income tax rates of 15% and 24% (depending on factors such as location) which only came into effect in a company's sixth full year of profit-making after a two-year tax holiday and three years at half-rate tax. Further concessions were available in certain sectors and locations. Domestic companies were subject to a standard enterprise tax rate of 33%, mitigated by sectoral and regional incentives. Domestic low-profit enterprises were levied tax at rates of 27% and 18%.¹⁵

The new law sets a standard rate of enterprise income tax of 25%,¹⁶ regardless of whether the enterprise is Chinese or foreign-owned. The statutory tax rate has therefore been reduced by eight percentage points for domestic enterprises and increased by ten or two percentage points for FIEs. The effective tax rate for domestic enterprises will also fall significantly with the lifting of the previous restriction on the tax deduction for wage expenses. The Chinese authorities calculate that the result will be CNY 41 billion more paid in enterprise income tax by FIEs in 2008, after the law has come into force, while domestic companies will pay CNY 134 billion less, so total revenue from enterprise income tax is expected to be CNY 93 billion lower than if the law had not been enacted.

The new law is in line with the recommendation of the OECD's Investment Committee and Committee on Fiscal Affairs that China attract FDI by enhancing the regulatory framework for investment rather than by offering fiscal and other preferential incentives to foreign investors. The OECD's 2003 *Investment Policy Review of China: Progress and Reform Challenges* cautioned against excessive reliance on special incentives to attract FDI as a substitute for establishing a broad enabling environment for investment characterised by openness, non-discrimination, transparency and effective rule of law.

The 2003 *Review* also stressed that the main concern of FIEs is to ensure that concessions already extended will not be revoked retroactively, but protected by grandfather clauses. The 2007 Enterprise Income Tax Law addresses this concern expressed in the *Review* by not including any retroactive rate change and phasing the increase to 25% for existing FIEs over a five-year transition period,¹⁷ so that they can adapt gradually to the new rate.

As pointed out in the preceding section, the August 2006 Regulations on the Acquisition of Domestic Enterprises by Foreign Investors make provision for checking on the use of special-purpose entities overseas by Chinese domestic firms making acquisitions in China. This as an important addition in view of the generally unrecorded but widespread practice of “round-tripping” by Chinese companies seeking to benefit from incentives offered to foreign investors.

By eliminating incentives for foreign investors in the Enterprise Income Tax Law, the Chinese government has now removed the motivation for round-tripping, which can be expected to dwindle rapidly. As a result, China's FDI statistics are likely to become more accurate, since they will no longer include an unknown proportion of investment that is really domestic investment disguised as foreign investment. Another beneficial outcome will be increased tax revenue resulting from the closing of this tax evasion loophole.

The removal of fiscal incentives for foreign investors will not remove incentives offered to investors in less-developed regions such as Western China and the Special Economic Zones and into sectors the government wishes to promote, such as environmental protection and renewable energy. As these incentives are non-discriminatory between foreign and domestic investors, they do not detract from the level playing field which the Chinese government is promoting by unifying the general enterprise income tax rate. For example, enterprise income tax for small-scale enterprises that meet certain conditions is 20%, and 15% for state-encouraged high-technology and new technology enterprises.¹⁸

The new law also increases the transparency of China's tax regime by bringing all enterprises within the scope of a single law.¹⁹ Previously, FIEs were governed by the 1991 Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises while domestic enterprises were governed by the 1993 Provisional Regulations of the People's Republic of China on Enterprise Income Tax. The Enterprise Income Tax Law is a step towards simplification of the plethora of tax legislation affecting FIEs in China. The promised further standardisation of non-discriminatory regional and sectoral tax incentives will also contribute to fulfilment of this objective.

Stronger measures in the new law to deal with tax avoidance, including provisions relating to transfer pricing, are broadly in line with OECD norms.²⁰ FIEs currently reportedly have a higher tax compliance rate than domestic Chinese enterprises, and multinational corporations operating in China which are based in OECD member countries are encouraged to comply with the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* and with the OECD *Guidelines for Multinational Enterprises*.

According to official figures, FIEs have paid more than USD 200 billion in tax since the 1990s and now account for 4.1% of total tax revenue. In encouraging increased tax compliance by domestic enterprises, these measures will therefore contribute to a more level playing field.

The Enterprise Income Tax Law is likely to stimulate longer-term investments by large multinational enterprises. The prior tax incentive regime encouraged the establishment of short-term investment projects that could be shut down at the end of the tax holiday and replaced by similar short-term investments. The limited evidence available suggests that small and medium-sized foreign investors were more likely to be attracted by tax incentives than large multinationals.²¹ The new law is therefore likely to lead to more stable inward direct investment.

Exemptions or deductions are available for income from: projects in agriculture, forestry, animal husbandry and fishery; major public infrastructure investment projects supported by the state; environmental protection, and energy and water conservation, projects; transfer of technology. Qualifying small-scale enterprises enjoy a reduced rate of 20% and state-encouraged high and new technology enterprises 15%. Governments in minority regions may reduce or exempt taxes for local enterprises.

Deductions are available to encourage R&D; employment of disabled workers; venture capital investment; technological upgrading; comprehensive resource utilisation; and the manufacture of specialised equipment for environmental protection, energy and water conservation, or production safety. The new Law gives the State Council powers to formulate special enterprise income tax incentives if “national economic and social development needs so require” or if an emergency seriously affects the business operations of enterprises. The granting of significant discretionary authority in the granting of tax incentives raises concerns over the provision of rent-seeking opportunities.

The Enterprise Income Tax law contains provisions to prevent or compensate for tax loss resulting from violation of transfer pricing norms. The tax authority may make adjustments based on reasonable methods for business transactions between an enterprise and its affiliates that are not in conformity with the arm's length principle and thus result in reduced taxable revenue or income for the enterprise or its affiliates. When an enterprise files its annual income tax returns with the tax authority, it must enclose an annual report on related party transactions, and it must provide relevant information to an investigation of related party transactions by the tax authorities.

Chinese officials appear to be concerned about the possibility that some foreign investment may be discouraged by the removal of tax incentives, and that consequently there is a need to improve the business environment

further to attract continued FDI inflows. Proposed measures include strengthening the rule of law, reinforcing infrastructure, investing in human capital and better protecting intellectual property rights.²²

On 27 February 2008, the State Administration of Taxation (SAT) issued a circular on How to Deal with Related Issues after Cancellation of Several Previous Tax Preferential Policies on Foreign-Invested Enterprises and Foreign Enterprises.²³ The circular allows a foreign investor to apply for a tax refund on direct re-investment of post-tax profit to increase registered capital or set up another foreign-invested enterprise, provided the investment was completed before the end of 2007 and was not made with profit earmarked for distribution. It also allows income tax exemption on income obtained by a foreign enterprise from transfer of know-how or allowance of credit to China if the contract was signed before the end of 2007. Finally, the circular specifies that a foreign-invested enterprise enjoying tax reductions or exemptions for a set period will have to refund the tax exempted or reduced if the nature of its production or the length of its business operation changes after 2008, if, as a result of such change, it no longer meets the original legal conditions for preferential treatment.

4. Property Rights Law effective from 1 October 2007²⁴

The Property Rights Law of the People's Republic of China was promulgated on 16 March 2007 and became effective on 1 October 2007 (Article 247). It enshrines in law, and elaborates in detail, the landmark change to China's state constitution in 2004 to include protection of private property. This is a welcome step forward in establishing a firm basis for the protection of investors, both domestic and foreign.

The Property Rights Law for the first time since the establishment of the People's Republic of China establishes private property rights, which are granted equality with state and collective property rights. This major innovation was hard fought during the drafting stage by opponents who claimed that this would change the country's socialist system and by those who were concerned that it would legitimate previous seizures of state-owned property by officials. It opens the way to legal actions by private individuals and other non-state actors such as companies to protect their rights, which are enumerated in detail in the new law. However, to ensure that the law was passed, a number of areas – including modalities of legal redress – have been left vague. These lacunae remain to be filled by other regulations and perhaps by an amended version of the Property Law following a review of initial implementation experience.

As is to be expected in a law designed to fit the “primary stage of socialism”, public ownership is assigned a “dominant role”, with “diverse

forms of ownership” (code for private and other forms of non-public ownership) developing side by side with it. The law states that the State shall develop the public sector while at the same time encouraging, supporting and guiding the development of non-public sectors of the economy. This is interpreted to mean that the State must ensure “equal legal status and right for development of all market players”, meaning that private property rights are as strong as public property rights (Article 3). The law states explicitly that the property rights of the State, collectives, individuals and others are protected by laws and may not be infringed (Article 4). At the same time, the attainment and exercise of property rights must accord with law and social morality and not harm the public interest or the legitimate rights and interests of others (Article 7).

Real property rights may only be exercised after registration (Article 9). Ownership is confirmed by first registration, regardless of who first signed the contract of sale. The Property Law states that registration must be done in the registration department of the place where the property is located and that there must be a unified registration system (Article 10). When this is implemented, it will simplify and clarify the existing system of multiple registration. Potential purchasers, for example, will only have to go to one land register to check ownership of a property.

To avoid multiple sales of the same property, notice must be filed of pending registration when agreement is reached on a transaction. Once this has been done, no other transaction may be completed without the consent of the original parties. Such notice lapses automatically after three months (Article 20).

An interested party may apply to correct a registry entry if he/she considers it to have been wrongly entered. If the other parties involved agree, or if there is evidence to prove that a mistake has been made, the entry is corrected in writing. If the other party does not agree, then the applicant may file a suit within 15 days of registering opposition to the register entry. If opposition registration is judged inappropriate, the person affected may claim damages from the applicant (Article 19). Any party providing false materials for registration bears responsibility for compensating anyone who is harmed as a result. The registration department itself is also liable to pay compensation for damage caused as a result of mistakes in registration (Article 21).

Infringement of property rights may be handled by pacification, mediation, arbitration or litigation (Article 32). Where property rights are found to have been infringed, the affected party may request that any encumbrance or hazard be removed (Article 35). Where real or movable property is damaged, the obligee may request repair or restoration (Article 36). Where the obligee suffers from infringement done to property rights, he or she

may claim damages and request that the infringing party bear other civil liabilities (Article 37). Interested parties may request affirmation of property rights when disputes arise over ownership (Article 33). If people without ownership rights take possession of real or movable property, the obligee has the right to request that the property be returned (Article 34).

State ownership is inviolate: no institution or individual is allowed to obtain the ownership of property owned exclusively by the State (Article 41). Collectively-owned land, houses and other real property owned by institutions or individuals may be expropriated according to law for public interest purposes. Compensation appropriate to the category of ownership shall be paid; for example, when a residence is expropriated, the residential conditions of the expropriated person(s) shall be guaranteed. Compensation may not be withheld, misappropriated or embezzled (Article 42).

Special protection is accorded to agricultural land. The transfer of agricultural land to construction land is limited so as to control the quantity of construction land. No expropriation of collectively-owned land in violation of authority and legal procedures shall be allowed (Article 43). This clause addresses the widespread practice of illegal land seizure from the farmers by officials for purposes of constructing factories or housing.

Expropriation of property is allowable under the Property Law for purposes of emergency handling or disaster relief. In such cases, property shall be returned to the owner after such expropriation or, if the property is damaged or lost, compensation for it shall be made (Article 44).

The state owns mineral resources, land, natural resources (*e.g.* forests, mountains, grassland, unclaimed land and beaches) except for those that are specified as collectively-owned, water and sea areas, specified wild animals and plants, the radio spectrum, specified cultural relics, national defence resources, specified public facilities (*e.g.* railways, roads, electric power, communications and gas pipelines).²⁵

Collectively-owned properties include lands, forests, mountains, grasslands, unclaimed land and beaches; collectively-owned buildings, production facilities, cultivated land and hydropower facilities; collectively-owned education, science, culture and health facilities (Article 58).

Individuals enjoy ownership of real and movable property such as legitimate income, houses, living goods, production tools and raw materials (Article 64). Their lawful savings, investments and returns are protected by law. Inheritance is also protected (Article 65).

The state, collectives and individuals may contribute to the establishment of a limited liability company, joint stock limited company or other enterprises (Article 67). The enterprise as a legal person has the right to possess, utilise, obtain benefit from and dispose of its real and movable

properties in accordance with laws, administrative regulations and its articles of association (Article 68).

The Property Law sets out in considerable detail the rights and responsibilities of owners and residents of shared residential accommodation (Articles 70-83) and of neighbours (Articles 84-92).

Now that housing reform has allowed residents of apartment blocks to own their own properties, it is important to specify rights and duties with regard to such matters as the maintenance of jointly-owned parts of buildings, the protection of building security, the ownership of public sites including roads and fields within apartment buildings and the apportionment of parking spaces.

The law also stipulates that users of property should respect the interests of neighbours in regard to such matters as water supply and drainage, electricity, heating and gas supply; the use of land for passage to the neighbour's property; ventilation, view and lighting. In particular, a user may not discharge pollutants, including not only air pollution, water pollution and solid waste, but also harmful noise, light or magnetic wave radiation (Articles 94-113). Since it is common practice for developers to carry out construction work with scant regard for side-effects, this clause is likely to be the basis for frequent litigation.

Where real or movable property is transferred to a transferee by a person without the power to do so, the rightful owner has the right to recover the property. The procedures to be followed in such cases are specified in detail (Articles 106-107), as are those for dealing with lost property (Articles 109-113).

Since all land and water are owned by the state, it is important to provide detailed specification of user rights so that those who have gained such rights lawfully may pursue their activities without hindrance. The Property Rights Law does this in Part III (Articles 117-169).

The Property Law guarantees the continuance of arrangements dating back to the beginning of the reform period in the early 1980s under which rural households lease land from collectives, explicitly stating the right of the contractor to possess, utilise and obtain profits from farmlands (for a renewable term of 30 years), forests (30-50 years) and grasslands (30-70 years), and to engage in crop farming, forestry and animal husbandry.

The right to use land for construction also includes possession, use and obtaining profits, as well as the right to build buildings and related facilities. The right to use of land for construction may be assigned or transferred, with strict regulation of transfer. Land used for industry, commerce, tourism or entertainment must be assigned by auction or invitation to bid. The purpose of land use may not be changed without official approval. The land use rights owner owns the buildings and related facilities, unless there is evidence to the

contrary. Land use rights for construction use may be used as a capital contribution.

Where land is used for building houses, the lease is automatically renewed upon expiry. Land use rights for other purposes may be renewed if the parties agree. The owner of land use rights for residential housing has the right to build houses on the land, except in the case of the destruction or loss of such land as a result of a natural disaster, in which case the authorities have to find new residential housing land to which to relocate residents.

Chapter XVI of the Property Rights Law covers the right to mortgage (Articles 179-207). Detailed provisions covering mortgage are important because of the large number of households buying their residences as a result of housing reform and because of the need for varied forms of finance needed to support the development of small businesses in a rapidly growing economy. The right of pledge, covered by Chapter XVII (Articles 208-240), is also important in an economy with a developing variety of credit requirements.

However, there may be cases in which investors have acquired land and/or other assets from local governments which the latter are now discovered to have acquired illegally, creating uncertainty for the continuing operation of the enterprises concerned.

5. Anti-Monopoly Law²⁶

In the 2003 OECD *Investment Policy Review of China*, the OECD proposed that China's competition policy could be further enhanced by combining and developing the various fragmentary and dispersed policy initiatives of different ministries and departments into a coherent policy that provides a sound, transparent and non-discriminatory framework for competition. It also pointed out that such a policy might well be made concrete in specific laws, formulated in a transparent manner to ensure consultation of all stakeholders, including foreign investors.

The Anti-Monopoly Law of the People's Republic of China was adopted at the 29th session of the Standing Committee of the 10th National People's Congress on 30 August 2007,²⁷ coming into force on 1 August 2008 (Article 57). The drafting process was long, having begun in the mid-1990s. In the interim, several drafts were circulated for comment to bodies outside China, including some sent to the OECD. A number of comments from such bodies appear to have been incorporated into the law.

The Anti-Monopoly Law, the first full competition law²⁸ to be promulgated in China since the establishment of the People's Republic, is a major step forward in that it establishes a basic framework for dealing with monopolistic practices. A key feature is that, for the most part, its provisions apply to all relevant enterprises, applying no distinction between domestic

enterprises and foreign-owned enterprises (FIE). The exception is a clause applying a national security review to acquisitions of domestic Chinese enterprises by foreign investors.

The body responsible for overall anti-monopoly organisation, co-ordination and guidance is the Anti-Monopoly Commission to be established by the State Council. The Commission is charged with: studying and drafting competition policies; organising the investigation and assessment of the state of overall market competition, and issuing assessment reports; constituting and issuing anti-monopoly guidelines; and co-ordinating anti-monopoly administrative law enforcement. The composition of the Commission is not specified in the Law (Article 9).

Another new body, the Anti-Monopoly Authority, is to be set up by the State Council to enforce the Law. The composition of the Authority is also not specified. The Law allows the authority to delegate its enforcement powers to corresponding agencies at provincial level (Article 10). For the Authority to function effectively it will be necessary to ensure that such delegation does not result in capture by local governments intent on maintaining barriers to the entry of external market players such as enterprises based in other provinces.

Activities prohibited by the Anti-Monopoly Law include: monopoly agreements (in Chapter 2); abuse of market dominance (Chapter 3); concentration of business operators (Chapter 4); and the abuse of administrative powers to eliminate or restrict competition (Chapter 5).

Monopoly agreements between competitors that are prohibited by the Law include those which: fix or change prices of commodities; limit the output or sales volume of commodities; allocate sales markets or raw material purchasing markets; restrict the purchase of new technology or new equipment, or restrict the development of new technology or new products; jointly boycott transactions (Article 13). Undertakings are prohibited from reaching monopoly agreements with counter-parties that fix the resale price or minimum resale price of products with respect to third parties (Article 14).

Exemptions are available for monopoly agreements that: improve technology or result in R&D of new products; upgrade product quality, reduce cost and improve efficiency, unify product specifications or standards, or implement the division of labour based on specialisation; improve the operational efficiency of small and medium-sized enterprises and enhance their competitiveness; save energy, protect the environment, or provide disaster relief and other charitable assistance; mitigate a serious decrease in sales volumes or distinctive production oversupply during an economic depression; safeguard legitimate interests in foreign trade and economic co-operation (Article 15).

The provisions in the new law against the abuse of administrative powers to eliminate or restrict competition are important because, as pointed out in the OECD's 2003 *Investment Policy Review of China*, it is not clear that the 2001 regulation prohibiting local protectionism has been wholly effective.²⁹

The Law states that administrations may not: set discriminatory fees and charges, set discriminatory standards or fix discriminatory prices for products from other regions; impose on products from other regions technical requirements or inspection standards different on those for similar local products, or require repeated inspection and certification on products from elsewhere; apply licensing only to products from other regions; set up checkpoints to prevent products from other regions coming in or local products going out; stop undertakings from other regions bidding locally by prescribing discriminatory qualification requirements or assessment standards, or by not publishing information according to law; reject or restrict investment or the establishment of branches by undertakings from other regions; compel undertakings to engage in monopolistic conduct; make regulations to eliminate or restrict competition (Articles 32-37).

Enterprises holding a dominant market position may not abuse their dominant market position by: selling at unfairly high prices or buying at unfairly low prices; selling products below cost without justification; refusing to enter into transactions with counter-parties without justification; constraining their counter-parties to enter into transactions exclusively with them with no justification; implementing tie-in sales without justification or imposing other unreasonable transaction terms; applying discriminating treatment on prices or other transactions terms to counter-parties without justification (Article 17).

Determining whether or not an undertaking holds a dominant market position depends on: the market share of the undertaking and competitive conditions in the relevant market; the ability of the undertaking to control the sales market or raw materials purchasing market; the financial status and technical conditions of the undertaking; the extent of dependence on the undertaking by other undertakings in respect to transactions; and the level of difficulty for other undertakings to enter the relevant market (Article 18). Dominant market position may be presumed if the market share of the undertaking is one half, if the aggregate market share of two undertakings is two-thirds, or if the aggregate market share of three undertakings is three-quarters (Article 19).

Concentrations of undertakings are defined in the law to include: a merger among undertakings; acquisition by undertakings of control of other undertakings by acquiring shares or assets; or by contract or other means, an acquisition by an undertaking of the ability to impose decisive influence on other undertakings (Article 20).

Concentrations that meet notification thresholds must be filed with the Anti-Monopoly Enforcement Authority (unless one of the undertakings involved holds over 50% of the shares with voting rights or assets of the other participating undertakings or more than 50% of the shares are owned by a single undertaking not participating in the concentration), otherwise they may not take place (Articles 21-22).

Within 30 days from the receipt of the correct documents the Anti-Monopoly Enforcement Authority must conduct a preliminary review and notify the undertakings in writing whether or not it has decided to initiate a further review. If not, or if no notification is received, the concentration may take place (Article 25).

Any further review must be completed within 90 days of the decision to conduct it, and the undertakings must then be notified of the resulting decision in writing. If the decision is against the concentration, reasons must be given. Extensions for 60 days may be allowed in certain circumstances (Article 26).

The Anti-Monopoly Enforcement Authority may then decide, and publicly announce its decision (Articles 28-30):

- That the concentration has the effect of limiting competition, and prohibits it.
- That the positive effect on competition outweighs the negative effect, or that the concentration is in the public interest, and allows it.
- To allow the concentration to go ahead but to impose restrictive conditions on it to reduce anti-competitive effects.

As well as deciding on concentrations notified to it as above, the Anti-Monopoly Enforcement Authority has powers to investigate suspected monopolistic conduct, including the right of entry to business premises, to interview the people involved, inspect and copy relevant documents and materials, seize evidence and examine bank accounts, while however protecting any commercial secrets obtained (Articles 28-42).

If the Anti-Monopoly Enforcement Authority decides that monopolistic conduct has taken place it must publish its decision (Article 44). An investigation may be suspended if the undertaking being investigated agrees to take concrete measures to eliminate the consequences of such monopolistic conduct within the time limit accepted by the Authority. The commitments must be made explicit and the Authority must monitor their performance, if necessary resuming the investigation if the undertaking fails to honour them, if material changes occur in the facts on which the suspension decision was based, or if new evidence comes to light (Article 45).

The Anti-Monopoly Enforcement Authority has the power to order undertakings to cease a monopoly agreement that violates the Law, confiscate

the illegal gains and impose fines of more than 1% and less than 10% of the previous year's turnover. Where the agreement has not yet been implemented the fines may not exceed CNY 500 000. Undertakings that confess to monopolistic conduct and provide important evidence may be exempt from or suffer mitigated punishment (Article 46).

As pointed out in the 2006 Review, under the 2003 Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors included a procedure for reviewing cross-border mergers and acquisitions in China that depended on market-share thresholds. In the Review the OECD welcomed the intention of the Chinese government to establish a non-discriminatory framework for considering industrial concentration, as drafts of the Anti-Monopoly Law indicated that domestic and foreign enterprises would be treated alike in the new law.

The Anti-Monopoly Law has fulfilled this promise of non-discrimination in almost all respects. Under the law, reviews are conducted without regard to the nationality of ownership of the enterprises involved. The exception is Article 31, which states that if the acquisition of a domestic enterprise or the involvement through other means in a concentration of undertakings by foreign capital affects national security, such acquisition shall be subject to a national security review in addition to the concentration review. It remains to be determined whether or not this provision refers to an existing national security review process, such as the "national economic security" review in the 2006 Regulations described above, or whether a new procedure is to be established. This may become clearer at a later stage when, as is normal for all major Chinese laws, implementing regulations are adopted.³⁰

Stakeholder consultations which may precede the publication of implementing regulations have already begun. On 27 March 2008, the Legislative Office of the State Council published draft *Provisions on Notification of the Concentration of Undertakings* for public consultation, inviting comments by 12 April 2008. The draft rules set out clear turnover and market share-based thresholds for notification of mergers, but suggest that the authorities will retain broad discretion in the way in which the rules are applied to particular transactions.³¹

Under Article 3 of the *Draft Provisions*, notification of a transaction will be required if the global turnover of all parties to a transaction in the preceding financial year exceeds CNY 9 billion and at least two parties' Chinese turnover in the preceding financial year exceeds CNY 300 million; the turnover of all parties to a transaction in China in the preceding financial year exceeds CNY 1.7 billion and the Chinese turnover of each of at least two parties in the preceding financial year exceeds CNY 300 million; or if the transaction will cause one party to gain a market share of more than 25% of the relevant market

in China. But under Article 4 the authorities can still require notification of a transaction if they consider that the transaction may have the effect of excluding or limiting competition, even if none of these criteria applies.³²

The *Draft Provisions* further outline procedures to be followed, for example by listing details of the information that must be submitted with a notification (Article 9). However, the authorities retain substantial discretion, including the authority to reject incomplete notifications (Article 11). The *Draft Provisions* require the Chinese authorities to establish a fast track system (Article 14), which could reduce the time required to obtain clearance of notifiable transactions. Where a transaction will “obviously” not result in the elimination or restriction of competition, the authorities must take a formal decision not to conduct further examination of the transaction as soon as possible.³³

Stakeholder consultation prior to the coming into force of the Anti-Monopoly Law may ensure that the Law is more workable and that it can be applied effectively from 1 August 2008. Key issues for the implementing regulations to clarify include the role of existing government agencies in implementing the law.

6. Revised catalogue for guiding foreign investment industries, effective from 1 December 2007

The National Development and Reform Commission (NDRC) and MOFCOM decreed on 31 October 2007 that the State Council (China's cabinet) had approved a revised version of the Catalogue for the Guidance of Foreign Investment Industries. The Catalogue was first published in 1997, then revised in 2002 and 2004. The new version came into force on 1 December 2007, replacing the 2004 revision. This is thus the third revision.

From its inception, the Catalogue has divided foreign investment projects into prohibited, restricted, permitted and encouraged categories. Lists of sectors included in each category were published, with the exception of the permitted category. Sectors not listed in the three published categories are presumed to be open to foreign investment, unless they are closed or limited by other regulations. Publishing a permitted list would be difficult because it would be impossible to include all sectors open to foreign investment, including industries that had not yet emerged.

The 2002 revision was promulgated in February 2002 and came into force in April that year. Following China's accession to the WTO in December 2001, this version contained amendments appropriately reflecting the liberalisation of China's investment regime embodied in the country's pre-accession agreements. The number of encouraged industries was increased from 186 to 262, while the number of restricted industries was cut from 112 to 75.³⁴

The second revision was announced by the NDRC and MOFCOM in November 2004 and came into force on 1 January 2005. Unlike the 2002 revision, this did not liberalise the foreign investment regime further. Nor did it impose major new restrictions on foreign investment. The long sectoral lists remained largely unaltered, with at least as many restrictions added as were removed. A detailed analysis of this revision is in the 2006 OECD *Investment Policy Review of China: Open Policies towards Mergers and Acquisitions*.³⁵

6.1. The encouraged list contains many new sectors, reflecting the evolution of China's industrial policy

The most prominent change in the 2007 revision of the Catalogue is the addition of many new sectors to the encouraged list, reflecting China's evolving industrial structure, which is producing an expanding need for many specialised and sophisticated technologies that China does not yet possess. This list can be seen as a showcase for the government's industrial priorities.

Environmentally-friendly technologies

These priorities include a tremendously strengthened emphasis on technology that protects the environment, saves energy and promotes recycling (see the account of government policy in this area in Chapters 4 and 5). Examples of the many encouraged sectors that meet these criteria include projects in all major sectors of the economy:

- Mining: Utilisation of mining gas and comprehensive application of ecological-recovery technology.
- Textile industry: Processing of special natural fibres that meet ecological requirements; comprehensive resource utilisation and environmental protection; manufacture of fluorine resources recycled from phosphorus chemical processing and aluminium smelting; manufacture of new types of fibre materials using renewable resources and biomass engineering technology.
- Construction: Manufacturing of energy-saving and environmentally-friendly building materials.
- Automobile industry: Manufacture of light-weight, eco-friendly new materials for automobiles and motorcycles; gas-efficient, low-noise, low-emission diesel engines; sprayers that can recover unused liquid complementary to large-scale tractors.
- Agriculture: Manufacture of equipment to conserve fertilisers and pesticides; comprehensive management technology for grassland-livestock balance.

- Energy and power: Manufacture of equipment to produce solar-powered batteries; manufacture of equipment for production and storage of hydrogen energy; manufacture of solar-powered air conditioners, solar-powered heating systems and solar-powered drying devices; integrated coal gasification combined cycle (IGCC) technology, circulating fluidised bed technology, pressurised fluidised bed combustion; wave energy power stations; biomass energy development technology.
- Pollution prevention: Manufacture of equipment for urban waste treatment; manufacture of equipment for preventing air pollution; manufacture of equipment for preventing water pollution; manufacture of equipment for solid waste treatment and disposal; manufacture of new technical equipment and instruments for environmental detection; manufacture of biodegradable materials; manufacture of environmentally-friendly printing ink and aromatic hydrocarbon oil.
- Recycling: Comprehensive utilisation of rural organic waste; manufacture of equipment for management and renewable use of waste plastics, electronic equipment, rubber and for recycling batteries; manufacture of equipment for the comprehensive use of waste tyres and old tyres; development and application of enterprises' manufacturing emissions recycling technology; re-manufacture of machine tools, automobile parts and construction machinery.
- Water resource conservation: Manufacture of water level data collection, processing and analysis, and flood-prevention warning devices and equipment; field instruments for analysing water quality; utilisation of seawater (direct use of seawater, desalination) and industrialisation of industrial waste water treatment and recycling.

Energy and natural resource exploitation

The encouraged list also contains some new items stemming from the energy and natural resource needs of China's rapidly expanding economy. Examples include: the exploration and development of bituminous rock, oil sand, heavy oil, ultra heavy oil and other unconventional oil resources; the exploration and development of seabed methane ice; manufacture of equipment used for oil extraction on land and sea; the development and application of new technology to increase the yield of mining debris.

High-tech manufacturing

The vast majority of additional sectors in the encouraged list are in high-tech manufacturing. The industries covered include aerospace, automotive, chemicals and fertilisers, construction materials, electronics, food and drink, geological equipment, infrastructure construction, machine tools, metallurgy,

mining machinery, pharmaceuticals, printing, railway equipment, shipbuilding and textiles.

Safety

Another set of additions to the encouraged list comprises technology to help address safety concerns. Projects in the list for this reason include food quality inspection and monitoring equipment; anti-bacterial equipment for food powder; bacteria-free solid and semi-solid food packaging facilities; and bacteria-free packaging materials. A major sub-category of this list is the manufacture of production safety and environmental protection devices, technologies and equipment. Also encouraged are the development and manufacture of underground well monitoring and disaster prediction systems for coal mines and integrated management systems for examining coal mine safety.

6.2. Export performance requirement removed from the Catalogue

Earlier versions of the Catalogue contained a clause allotting “encouraged” status to foreign investment in items in the “permitted” list that are to be directly exported. Removal of this clause in the 2007 revision may reflect objections from WTO partners to whom China had promised before WTO accession not to impose performance requirements on foreign investment – including in the 2003 *OECD Investment Policy Review of China*³⁶ – and is also consistent with the lower priority now given by the Chinese government to promoting exports now that the country has accumulated a mountain of foreign exchange reserves through a succession of record trade surpluses.

6.3. Several new items have been added to the list of restricted sectors

Unlike the encouraged list, the restricted investment industries list has not been greatly enlarged. However, there are a number of new additions and also some deletions.

In the primary sector, the development of food and oil seed is no longer restricted, but the development and production of new types of agricultural goods are. The mining of non-ferrous metals including wolfram, tin, antimony, molybdenum and fluorite is no longer restricted; on the other hand, the restriction on survey and mining of barite remains, while exploration and mining of phosphorus ore and the mining of polymetallic manganese nodules and sea sand have been added to the restricted list.

The manufacture of compound sweeteners is no longer restricted. A new restriction has been placed on investment in the processing of edible lipids from soybean and rapeseed and deep-processing of corn. The manufacture of biofuels (ethanol and biodiesel) has been added to the restricted list. The manufacturing of carbonated beverages with foreign trademarks was already under restriction,

now all carbonated beverages are restricted. The former restriction on the processing and production of cigarettes and filter tips has been replaced by one on the processing and production of tobacco threshing and redrying.

In the preceding version of the Catalogue, the construction and operation of oil refineries was restricted. This restriction has now been lifted for refineries with annual production of 8 million tonnes or more. New restrictions have been added on the manufacture of fluorine compounds, artificial rubber and chlorine compounds, including polyvinyl chloride (PVC) obtained through the calcium carbide process, together with the manufacture of potassium permanganate through the Siemens-Martin process.

In medical and pharmaceutical products, investment in multi-vitamin and calcium tablets has been put under restriction along with type 1 psychoactive drugs. The manufacture of fibre and non-fibre polyester and urethane elastic fibre has been derestricted. In metallurgy, new restrictions have been placed on the smelting of: tungsten molybdenum, tin (except tin compounds), antimony (including antimony oxide and antimony trisulphide), electrolytic aluminium, copper, lead, zinc and other rare metals.

In the machinery industry, the pre-existing restriction on medium-sized and small bearings has been expanded to include manufacture of all types of bearings and parts and semi-finished models. The restriction on cranes of less than 50 tonnes has been altered to one on the manufacture of crawler and wheeled cranes of less than 300 tonnes. To the restriction in the previous catalogue on bulldozers has been added restrictions on hydraulic excavators, wheeled loading machines, graders, road rollers, fork-lift trucks, off-highway automatic dumpers, pavement milling machines, horticulture machines and cement mixers. The repair, design and manufacture of ordinary ships (including parts) has been added to the restricted list, with the proviso that the Chinese side must hold a controlling interest. Another addition is the manufacture of tax-controlled cash registers.

In the energy sector, coal-fired power plants with a single-machine capacity of 300 000 MW or less remain on the restricted list. This has been relaxed to a capacity limit of 100 MW in Tibet, Xinjiang and Hainan. The construction and operation of electricity grids has been added to the restricted list, with the proviso that the Chinese side must hold a controlling interest.

In the financial sector, financial leasing companies and foreign exchange brokerages have been removed from the restricted list, futures trading companies (which were formerly prohibited) and credit rating and evaluation services have been added. In real estate, the construction and management of theme parks has been removed, real estate secondary market exchanges, intermediaries and brokerages have been added.

A new item in the scientific research, technology services and geological survey industries is photography services, including aerial photography and stunt photography services, but not aerial photography for surveying and drawing.

The construction and management of golf courses has been moved from the restricted to the prohibited list (see below). Performance agent companies and the operation of entertainment venues have been added to the restricted list.

6.4. The list of prohibited foreign investment industries has expanded slightly

A few new items have been added to the list of prohibited foreign investment industries, while there have been no significant deletions.

In the previous catalogue, foreign investment in the production and development of genetically modified seeds was prohibited. This prohibition now also extends to genetically modified livestock, aquatic seeds and seedlings.

A completely new prohibition has been put on foreign investment in the survey and mining of tungsten, molybdenum, tin, antimony and fluorite.

Prohibitions on foreign investment in the processing and preparation of traditional Chinese medicines have been refined to correspond to regulations protecting natural medicinal resources and rare and endangered plants and to specific methods of preparation.

Presumably in line with the government's environmental protection policies, foreign investment has been prohibited in open-cell (with discharge of acid mist) lead acid batteries, silver-oxide button batteries containing mercury, paste-type zinc-manganese batteries and nickel-cadmium batteries.

Smaller coal-fired power stations, with sizes below those specified in the restricted list (see above) have been added to the prohibited list.

Social research and surveys have been added to the list of activities in which foreigners may not invest, as have R&D and application of stem cell and genetic diagnosis and treatment technology, geodetic surveys, ocean mapping, aerial photographic surveys, plotting of borders of administrative districts, including topographical mapping, and the creation of digital navigation maps from ordinary maps.

The pre-existing prohibition against foreign investment in the construction and operation of national nature reserves has been extended to include internationally-recognised wetlands.

Compulsory education institutions (i.e. ordinary schools) have been subject to foreign investment prohibition in previous catalogues. Foreign

investment is also now banned in military, police, political, party and other educational institutions in special categories.

The prohibition on foreign investment in film distribution now also includes cinemas. As noted above, foreign investment in the construction and operation of golf courses, formerly restricted, is now prohibited.

6.5. Presumed rationale for the 2007 changes in the Catalogue

The revised 2007 Catalogue continues the tradition of regarding foreign capital as a tool to be used by the government to achieve its economic development objectives.

Foreign investors were first invited to China nearly three decades ago so that they could use China as an export manufacturing base to generate foreign exchange earnings, and the domestic market was initially closed to them. The situation has now changed radically: the Chinese government is keen to use foreign investment to fill gaps in its own industrial structure, and is therefore encouraging foreign investment targeting the domestic market. This is a policy change much hoped for by many companies attracted to China in earlier decades by the potential size of the China market.

There is also no longer a requirement to encourage exports, now that these have surged ahead of imports for several years, largely because of the activities of foreign-invested enterprises (FIEs). By March 2008, the share of FIEs in China's merchandise exports had reached 57.5%.³⁷ In 2007, China had a trade surplus of USD 262.2 billion, 47.7% higher than in 2006, and the surplus did not start to shrink until February 2008.³⁸ As a result, China's foreign-exchange reserves reached record highs of USD 1 528.2 billion at end-December 2007 and USD 1 905.6 billion at end-September 2008.³⁹

The 2007 revision was welcomed in the official Chinese media as contributing to the implementation of policies on environmental protection, energy conservation and recycling, noting that the encouraged list promotes investment in these areas while high consumption and pollution industries, along with the exploitation of rare mineral resources, are closed to foreign capital.

When China first opened to foreign investment in the late 1970s, it attempted to attract high-tech FDI, but in practice welcomed in other sectors that were of greater interest to the limited range of (mainly Hong Kong, China based) foreign investors who were available at the time, such as hotels and textiles. Having developed a relatively comprehensive industrial base, the Chinese government now seeks to upgrade to a higher level of technology by bringing it in from abroad. Thus, the Catalogue is now more overweight than before in the list of encouraged investment sectors.

6.6. The Catalogue is unwieldy and less than transparent

The 2003 OECD *Investment Policy Review of China*, while welcoming the 2002 Catalogue as a major step forward in FDI regime liberalisation, encouraged the Chinese authorities in their efforts to achieve further liberalisation by removing more categories of project from the prohibited and restricted catalogues and also to consider replacing the catalogue regime with a simple closed list.⁴⁰ The 2006 *Review* reiterated that the *Catalogue* appears an unwieldy regulatory instrument whose purposes might better served by less restrictive and more transparent means. The current *Review* retains that judgment, based on careful consideration of the latest revision.

Some amendments are in line with OECD recommendations

The OECD welcomes amendments made by MOFCOM and the NDRC to the Catalogue in line with the recommendations in the 2003 *Review*.

The 2003 *Review* said that there appears to be no advantage to be gained from banning FDI from entering the financial futures sector that could not be more effectively obtained by imposing appropriate prudential regulation covering both domestic and foreign-owned enterprises; as noted above, this prohibition has been replaced by a restriction (see above).

Also, in the 2003 *Review* the OECD noted that “since the inclusion of a proposed foreign investment project in either the permitted or the restricted foreign investment list can determine whether or not it is approved, this stipulation may be regarded as effectively imposing an export performance requirement on such projects”, and that China is committed to implementing the WTO Agreement on Trade-Related Investment Measures (TRIMs) in full from the date of accession. The OECD therefore welcomes the removal of the clause giving “encouraged” status to sectors in the “permitted” list dedicated to export manufacture.

Some inappropriate prohibitions remain

As noted in the 2003 *Review*,⁴¹ the Catalogue contains prohibitions on foreign investment that are unnecessary because they relate to activities that are already illegal, such as pornography and gambling. Some other activities prohibited to foreign investors, like tiger bone and ivory carving, are illegal under international agreements and should not be indulged in by anyone, Chinese or foreign. The OECD has also suggested that preserving traditional industries, such as tea and Chinese medicine, might be done more effectively by less restrictive means, such as increased training, than by banning foreign investment in these sectors.

The OECD notes that the restriction on foreign investment in genetically modified seeds, which it questioned in the 2003 *Review*,⁴² has not only been

retained, but has been expanded. The intention appears to be protectionist, as similar restrictions are not applied to domestic investors.

A similar objection applies to prohibitions and restrictions on foreign investment in areas deemed polluting or wasteful. Discrimination against foreign investment would appear to be a less effective way of implementing policy to protect the environment, save energy and promote recycling than non-discriminatory measures such as anti-pollution laws, enforced regardless of the nationality of the investor.

A serious problem with the Catalogue is that it is incomplete, and to that extent non-transparent. Some specific industry restrictions which have been announced in recent years are included in the Catalogue, some are not. For example, the Catalogue states that foreign investors may not enjoy majority ownership of enterprises making complete automobiles. On the other hand, as noted in the 2006 Review, a similar restriction in the iron and steel industry is not in the Catalogue.⁴³ Therefore the presumption that any sector not mentioned in any of the three published lists is automatically permitted is invalid. Investors (and perhaps also local officials who have to implement the policy) may not always be fully aware which sectors are permitted.

These shortcomings could be addressed by replacing the current “bottom-up” approach, which (as in many other developing countries) has developed as a result of the phased opening up of a formerly closed investment regime, with a “top-down” approach, which starts with a presumption that all sectors are open to foreign investment except those explicitly cited in a closed list. This list would typically consist of a few sectors closed to protect public order and national security and not much else. As indicated above, many of the objectives of the Catalogue could be achieved more effectively by means other than blocking capital inflows into sectors of the economy and imposing discriminatory ownership restrictions on foreign investors.

Notes

1. This section is based on a Supplement to the 2006 *OECD Investment Policy Review of China – Recent Developments in China’s Policies towards Cross-Border Mergers and Acquisitions (M&A)*, published on the OECD’s China investment website www.oecd.org/daf/investment/china on 11 December 2006.
2. China Economic Information Network, *Semi-monthly Business Review*, Issue No. 063, 28 November 2006.
3. This may reflect a perception by Chinese officials that the definition of “national security” has recently been broadened to one of “national economic security” elsewhere, particularly in the United States, where it is seen as having prevented acquisitions by Chinese enterprises. See, for example, the article *Mergers and Acquisitions by Foreign-Invested Enterprises and National Security* [Waizi Binggou yu

Guojia Anquan, 外资并购与国家安全] by Xing Houyuan published on 20 September 2007 on the MOFCOM Chinese-language FDI website: www.fdi.gov.cn.

4. For example, in the article *Mergers and Acquisitions by Foreign Capital and National Economic Security* [Waizi Binggou yu Guojia Jingji Anquan, 外资并购与国家经济安全] by Wang Zhile published on the MOFCOM Chinese-language FDI website: www.fdi.gov.cn on 2 July 2007, in which the author argues that “there is still not yet any single sector that is really monopolised by foreign-invested enterprises”.
5. *Guiding Opinion Concerning the Advancement of Adjustments of State Capital and the Restructuring of State-Owned Enterprises* [Guanyu Tuijin Guoyou Ziben Tiaozheng he Guoyou Qiye Zhongzu de Zhidao Yijian 关于推进国有资本调整和国有企业重组的指导意见], 5 December 2006, SASAC website: www.sasac.gov.cn.
6. *China defines key national economic sectors*, Xinhua, 18 December 2006.
7. *China names key industries for absolute state control*, China Daily, 19 December 2006.
8. Circular of the Ministry of Finance, State Development and Reform Commission, General Administration of Customs and State Administration of Taxation on Import Taxation Policies to Implement the Opinions of the State Council of Invigorating Equipment Manufacturing, *Cai Guan Shui* [2007] No. 11.
9. This section is largely based on a Supplement to the 2006 OECD Investment Policy Review of China entitled *The OECD Welcomes Policy Advances at China's 2007 National People's Congress Session*, which was originally published on the OECD website on 27 March 2007.
10. The Chinese text of the law is available at the State Administration of Taxation website: www.chinatax.gov.cn. An unofficial English translation is available at: www.kpmg.com.cn and www.lehmanlaw.com.
11. Income Tax Law of the People's Republic of China on Foreign-Investment Enterprises and Foreign Enterprises, Chairman Order [1991], No. 45.
12. Interim Regulations on Enterprise Income Tax, State Council Order [1993], No. 137, a consolidation of regulations passed in the 1980s.
13. Both laws are repealed as of 1 January 2008.
14. Non-resident enterprises pay 20%.
15. OECD (2003b).
16. Enterprise Income Tax Law, Article 4.
17. Enterprise Income Tax Law, Article 57.
18. Enterprise Income Tax Law, Article 28.
19. Article 1 of the Enterprise Income Tax Law stipulates that all enterprises and other organisations that obtain income within the People's Republic of China shall be taxpayers of enterprise income tax and shall pay enterprise income tax in accordance with the Law.
20. E.g. Enterprise Income Tax Law, Articles 14 and 17.
21. Li Jinyan (2007).
22. *How to Attract Foreign Investment after Unifying the Two Tax Rates* [Liang Shui Bing Hou Ruhe Xiyin Waizi, 两税合并后如何吸引外资] by Xie Tongyin, published on the MOFCOM Chinese-language FDI website: www.fdi.gov.cn on 16 August 2007.
23. Guo Shui Fa (2008) No. 23, on www.mofcom.gov.cn.

24. This section is an expanded version – based on the full text of the law, which became available later – of initial comments in the Supplement to the 2006 OECD *Investment Policy Review of China* entitled *The OECD Welcomes Policy Advances at China's 2007 National People's Congress Session*, which was originally published on the OECD website on 27 March 2007.
25. Property Rights Law, Articles 46-52.
26. This section draws in part on the analysis of the new Anti-Monopoly Law in an OECD report on *The Challenges of Transition for Competition Law and Policy in China* [DAF/COMP/GF(2008)2] presented to the 21-22 February 2008 OECD Global Forum on Competition.
27. The version of the law referred to in this section is the official translation published on the MOFCOM foreign investment website: www.fdi.gov.cn.
28. The 1980 Interim Provisions for the Promotion and Protection of Competition in the Socialist Economy (the “Ten Articles on Competition”) an subsequent decisions and statements by government and Communist Party bodies in the 1980s did address key competition issues, but did not amount to a complete law.
29. OECD (2003b).
30. Yin Yanling of the Anti-Monopoly Office of the Department of Treaty and Law of MOFCOM confirmed in a presentation to the OECD's Competition Committee on 21 February 2008 that such implementing regulations will be adopted.
31. Clifford Chance Client Briefing, April 2008.
32. Clifford Chance Client Briefing, April 2008.
33. Clifford Chance Client Briefing, April 2008.
34. OECD (2003b).
35. OECD (2006c).
36. OECD (2003b).
37. MOFCOM foreign investment website: www.fdi.gov.cn.
38. MOFCOM website: www.mofcom.gov.cn.
39. State Administration of Foreign Exchange (SAFE) website: www.safe.gov.cn.
40. OECD (2003b).
41. OECD (2003b).
42. OECD (2003b).
43. OECD (2006c).

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- OECD (2003b), *Investment Policy Review of China: Progress and Reform Challenges*, Paris.
- OECD (2006c), *Investment Policy Review of China: Open Policies towards Mergers and Acquisitions*, Paris.

ANNEX 1.A1

Differences between the 2003 Interim Provisions and the 2006 Regulations

The new regulations add to Article 6 requiring examination and approval a paragraph stipulating that if the enterprise being acquired is a domestic listed company, it shall also carry out relevant procedures with the securities regulatory authority of the State Council, i.e. the China Securities Regulatory Commission (CSRC), pursuant to the *Measures Governing Strategic Investment Made by Foreign Investors in Listed Companies*.

Two articles in the 2006 *Regulations* did not appear in the 2003 *Interim Provisions*. These make explicit the application of current tax and foreign exchange legislation to enterprises acquired by foreign investors and do not appear to add any extra legal obligation. Article 7 of the new regulations states that the parties involved in the enterprise being acquired by a foreign investor shall pay taxes in accordance with tax regulations of China and accept supervision of tax authorities. Article 8 states that the parties involved with the enterprise being acquired by a foreign investor shall handle procedures with the relevant authority in charge of administration of foreign exchange approval, registration, filing and amendment in a timely manner in compliance with Chinese foreign exchange laws and administrative regulations.

As in the 2003 *Interim Provisions*, the contribution made by foreign investors is expected to be at least 25% of the registered capital. If it is less, then the approval certificate for the new enterprise will be marked “foreign investment proportion less than 25%”. The 2006 *Regulations* add that this phrase will also be added to the enterprise’s business licence and foreign exchange certificate, and that the enterprise shall not enjoy treatment of a foreign-invested enterprise (FIE). Any foreign loans it may borrow shall be handled in accordance with the relevant regulations governing foreign loans

borrowed by non-FIEs, except as otherwise provided by laws and administrative regulations.

The 2006 *Regulations* include a new clause on the acquisition by a domestic company, enterprise or natural person of an affiliate of the domestic company in the name of an overseas company lawfully established or controlled outside China. This states that such an enterprise shall not enjoy FIE treatment unless the overseas company subscribes to any increased capital of the domestic company or contributes additional capital to the enterprise newly formed after acquisition and the amount of the increased capital exceeds 25% of the new enterprise's registered capital. Where the contribution made by any foreign investor other than the actual controlling party of the FIE to the registered capital of the enterprise is higher than 25%, the enterprise shall enjoy FIE treatment.

This is further elaborated by another new clause requiring application to MOFCOM for examination and approval of the acquisition of any company inside China affiliating to a domestic company, enterprise or natural person made in the name of an overseas company lawfully established or controlled by a domestic company, enterprise or natural person. The parties concerned shall not circumvent the above requirements by making domestic investment through an FIE or otherwise.

The examination and approval authority specified in the 2006 *Regulations* is the Ministry of Commerce (MOFCOM) at national and provincial level, unchanged from the 2003 *Interim Provisions*, except that the approval authority was the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) prior to a restructuring of ministries later in 2003. The registration authority also remains the State Administration of Industry and Commerce (SAIC). The 2006 *Regulations* add that the foreign exchange control authority shall be the State Administration of Foreign Exchange (SAFE) and its local branches.

Article 12 of the 2006 *Regulations* adds a new requirement that application for examination and approval must also be made when a foreign investor obtains the actual controlling rights of a domestic enterprise if the acquisition involves any major industry, or has or may have an impact on national economy security, or may result in transfer of the actual controlling right of the domestic enterprise owning any famous trademarks or traditional Chinese brands. If the party concerned fails to make an application to MOFCOM and its acquisition causes or may cause a significant impact on national economy security, MOFCOM, together with the relevant authorities in charge, may demand that the party concerned ceases the transaction and that it transfers relevant equity interests and assets, and they may take any other effective action to eliminate the impact of the acquisition on national economic security.

The requirement in the 2003 *Interim Provisions* that a domestic enterprise selling assets shall give notice to creditors and make a public announcement in a newspaper at provincial level or above within ten days of the adoption of the resolution to sell the assets has been altered in the 2006 *Regulations*. The enterprise must now carry out the same obligations fifteen days before the investor submits application documents to the examination and approval authority.

Article 15 of the 2006 *Regulations* adds a new clause on related party transactions. The parties to an acquisition must make it clear whether or not there is any relation of affiliation between them. If both are under the control of a single party, they must disclose this fact to the examination and approval authority and explain whether or not the acquisition purpose and appraisal results conform to fair market value. Neither party may circumvent these requirements by means of trusteeship, holding, through agency, or otherwise.

Article 9 of the 2003 *Interim Provisions* states that where an FIE established after an equity merger or acquisition increases its registered capital, investors shall publish a schedule for capital contribution in the contract and articles of association of the FIE. If the capital contribution is to be paid in a lump sum, this must be contributed within six months from the date of issue of the FIE business licence. If it is to be paid in instalments, the investors' first instalment shall be not less than 15% of their respective capital subscription and must be made within three months from the date of issue of the FIE business licence.

The 2006 *Regulations* include a slight alteration to the stipulation of the 2003 *Interim Provisions* in this regard. Article 16 states that where a foreign investor subscribes to any increased capital of a domestic company, the shareholder(s) of the limited liability company or the domestic shareholding company established by means of sponsorship shall contribute no less than 20% of the increased registered capital when the domestic company applies for its FIE business licence. The schedule for contributions to the rest of the enterprise's increased registered capital shall be in conformity with the Company Law, relevant laws and regulations on foreign investment and the provisions of the Regulations on Administration of Company Registration. Relevant stipulations of other laws and administrative regulations shall also be followed where necessary.

An entire new Chapter IV entitled *The Acquisition of a Domestic Company by a Foreign Investor through Payment of Equity Interests* has been added in the 2006 *Regulations*. This form of payment for acquisition is not covered in the 2003 *Interim Provisions*. The new regulations allow the acquisition of any equity interests held by shareholders of a Chinese domestic company through payment of equity interests held by shareholders of an overseas company or

additional stocks issued by the overseas company. The acquiring company must be lawfully established in a jurisdiction with a complete corporate legal system. No punishment must have been imposed on the company or its managers for the previous three years. Unless it is a special-purpose company, it must be listed in a place with a complete and mature system of securities exchange.

The equity interests contributed by the overseas company in payment for acquisition of a domestic company must be: lawfully held and transferable according to law; subject to no dispute of ownership or lien; lawfully listed for public trade on an overseas securities exchange market; in the form of shares whose trading price has been stable for the previous year.

To acquire a domestic company through payment of equity interests, the domestic company or its shareholders must hire an acquisition consultant to conduct due diligence and issue an acquisition consultant report on the application documents, the overseas company's financial status, and conformity with the 2006 *Regulations*. The acquisition consultant must have a good reputation, possess working experience within the industry, have no record of significant illegal acts, and be able to analyse the legal system of the jurisdiction where the company is registered and listed and the company's financial status.

The examination and approval process by which a foreign investor applies to MOFCOM to acquire a domestic Chinese company through payment of equity interests is similar to that for other forms of acquisition, except that an extra set of documents is required:

- A description of any major changes in regard to the equity interests and assets of the domestic company during the previous year.
- An acquisition consultant report.
- Certifications of incorporation of the domestic company and the overseas company involved in the acquisition or identification materials of their shareholders.
- A description of the status in regard to the equity shares held by shareholders of the overseas company and a name list of shareholders holding over 5% of the overseas company's shares.
- The articles of association of the overseas company and a description of any external security provided by the company.
- An audited financial report of the overseas company for the most recent year and a status report regarding the transactions of its stocks for the preceding six months.

MOFCOM shall examine the acquisition application within 30 days of receiving application documents. An approval certificate valid for six months from the date of issue of the business licence shall be issued if all

requirements are met. The domestic company being acquired must complete change formalities within 30 days of receiving the certificate. It will then receive an FIE business licence and an FIE foreign exchange certificate, both valid for eight months from the issue date. When handling the formalities of registration of changes with the relevant registration authority, and the domestic company must provide in advance documents signed by its legal representative for future restoration of its equity structure, if applicable, including but not limited to the letter of application for change of equity interests, amended articles of association and equity transfer agreement. Within six months of the issue of the business licence the domestic company or its shareholders shall apply to MOFCOM and SAFE for examination and approval and registration of making overseas investment and establishment of overseas enterprise, including in their submission the approval certificate and business licence. MOFCOM issues a new approval certificate for overseas investment by the Chinese enterprise and a new FIE approval certificate. The domestic company must then apply within thirty days for an ordinary business licence and foreign exchange certificate. If the domestic company and the overseas company fail to complete procedures for change of equity interest within six months of the issue of the original business licence, the certificates of approval become null and void and the registration authority shall examine and approve to change the registration to its pre-acquisition state in accordance with the relevant equity change documents submitted earlier. If additional stocks are not issued by the domestic company before the registration authority approves the change of registration then the domestic company shall reduce its registered capital accordingly and make a public announcement in the newspapers under the Company Law.

The domestic company may not distribute profit to shareholders, provide any guarantee to its affiliates or pay any amount incurred from the equity transfer, reduction of funds, liquidation or any other accounts of capital-related items before obtaining the first certificate of approval and foreign exchange certificate.

Chapter IV of the 2006 *Regulations* also includes provisions on special-purpose companies, which are defined as any overseas company controlled, directly or indirectly, by a domestic company or Chinese natural person inside China for overseas listing of its/his/her share interests. The section applies to acquisitions of equity interests held by shareholders of domestic companies or additional stocks issued by domestic companies through payment of equity interests by shareholders of special-purpose companies or additional stocks issued by special-purpose companies for purposes of overseas listing.

Transactions for purpose of overseas listing of special-purpose companies must be approved by the China Securities Regulatory Commission (CSRC). The county or region where overseas listing of a special-purpose

company is proposed must have complete legal and supervisory systems, and the local securities supervisory and administration authorities must have entered into memorandum of understanding on co-operation with the CSRC and co-operate effectively with it.

A domestic company providing its share interests for overseas listing must meet these requirements:

- The title to its property rights is clear without question and there is no dispute, existing or threatened, regarding its property rights.
- It has a complete system for business operation and is capable of maintaining constant operation.
- It possesses a healthy and complete company operation structure and internal management system.
- No record shows any commitment of any material violation of law by the company and its shareholders in the previous three years.

A domestic company wishing to establish a special-purpose company overseas must apply to MOFCOM for examination and approval, submitting the following documents in addition to those normally required for establishing an overseas investment:

- The identification certificate of the ultimate controlling person of the proposed special-purpose company.
- The business plan of the proposed special-purpose company for overseas listing.
- The evaluation report provided by the acquisition consultant regarding the issuing price of the special-purpose company's stocks to be listed overseas.

The total value of stock issuing price for overseas listing of the special-purpose company shall not be lower than the equity value of the acquired domestic company as appraised by the relevant Chinese assets evaluation organ.

For purpose of acquisition of a domestic company by its special-purpose company through payment of equity interests, the domestic company must also submit to MOFCOM:

- The relevant approval certificate and documents for making overseas investment and establishing overseas enterprise when the special-purpose company was set up.
- The overseas investment foreign exchange registration form of the special-purpose company.
- The identification certificate of the ultimate controlling person or the incorporation certificate and articles of association of the special-purpose company.

- The business plan of the special-purpose company for overseas listing.
- The evaluation report provided by the acquisition consultant regarding the issuing price of the special-purpose company's stocks to be listed overseas.

If a domestic company targets an overseas company holding any equity shares of a special-purpose company as the main body through which an overseas listing will be made, the domestic company must submit these application documents:

- The incorporation certificate and articles of association of the targeted overseas company.
- Detailed descriptions of the transaction arrangements and price conversion assessment made by and between the special-purpose company and the targeted overseas company regarding the equity interests of the acquired domestic company.

MOFCOM shall issue an official reply of approval in principle if it consents to these documents submitted. The Domestic Company shall submit listing application documents to the CSRC, which must decide whether or not to grant approval within 20 days. After approval is granted, the domestic company shall apply to obtain from MOFCOM the formal approval certificate, valid for one year from issue of the business licence. Any change in the equity interests of the special-purpose company due to acquisition must be registered with MOFCOM and the local SAFE office. Within 30 days of receiving the certificate of approval, the domestic company must register these with MOFCOM and SAFE, who then issue an FIE business licence and an FIE foreign exchange certificate to the domestic company, both valid for fourteen months from date of issue. It must also provide in advance documents signed by its legal representative for the purpose of future restoration of its equity structure, if applicable, including the letter of application for change of equity interests, amended articles of association and equity transfer agreement. Within 30 days of overseas listing by the domestic company or its affiliate, the domestic company must report to MOFCOM regarding the overseas listing and relevant financing revenue returning plan and must apply for issuance of a new FIE approval certificate. Simultaneously, within 30 days of completion of the overseas listing, the domestic company shall report it to the CSRC and submit a financing revenue returning plan to SAFE. Within 30 days of receiving the approval certificate the domestic company must apply to MOFCOM and SAFE for an FIE business licence. If the company fails to report to MOFCOM in time, its original approval certificate becomes null and void and its equity structure is restored to its status preceding the acquisition.

The overseas listing revenue of a special-purpose company shall be arranged for returning for use within China in accordance with the revenue returning plan submitted to SAFE by:

- Providing a business loan to the domestic company.
- Establishing a new FIE in China.
- Acquisition of the domestic company.

The profits, dividends and foreign exchange income obtained by capital variation received by the domestic company and natural person(s) from its special-purpose company shall be returned to China within six months of receipt. Profits and dividends can be deposited in a foreign exchange current account or provided for foreign exchange settlement. Subject to SAFE approval, the foreign exchange income from capital variation can be maintained in a special account of capital items or provided for settlement. If a domestic company fails to obtain its final approval certificate within one year from the issue date of the original business licence, its original approval certificate becomes invalid.

After the special-purpose company has completed its overseas listing and the domestic company has obtained its final approval certificate and business licence, any further acquisition of the domestic company through payment of equity interests of the special-purpose company must be done in accordance with the procedures outlined above for acquisition of domestic company by a foreign investor through payment of equity interests.

ANNEX 1.A2

*Statistical Tables*Table 1.A2.1. **FDI inflows to developing countries in 2006**

USD millions, balance of payments basis

China	78 095
Hong Kong, China	42 891
Singapore	24 191
Turkey	20 070
Mexico	19 222
Brazil	18 782
India	17 453
Thailand	10 750
Egypt	10 043
Chile	7 952
Colombia	6 463
Malaysia	6 064
Indonesia	5 580
Argentina	4 840
Philippines	2 086
Vietnam	1 954*

* 2005.

Source: IMF, Financial Statistics.

Table 1.A2.2. **FDI inflows, 1979-2007**

	Projects newly contracted	Contracted FDI inflows (USD million)	Realised FDI inflows (USD million)
1979-1982	920	4 958	1 769
1983	638	1 917	916
1984	2 166	2 875	1 419
1985	3 073	6 333	1 956
1986	1 498	3 330	2 244
1987	2 233	3 709	2 314
1988	5 945	5 297	3 194
1989	5 779	5 600	3 393
1990	7 273	6 596	3 487
1991	12 978	11 977	4 366
1992	48 764	58 124	11 008
1993	83 437	111 436	27 515
1994	47 549	82 680	33 767
1995	37 011	91 282	37 521
1996	24 556	73 276	41 726
1997	21 001	51 003	45 257
1998	19 799	52 102	45 463
1999	16 918	41 223	40 319
2000	22 347	62 380	40 715
2001	26 140	69 195	46 878
2002	34 171	82 768	52 743
2003	41 081	115 069	53 505
2004	43 664	153 479	60 630
2005	44 019	189 065	60 325
2006	41 485	*	69 468
2007	37 888	*	82 658

* MOFCOM stopped publishing contracted FDI figures in December 2005.

Source: MOFCOM website: www.fdi.gov.cn.

Table 1.A2.3. **FDI inflows as a proportion of gross fixed capital formation and GDP**

	% of gross fixed capital formation	% of GDP
1979-1982	0.5	0.2
1983	0.9	0.3
1984	1.3	0.4
1985	1.7	0.6
1986	2.0	0.8
1987	1.9	0.7
1988	2.1	0.8
1989	2.0	0.7
1990	2.5	0.9
1991	3.0	1.0
1992	6.0	2.2
1993	10.1	4.3
1994	14.3	5.8
1995	12.3	5.0
1996	12.1	4.7
1997	12.5	4.6
1998	12.0	4.3
1999	10.1	3.7
2000	9.7	3.4
2001	9.8	3.6
2002	9.6	3.6
2003	7.9	3.2
2004	7.3	3.1
2005	6.2	2.6
2006	4.6	2.4
2007	4.1	2.3

Calculated by OECD from non-financial FDI inflows, gross fixed capital formation and GDP at current prices, and annual average USD/CNY exchange rates.

Source: MOFCOM website: www.fdi.gov.cn; National Bureau of Statistics website: www.stats.gov.cn; Chinability website: www.chinability.com.

Table 1.A2.4. **China's inward FDI in 2007 by source,
number of projects contracted**

Non-financial FDI only

	No. of projects		% change	Share in total		% change
	2007	2006		2007	2006	
Total	37 871	41 473	-8.7			
10 Asian countries and territories	27 363	28 863	-5.2	72.3	69.6	2.7
Hong Kong, China	16 208	15 496	4.6	42.8	37.4	5.4
Indonesia	68	115	-40.9	0.2	0.3	-0.1
Japan	1 974	2 590	-23.8	5.2	6.2	-1.0
Macau, China	856	868	-1.4	2.3	2.1	0.2
Malaysia	285	336	-15.2	0.8	0.8	-0.1
Philippines	83	147	-43.5	0.2	0.4	-0.1
Singapore	1 059	1 189	-10.9	2.8	2.9	-0.1
Korea	3 452	4 262	-19.0	9.1	10.3	-1.2
Thailand	79	108	-26.9	0.2	0.3	-0.1
Chinese Taipei	3 299	3 752	-12.1	8.7	9.0	-0.3
European Union	2 384	2 619	-9.0	6.3	6.3	0.0
Belgium	52	68	-23.5	0.1	0.2	0.0
Denmark	71	56	26.8	0.2	0.1	0.1
United Kingdom	475	462	2.8	1.3	1.1	0.1
Germany	548	576	-4.9	1.4	1.4	0.1
France	268	338	-20.7	0.7	0.8	-0.1
Ireland	30	16	87.5	0.1	0.0	0.0
Italy	348	409	-14.9	0.9	1.0	-0.1
Luxembourg	31	41	-24.4	0.1	0.1	0.0
Netherlands	182	262	-30.5	0.5	0.6	-0.2
Greece	16	11	45.5	0.0	0.0	0.0
Hungary	12	19	-36.8	0.0	0.0	0.0
Spain	193	167	15.6	0.5	0.4	0.1
Austria	57	67	-14.9	0.2	0.2	0.0
Finland	23	39	-41.0	0.1	0.1	0.0
Sweden	78	88	-11.4	0.2	0.2	0.0
North America	3 320	4 093	-18.9	8.8	9.9	-1.1
Canada	693	888	-22.0	1.8	2.1	-0.3
United States	2 627	3 205	-18.0	6.9	7.7	-0.8
Selected free ports	3 233	4 106	-21.3	8.5	9.9	-1.4
Mauritius	243	281	-13.5	0.6	0.7	0.0
Cayman Islands	342	414	-17.4	0.9	1.0	-0.1
British Virgin Islands	1 883	2 605	-27.7	5.0	6.3	-1.3
Samoa	765	806	-5.1	2.0	1.9	0.1
Other	2 314	2 670	-13.3	6.1	6.4	-0.3

Source: MOFCOM FDI website: www.fdi.gov.cn.

Table 1.A2.5. **China's inward FDI in 2007 by source, value of actually utilised investment (USD million)**

Non-financial FDI only

	Actually utilised investment		% change	Share in total		% change
	2007	2006		2007	2006	
Total	74 767.8	65 821.0	13.6			
10 Asian countries and territories	41 383.4	36 279.4	14.1	55.3	55.1	0.2
Hong Kong, China	27 703.4	21 307.2	30.0	37.1	32.4	4.7
Indonesia	134.4	106.9	25.8	0.2	0.2	0.0
Japan	3 589.2	4 759.4	-24.6	4.8	7.2	-2.4
Macau, China	637.0	677.7	-6.0	0.9	1.0	-0.2
Malaysia	397.3	451.2	-12.0	0.5	0.7	-0.2
Philippines	195.3	142.3	37.3	0.3	0.2	0.0
Singapore	3 184.6	2 463.0	29.3	4.3	3.7	0.5
Korea	3 678.3	3 993.2	-7.9	4.9	6.1	-1.1
Thailand	89.5	148.6	-39.8	0.1	0.2	-0.1
Chinese Taipei	1 774.4	2 229.9	-20.4	2.4	3.4	-1.0
European Union	3 838.4	5 439.5	-29.4	5.1	8.3	-3.1
Belgium	95.8	81.1	18.2	0.1	0.1	0.0
Denmark	125.1	196.2	-36.2	0.2	0.3	-0.1
United Kingdom	830.9	754.5	10.1	1.1	1.1	-0.0
Germany	734.0	2 003.0	-63.4	1.0	3.0	-2.1
France	456.0	395.3	15.3	0.6	0.6	0.0
Ireland	61.0	24.1	153.8	0.1	0.0	0.0
Italy	347.9	358.1	-2.8	0.5	0.5	-0.1
Luxembourg	82.5	94.9	-13.1	0.1	0.1	-0.0
Netherlands	616.7	864.6	-28.7	0.8	1.3	-0.5
Greece	2.4	0.2	1 019.0	0.0	0.0	0.0
Hungary	8.2	9.9	-16.9	0.0	0.0	-0.0
Spain	213.2	242.8	-12.2	0.3	0.4	-0.1
Austria	82.3	152.5	-46.0	0.1	0.2	-0.1
Finland	55.9	55.9	0.0	0.1	0.1	-0.0
Sweden	126.4	206.4	-38.8	0.2	0.3	-0.1
North America	3 012.8	3 441.7	-12.5	4.0	5.2	-1.2
Canada	396.6	441.8	-10.2	0.5	0.7	-0.1
United States	2 616.2	3 000.0	-12.8	3.5	4.6	-1.1
Selected free ports	22 625.6	16 534.3	36.8	30.3	25.1	5.1
Mauritius	1 332.5	1 105.5	20.5	1.8	1.7	0.1
Cayman Islands	2 570.8	2 131.8	20.6	3.4	3.2	0.2
British Virgin Islands	16 552.4	11 677.3	41.7	22.1	17.7	4.4
Samoa	2 169.9	1 619.8	34.0	2.9	2.5	0.4
Other	3 907.6	4 126.2	-5.3	5.2	6.3	-1.0

Source: MOFCOM FDI website: www.fdi.gov.cn.

Chapter 2

China's FDI Statistics

International comparability is an indispensable feature of FDI statistics for any country, particularly if it is a major player in the global economy. The OECD's Benchmark Definition of Foreign Direct Investment sets the world standard for measuring FDI. Within that framework, the OECD has established close links with China to provide assistance in best practices through its network of experts. This chapter evaluates recent improvements in China's FDI statistics and makes a number of recommendations based on the Benchmark Definition.

In line with China's prominent role as host for foreign investment, the FDI statistics of China compiled and disseminated by the Chinese Ministry of Commerce (MOFCOM) were traditionally limited to inward investments only. A new publication, jointly prepared by MOFCOM and the State Administration of Foreign Exchange (SAFE), was released for the first time in 2005 enumerating and analysing China's outward direct investment. This initiative was welcomed by policy analysts and other users of FDI statistics who need comprehensive data with which to monitor and assess the role of China as investor country. Chapter 3 of this Review provides a full analysis of China's outward investment since the early days of its open door' policy.

In addition to MOFCOM's FDI statistics, SAFE publishes balance of payments and international investment position statistics which include aggregate totals for direct investment but do not provide detailed information on partner countries and on industry classification.

The OECD's Benchmark Definition of Foreign Direct Investment sets the world standard for measuring FDI. Within that framework, the OECD has established close links with China to provide assistance in best practices through its network of experts, the Working Group on International Investment Statistics of the Investment Committee (WGIIS), who have the technical responsibility for setting the methodological recommendations.

At end-2006 MOFCOM visited OECD headquarters in Paris to establish the foundations of a China/OECD Dialogue on FDI statistics for policy making. Senior officials from OECD member governments also attended this meeting. The purpose of the co-operation is to promote an exchange of views and experiences between Chinese and OECD experts and provide assistance to China to improve its statistics on inward and outward FDI flows and stocks. Experts attending the meeting agreed that FDI statistics form an important and necessary component for the analysis of the global economy, keeping in mind the undisputed role of FDI for development as set out by the Monterrey consensus.

As a conclusion of the exchange of views, China endorsed the practical co-operation framework on FDI statistics proposed by Mr. M. Schekulin, Chairman of the Investment Committee, who recalled that "better investment statistics and better analysis of investment data for a more rational investment policy making" is one of the Committee's four priority areas. He indicated that a China-OECD Dialogue on FDI statistics should aim at: a) establishing a

framework for continued networking between Chinese and OECD experts for FDI statistics; and b) developing medium-term priorities.

The practical application of this programme was articulated in four concrete proposals:

1. Identifying a group of core experts composed of Chinese and OECD officials, the OECD Secretariat, and other international organisations.
2. Enabling visits, discussions and meetings of experts, including by:
 - a) inviting Chinese officials to regular OECD WIIS meetings,
 - b) organising visits by OECD experts to meet Chinese officials,
 - c) organising seminars/meetings to inform Chinese statisticians and the analysts of the standards adopted by the *OECD Benchmark Definition of FDI*; to provide assistance to Chinese statisticians on practical implementation issues; to introduce FDI globalisation indicators; to discuss analytical interpretation of FDI statistics; to respond to other requirements.
3. Other concrete outputs:
 - a) Translation of the *OECD Benchmark Definition of FDI*, 4th edition, into Chinese.
 - b) Incorporating the FDI statistics of China in OECD's *FDI Statistics Yearbook* (using standard framework at an advanced stage of the co-operation when China adopts some of the basic recommendations).
 - c) Presenting special papers for discussion and publication.
 - d) Exchange of staff.
4. Programme assessments: Regular reports to China and to OECD Investment Committee using the self-evaluation tools established by the Committee for its outreach activities.

The first step for the implementation of this programme was a seminar on "Measuring FDI to promote a harmonious society" organised at the occasion of the 11th China International Fair for Investment and Trade (CIFIT) in September 2007. The seminar was organised as a parallel event at CIFIT, under the auspices of the OECD WGIIS in co-operation with MOFCOM.

The seminar attracted a rather large audience, most of whom were Chinese. Following a presentation of its analysis of recent FDI trends and developments, the OECD Secretariat discussed the importance of measuring the FDI activity. This presentation was complemented by Japanese experience and by China's presentations of its inward and outward statistics. The Netherlands presented the challenges ahead for enterprises (both as direct investors and as direct investment enterprises) in the process of information gathering for FDI statistics. MOFCOM is the principal body responsible for

China's FDI statistics. Inward and outward FDI statistics are dealt by different MOFCOM departments.

MOFCOM has put the following concrete programme proposals to the OECD which are currently under consideration and discussion: i) An evaluation of China's FDI statistics; ii) a study on off-shore/free port jurisdictions, also looking at hedge funds and private equity funds; iii) co-operation with China for implementing an inward direct investment survey; iv) co-operation with China to implement FDI stock statistics as well as merger and acquisition (M&A) statistics.

The methodology for compiling foreign direct investment statistics can be very complex. Applying internationally agreed standards is the only means to achieve comprehensive statistics which are comparable across countries. International comparability is an indispensable feature of FDI statistics for any country, particularly if it is a major player in the global economy.

A recurring question is that of whether China's FDI statistics are internationally comparable.¹ The continuing absence of metadata² is a major gap while there is no descriptive information on the methodology China uses to compile these statistics. This lack of transparency leaves a number of questions unanswered and therefore has a direct impact on the quality assessment of the statistics. In consequence, it is not possible to declare objectively that China's FDI statistics are in line with the methodology recommended in the OECD Benchmark Definition of FDI (fully consistent with IMF's recommendations). OECD has a fully-fledged objective assessment tool, the Survey of Implementation of Methodological Standards for Direct Investment (SIMSDI). China was invited in early 2008 by the OECD to take this survey in response to the request by MOFCOM for a review of its statistical system. The result of this exercise will allow developing metadata for inward and outward FDI statistics of China, to deepen the understanding of the data and to identify areas for improvement.

Having formulated this general point of prime importance, the following observations can be made, based on MOFCOM's publications relating to China's FDI statistics which appear to be deviations from international standards:

1. The formats used for disseminated inward and outward foreign direct investment statistics of China are different. Even if inward and outward FDI are not treated in the same department of MOFCOM, tabular presentations and accompanying labels can be standardised. FDI outflows by partner country (or by industry) are presented in a single table for several years, a format which could be usefully applied as a model for inward investments. All OECD countries provide their statistics based on similar standardised presentations recommended by international organisations. It is notable

also that the statistics showing outward investments by partner country exclude investments in the financial sector, while MOFCOM does not separately publish similar information on this sector of the economy. As a result of a recommendation in the 2003 investment review of China, MOFCOM established the “invest in China” website (www.fdi.gov.cn), which provides monthly cumulated flow statistics. Nevertheless, annual data is difficult to track from this website, which presents differences in coverage between the Chinese and English versions. Regarding inward investment, China distinguishes between “contracted FDI” and “realised FDI”, although the former is in the process of being abandoned. The distinction between the two concepts is not clearly described and there is some concern that the latter may correspond to inflows of funds which do not necessarily comply in all cases with FDI criteria. This important conceptual distinction requires explanatory information.

2. Classifying direct investment by industry sector provides valuable information to analysts. China's inward and outward FDI are also presented by industry. Nevertheless these data are classified according to a national classification which is not in line with International Standard Industry Classification (ISIC) which is required for international comparability of the data, for example with OECD countries. Sectoral time series are difficult to compile and assess because the industrial classification used for all past years is not totally uniform. Moreover, it is essential to indicate in notes whether the industry classification used is that of the direct investor or of the direct investment enterprise.
3. China provides information on FDI stocks, both for inward and outward investment. What is published as inward FDI stocks are only cumulated flows. These figures should be used with caution. While cumulated flows may indicate general trends of FDI in the absence of actual stock data, they cannot be considered as proxy for a structural analysis of FDI. On the other hand, it is not possible to comment on outward FDI stocks in the absence of any metadata. The Chinese government is invited to consider implementing a survey system – the primary source used by OECD countries – to compile accurate FDI stock statistics.
4. China's FDI statistics do not provide information on direct investment income. There is no published information on direct investment income on equity (dividends and reinvested earnings) and income on debt (interest), which is the standard presentation recommended by the Benchmark Definition of FDI and applied by OECD countries.
5. China's FDI statistics do not show separately the main components of FDI, equity financing (equity and reinvested earnings) and inter-company loans. The analysis of each component by partner country and by industry sector

separately provide valuable analytical information. These breakdowns are recommended by the Benchmark Definition and are applied by OECD countries.

6. Apart from private estimates, there is, to our knowledge, no official measure of “round-tripping” of domestic funds returning back to China in the form of FDI. Any sound analysis will require segregation of such funds. The new OECD Benchmark Definition of FDI provides methodological elements to identify such funds. Moreover, it is useful to compare partner country or territory estimates, such as estimates by Hong Kong, China of round-tripping with China, that may be available.
7. Regarding basic definitions used by China there is no information available. China is invited to apply the definitions and concepts as well as the breakdowns recommended by the revised edition of the Benchmark Definition (see Box 2.1).

Box 2.1. OECD Benchmark Definition of Foreign Direct Investment, 4th edition

Foreign Direct Investment (FDI) occurs when a business located in one country (the *direct investor*) invests in a business located in another country (the *direct investment enterprise*) with the objective of creating a strategic and a lasting relationship. Within an effective policy framework FDI can assist host countries in developing local businesses, promoting trade and contributing to technology transfer. Similarly, it can provide greater market access to businesses in home countries. Governments, businesses and other stakeholders need reliable FDI statistics to inform and support their decisions for investments worldwide.

The OECD completed in May 2008 the 4th edition of its *Benchmark Definition of Foreign Direct Investment (BMD4)* which sets the world standard for FDI statistics and provides a single point of reference for statisticians and users of FDI statistics. It is fully consistent with the *IMF Balance of Payments and International Investment Position Manual, 6th edition*. The revision largely corresponds to the introduction of new data breakdowns and statistical treatments to adjust the traditional canvas of FDI statistics to rapidly changing business structures as a consequence of the removal of legal and regulatory restrictions. In terms of new breakdowns the Benchmark Definition provides a methodology to classify FDI by type, such as whether mergers and acquisitions or greenfield investments, and to identify the ultimate investor.

Box 2.1. OECD Benchmark Definition of Foreign Direct Investment, 4th edition (cont.)

For statistical purposes, it is considered that the lasting interest is evidenced when a direct investor owns 10% or more of the voting power of a direct investment enterprise. In other words, the motivation of the direct investor is to exert some degree of influence over the management of the direct investment enterprise whether or not it entails a controlling interest. Direct investment enterprises are corporations or quasi-corporation which may either be subsidiaries (including branches), in which over 50% of the voting power is held, or associates, in which between 10% and 50% of the voting power is held. The relationship between the direct investor and its direct investment enterprises may be complex and bear little or no relationship to management structures. Direct investment relationships are identified according to the criteria of the Framework for Direct Investment Relationships (FDIR) including both direct and indirect direct investment relationships.

FDI statistics include three main data series: *direct investment positions* (equity including reinvestment of earnings and debt), *direct investment income flows* (distributed earnings, reinvested earnings, interest income) and *direct investment financial flows* (equity, reinvestment of earnings and debt). Market value is the preferred conceptual basis to measure both direct investment positions and flows. FDI statistics are presented for the reporting country according to two standard templates and in each case according to the direction of investments (inward and outward investments): i) FDI by partner country; ii) FDI by economic activity (according to ISIC4).*

One major worry for users of FDI statistics is the problem of “capital in transit” which may take different forms. Multinational enterprises (MNEs) increasingly have recourse to complex structures to manage their financing. In many cases (although not all) they use the services of what is generically called Special Purpose Entities (SPEs) such as holding companies, shell companies, brass-plate companies or financing subsidiaries. Including the transactions through these entities in FDI statistics distorts the measurement of genuine FDI by: i) overstating FDI for the country hosting SPEs; ii) overstating overall FDI by double (or multiple) counting; iii) misallocating the origin and/or destination of FDI.

* ISIC: International Standard Industry Classification.

Notes

1. See *Investment Policy Reviews: China*, Annex 1, International Comparability of China's FDI statistics.
2. Metadata refers to methodological information, 2003, OECD.

Chapter 3

China's Outward Direct Investment

Following its success in opening the economy and attracting inward FDI, China has been rapidly becoming an important source of outward foreign direct investment (OFDI) in recent years. Starting from virtually no OFDI in 1979, China had accumulated USD 90.6 billion of OFDI stock overseas by the end of 2006. China's OFDI flow and stock now stand the 4th largest and the 6th largest, respectively, among developing countries. This chapter provides a unique account of the motivations for and development of China's OFDI in the light of government policy encouraging companies to "go global", focusing in particular on Chinese investment in Africa.

Overview

Following its success in opening the economy and attracting inward FDI, China has been rapidly becoming an important source of outward foreign direct investment (OFDI) in recent years. Starting from virtually no OFDI in 1979, the initial year of China's open door policy, China had accumulated USD 90.6 billion of OFDI stock overseas by the end of 2006, realised through the remarkable surge of outward investment flows from China during 2000-2006, when its OFDI flow in 2006 rose to the level more than 19 times as large as the 2000 flow level. China's OFDI flow and stock now stand the 4th largest and the 6th largest, respectively, among developing countries.

- As a late comer as a global investor, however, China's OFDI stock still accounts for only 0.6% of total OFDI stocks in the world, and, in terms of ratio to GDP, it lags far behind the world average.
- China's OFDI has been flowing into developing countries at a higher rate than developed countries with about 95% of outward flows directed to the developing world over 2003-2006. On the other hand, mergers and acquisitions (M&As), which are emerging as a dominant vehicle for Chinese enterprises' outward operations, are targeted more at industrialised countries.
- The services sector has attracted the largest sectoral share of China's OFDI, followed by the primary sector and the manufacturing sector.
- China's OFDI volumes have been dominated by large state-owned enterprises (SOEs) as their average investment size is much larger than that of Chinese enterprises in the private sector. All ten largest Chinese multinational enterprises by OFDI stock are SOEs and more than half are operating in the natural resources sector.
- China's official OFDI statistics may continue to underestimate the actual volume of outward flows, although measurement procedures have improved in recent years. In comparison to China's FDI stocks reported by the OECD Member countries in their respective inward FDI statistics, China's official stock figures are 40% smaller on average.

In China's highly controlled economic system, the government's policy and strategy have been always among the most significant determinants in explaining the development of China's OFDI. In 2000, China officially initiated a "go global" strategy to promote its OFDI, signifying the change in

the government's approach from one of tightly restricting capital outflows to one of encouraging Chinese enterprises to invest abroad. Consistent with its "go global" policy, the government has been streamlining its OFDI administration system as well as relaxing its control on outward capital flows. However, China's OFDI administration system has still remained rather restrictive and complex, requiring prior approvals from different government bodies.

Along with the gradual relaxation of government control, China's OFDI projects have been more and more driven by commercial motivations rather than the government's political agenda. The extent of the government's intervention varies, depending on the motivations of OFDI projects with resource-seeking projects receiving a disproportionate share of the government's direct and indirect support.

China's contemporary relationship with Africa has been driven by a strong commercial impulse and an economic rationale. China now considers Africa as not only an important source of energy and other crucial natural resources required for its fast growing economy but also a rapidly expanding market for Chinese products.

- While its direct investment flows into Africa have accelerated in recent years, registering a sevenfold increase over 2003-06, China's investment position in Africa has remained far from matching those of traditional investor countries from Europe and North America, accounting for less than 1% of total FDI stock found in Africa. Among developing countries, however, China has become a leading source of FDI in Africa.
- China's OFDI in Africa is highly diversified, reaching 48 countries in the continent. The top five countries hosting the largest China's OFDI stocks are all resource-rich countries, including Algeria, Nigeria, South Africa, Sudan and Zambia.
- The average size of Chinese enterprises' investment projects in Africa has been relatively small. Large OFDI deals, mostly in the natural resources sector, have been executed by only a few giant Chinese SOEs, and the majority of projects have been carried out by numerous small and medium-sized enterprises, mostly in the manufacturing sector and the services sector.
- While natural resources-seeking is clearly a primary motivation for Chinese investors, China's OFDI in Africa has not been particularly skewed towards the natural resources sector in international comparison. Market-seeking is also a prominent motivation for Chinese enterprises investing in Africa, especially in the manufacturing sector and the construction sector.
- The size of China's official development aid (ODA) flows to Africa is more than twice as large as that of China's total FDI flows to Africa, and China has strategically aligned its ODA resources with OFDI policy to support Chinese enterprises investing in Africa.

The successful expansion of China's exports has been increasingly causing a protectionist reaction in many host countries, which has prompted China to substitute direct investment for exports. The large accumulation of foreign exchange reserves has given rise to pressures on China to achieve equilibrium in its international financial flows by revaluing the currency. Encouraging capital outflows including OFDI is one way of mitigating this revaluation pressure. Given these prevailing economic conditions, the upward trend in outward investment flows from China is likely to continue not only in Africa but also in other regions of the world. It will be supported by further liberalisation of administrative procedures and capital controls on outward investment as the government's "go global" policy matures.

1. Overview of China's outward foreign direct investment

During the last quarter of a century, China impressed the world with its sustained economic growth accompanied by vigorous investment demand, massive capital inflow and rapid export expansion.

With a growing confidence in participating in the global economy, many Chinese enterprises already engaged in international business have started significant investment abroad and the government's strong support for Chinese enterprises' "go global" strategy has turned China into an emerging source of capital in the world while at the same time it remains a favourite destination of foreign capital. As of end-2006, China's cumulative stock of outward foreign direct investment (OFDI) reached USD 90.6 billion,¹ more than three times the level recorded in 2000. It was realised through the remarkable surge of OFDI flows from China during 2000-06 with an average flow of USD 7 billion per annum and an average growth rate of 116% per annum.

While the recent rapid expansion of Chinese investment abroad has drawn wide attention, the presence of China's OFDI in the world still remains small in relation to that of the industrialised countries' OFDI. Moreover, the amount of OFDI stock owned by China is only about one quarter of the FDI stock owned by foreign countries in China. Nonetheless, the emergence of China as a source of FDI in the world may be considered as a logical step in the country's economic development and there is every indication that China will continue to search for investment opportunities abroad in the foreseeable future. Thus it is likely that China's OFDI will accelerate.

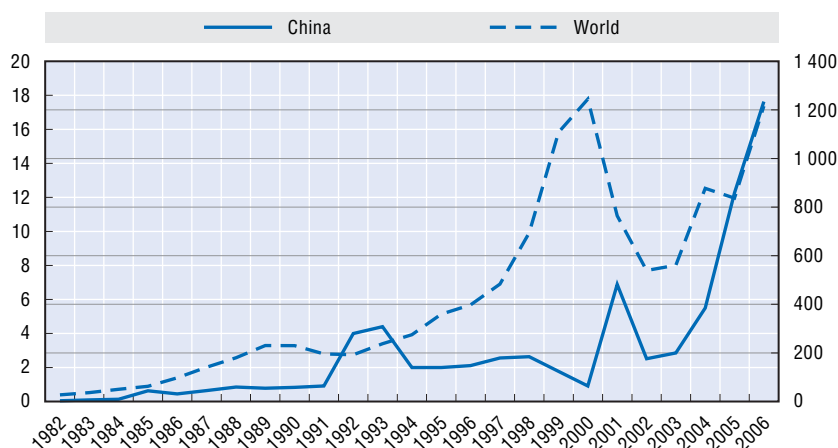
China's OFDI has evolved not only in size but also in terms of geographical and sectoral distribution over time, responding to the government's strategy, the conditions of Chinese economy, and bilateral economic relationships with foreign countries. This chapter presents an overview of China's OFDI, making use of the available official data.

China's OFDI flows have recently recorded a steep rise, though from a low base

China's overseas investment is a recent phenomenon. Starting from virtually no OFDI in 1979, the starting year of China's open door policy, China's OFDI remained negligible around an average amount of USD 450 million per annum during the 1980s.² In these early years of China's economic transition, most Chinese firms did not have sufficient knowledge and competitiveness to carry out outward investment projects, and the country's overall capital outflow was strictly restricted by the government, given the severe scarcity of foreign exchange. In 1992, OFDI flows from China briefly shot up to USD 4 billion, more than three times the figure of the previous year. However the momentum did not last for more than a few years and China's OFDI stagnated around an average flow of USD 2.3 billion per annum over the whole of the 1990s.

In 2001, China's OFDI flows took off, posting a big jump with an outflow of USD 6.9 billion – more than six times the figure recorded in the previous year. This coincides with China's accession to the WTO, in advance of which China made great progress in liberalising its trade, investment and financial regimes and China's official announcement of the “go global” policy within its 10th five-year plan (2001-05). This time the momentum seems to be sustained into a robust upward trend with a steep acceleration in 2005-06 after the government substantially relaxed OFDI regulations in 2004³ (see Figure 3.1). The average annual growth rate of China's OFDI registered 116% for the period

Figure 3.1. **China's OFDI – flow: 1982-2006**
USD billions



Note: The left vertical axis measures China's OFDI and the right axis measures the world's OFDI.

Source: MOFCOM and UNCTAD.

from 2000 to 2006, which is among the fastest in the world and is particularly impressive compared with the average growth rate of only 6% for total OFDI flows from the whole world for the same period. The latest figure from the Ministry of Commerce (MOFCOM) showed USD 17.6 billion⁴ of OFDI flow for 2006, accounting for 1.5% of total OFDI flows from the world. China's OFDI flow stands at the 18th largest in the world and at the 4th among the developing and transitional countries after Hong Kong, China; Brazil; and Russia (see Table 3.A1.1).

China's emergence as a source of OFDI is part of the growing trend of emerging economies' outward investment, which recorded an average growth rate of 31% over 2000-06 and reached USD 174 billion in outward flow for 2006, accounting for 14.3% of total OFDI flows from the world. China's performance in accelerating its OFDI over the same period is remarkable even among emerging economies. However, caveats are that statistics in emerging economies tend to be patchy and relatively unreliable as omissions and under- or over-estimations are prevalent (see Box 3.1).

China's OFDI stock has steadily accumulated, though remained relatively small in the world

Through the expansion of OFDI flows, China has been gradually accumulating FDI stock overseas. By end-2006, cumulative OFDI owned by China climbed to USD 75 billion.⁵ However, being a late comer as an FDI source country, China's presence in the world as a global investor has remained relatively small. China's OFDI stock as of 2006 still accounted for only 0.6% of total OFDI stocks in the world. This figure put China at the 23rd largest in the world and at the 6th largest among the developing countries after Hong Kong, China; Russia; the British Virgin Islands; Singapore; and Chinese Taipei. Furthermore, in terms of a ratio to GDP, China's OFDI stock is equivalent to 2.9% of its GDP in 2006, lagging far behind the global average of 26.1% as well as the proportions for developed (30.7%) and developing countries (13.9%)⁶ (see Figure 3.2 and Table 3.A1.3).

In comparison with the 30 OECD member countries, China's OFDI stock ranked in 2006 at the 19th largest, behind Austria but ahead of Portugal. While in terms of the recent outward flows China moved ahead of a few more OECD member countries, China's share, at 1% of world total outward direct investment flows over the last four years (2003-06), is dwarfed by 82.3% share accounted for by all the OECD member countries. Furthermore, in terms of a per capita value, China's OFDI stock of USD 57 per capita is far below the OECD average of USD 9 111 per capita (see Table 3.A1.4).

Box 3.1. Measurement of China's OFDI

The data for 2003-06 used in this chapter are obtained from MOFCOM's Statistical Bulletin of China's Outward Foreign Direct Investment which started its annual publication of OFDI statistics in accordance with international standards in 2003. Before 2003, the method used by MOFCOM to collect OFDI statistics was inconsistent with international standards, and it is believed that the official statistics seriously underestimated the actual OFDI volumes from China. For example, MOFCOM's OFDI statistics did not include investments made after initial approval, and only equity investments were captured.¹ Through extensive consultation, however, MOFCOM and the National Bureau of Statistics formulated the *Statistics System of Chinese Foreign Direct Investment* in 2002² to incorporate the definitions, statistical principles and methodology based on *OECD Benchmark Definition of Foreign Direct Investment (Third Edition)* and *IMF Balance of Payment Manual (Fifth Edition)*.

While the government's efforts to adopt and implement international standards in collecting and publishing OFDI statistics have substantially improved the reliability of data, underestimation of the actual OFDI volumes may still be the case in current official statistics. Since MOFCOM collects data based on its approval and registration record of OFDI projects, investment projects undertaken by enterprises which have escaped the formal approval and registration procedures through MOFCOM may have been omitted. A field interview conducted by FIAS/IFS/MIGA,³ indeed, found that most private firms interviewed did not apply for their investment projects abroad. In comparison to China's FDI stocks reported by the OECD member countries in their respective inward FDI statistics, China's OFDI stocks reported by MOFCOM are on average 40% lower with a few exceptions such as the United States and Japan (see Table 3.A1.2).

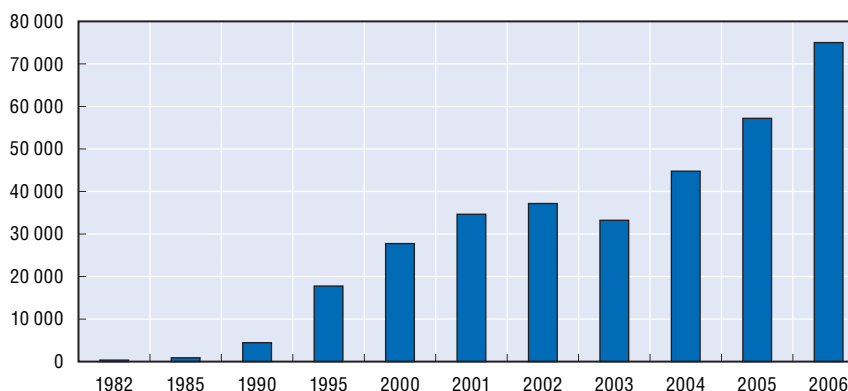
1. The international practice also considers re-investment with overseas earnings as well as loans from parent companies to overseas subsidiaries as OFDI flows.
2. It was further revised in 2004 and 2006.
3. Yao, Y. and He, Y. (2005).

China's OFDI has a high concentration in a few offshore financial centres

According to MOFCOM, at the end of 2006, more than 5 000 Chinese investment entities have established nearly 10 000 overseas enterprises through direct investment across 172 countries and/or economies. While the list of countries receiving China's OFDI has been getting longer, indicating diversification of outward investment, China's OFDI flows have been highly concentrated in a few host countries. The top five destinations for China's OFDI accounted for 85.5% of total OFDI flows from China over 2003-06 and 84.5% of total OFDI stocks owned by China as of end-2006 (see Tables 3.A1.6 and 3.A1.7).

Figure 3.2. **China's OFDI – stock: 1982-2006**

USD millions



Source: MOFCOM (data for 2003-06) and UNCTAD (data for 1982-2002).

The largest share of stock was found in Hong Kong, China, absorbing more than half of the country's total stock. It is easily understood from Hong Kong, China's special role as China's offshore platform from which Chinese enterprises can raise funds for their domestic business activities as well as for their investment projects in third countries. In addition to Hong Kong, China, popular tax havens or offshore financial centres of the British Virgin Islands and the Cayman Islands have been favourite locations for Chinese investors. Indeed, 80% of China's OFDI flows headed towards one of the three economies (Hong Kong, China, the British Virgin Islands and the Cayman Islands) over 2003-2006. The other destinations favoured by Chinese enterprises include Australia, Denmark, Korea, Macao, China, Russia, Singapore, Sudan and the United States.

Part of the attraction of offshore financial centres as OFDI destinations may result from the fact that the Chinese government's long-term capital controls have hampered the deepening of China's domestic capital market. In the face of domestic financial constraints, these financial offshore centres can be effectively used as locations of regional headquarters, holding companies or special vehicle enterprises for which efficient financial services and unconstrained financial flows are crucial. By transferring capital to these offshore financial centres, large Chinese enterprises may also diversify domestic risks and gain flexibility in corporate financing and intra-corporate restructuring.

However, a significant portion of the funds invested in these offshore financial centres are likely to be channelled subsequently to ultimate host countries and/or to flow back to China later as FDI inflows, a phenomenon commonly known as round-tripping. The three most popular offshore

financial centres are also the major sources of inward FDI in China. While Hong Kong, China is the single largest source of China's inward FDI, accounting for nearly 30% of total FDI inflows to China, the British Virgin Islands and the Cayman Islands contributed to 15% and 3%, respectively, of total FDI inflows to China in 2005 (see Table 3.A1.8). Typical estimates for round tripping flows are in the range of 20-30% of total FDI inflow to China,⁷ though it is very difficult to prove the link between foreign direct outflow and inflow on a dollar-for-dollar basis. Therefore, all such estimates of the size of round-tripping are bound to be mere guesswork. Since the bulk of China's OFDI flows into offshore financial centres from which further investments are made in the ultimate host countries, the true distribution of China's OFDI is hard to assess.

Asia has been the favourite region for China's OFDI in recent years

Regional distribution of China's OFDI has undergone gradual shifts over the years. In the initial phase of China's OFDI (1979-91), China's OFDI flow was concentrated in North America and Oceania, accounting for close to 80% of total outflow from China. During this period, China's outflow had never exceeded USD 1 billion per annum and major investment projects in these two regions were in the natural resources sector and were undertaken by the large state-owned enterprises (SOEs), including mining, an aluminum smelter, a sawmill and oil extraction in Australia and Canada.

Since then, China's OFDI has increasingly shifted its focus away from developed countries in North America and Oceania to developing countries in Asia with Hong Kong, China being by far the largest recipient. By end-2006, 64% of China's OFDI stock was found in Asia. Out of this stock in Asia, about 88% is invested in Hong Kong, China, followed by Korea (2%), Macao, China (1.3%) and Singapore (1%).

While Asia on average received the biggest portion of China's OFDI, accounting for 47% of the country's total flows over the last four years (2003-06), diversification of China's OFDI flows to other regions, particularly offshore financial centres, is being observed. In 2005 and 2006, Latin America and the Caribbean overtook Asia as the top regional destination of China's OFDI flows: the share of China's OFDI flows to Latin America and the Caribbean recorded 53% in 2005 and 48% in 2006, compared with 37% and 42%, respectively, received by Asia. These investment flows into Latin America have been totally dominated by a few offshore financial centres (the Bahamas, the British Virgin Islands and the Cayman Islands) which accounted for 97% of the regional flows over 2003-06. As of end-2006, Latin America hosted 26.3% of China's total OFDI stock, out of which 96.4% was found in one of the three sunny offshore financial centres.

China's investment in Africa experienced a breakthrough in 2004 when its OFDI flow into Africa surged by more than four times from the level of the previous year. Over 2003-2006 Africa received 3.6% of total outflows from

China, which is slightly lower than Europe. As investment projects in Africa predominantly focus on natural resources sectors, the major African recipient countries of China's OFDI are all rich in natural resources, including Algeria, Nigeria, Sudan and Zambia. As of end-2006, 3.4% of China's total OFDI stock was found in Africa, ranking Africa at the third most attractive region by stock for China after Asia and Latin America. More detailed analyses of China's OFDI in Africa are found in Section 4.

Europe received 3.6% of total OFDI flows from China over the last four years (2003-2006). While investment flows to Western Europe stagnated around USD 120 million annually, investment to Central and Eastern Europe increased from USD 38 million in 2003 to nearly USD 500 million in 2006. Russia became the most popular destination in Europe for Chinese investors, accounting for 58.9% of outflows to Europe, followed by Germany (19.9%) and the United Kingdom (7.1%). As of end-2006, 3% of the country's total OFDI stock has accumulated in Europe, 53.7% of this in Central and Eastern Europe and 46.3% in Western Europe.

North America and Oceania, two regions which used to receive the majority of China's OFDI in the early years, accounted for only 2.1% and 1.4% of total outflows from China, respectively, over the last four years (2003-2006). The United States received 81% of regional flows to North America, and Australia captured 90% of regional flows to Oceania (see Tables 3.A1.9 and 3.A1.10).

China's OFDI is increasingly channelled towards developing countries

There is a clear trend that China's OFDI is flowing into developing countries at a higher rate than developed countries. Since the proportion of China's OFDI stock found in developing countries surpassed the proportion found in developed countries in 1999, a larger and larger share of investment outflows from China is directed towards developing countries.⁸ During 2003-2006, the developing countries received 94.7% of total investment outflows from China, and by end-2006, hosted 95.3% of total China's OFDI stocks. Hence China is increasingly an important source of capital for economic development in developing countries. At the same time, Chinese investors' preference for developing countries explains why China's outward investors are seen less risk-averse by many analysts than international investors from other countries.⁹

M&A is becoming a common modality of OFDI from China

Mergers and acquisitions (M&As) have gradually emerged as a dominant vehicle for China's OFDI, while joint-ventures and establishment of overseas subsidiaries were two investment modalities typically used by Chinese enterprises in the earlier years. China's OFDI through cross-border M&As increased from a mere USD 60 million in 1990 to USD 5.3 billion in 2005, further to USD 15 billion in 2006 (see Table 3.1). Cross-border M&As by Chinese enterprises are especially popular in technology and communications and in

natural resources sectors, and are used as a quick option to acquire advanced technology, sales networks, brand names and other strategic assets overseas. Different from the overall patterns of regional distribution of China's OFDI, M&A deals are targeted more at industrialised countries such as North America: 67% of M&As in terms of bid value were executed in North America and the EU.¹⁰

Table 3.1. **M&As vs. China's OFDI**

	1988-89 (average)	1990-19 (average)	2000-20 (average)	2003	2004	2005	2006
China's deals	109	430	3 561	1 647	1 125	5 279	14 904
As a ratio in total OFDI flow (%)	13.9	16.7	43.6	57.7	20.5	43.1	84.5

Source: MOFCOM (for China's OFDI flows) and UNCTAD (for China's purchase in M&As).

M&As, which now account for a significant share of China's OFDI, are an option mainly used by large Chinese multinational enterprises (MNEs). Most smaller investors still use establishment of sales offices as a primary mode for outward investments as many of them are engaged in trading and manufacturing Chinese products.

Further appreciation of the Chinese currency may encourage more Chinese enterprises to search for M&A deals abroad as they strive to enhance their positions in the international market. One survey has also revealed that more Chinese enterprises are willing to use M&As than in the past.¹¹ In the meantime, Chinese enterprises are gaining knowledge on how to evaluate M&A deals better and how to integrate an acquired business effectively and enhance its corporate value on a long-term basis. In particular, to improve the performance of a merged business, Chinese enterprises often have to overcome deep cultural gaps and familiarise themselves with the social, environmental and legal/regulatory systems of the host countries.

Sectoral composition of China's OFDI reveals motivations of Chinese enterprises

Sectoral distribution of China's OFDI shows that China's OFDI is mostly directed to two sectors: the natural resources sector to provide supply to satisfy expanding domestic demand of energy and mineral products, and the services sectors such as finance, transport and wholesale and retail to support China's export and import activities. It is noteworthy that the manufacturing sector has never gained prominence in the country's OFDI activities to the extent comparable to its status in exporting and attracting foreign direct investments. Up to the mid-1990s, 60% of China's OFDI was found in the services sectors, typically to facilitate trade. The remaining OFDI was divided between the natural resources sectors (25%) and the manufacturing sector (15%).

During the last four years for which OFDI statistics are available (2003-2006), the sectoral composition of China's OFDI flows fluctuated, being sensitive to

execution of a few large investment deals. On average, the services sectors attracted the largest proportion of total outflows accounting for 47%, followed by the primary sector (38%), consisting of agriculture, forestry, animal husbandry, fishery, mining, quarrying and petroleum, and the manufacturing sector (15%). While the share of the mining, quarrying and petroleum subsector is affected by a few large natural resource development projects and/or M&A deals, it is worth mentioning that nearly half (48.4%) of foreign investment went to this subsector alone in 2006 (see Table 3.A1.11).

As of end-2006, the share of the services sector in China's total OFDI stock remained the largest, accounting for 65% of stock, followed by the primary sector (25%), almost all going to the mining, quarrying and petroleum sub-sectors, and the manufacturing sector (10%) (see Table 3.A1.12). Within the services sector, the most popular subsector was "leasing and business services", which includes investments in holding companies, regional headquarters and/or special-purpose entities, often established in popular offshore financial centres. Since these holding companies own diversified business activities across the world, making investments further to third countries, it is hard to classify their true investment portfolios by industry and sector. The services sector also includes sub-sectors, such as "wholesale and retail trade" and "transport, warehousing, and postal services", closely linked with China's export and import activities which have enjoyed various forms of government support and remain significantly large in terms of share in China's total OFDI stock. Within the manufacturing sector, the main sub-sectors investing overseas are: telecommunications, computer, and other electronic equipment; textile; pharmaceutical; and iron and steel processing.

MOFCOM started publishing OFDI statistics for the financial sector for the first time in 2006. According to the 2006 statistics, the financial sector made foreign direct investment of USD 3.5 billion, mainly in the banking industry, amounting to 16.7% of total OFDI flows for the year. As of end-2006, the cumulative OFDI stock in the financial sector reached USD 15.6 billion, equivalent to 17.2% of total OFDI stock. The stock is represented by 47 bank branch offices, 31 bank affiliated institutions, 12 bank representative offices and 12 insurance institutions in 19 countries including the United States, Japan and the United Kingdom. As demonstrated by the recent entry of China Minsheng Bank and China Merchants Bank into the US market,¹² Chinese banks are actively looking for overseas investment opportunities to expand their businesses, tap the savings of the Chinese diaspora,¹³ diversify earnings and gain access to more sophisticated financial management techniques and practices in developed countries. As essential business support to other Chinese enterprises investing abroad, Chinese banks are also investing in developing countries, most recently in Africa, where the needs for financial support by Chinese enterprises have been expanding.¹⁴

Large State-Owned Enterprises (SOEs) have been major players in China's OFDI

China's initial OFDI projects were all carried out by several large SOEs authorised by the government to operate overseas business. Through extensive reform to restructure China's industrial sector, the presence of SOEs has gradually declined, giving way to emerging private-sector operations in many industry sectors. While this overall trend applies to China's OFDI activities, the pace of privatisation in OFDI has been relatively slow. According to one analysis,¹⁵ the share of OFDI stock held by Chinese SOEs under central government administration stood around 84% of the country's entire outstanding OFDI stock as of end-2005¹⁶ and the share of China's OFDI flows made by SOEs accounted for 83.7% of the country's total outflows in 2004-06. The remaining portion of OFDI was undertaken by either SOEs under local government administration or non-SOEs of various ownership structure including limited-liabilities enterprises, privately-owned enterprises and foreign-invested enterprises.

Despite the dominance of SOEs by value of China's OFDI, an increasing number of non-SOEs have been getting involved in overseas investment projects. Since the average size of investment projects by non-SOEs is substantially smaller than that by SOEs, the actual rate of participation by non-SOEs in OFDI activities is generally under-recognised. According to the 2005 MOFCOM statistics, the share of SOEs in number of outward investing entities dropped to 29% in 2005 from 43% in 2003 and 35% in 2004, and the largest number of outward investing entities were limited-liabilities enterprises accounting for 32% of total.¹⁷ Hence, in terms of number, non-SOEs actually lead implementation of overseas investment projects with each making a relatively small-sized investment mostly under USD 5 million.¹⁸ Many of these non-SOEs are found in the manufacturing sector.

Large SOEs have inherent advantages in undertaking large foreign investments since they can enjoy formal as well as informal support from the government in the area of finance, networking, information access and administrative procedures. They can also rely on monopolistic power in their respective subsector in the domestic market which has been protected by the government. For example, the dominance of large Chinese SOEs in the natural resources sectors can be explained easily from their monopolistic status, the government's extensive support for natural resources-seeking investments abroad and their preferential access to financial resources. As a result, all of the ten largest Chinese multinational companies by OFDI stock are SOEs and more than half of them are operating in the natural resources sectors (see Box 3.2). However, as the government has started introducing OFDI friendly policies and measures in a more comprehensive manner and encouraging outward capital flows as a general policy, non-SOEs are expected to be more and more active in exploring overseas investment opportunities.

Box 3.2. The Largest Chinese MNEs

China has for a long time been favouring large enterprises in its industrial policy, especially large state-owned enterprises (SOEs). Since 1998,¹ the government has a specific priority of “grasping the large and letting go the small” (zhuādà fàngxiǎo, or 抓大放小) which aims to create strong and competitive large enterprises and develop them into global champions – large multinational firms with global recognition and competitiveness, and at the same time to allow the small and medium-sized SOEs to face market forces. Through consolidation of SOEs, the number of SOEs has been reduced, generating several large enterprises. In 2003, the State-owned Assets Supervision and Administration Council (SASAC) of the State Council was established to supervise the 196 largest central SOEs, with USD 0.9 trillion of combined net assets.² China wants to increase the number of Chinese firms listed in Fortune 500 to around 50 by 2015. Political, financial and administrative support was offered to identified SOEs or state-affiliated enterprises which are considered as candidates for would-be global champions.

The 10 largest Chinese enterprises ranked by outward FDI stock in 2006³ are:

1. China Petrochemical Corporation (Sinopec): Incorporated in 1998, Sinopec Group is a SOE solely invested by the State. Its key business activities are in oil, natural gas, and petrochemicals. It is the country's largest producer and distributor of refined oil products.
2. China National Petroleum Corporation (CNPC): CNPC is an SOE with a broad range of upstream and downstream operations in oil and natural gas.
3. China National Offshore Oil Corporation (CNOOC): CNOOC is a state-owned integrated energy company.
4. China Resources Holdings Co., Ltd.: Starting as Liow & Company in 1938 in Hong Kong, it is a state-owned conglomerate with a wide range of business covering properties, food, breweries, petrochemicals, retail, textiles, cement, and electricity.
5. China Mobile Communications Corporation: Established in 2000, it is a state-owned telecommunication company with not only basic mobile services but also data, IP telephone and multimedia services.
6. China Ocean Shipping Group Company (COSCO): COSCO is the country's largest shipping company with 25 wholly owned subsidiaries.
7. CITIC Group: It is a state-owned conglomerate owning 44 subsidiaries. Its core business is in finance and investment.
8. China National Cereals, Oils and Foodstuffs Corporation (COFCO): COFCO has been engaged in trading in cereals, oil and food, and since 1992 has been increasingly diversified.

Box 3.2. The Largest Chinese MNEs (cont.)

9. China Merchants Group: Founded in 1872, it is now a diversified conglomerate owned by the State but based in Hong Kong, China. Its main businesses cover three core sectors of transportation and related infrastructure (ports, toll roads, energy transportation and logistics), financial investment and asset management, as well as property development and management.
10. Sinochem Corporation: It is an SOE operating globally in petroleum, fertiliser and chemicals.

All of the ten enterprises above are SOEs under the direct control of SASAC of the State Council. Many of the large SOEs operate in the natural resource related sectors and the telecommunications sector, all of which are characterised by monopolistic market conditions. By implementing an expansion strategy, these large SOEs currently own widely diversified businesses around the world.

China's OFDI is dominated by these large Chinese MNEs, most of them SOEs. For example, at the end of 2004, the 30 largest Chinese MNEs in terms of OFDI stock (more than 2/3 are SOEs) accounted for 80.4% (USD 36 billion) of the country's total OFDI stock and the same 30 largest contributed to 77% of total FDI outflows in 2004.

Many of these giant players from China are also ranked in the international top listings including a list of the largest MNEs from developing countries by foreign assets published by UNCTAD and the fortune global 500 list published by Fortune. In 2005, 10 Chinese MNEs (all of them SOEs) entered a list of top 100 non-financial TNCs by foreign assets from developing countries with combined foreign assets of USD 51.6 billion, foreign sales of USD 60.3 billion and foreign employment of 118 465. In Fiscal Year 2007, 24 Chinese enterprises with combined revenue of USD 838 billion were listed in Fortune Global 500, up from 20 Chinese enterprises in 2006 and only 3 in 1995. Out of 24 enterprises in the 2007 Global 500, 10⁴ are also among the 30 largest Chinese (non-financial) enterprises by outward FDI stock.

1. This strategy was formulated in the mid-1990s under the direction of then Vice Premier Zhu Rongji, officially established as China's reform strategy at the Fifteenth National Congress in 1997 and put into full implementation in 1998.
2. www.sasac.gov.cn.
3. MOFCOM (2006).
4. These are Sinopec, China National Petroleum Corporation, China National Offshore Oil Corporation, China Mobile Communications Corporation, China Ocean Shipping Company, Sinochem, China State Construction Engineering Corporation, China Telecommunications Group Corporation, Shanghai Automotive Industry Corporation, and Shanghai Baosteel Group Corporation. Fortune Global list includes financial institutions, but the largest enterprise list by outward FDI stock compiled by MOFCOM does not include financial institutions.

Both macroeconomic and microeconomic conditions explain recent developments in China's OFDI

The recent dramatic expansion in China's OFDI, backed by the government's "go global" strategy, reflects two fundamental developments in the Chinese economy, one macroeconomic and the other microeconomic. At the macroeconomic level, China needs to balance its international capital flows better in the face of mounting pressure to revalue its currency. As a result of persistent trade as well as capital account surpluses, China's official foreign exchange reserves climbed up to an unprecedented level of USD 1.905 trillion as of end-September 2008. While China has been gradually making its foreign exchange regime more flexible, for example by adopting an adjustable peg basket system against the dollar in July 2005 and allowing incremental appreciations of the exchange rate, adjustments would not be enough to stave off the revaluation pressure effectively. Further exchange rate flexibility would solve a classic conflict between internal and external balance under the tight currency peg arrangements. In the meantime, a policy of encouraging capital outflows including foreign direct investment outflows as well as portfolio investment outflows¹⁹ would help reduce the currency pressure by partially offsetting vigorous capital inflows to the country.

At the microeconomic level, many more Chinese enterprises have strong incentives as well as capacity to implement internationalisation strategies in order to advance their comparative advantage and profitability. Over the period of absorbing foreign investments into the country, many Chinese firms have gained the knowledge and experience crucial to operating business abroad via their foreign partners, and hence are ready to take up their international expansion/diversification programmes. Moreover, the emergence of overcapacity observed in some industry sectors within the domestic market is working as a push factor for Chinese enterprises exploring new markets overseas. As China's recent enthusiasm for OFDI is based more on an economic rationale than on a political agenda, the trend is expected to continue in future so far as underlying economic factors remain the same. Further discussion on the motivations of China's OFDI is found in Section 3.

Given the prevailing economic conditions, the upward trend in outward investment flows from China is likely to continue in the near future. It will be supported by further liberalisation of administrative and capital controls on outward investment as the government's "go global" policy matures. Through the reform programmes of Chinese SOEs and China's industrial sector in general, private-sector enterprises will gradually expand their share of overseas investment activities from China while certain sectors such as energy will remain dominated by large SOEs.

2. The government's policy on OFDI

In China's highly controlled economic system, shifts in the government's policy and strategy have always been among the most significant factors in explaining developments in China's OFDI. Since the start of the "open door" policy in 1978, the government has made incremental adjustments to OFDI policy in response to its perception of the political and economic needs of the country. Overall, China's OFDI policy has been shaped by the government's considerations of the reform needs of state-owned enterprises (SOEs), its industrial policies, the gradual relaxation of cross-border capital flow controls and bilateral relationships with host countries.

The government has developed a complex system of OFDI administration involving several different governmental bodies which guide the size and pattern of China's OFDI flows. China's policy framework governing OFDI covers a range of issues including the examination and approval process, the encouragement of specific types of projects, the system of foreign exchange control, and the SOE assets management and monitoring procedures. As the government's approach to OFDI has changed from one of tightly restricting capital outflows to one of encouraging Chinese enterprises to invest abroad, the policy framework has been adjusted to reflect the government's degree of willingness (or unwillingness) to allow Chinese enterprises' outward investment. This section lays out these policy adjustments and related changes in the administration and regulation of China's OFDI.

China's OFDI was strictly restricted up to the mid-1980s

In the early years of reform up to the mid-1980s, overseas investment activities were limited to state-owned foreign trade corporations under the supervision of the Ministry of Foreign Economic Relations and Trade (MOFERT)²⁰ and provincial and municipal economic and technology co-operation enterprises under the supervision of the State Economic and Trade Commission (SETC).²¹ Although the government placed more emphasis on formulating policies to attract FDI into China than on encouraging FDI out of China, these state-owned enterprises nevertheless expanded business overseas by taking advantage of their high degree of autonomy in operation to establish international business links.

In August 1979, the State Council released a document stating that the setting up of overseas operations by Chinese enterprises was one of thirteen official policies for opening the economy.²² However, there was no overall coherent framework designed to regulate overseas investments by Chinese enterprises, and all decisions on overseas investment projects had to be made by the State Council, which approved projects on a case-by-case basis. For example, the State Council approved the establishment of four large SOEs²³

specialised in overseas engineering and construction works and labour services which were expected to play a pioneering role in entering the international market. The China International Trust and Investment Corporation (CITIC) was also created as a ministerial-level corporation which enjoyed special permission from the top government officials to conduct investment activities both at home and abroad. Furthermore, even after the introduction of various administrative procedures for OFDI, these selected SOEs continued to operate outside of the standard administrative framework, and hence their investment activities were often not registered in MOFERT's official statistics.²⁴

Due to the tight control of the State Council, it is believed that OFDI projects during this period were closely linked to the government's political considerations rather than the enterprise's commercial motivation and were approved on the basis of their contribution to China's political and economic influence and trade relationships. By early 1985, there were only 113 non-trade Chinese enterprises investing abroad with accumulated foreign investment stocks totalling USD 150 million.

In the mid-1980s the government introduced a series of regulations governing OFDI

In the mid-1980s, the government made a major move to standardise the regulations governing China's OFDI by introducing *The Notice about Principles and the Scope of Authority for Examination and Approval of Establishing Non-trading Enterprises in Foreign Countries, Hong Kong and Macao* (1984) and *Interim Regulations on the Administrative Measures and Procedures of Examination and Approval of Establishing Non-trading Enterprises Abroad* (1985). These regulations extended the right to apply for permission to invest abroad to any legal-entity enterprises which could demonstrate access to sufficient capital, adequate technical and operational know-how, and alliance with a suitable overseas joint-venture partner. These regulations constituted the core of China's OFDI administration and remain applicable today after undergoing several revisions.

While the regulations cover any potential Chinese outward investors, the country's OFDI continued to be dominated by the large SOEs which could benefit from their already established foreign networks and experiences as well as the government's support. During this period, SOEs other than the trading corporations, such as Shougang (the Capital Steel and Iron Corporation), started to join the ranks of overseas direct investors. Domestic liberalisation and decentralisation, initiated by Deng Xiaoping's journey to the South in 1992, encouraged local governments at the provincial and municipal levels to promote actively overseas business operations of the enterprises under their supervision.

By the late 1990s, the government's approach turned favourable to Chinese outward investors

In the early 1990s, the government was faced with a streak of state asset losses from speculative investments in the real estate and stock markets in Hong Kong, China and, as a response, tightened its control on financial outflows, including OFDI flows. In particular, government agencies such as the State Planning Commission (SPC, since reorganised as the National Development and Reform Commission, NDRC) and the State Administration of Foreign Exchange (SAFE) were instructed to examine investment proposals of more than USD 1 million before the proposals could be sent to the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) for approval.

However, by the late 1990s, the government's attitude towards OFDI changed from merely allowing to actively encouraging Chinese enterprises, while support programmes were often targeted to certain industries and large SOEs rather than uniformly implemented. For example, Chinese enterprises engaged in processing and assembling raw materials, parts and machinery exported from China, mainly in light industry sectors such as textiles, machinery and electrical equipment, were supported with export tax rebates, foreign exchange assistance and financial assistance for their OFDI projects. Encouragement to large SOEs' investment overseas was provided as part of the government initiatives to nurture national champions in the strategic sectors which were expected to spearhead the country's industrialisation and gain global competitiveness.²⁵

Since the early 2000s the government has consolidated the "go global" strategy

Since the early 2000s the government's policy to promote OFDI flows has been given increased impetus under the title of "go global" (zou-chu-qu, 走出去 – literally "go out"). This policy was officially initiated by former Premier Zhu Rongji in his 2000 report to the National People's Congress on the work of the government. Accordingly, the Tenth Five Year Plan (2001-05) listed overseas investment by Chinese enterprises as one of the four key thrusts to enable the Chinese economy to "adjust itself to the globalisation trend".²⁶ In March 2004, Premier Wen Jiabao advocated in his speech at the Tenth National People's Congress that China should speed up implementation of the strategy of "go global", and co-ordinate and guide Chinese investment abroad more effectively. Enterprises under all forms of ownership are encouraged to invest in overseas operations and expand their international market shares. The "go global" strategy is stressed again in the current Eleventh Five-Year Plan (2006-2010).

The government's intention to promote China's OFDI has frequently been mentioned by high-level diplomatic missions to other countries which were often accompanied by Chinese business delegations. Chinese enterprises have been directly and indirectly assisted by the government in winning procurement and construction contracts as well as natural resources exploration rights. For example, during President Hu Jintao's tour to several Latin American countries in November 2004, China signed some 400 agreements and business deals and promised an investment plan totalling USD 100 billion in Latin America over the following ten years.²⁷

This turn in OFDI policy is a logical consequence of the country's success in attracting FDI and promoting exports in previous decades and is consistent with the overall framework of continuing reform and liberalisation of the Chinese economy. What has triggered this policy shift, however, is the government's recognition of two major developments: 1) the successful expansion of China's exports has been increasingly causing protectionist reaction in many host countries; and 2) the large accumulation of foreign exchange reserves has given rise to pressures from other countries on China to achieve equilibrium in its international financial flows by revaluing the currency. The government started to consider the implementation of OFDI-friendly measures as a way to circumvent trade frictions as well as to mitigate revaluation pressure.

The reform of OFDI administration has taken the form of streamlining approval procedures and relaxing foreign exchange controls for outward investment. Approval authority has been decentralised from the central level to the local level; the application requirement for OFDI proposals has been simplified with fewer items to submit to the authority; a specific time limit for each application step has been imposed on the approval authority; and online application procedures have been introduced to improve transparency.²⁸

In parallel, the government has carried out step-by-step liberalisation of the restrictions on the use of foreign exchange for OFDI purposes. The task of examining the legitimacy of foreign exchange use for OFDI projects, up to a certain size of projects, has been decentralised to the local-level branches of SAFE in several pilot areas;²⁹ compulsory repatriation of overseas profits back to China has been abolished to allow Chinese enterprises to re-invest their profits overseas; the deposit required to guarantee remittance of profit from OFDI projects has also been abolished;³⁰ the size of projects up to which local-level branches are authorised to handle has been gradually increased³¹ while this decentralisation arrangement has been rolled over from the pilot areas to the whole country; and finally the government eliminated the long-imposed quota of USD 5 billion per annum on foreign exchange allocation for OFDI in 2006.³²

In addition to the administrative reform mentioned above, the government has also formulated specific measures on OFDI reflecting the emerging priorities in its industrial policy. In October 2004, the government announced a plan to provide interest-subsidised loans to priority OFDI projects. These priority projects may include: projects to develop natural resources which are in short supply within the country; manufacturing and infrastructure projects leading to exports of domestic technology, products, equipment and labour; R&D projects accessing advanced global technology, managerial skills and talents; and merger and acquisition (M&A) projects with a potential to strengthen Chinese enterprises' international competitiveness.³³ Furthermore, the NDRC instructed China Export and Credit Insurance Corporation (SINOSURE) to provide services such as risk assessment, risk control, and investment insurance for the same four types of priority OFDI projects.

As a general support to Chinese enterprises planning OFDI projects, the government has started to provide information and guidance. For example, MOFCOM, through its information bank,³⁴ offers information useful for Chinese enterprises planning OFDI projects, such as: investment demand in host countries, opportunities for participation in business fairs, and FDI policies and regulations in host countries. MOFCOM has also started collecting information on problems, obstacles and/or barriers faced by Chinese investors³⁵ which is used to inform other fellow Chinese investors as well as to react promptly on problem solving through bilateral mechanisms if necessary.

In July 2004, MOFCOM, jointly with the Ministry of Foreign Affairs, released the first *Guidelines for Investments in Overseas Countries' Industries* in which a catalogue list of recommended industry sectors for China's OFDI were presented for each of 68 host destinations.³⁶ This list is used as a basis for MOFCOM to approve and administer OFDI projects. However, MOFCOM emphasised that the list is meant to assist Chinese enterprises in identifying promising industry sectors in each host country, and hence, not to impose any sectoral allocation on outward investment.

The government plans to transform its role from one of approving and controlling to one of monitoring and facilitating investment projects, as stated in the *Decision on Reforming the Investment System* issued by the State Council in July 2004, which relates mainly to investment in China, both domestic and foreign, but also covers outward investments from China. The progressive efforts made in the OFDI administration system since the early 2000s were in line with this overall direction of moving towards a more transparent and open policy framework. A challenge which the authorities are facing is to improve the monitoring system for statistical, tax and other similar purposes while continuing to reduce the scope of operations subject to the government's prior approval.

The current system of China's OFDI administration can benefit from further improvement

While the government's system of administration and regulation of OFDI has been evolving to reflect changing priorities and economic needs, Chinese enterprises investing overseas still have to go through a complex set of burdensome administrative procedures. Lightening this burden would allow market forces to play a fuller role in allocating investment overseas.

China's regulations on OFDI remain fragmented, as they are overseen by several different government bodies. In addition to the State Council, three other government bodies, namely the NDRC, MOFCOM and SAFE, have various influences on OFDI. The role of each government body in China's OFDI administration and regulation is described in the following:

State Administration of Foreign Exchange (SAFE)³⁷

SAFE is the government agency responsible for China's foreign exchange control system, and is accordingly in charge of regulating the use of foreign exchange in OFDI projects. Before a specific project review can start, each OFDI proposal must be verified by SAFE for the legitimacy of its sources of foreign exchange whether it derives from an enterprise's own holdings, purchases made with renminbi, bank loans, or a combination of these. Then SAFE's opinion on the source of the foreign currency has to be attached to the application for each OFDI project filed with MOFCOM.³⁸ After obtaining approval from the NDRC, MOFCOM or both, all OFDI projects must be registered with SAFE to obtain a foreign exchange registration certificate, which is a prerequisite to remitting any currency overseas.

According to SAFE's *Circular on the Revision of Certain Foreign Control Policies Relating to Overseas Investment* (2006), approval authority for OFDI projects with an estimated investment amount of less than USD 10 million in foreign exchange is delegated to the respective local-level branch of SAFE, while OFDI projects exceeding this ceiling have to be sent to the central-level SAFE office for approval. Previously, this ceiling was only USD 3 million and delegation of authorisation power to the local level was limited to the pilot SAFE branches, including Shanghai, Beijing and several eastern coastal provinces.³⁹

While waiting for approval from the NDRC, MOFCOM or both, Chinese enterprises are allowed to request SAFE's permission on early-stage overseas remittance in order to cover preliminary expenditures up to 15% of total foreign exchange amounts estimated for the projects concerned. These preliminary expenditures may include: funds for acquiring shareholder rights in overseas companies or rights and interests in overseas assets; deposits required by the local laws or according to the demands of the project or the seller; market investigation fees; facility and equipment rentals; hiring costs;

intermediaries' fees; and bidding deposits.⁴⁰ The local-level SAFE branches can grant preliminary permission on early-stage overseas remittance based on submission either of an outward foreign direct project approval application or of documentation showing investment intent.⁴¹ In case of lack of completion of the approval procedures within six months from the first remittance of preliminary expenses, the Chinese enterprise is required to repatriate any remaining funds in its overseas account to its domestic foreign exchange account.

SAFE has for a long time imposed an annual cap on the overall amount of foreign exchange to be approved for OFDI purposes and has used the cap to block a number of proposed overseas investment projects. This annual cap was originally USD 3.3 billion. This was raised to USD 5 billion in 2005. However, the ceiling on OFDI was neither realistic nor practical. In 2001, China's OFDI flows reached a record USD 6.9 billion. Accordingly, the 2006 Circular completely eliminated this cap.⁴²

As Chinese enterprises explore overseas deals which are larger, more complicated and more time-sensitive, the government is likely to undertake further reform of its foreign exchange control system. With the huge accumulation of foreign exchange reserves in the country, China is aware of the need to facilitate greater capital outflows as demonstrated by implementation of the Qualified Domestic Institutional Investor programme.

NDRC and MOFCOM

The NDRC and MOFCOM share the power of vetting the legitimacy and usefulness of OFDI proposals. The NDRC is a macroeconomic management agency under the State Council and is in charge of formulating policies for economic and social development, maintaining a balance of economic aggregates and guiding overall economic system restructuring.⁴³ Within the NDRC, the Department of Foreign Capital Utilisation is responsible for recommending policies for overseas investment and approving China's OFDI projects requiring large amounts of foreign exchange. The NDRC reviews OFDI proposals to determine whether the projects comply with the laws and regulations of the state and the industrial policies; whether the projects contribute to sustainable development of the economy and society; whether the projects follow the administrative prescriptions of national capital projects and foreign loans; and whether the investors possess adequate capacity to carry out the projects.⁴⁴

On the other hand, MOFCOM is in charge of setting administrative measures and specific policies, guiding China's overseas investment, approving each OFDI proposal, and recording OFDI data. The evaluation criteria used by MOFCOM in approving OFDI projects are essentially similar to

those used by the NDRC but seem to include more micro-level examinations specific to the host countries and the projects concerned.

Prior to July 2004, all international investments larger than USD 1 million required both central-level NDRC approval and central-level MOFCOM approval.⁴⁵ The authorities would examine detailed information on the commercial value, the financing arrangements, and even the technical aspects of each proposed transaction. In July 2004, the State Council issued *The Reform of the Investment System Decision* to bolster Chinese enterprises' competitiveness in overseas investment, and decentralise approval authority to the local level within both the NDRC and MOFCOM.⁴⁶

Under current regulations, there are five categories of OFDI project, each subject to a different approval process by the State Council, the NDRC and/or MOFCOM.⁴⁷

1. Projects with total investment amount in excess of USD 200 million or with total foreign exchange in excess of USD 50 million: The projects in this category are initially reviewed by the NDRC to determine whether they are consistent with the government's economic security, industrial policy and capital management. After the NDRC completes evaluation of the projects, they are sent to the State Council for ultimate approval.
2. Projects in resource extraction with total investment amount in excess of USD 30 million or any kind of projects with total foreign exchange in excess of USD 10 million: The projects in this category are reviewed and approved by the NDRC at central level.
3. Projects of SOEs under the administration of the central government: For the central SOEs, projects with a total investment of less than USD 30 million and with total foreign exchange requirement less than USD 10 million do not need to undergo the NDRC's approval process, but are simply registered with the NDRC which issues a certificate of registration. Although the NDRC approval is not required, these projects have to obtain approval from MOFCOM which examines the viability of proposals. In conducting its examination, MOFCOM is instructed to seek advice from the Economic and Commercial sections of Chinese embassies located in the host countries.
4. Projects by others with a total investment of less than USD 30 million and with foreign exchange requirement less than USD 10 million: The projects in this category are approved by the NDRC at local level, which in turn reports their findings to the central NDRC office upon completion of review and approval. Subsequently the projects have to be sent to MOFCOM at the local level for further approval.
5. Projects targeting Chinese Taipei and other economies not having diplomatic ties with China: Regardless of project sizes, the projects in this category are reviewed by the NDRC at local level, which in turn reports its findings to the

State Council. In conducting its examination, the local-level NDRC office is instructed to consult with relevant government departments.

After obtaining approval, registering projects, and starting actual investment, Chinese enterprises are required to submit an annual report to MOFCOM and SAFE for their review.

Possible further reforms of OFDI administration and regulation

China does not have a centralised government body driving the country's globalisation efforts. During the external liberalisation process, while continuing to adhere to its obligations under the country's 1996 declaration of adherence to IMF Article VIII which provides for free payments and transfers in relation to international current transactions, China has developed a comprehensive exchange control and monitoring system covering all balance of payments transactions, the official objective of which is to manage international capital flows, maintain the autonomy of domestic monetary policy, and prevent Chinese enterprises from taking excessive external risks. While the foreign exchange control system has been evolving to adapt to the extent to which the Chinese economy is integrated with the global economy, SAFE has been and will remain an independent authority administering OFDI for the foreseeable future.

China's OFDI administration procedures could be further streamlined to reduce the unnecessary burden on Chinese enterprises investing overseas. This is especially important for small and medium-sized enterprises (SMEs) and all enterprises contemplating international investment for the first time. For example, the government could consider eliminating the requirement of obtaining approval from MOFCOM and the NDRC for at least relatively small-size projects proposed by private enterprises. Judgments on the viability of investment projects should be primarily the task of enterprises based on their risk-adjusted profit maximisation calculations and do not need to be confirmed or screened by the government. Experience has shown that administrations do not have the capabilities to make better judgments than enterprises on their own investment projects.

The government may wish to consider focusing on the provision of information useful for all Chinese investors, such as the relevant laws, regulations and policies related to foreign direct investment in host countries as well as the social and environmental regulations and practices of host countries to be complied with by Chinese (and all other) investors. MOFCOM has already made a move in this direction by starting an information bank and providing relevant information on its website.

Policy co-ordination among the three government bodies administering OFDI can be further improved. Each body requires a different set of

documentations and certificates which could be consolidated to make paperwork easier and more efficient for Chinese outward investors. While MOFCOM has significantly improved its transparency by informing the public of its administrative procedures and required documents on its website, other government bodies seem to lack an equivalent level of transparency. Another possible improvement is the creation of a “one-stop shop”, such as a single website, where Chinese outward investors can go to look for a complete set of requirements covering all three government bodies.

According to the survey undertaken by FIAS/IFC/MIGA⁴⁸ regarding perceived impediments to OFDI projects, the majority (58%) of enterprises interviewed pointed to the limitations on foreign exchange use as major impediments, followed by the lengthy time of the application process (44%), limited financial resources (35%), the high costs of complying with procedures and regulations (24%), and the strict check on the source of funds (17%).

The government uses various incentives to encourage and guide priority OFDI projects

The scope of government intervention in supporting OFDI includes financial incentives in the form of preferential access to loans, fiscal incentives, and indirect assistance to overseas activities by Chinese enterprises through its official development aid (ODA) programmes and diplomatic missions.

Financial incentives

Financial incentives provided by the government are the most powerful tools in promoting OFDI. Chinese enterprises on the priority list can benefit from the government's financial support in the form of access to below-market rate loans, direct capital contribution, and subsidies associated with the official aid programmes. Two policy banks, China Development Bank (CDB) and China Export and Import Bank (Exim Bank), are major providers of these financial incentives, but other major state-owned commercial banks are typically lined up to finance OFDI projects in response to strategic shifts in the government policy. For example, CDB and Exim Bank provided the telecommunications infrastructure provider Huawei with a USD 10 billion⁴⁹ and a USD 600 million⁵⁰ line of credit respectively to help its global expansion plan; the Industrial and Construction Bank of China (ICBC) offered a long-term soft loan of USD 7 billion to China National Offshore Oil Corporation (CNOOC) in supporting its (unsuccessful) bid to acquire a large US oil firm, Unocal,⁵¹ and the acquisition of PetroKazakhstan by PetroChina Company Ltd. and the acquisition of Ssangyong Motors by Shanghai Auto were also financed by domestic state-owned commercial banks.⁵²

Exim Bank has been especially instrumental in promoting the government's "go global" strategy. Only relatively large projects using a majority of goods and services from China can be funded through concessional loans from Exim Bank.⁵³ In 2004, the NDRC and Exim Bank jointly announced that Exim Bank would earmark a portion of its budget for OFDI projects with at least a 2% interest rate discount and possibly other preferential lending terms.⁵⁴ The Ministry of Finance (MOF) will cover the gap between the actual market rate and the subsidised rate offered by Exim Bank to projects whenever supported by the government. Consequently, Exim Bank received a substantial capital injection from the government in 2005.

The government has also established special funds to back up China's OFDI projects. In 2005, the MOF and MOFCOM jointly announced that special funds for foreign economic and technical co-operation would be established to provide direct subsidies and discount loans to Chinese enterprises which plan to expand their business abroad by setting up plants and/or research and development centres and to conduct various forms of economic and technical co-operation in agriculture, forestry, animal husbandry and fisheries.⁵⁵

The government's official aid programmes indirectly support Chinese enterprises' overseas operations. Firstly, most infrastructure construction projects offered under the government's ODA programmes require Chinese firms as construction contractors and/or equipment and material suppliers.⁵⁶ By winning contracts financed by ODA programmes, Chinese enterprises can keep engaged in host countries, establishing subsidiaries and diversifying their businesses. Secondly, these infrastructure projects are often offered as part of a package to win much larger commercial projects from the concerned host country which typically involve large-size acquisition of natural resources related assets by Chinese enterprises.

By actively guiding Chinese state-owned banks to fund OFDI projects, the government may increase the risk of undermining the commercial principle and the profitability of the banks as well as create moral hazard by encouraging Chinese enterprises to take high risk in investments. Chinese banks' aggressive financing to China's OFDI projects, if not transparent, may be questioned by host countries as well as the international community for their lending criteria. Moreover, subsidisation of cross-border acquisitions by Chinese government may cause international competitors to raise allegation of unfair competition in the light of perceived close connection between the government and large Chinese SOEs.

Chinese state-owned banks have been undergoing reform programmes to harmonise their corporate governance and risk management systems with international standards and have been making progress in incorporating environmental and social safeguards in their lending criteria. Their transformation

into joint stock companies and subsequent IPOs bring in greater transparency, tighter supervision and closer scrutiny by regulators and public shareholders, giving the right incentives to their operations. Further reforms and efforts by Chinese state-owned banks are encouraged to enhance the competitiveness and sustainability of China's OFDI projects by directing funds to the most viable projects and safeguarding against environmental and social problems.

Non-financing incentives

Since 1986, the government has been providing all Chinese enterprises overseas with exemption from corporate income tax for five successive years after the beginning of operations. After the initial five years, Chinese enterprises operating in the host countries with double taxation treaties with China continue to enjoy exemption from income tax. In addition to the central government's tax incentives, some local governments have extra arrangements to promote OFDI projects by providing Chinese enterprises based in their localities with exemption from corporate and individual tax for certain specified periods. By mid-2007, China had concluded double taxation treaties with 88 countries as well as bilateral investment treaties (BITs) with 121 countries⁵⁷ in the world to protect the legal rights and interests of Chinese enterprises investing abroad.⁵⁸

Chinese enterprises exporting equipment as well as raw and/or processed materials to their overseas investment projects have been entitled to an exporter's refund of value-added tax as is the case for other exports from China. If licensing or quota restrictions exist, their exports to supply OFDI projects are treated preferentially over other exports by the government. Imports from Chinese enterprises operating abroad are often given preference such as exemption from tariffs.⁵⁹

Possible ways forward

Chinese enterprises have benefited from their government's financial and non-financial incentive schemes to promote OFDI under the "go global" strategy. However, without a centralised government body driving China's globalisation efforts, OFDI policies and implementation have not been well synchronised and the administration of OFDI projects has remained fragmented, with different government bodies exercising independent power over OFDI projects. The beneficiaries of the government incentives have been so far biased towards large SOEs operating in priority sectors.

To advance the government's "go global" strategy in a manner more inclusive of SMEs, the government can further remove the administrative burdens on Chinese investors and address two areas for which further government intervention may be especially useful:

Firstly, the government can play a more active role in advising and providing information to Chinese investors on the laws and regulations of host countries. These may include not only the foreign investment laws and regulations but also those concerning labour, environmental and social practices which Chinese investors should be aware of. A survey by FIAS/IFC/MIGA revealed that many enterprises investing in developed countries⁶⁰ found a lack of knowledge of local laws and regulations to be their most serious political risk when engaged in OFDI projects. While Chinese embassies are known to be active in assisting Chinese enterprises already investing in respective host countries, the government can improve bilateral and multilateral co-operation by also disseminating relevant information among potential Chinese investors.

Secondly, the government may wish to consider promoting and encouraging the use of various risk hedging tools for Chinese investors overseas. The majority of enterprises cite exchange rate volatility as a significant risk in outward investment projects.⁶¹ As the gradual liberalisation of the exchange rate management system in China may bring in more uncertainty and volatility in the exchange rate in the future, Chinese enterprises can benefit from the availability and knowledge of various risk management tools.

3. Motives for China's OFDI

As government controls on outward investment have been steadily relaxed, China's OFDI has become more and more driven by Chinese enterprises' own commercial motivations, rather than the government's political agenda. To be approved and implemented, China's OFDI projects have to pass two tests: Chinese enterprises' evaluation showing the projects to be profitable and commercially viable, and the government's agreement that the projects are in the country's interest. The major outward investors are large state-owned enterprises (SOEs) for which the government's intentions may arguably dominate the enterprise's commercial calculations, even though many SOEs are encouraged by the government to act as autonomous enterprises maximising profits. Given the major role which the government plays in the Chinese economy, China's OFDI has been often seen as part of the broader process of economic reform and political activity, rather than as purely entrepreneurial activity.

OFDI projects may be driven by five major motivations

China's OFDI is multi-faceted in terms of characteristics, but can be categorised into the following five types: 1) projects seeking natural resources; 2) projects seeking product markets; 3) projects seeking strategic assets

including advanced technology, brand names and customer/distribution networks; 4) projects seeking diversification; and 5) projects seeking efficiency. Chinese enterprises could be pursuing multiple objectives in one investment project; hence some investment projects could be classified under more than one category (see Box 3.3).

Resource-seeking projects

Resource-seeking has been the main consideration for China's OFDI projects ever since China started to invest abroad. Gaining access to natural resources on which the country depends can provide the benefits of long-term supply security. Chinese enterprises which are engaged in imports and exports of natural resources or are utilising natural resources as production inputs may benefit from internalisation by integrating extraction/development of natural resources into their extended line of business. Large price fluctuations typically observed in the natural resources market may make many enterprises turn to protective measures against the price volatility risk including direct controls of natural resources production. Furthermore, large enterprises with monopolistic power in the domestic market may be able to enhance their monopolistic rents by vertically integrating their upstream businesses overseas.

Resource-seeking OFDI is driven by China's large, rapidly expanding domestic demand for natural resources to fuel its economic growth. Over the past two decades, China has moved from being East Asia's largest oil exporter to becoming the world's second largest importer of oil.⁶² Explosive growth in demand has been also seen in aluminum, copper, nickel, iron ore, timber and other key commodities. Naturally, the government has placed securing the natural resources crucial for industrial growth at the top of its agenda and the NDRC has been encouraging Chinese energy firms to purchase equity in upstream energy suppliers, principally through overseas acquisitions. The government's intention of securing natural resources overseas is demonstrated in its diplomatic relations with resource-rich countries, to which China has sent high-ranking officials on missions and has provided official development aid (ODA) programmes. To assist Chinese state-owned energy enterprises in winning overseas deals of natural resources acquisition/development, the government has often offered infrastructure projects as well as politically important landmarks through the government's soft loan or grant programmes as one package deal to the countries where the target natural resources are located. In addition to using diplomatic channels, the government intensively supports Chinese enterprises in carrying out resource-seeking OFDI projects by making preferential loans available to them through state-owned policy banks and commercial banks.

Box 3.3. Major OFDI deals by Chinese enterprises (2004-07)

Chinese enterprises	Invested project/ acquired asset	Host country	Estimated investment amount (USD billion)	Date	Comment	Major motivation
Wuhan Iron and Steel and other three steel mill companies	Wheelara joint-venture with BHP billion for mining iron ore	Australia	9.3	2004	Agreement signed	(1) Iron ore
CNPC	Petrokazakhstan	Canada/ Kazakhstan	4.18	2005	Acquired	(1) Oil
China Minmetals	CODELCO	Chile	0.55	2005	Agreement signed	(1) Copper
Sinopec	99.49% stake in Udmurtneft OAO	Russia	3.65	2006	Acquired	(1) Oil
CITIC	Kazakh oil assets of Nations Energy Company	Canada/ Kazakhstan	1.91	2006	Acquired	(1) Oil and (4)
China Metallurgical Group	Aynak copper field and related infrastructure project	Afghanistan	2.8	2007	Agreement signed	(1) Copper
Shanghai Baosteel	Joint-venture with Companhia Vale do Rio Doce for a steel slab plant	Brazil	3-4	2007	Letter of intent signed	(1) Steel
Sinopec	Development of Yadavaran onshore oil field	Iran	2	2007	Agreement signed	(1) Oil
Industrial and Commercial Bank of China	20% stake in Standard Bank	South Africa	5.49	2007	Completed	(2) and (4)
Bank of China	669 branches including a recent opening at London	28 countries	40% of its net profits from overseas	By 2007		(2) and (4)
Lenovo	IBM (PC hardware division)	USA	1.75	2004	Completed	(3) Computer
Nanjing Auto	MG Rover	UK	N/A	2005	Completed	(3) Automobile
China Mobile	China Resources Peoples Telephone	Hong Kong, China	0.43	2005	Completed	(4)
Bank of China	Singapore Aircraft Leasing Enterprise	Singapore	3.43	2006	Completed	(4)
State Grid Corporation	Consortium led by the Philippines' Monte Ore Grid Resources for grid operation privatisation	Philippines	3.95	2007	Bid awarded	(4)
Failed deals						
China Minmetals	Noranda	Canada	5	2004	Aborted	(1) Copper and zinc
CNOOC	Unocal	USA	19.5	2005	Aborted	(1) Oil
Haier	Maytag	USA	1.28	2005	Aborted	(3) Washing machine
China Mobile	Millicom International Cellular	Luxembourg	5.3	2007	Aborted	(3)

Note: Major motivations include: (1) resource-seeking, (2) market-seeking, (3) strategic-asset-seeking, (4) diversification-seeking and (5) efficiency-seeking.

Source: Various articles from *Financial Times*, *International Herald Tribune*, *International Petroleum Finance*, *People's Daily*, and *Xinhua*.

Prior to 1991, China's resource-seeking investments were mostly found in North America and Oceania, which were the leading destinations in terms of attracting investment outflows from China in this early phase.⁶³ Since then, the geographical landscape for China's resource-seeking OFDI projects has expanded further to Africa, Asia and Latin America. During 2003-06, resource-rich countries such as Algeria (2006), Indonesia (2004), Kazakhstan (2005), Sudan (2004), Nigeria (2004) and Zambia (2006) appeared in the top-ten list of China's OFDI destinations due to large natural resources acquisition/development deals executed during each year (see Table 3.A1.6). Chinese energy SOEs have sometimes teamed up with Indian counterparts to acquire natural resources assets in other developing countries.⁶⁴ Despite recent media reports on China's aggressive acquisition of natural resources overseas, however, the share of natural resources related OFDI in total stock actually decreased from 2003 to 2005 and only picked up in 2006.

Box 3.4. MNEs seeking resources – China National Petroleum Corporation (CNPC)

CNPC was created in 1988 as an SOE to handle all petroleum activities in China which were originally the responsibility of the Ministry of Petroleum. Currently, CNPC is the largest oil and gas producer, supplier and overseas resources developer in China with total assets of CNY 1.4 trillion and more than 1 million employees, supplying 58% of the country's total crude oil output. CNPC began its international operations in 1993 when it signed a service contract with the government of Peru to manage an oil field. Since then, CNPC has been keen on acquiring oil contracts and stakes in oil companies in Sudan, Kazakhstan, Uzbekistan and Venezuela. By end-2006, CNPC had invested in 65 oil or gas projects in 26 countries, expanding its production capacity, transport (pipeline) networks, and oil refining and processing capacity. CNPC now produces 21% of its crude oil output from overseas. The enterprise aims to integrate downstream operations including products marketing to become an internationally competitive oil and gas company. Its subsidiary company, Petrochina Co., Ltd., is listed in New York and Hong Kong.

On 26 October 2005, CNPC acquired PetroKazakhstan, Kazakhstan's second largest foreign petroleum producer, and largest manufacturer and supplier of refined products, by gaining 67% of the company's shares. This deal gave CNPC the ownership of 11 oilfields, licences for 5 exploration blocks, the largest refinery in Kazakhstan, and the transport and sales network consisting of sales companies and service stations. In the first year of operation, the crude production of PetroKazakhstan reached a record high of 10.5 million tons.

One distinctive feature of resource-seeking OFDI from China is that investments are dominated by a few large SOEs such as China National Offshore Oil Corporation (CNOOC), China National Petroleum Corporation (CNPC), Sinochem and Sinopec in the energy sector; and Baosteel, China Minmetals and Capital Iron and Steel Corporation in the mineral sector. Since resource-seeking investment normally requires a large up-front financial commitment, these large SOEs possess the immense advantage of having access to financial resources which can be preferentially offered from the state-owned banks as well as being raised from foreign stock exchange markets via share-listings. Not surprisingly, therefore resource-seeking is not frequently cited as a motivation to invest abroad by a sample of Chinese enterprises which includes a significant portion of non-SOEs and small and medium-sized enterprises (SMEs).⁶⁵

Market-seeking projects

Market-seeking motives have become important for those Chinese enterprises which aim to expand business overseas by relying on their comparative advantage already established in domestic and foreign markets; or those which intend to find new markets overseas, pushed by intense competition in the domestic market. A large number of enterprises with this motive are found in the manufacturing sector. The survey by FIAS/IFC/MIGA revealed that 85% of the interviewed enterprises considered market-seeking very important or important⁶⁶ – the top-ranked motive among all for their OFDI. In the earlier period, market-seeking OFDI projects were typically undertaken through setting up local branches or distribution centres to facilitate trade, wholesale and retail of Chinese goods. In the later period, many more Chinese enterprises have been investing in production facilities, plants and supply chains, partially replacing exports of their products.

Unlike in the natural resources sectors, the government's support for OFDI in the manufacturing sector has not been crucial in encouraging Chinese manufacturers to go abroad, even though government policy recognises investment to develop global competitiveness and expand markets as key OFDI projects qualifying for financial incentives. The government has supported OFDI projects in the manufacturing sector to the extent that they could promote exports from China, but these export-related OFDI projects have been generally small in size. Rather, outward investments in this sector have been motivated by Chinese manufacturers' survival strategies in an increasingly competitive market environment and/or have been based on their long-term business development strategies.

Since the mid-1990s, excessive competition in the domestic market, with a large number of multinational enterprises entering and investing in China, has caused falling margins and overcapacity in certain mature industries such

as textiles and clothing, bicycles, footwear, and electrical appliances.⁶⁷ In the face of this earnings pressure, Chinese enterprises have been trying to find new markets overseas by establishing not only local sales and distribution centres but also overseas production bases from which they can gain direct access to local markets. These types of OFDI are found in both developed and developing countries. As deregulation in the services sectors makes progress in accordance with China's WTO accession agreements, competitive pressures may push more Chinese enterprises in the services sectors out to explore international markets in the near future.

Chinese manufacturers' investment in certain developing countries is also undertaken with a view to taking advantage of preferential access to the ultimate sales markets in developed countries. Investment in garment factories in Mauritius and Jamaica is targeted at the US market, and investment in cotton manufacturing in Turkey at the EU market, while investment in clothing factories in Fiji is aimed at the Australian market. Due to its immense success in exporting products over the past years, China has been increasingly facing resistance from major export destinations, including various trade barriers such as prohibitory tariffs, import quotas and anti-dumping sanctions. OFDI may be one solution to maintain access to these ultimate sales markets, circumventing regional protectionism as well as mitigating frictions with trade partners. A prominent example is the Haier Group which has established manufacturing facilities and assembly plants in the United States and Europe to avoid quota restrictions and potential anti-dumping sanctions.

Strategic asset-seeking projects

Strategic asset-seeking has been an increasingly demonstrated motive for China's OFDI since the late 1990s. Foreign enterprises which own proprietary technology, globally-recognised brand names and/or established customer networks and sales channels are the target of acquisition by Chinese enterprises. They consider the acquisition as a short-cut to gain these strategic assets without incurring large expenses on research and development, international marketing campaigns and development of an overseas customer base. In an increasingly competitive world, many Chinese enterprises are aware of the need to shift their strategy from one of competing on low cost and aggressive pricing to one of competing on innovation, brand image and services with higher profit margin. For example, Lenovo's decision to purchase IBM's computer unit was clearly influenced by the motive of seeking strategic assets – in this case, a globally-recognised brand name,⁶⁸ and China's largest independent power producer, Huaneng Group, acquired half of the Australian power generation subsidiary of Shell-Bechtel venture, InterGen, with an aim to obtain operational skills in deregulated markets.⁶⁹ Access to

Box 3.5. MNEs seeking new markets – ZTE Corporation¹

Established in 1985, Zhongxing Telecom Equipment (ZTE) corporation is a Shenzhen-based telecom equipment vendor owned by a consortium of state-owned, private and public shareholders. ZTE's product range has expanded over time to include virtually every sector of the wireline, wireless, terminal and service markets. After an intense lobbying effort, the government eventually allowed ZTE to list its shares under the listing quota system² and the company went public in Shenzhen in 1997 and in Hong Kong in 2004.

Competition for telecommunications equipment is fierce since China fully opened up its market, so winning a significant domestic market share is an enormous challenge for a latecomer. Pushed out by this domestic competition from entrenched multinational vendors such as Alcatel, Ericsson, Lucent, Motorola, Nortel, Nokia and Siemens, ZTE found overseas markets, especially in developing countries, a potentially lucrative place to sell its products and provide its services. By successfully exploiting its comparative advantage of the compatibility in telecommunications equipment models between China and other developing countries and its relatively high cost-performance ratio, the enterprise could quickly meet the effective demand of telecommunications equipment in several developing countries and multiply its business model in others.

Starting from export of its expanding variety of products, ZTE made its first foreign investment in 2000. ZTE's OFDI projects include overseas customer service centres, sales representative offices, factories, and several R&D centres, including in the United States, Sweden, France, India, and Pakistan. So far, ZTE has established partnerships with over 500 operators in more than 120 countries around the world; ZTE's overseas assets account for 10% of its total and its overseas staff reach about a quarter of its total staff.

ZTE's market share in Africa is expanding rapidly due to its aggressive strategy in seeking markets in developing countries. Since it won a contract to build a mobile phone network in Algeria for USD 32 million in 2004, ZTE has struck similar deals in Ghana and Lesotho, and recently also in Ethiopia. In 2004, the first Wideband Code-Division Multiple-Access (WCDMA) network was launched in Tunis by ZTE. In Angola, it signed a framework agreement to supply telecommunications equipment worth USD 69 million with the Angolan fixed line telecommunications utility, Mundo Startel. ZTE is also planning to invest USD 400 million in Angola to construct the country's telecommunications network, improve military telecommunications system, construct a mobile phone factory, create a telecommunications training institute and establish a telecommunications research laboratory. ZTE also has won a majority stake (USD 16.1 million) in Sonitel, Niger's state-owned telecommunications company, outbidding France Telecom, and has constructed a telecommunications network in partnership with Zamtel in Zambia.

Box 3.5. MNEs seeking new markets – ZTE Corporation¹ (cont.)

While ZTE has made great inroads into Africa, there are reputational hazards in ZTE's African business that the company might wish to avoid in future. The company donated 144 million Kenyan shillings (USD 2.1 million) in 2005 to Telkom Kenya, and was subsequently awarded a contract to install 26 000 switching lines in Nairobi and Mombasa. Though ZTE denied any corrupt practice in its donation, a gift like this invites suspicion from the international community.

1. The quota system was scrapped in 2001.
2. Based on Leander, T. (2007).

advanced proprietary technology and other strategic assets is also one of the government's expressed goals in encouraging China's OFDI.

To obtain strategic assets available overseas, merger with an acquisition of a foreign enterprise in developed countries such as North America, Europe and Japan is the most popular mode of investment, followed by a strategic joint venture. Establishment of R&D centres in advanced countries is also used by Chinese enterprises which aim to tap into human resources available in these countries. According to the FIAS/IFC/MIGA survey, about half of the sample enterprises stated strategic assets-seeking or global competitiveness strategy as a very important or important factor for determining their outward investment. As Chinese enterprises strive to upgrade their global competitiveness, this type of OFDI is expected to increase in the near future.

Diversification-seeking projects

Diversification-seeking OFDI is mainly pursued by large SOEs which used to enjoy monopoly power in the country's foreign trade in their respective industries. Due to the industrial reforms that have taken place since 1979, these state-owned trading giants have lost their monopoly positions and have been forced to diversify to other business areas if they want to survive. They have benefited from their comparative advantage in international diversification resulting from their past international experience and the established networks which they build up as trading houses. On the other hand, the government's strategy of nurturing national champions has benefited relatively large Chinese enterprises, mostly SOEs, which aimed to expand and diversify their business internationally.

Examples of Chinese enterprises pursuing diversification-seeking OFDI include China National Chemicals Import & Export Corporation (Sinochem) and China Resources Corporation. Both were originally large trading companies under the direct control of the former MOFTEC. In late 1987,

Box 3.6. **MNEs seeking strategic assets – China National BlueStar (Group) Corporation**

China National BlueStar Corporation (BlueStar) is a large SOE with its focus on chemical products and new materials. Starting from a specialised cleaning company in Lanzhou City in 1984, BlueStar has expanded its cleaning business and has developed new technology and equipment in competition with foreign enterprises. Currently, it has total assets of CNY 30 billion including more than 30 subsidiaries and scientific research institutes as well as holding shares of three public listed companies (BlueStar Cleaning, BlueStar New Materials, and Chenyang Chemicals). In 2004, BlueStar became a subsidiary of China National Chemical.

BlueStar has greatly enhanced its technology and management level through overseas mergers and acquisitions. In 2005, it acquired Drakkar, the parent company of a world-leading animal nutritional feed firm based in France, for USD 460 million to extend BlueStar's product line. Later in 2006, it also bought French company Rhodia's organic silicon business including its patents, manufacturing equipment and distribution channels as well as the company's sulphide business. After these M&A deals, BlueStar became the world's second and third largest producer of methionine and organic silicon, respectively, and the largest Chinese investor in France.

In 2007, Blackstone Group purchased a 20% share of BlueStar for USD 600 million. With Blackstone's overseas network, it is aiming to integrate its business in France more effectively and eventually group the assets for an initial public offering in Shanghai or Hong Kong by the end of 2008.

Sinochem, which formerly enjoyed a monopoly in trading petroleum, chemical fertilisers and raw materials for plastics manufacturers, obtained permission from the State Council to start a new business including overseas investment on a trial basis and was subsequently designated the first pilot corporation in China to diversify its business with the objective of becoming a top multinational enterprise. Currently, Sinochem is a highly diversified multinational enterprise, listed in Fortune Global 500, with business encompassing agriculture, energy, chemicals, finance and real estate. A similar experience applies to the case of China Resources Corporation. It started using its Hong Kong, China base to diversify its operations through outward investment in the face of dwindling monopolistic power in trade between China and Hong Kong, China. It currently owns 11 listed and 8 unlisted companies with its core business in the four sectors of manufacturing and distribution of daily-use consumer goods; properties and related industries; infrastructure and public utilities; and pharmaceutical production and distribution.

Efficiency-seeking projects

Even though China still has an ample supply of labour within the country, efficiency-seeking is one of the motives expressed by manufacturing enterprises investing in developing countries. As Chinese industrial structure moves up the value chain and China's exports shift toward more high-tech products, China will shed low-tech and labour-intensive manufacturing to secondary locations in western inland provinces and foreign countries, consistent with a flying-geese model. For example, since the late 1990s, China's investment in ASEAN countries has started to show a strong bias toward low-tech labour-intensive manufacturing and assembly plants. Establishment of joint-ventures or wholly-owned factories in developing countries is especially popular in household electrical appliances,⁷⁰ automobile production,⁷¹ the textile industry⁷² and the agricultural industry.⁷³

Efficiency-seeking outward investment is a common activity of multinational enterprises which are truly global players and are able to take advantage of differences in market characteristics, costs, physical and human resource endowment, and government policies worldwide without national constraints. Large Chinese enterprises aspiring to be among the ranks of truly global investors have started to demonstrate their capacity and willingness to follow the path of other multinational giants by making efficiency-seeking outward investment.

Small and medium-sized enterprises may invest abroad to replicate their production model in other developing countries where China's labour-intensive model of producing low value-added goods fits in well with the endowment pattern as well as the stage of economic development and therefore is relatively easy to transplant. At the same time Chinese enterprises may still have slightly more advanced technology, a better international marketing system and more sophisticated managerial skills than host countries in the developing world. By establishing production facilities in these host countries and integrating them into the global manufacturing chain, China can also benefit from an increased export of capital goods and raw materials to their overseas production facilities. The expected appreciation of Chinese currency and rising labour costs may push more domestic enterprises out to maintain the cost competitiveness of their products in the international market.

Are the motivations to invest overseas influenced by the government?

The governance structure of China's SOEs indicates that their decisions, including overseas investment decisions, might be influenced by the government's intentions rather than by the purely commercial goal of maximising shareholder wealth. Though most Chinese SOEs are now partially

held by the public as a result of reforms aimed at commercialising them, they still have governance and incentive structures different from non-SOEs: the government holds non-tradable shares of the SOEs; their board members and top managers are appointed by the government; their operations are not threatened by bankruptcy and takeover; and they have relatively easy access to government subsidies and below-market rate loans. These features are especially true for the large Chinese SOEs whose assets are administered by the State-Owned Assets Supervision and Administration Commission (SASAC).⁷⁴ As of mid-2007, SASAC controls 155 Chinese SOEs with combined assets of more than USD 1.5 trillion and holds the power of deciding on major issues including human resources, budgets and investment strategies. This has contributed to the perception that decisions to invest abroad may be made by the government to achieve its strategic/political agenda.

In terms of the five categories of China's OFDI mentioned above, the government's intervention and influence have been important for projects with the motivation of seeking natural resources, strategic assets and diversification, but have not been very important for projects with the motivation of seeking markets and efficiency. The former three categories of OFDI may be more influenced by the government's strategic agenda, such as securing energy resources and nurturing national champions with international competitiveness. On the other hand, the latter two categories of OFDI are more likely to be a result of purely commercial calculations based on Chinese enterprises' comparative advantage in the host countries.

Foreign governments, especially from developed countries, are increasingly concerned about China's OFDI motivated by non-commercial reasons. Their concerns include that OFDI seeking strategic assets may conflict with host country national security interests, and that OFDI with non-commercial motivations may lead to loss of productivity and efficiency in the host country economy. These concerns have been fuelled by the common perception that many Chinese SOEs do not comply with internationally-recognised standards of responsible business conduct, including principles of corporate governance.

4. China's direct investment in Africa

China and Africa have decades of relationships which have evolved from being highly influenced by ideological and political considerations to being increasingly driven by commercial motivations. While the evolution of China's economic relationship with Africa is on a parallel with that of China's overall economic relationship with foreign countries, it illustrates the unique characteristics of China's OFDI more clearly than with any other region.

In the 1950s, China provided support to liberation movements in many African countries, and after their independence, benefited from the numerical advantage of African countries in the United Nations General Assembly to push China's political agenda, in particular the restoration of China's representation there and in the Security Council. However, Africa's importance in China's foreign policy declined in the 1980s and 1990s while China turned its focus to internal economic reform and modernisation by attracting foreign capital and technology into the country. Africa was not perceived by China as a source of the capital and technology desired for modernising China's industry.

In recent years, there has been a great revival of China's relationship with Africa. What is new in the contemporary China-Africa relationship is a strong commercial impulse and an economic rationale, supported by China's economic success and growing confidence in participating in the global economy. China has become Africa's second largest trading partner after the United States, surpassing France, with more than USD 50 billion of trade recorded between China and Africa in 2006, up from a mere USD 5.6 billion in 1999 (see Box 3.7). China increasingly considers Africa as not only an important source of energy and other crucial natural resources required for its fast growing economy but also a rapidly expanding market for Chinese products, especially manufactured goods. Africa's renewed importance for China has been also demonstrated by a series of high-profile visits by Chinese officials to African countries making promises to increase its official development assistance (ODA) programmes.

One milestone for the contemporary China-Africa relationship was the first summit of the Forum on China Africa Co-operation (FOCAC) which took place in Beijing in October 2000.⁷⁵ The forum has become an important platform for dialogue on various issues between China and African countries, leading to the formulation of a road map of co-operation in politics, economy, international affairs and social development. It was followed by the second summit of FOCAC in 2003, and most recently in November 2006 by the third summit of FOCAC at which China announced a large economic co-operation and assistance package to Africa. The package included a preferential credit line of USD 5 billion, the establishment of a USD 5 billion China Africa Development Fund to support China's OFDI projects in Africa, a further opening of Chinese markets for African exports, a series of public infrastructure projects, the cancellation of official debts owed by eligible African countries, and the establishment of three to five economic and trade co-operation zones in Africa. These pledges were summarised in the Beijing Action Plan (2007-09) as a road map of China-Africa co-operation in the following three years.

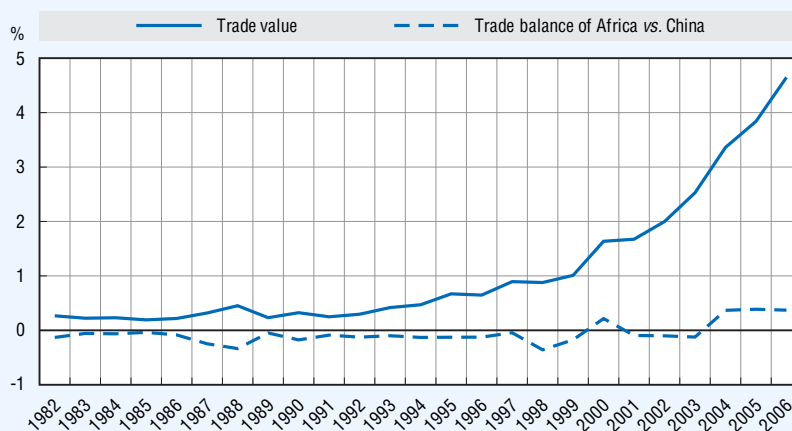
China's recently intensified engagement in Africa culminated in the country's first African Policy Paper issued in January 2006. Based on the principles of "mutual benefits", "common development" and "win-win

Box 3.7. The trade relationship between China and Africa

Trade between China and Africa accelerated during 2000-06 at an average rate of 33% per annum. In 2006, China's exports to Africa reached USD 22.9 billion, rising from USD 4.2 million in 2000. China's exports to Africa mostly consisted of machinery and transport equipment, textiles and apparel, and other manufactured products (which together amounted to 87% of China's total exports to Africa). On the other hand, China imported USD 26.9 billion from Africa in 2006, rising from USD 5.4 billion in 2000. China's imports from Africa are dominated by oil and natural gas (together 62% of China's total imports from Africa),^{*} ores and metals (17%) and agricultural raw materials such as logs and cotton (together 7%). In particular, China's dependence on Africa for its oil imports has been increasing and Africa currently supplies nearly a third of China's oil imports. China's five most important trade partners in Africa are Angola, South Africa, Sudan, Nigeria and Republic of Congo.

Figure 3.3. **Trade value between Africa and China: 1982-2006**

As a ratio to African GDP



Source: IMF.

China's trade value with Africa has increased at a faster pace than China's overall trade with the world: the growth rate of trade between China and Africa in 2000-06, at 33.1% per year, was higher than the 24.8% growth rate recorded for China's total foreign trade. As a result, the share of trade with Africa in China's overall trade increased from 2% in 2000 to 2.8% in 2006. This figure is very close to Africa's share of overall OFDI flows from China in the same year, which amounted to 2.9%.

Box 3.7. The Trade Relationship between China and Africa (cont.)

For China, Africa is still a minor partner, representing less than 3% of its trade value worldwide. However, from Africa's point of view, China is becoming an important trade partner: Africa's share of trade with China in its total trade with the world climbed to 8.6% in 2006 from 3% in 2000 and China overtook France as the second largest partner for Africa by trade value in 2006, following only the United States. China accounted for about 40% of Africa's total exports to Asia and 36% of Africa's total imports from Asia. China has become a dominant trade partner especially for Benin, Republic of Congo, Angola, Equatorial Guinea and Sudan: for all of them, China accounted for more than 25% of their total trade values.

Compared to the advance made in the trade relationship between China and Africa, direct investment flows between the two parties have been more modest. China accounts for only 0.6% of total FDI stock found in Africa as of end-2006 and 1.2% of total FDI flows into Africa during 2003-05. Compared with the OECD member countries, China's FDI contribution to Africa during 2003-05 is ranked the 8th largest (see Table 3.A1.14).

* Three major oil exporters to China are Angola (accounting for 47% of oil exports from Africa to China), Sudan (25%) and Republic of Congo (13%).

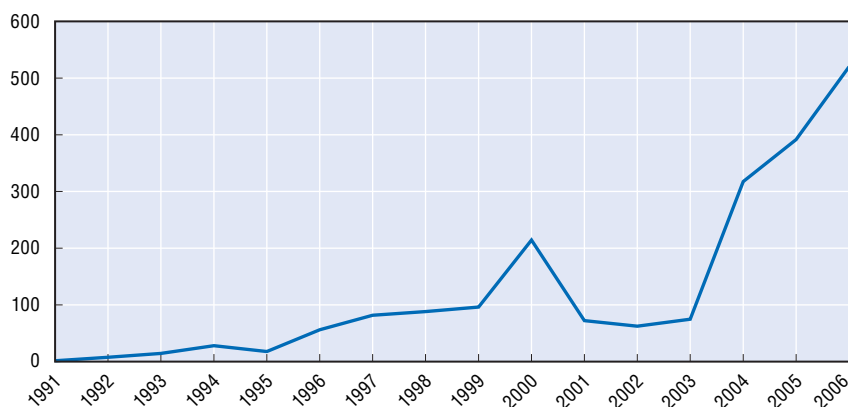
results", the policy paper outlines the government's intentions to promote trade, investment, financial services, agriculture, infrastructure, resources development and tourism in Africa.

China's new engagement with Africa is emerging but China has remained a minor investor in Africa

China's FDI in Africa has rapidly increased since the late 1990s, starting from a very low base. China's OFDI flows into Africa were estimated to be USD 107 million per annum in the latter half of the 1990s, rising from a mere USD 14 million in the former half of the 1990s.⁷⁶ Robust investment flows to Africa continued further in the 2000s, keeping pace with the general trend of China's outward investment volume worldwide. During the period 2003-06, an average of USD 326 million of investment was made annually by Chinese enterprises in Africa. By end-2006, China's OFDI stock in Africa had reached USD 2.6 billion (see Figure 3.4 and Table 3.2).

Though the recently observed rise in China's direct investment in Africa has drawn wide attention, as is also the case for its global position as an investor, China has so far remained a relatively small investor in Africa. China's FDI stock of USD 2.6 billion⁷⁷ in Africa in 2006 accounted for less than 1% of total FDI stock owned by all foreign counties in Africa, and European and

Figure 3.4. **China's OFDI in Africa – flow: 1991-2006**
USD millions



Source: MOFCOM (data for 1991-2002 based on an approval record; and data for 2003-06 based on a balance of payments record)

Table 3.2. **China's OFDI in Africa – flow and stock**

	1991-95 (annual average)	1996-2000 (annual average)	2001-06 (annual average)	2003	2004	2005	2006
Flow (USD million)	14	107	240	75	317	392	520
As a share in total OFDI flows from China (%)	15.10	31.30	5.20	2.60	5.80	3.20	2.90
Stock (USD million)				491	900	1 595	2 557
As a share in total OFDI stock from China (%)				1.50	2.00	2.80	3.40

Source: MOFCOM.

North American countries with traditional ties with Africa have continued to occupy prime positions as foreign investors in Africa. The top investor in Africa remained the United Kingdom with a 16.6% share of total FDI stock in Africa, followed by the United States with a 9.2% share and France with a 7.7% share (see Table 3.A1.14). In terms of flow, China's share in total FDI flows to Africa is slightly larger than its share of FDI stock, at 1.2% over 2003-05, but this is overwhelmed by the large inflows originating from the United Kingdom (42.2%), the United States (9.2%), France (7.6%), Spain (5.6%) and the Netherlands (4.9%). Among Asian investors, however, China exceeded Japan and Korea in both flow and stock of direct investment in Africa; and China has become a leading source of FDI in Africa from developing countries.

Although it is consistent with Chinese investors' general preference for developing countries as OFDI destinations, China's expansion into Africa does not

seem particularly outstanding. Though China's pragmatic approach to economic relationships with Africa, based on the principle of "no interference in internal affairs", has allowed Chinese enterprises to expand business in certain African countries from which enterprises from other industrial countries have had to withdraw due to concerns regarding human rights violations, weak governance and corruption, China's overall investment position in Africa is far from matching those of traditional foreign investors in Africa.

The average size of China's OFDI in Africa is relatively small

One characteristic of China's direct investment in Africa is the relatively small average size of investments made by Chinese enterprises. There are around 750-800 Chinese enterprises actively investing in Africa, of which only about 100 are state-owned and the rest are private enterprises with various business interests ranging from trade, manufacturing, construction, services and communications to agriculture and natural resources development.⁷⁸ Large investment deals which have caught public attention were executed almost without exception by giant SOEs acquiring natural resources assets or developing natural resources extraction/processing projects. On the other hand, numerous small and medium-sized enterprises (SMEs), mostly private, have been investing small amounts in the manufacturing and services sectors.

In case of the construction industry, the long-term presence of large SOEs in the construction business in Africa⁷⁹ has led to a number of spin-off enterprises established by former employees of such large Chinese construction SOEs as China Overseas Engineering Corporation, China Roads and Bridges Corporation and China Railway Construction Corporation. These Chinese entrepreneurs stayed on in Africa even after the construction contracts were over and have typically become independent sub-contractors for their former employers.

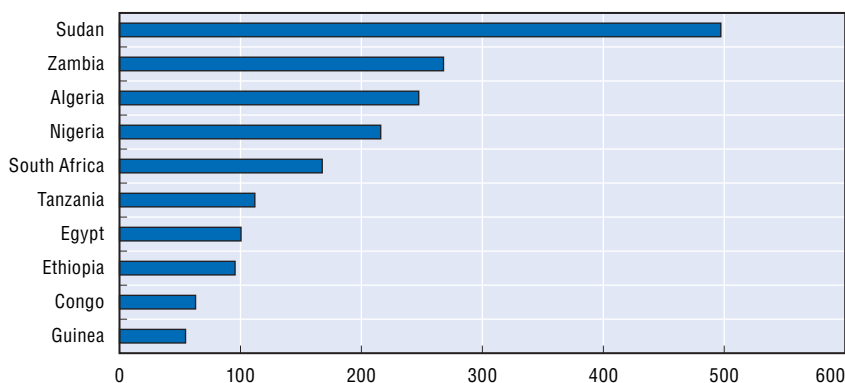
Chinese investment is highly diversified among African countries

The geographical composition of China's direct investment in Africa is highly diversified, reaching 48 countries in the African continent (see Figure 3.5 and Table 3.A1.15). The top five countries with China's largest OFDI stocks, all of them resource-rich countries (Algeria, Nigeria, South Africa, Sudan and Zambia), accounted for 54.6% of China's total OFDI stock in Africa as of end-2006. Sudan is the only country in Africa which has entered the worldwide list of top ten OFDI destinations favoured by Chinese enterprises: in terms of stock, Sudan ranked the 10th largest in the world in 2005 and the 9th largest in 2006.

For several African host countries China's investment has become prominent as a source of FDI: African countries which sourced more than 5%

Figure 3.5. **Top African recipients of China's OFDI stock**

As of end 2006, USD millions



Source: MOFCOM.

of their FDI stocks from China so far are Niger (27.5% of its FDI stock received from China), Madagascar (10.8%), Guinea (8.0%), Zambia (7.1%), Gabon (6.5%), Benin (6.4%) and Mauritius (5.7%).

In terms of investment flows, the list of African countries favoured by Chinese enterprises did not change much during 2003-2006, with Algeria, Nigeria, Sudan, South Africa and Zambia in the top list. These five popular destinations continuously absorbed more than a half (76.2%) of China's OFDI flows into Africa during 2003-2006 (see Table 3.A1.16).

China's OFDI has also flowed into African countries from which other countries have decided to withdraw or abstain from investing due to concerns regarding human rights abuses, corruption and repressive regimes. The Chinese government has, for example, supported some investments in such troubled countries as Angola, Sudan and Zimbabwe. When Angola ended a 27-year civil war in 2002, China offered a USD 2 billion oil-backed credit line for financing the country's reconstruction efforts in March 2004⁸⁰ in spite of the long-criticised mismanagement of oil revenues by the Angolan government. In return for the credit offer, Sinopec succeeded in winning a 50% stake in Offshore Block 18 from Sonangol, the Angolan state oil company. In March 2006, Sinopec and Angolan state-owned Sonangol formed a joint-venture, Sonangol-Sinopec International, to develop a new refinery at Lobito with an estimated investment cost of USD 3 billion.⁸¹

Since the late 1990s China has aggressively cultivated its oil relationship with Sudan while other countries withdrew due to the Darfur crisis and Sudan's poor record of public spending practices.⁸² By end-2006, China had OFDI stock of nearly USD 0.5 billion in Sudan, including CNPC's 45% stake in the Greater Nile Petroleum Operating Company. CNPC also invested in the

country's largest oil refinery in collaboration with the Energy Ministry, and owns many fields in the southern Darfur. In Zimbabwe, China has signed an energy and mining deal worth USD 1.3 billion while other companies have been discouraged by the country's unpalatable human rights record.⁸³

China's OFDI in Africa has not been particularly skewed towards the natural resources sector

In terms of sectoral composition, during 1979-2000⁸⁴ the manufacturing sector received the largest amount of China's investment flows (46.2%), followed by resource extraction (27.6%), services (18.3%) and agriculture (7.0%) (see Table 3.A1.17). Considering that about 50-80 % of FDI goes to natural resource exploitation in most African countries,⁸⁵ China's OFDI in Africa is not particularly biased towards the natural resources extraction sector in international comparison. A large portion of China's investment in the services sector has been in construction due to China's long engagement in investing in infrastructure projects in Africa.

China's FDI flows to Africa have mainly taken the form of equity joint-ventures with local enterprises. Chinese enterprises consider that finding a suitable local firm as a business partner is very important for project success.

Though disaggregated data are not available with which to analyse the more recent sectoral composition of China's OFDI in Africa, a series of large investments made in oil and mineral extraction are likely to have contributed to an increasing share of the resource extraction sector in recent years.

Markets and resources are two main motives for China's OFDI in Africa

The main motives for Chinese enterprises to invest in Africa are market-seeking and resource-seeking. While resource-seeking OFDI is led by a few large SOEs with strong government backing (e.g. CNOOC, CNPC and Sinopec), market-seeking OFDI is driven by not only a few large SOEs but also numerous relatively small-sized private enterprises in such sectors as trading, wholesale and retail, manufacturing and other services.

The expanding demand for energy and other natural resources essential to sustain China's economic growth and the abundance of these resources in Africa have naturally determined the recent evolution of China's economic relationship with Africa. Currently, nearly a third of China's oil imports come from Africa where Angola, Sudan, Republic of Congo, Equatorial Guinea and Nigeria are the top African oil exporters to China. These African countries with strong oil trade links with China are also recipients of many of China's OFDI projects, infrastructure projects carried out by Chinese constructors, and China's ODA programmes. These three contributions from China to Africa are highly interrelated: large OFDI deals in the natural resources sector are often

accompanied by infrastructure projects which are financed through China's ODA programmes. These infrastructure projects are commonly carried out by Chinese contractors as required by the terms of China's concessional loans and grants. Furthermore, ports, electricity plants, roads and railroads constructed by Chinese contractors may provide better transport, logistics and utility services which can be useful for other Chinese enterprises' operations in Africa.

Examples of resource-seeking OFDI projects are listed in Box 3.8. The resources sought after by Chinese enterprises in Africa include: oil in Algeria, Angola, Republic of Congo, Côte d'Ivoire, Equatorial Guinea, Gabon, Kenya, Libya, Namibia, Nigeria and Sudan; copper in Republic of Congo, Zambia and Democratic Republic of Congo; chrome in South Africa and Zimbabwe; iron-ore in Gabon, and fisheries in Ghana and Morocco. Among major Chinese enterprises in the natural resources sector, CNPC has invested the largest amount in the African continent, covering 8 countries with a large stake in Sudan. Sinopec has oil and gas exploration and production business in 6 countries. CNOOC has recently committed USD 2.3 billion to acquire a 45% stake in Nigeria's Akpo oil field⁸⁶ and signed an exploration contract with Equatorial Guinea for an offshore oil block.⁸⁷

There are two broad types of market-seeking OFDI projects in Africa: investment targeted for the market in African countries and investment targeted for the market in third countries, typically developed countries. For the latter type of OFDI projects, investors intend to take advantage of the preferential market access provided by developed countries to African countries through such mechanisms as the African Growth and Opportunity Act (AGOA) offered by the United States, the Everything But Arms initiative offered by the EU, and the Economic Partnership Agreement between the EU and Africa, the Caribbean and the Pacific (ACP) countries.⁸⁸ It is believed that these trade agreements have contributed to the establishment of apparel factories in Lesotho, Mauritius, Rwanda and Swaziland and investments in the light manufacturing and agribusiness sector in Tanzania. Investment to seek markets in third countries is bound to be very sensitive to the terms of the trade agreements; and the expiration of the Multifibre Arrangement (MFA) in January 2005 caused many investors in apparel factories to leave Africa.

African local markets are still small but have been actively explored by Chinese enterprises operating in the manufacturing and services sectors. In the services sector, the construction industry has been prominent. China's construction business in Africa has a long history including the construction of the Tanzam Railway in Zambia in the 1960s-1970s, and has been very successful in winning construction contracts in Africa.⁸⁹ Chinese construction companies have a comparative advantage over those from developed countries since they have access to relatively cheap financial sources provided by Chinese state-owned banks as well as a relatively cheap labour force⁹⁰ and

Box 3.8. China's Resource-seeking OFDI projects in Africa

Algeria (China's FDI stock around USD 247 million as of end-2006 – rank 3 in Africa)	Sinopec	Oil	It signed a contract for USD 525 million to develop the Zarzaitine oil field in 2002; and holds exploration licences for several blocks in the Amguid Massaoud Basin and in the Oued Mya Basin.
	CNPC	Oil	It acquired oil refineries for USD 350 million in 2003; and holds several exploration licences for blocks in the Oued Mya Basin, Adra/Sbaa Basin and Cheliff Basin.
	PetroChina	Oil	It signed a contract with Hydrogen Carbide (Algeria) to develop oilfields and construct a refinery in 2003.
Angola (China's FDI stock around USD 37 million as of end-2006 – rank 17 in Africa)	Sinopec	Oil	It secured a 40% stake in Block 18 for more than USD 1.4 billion in 2006 after Exim Bank offered a USD 2 billion oil-backed loan to Angola between 2005 and 2006 and entered into a joint-venture agreement with Sonangol to build an oil refinery in Lobito.
Côte d'Ivoire (China's FDI stock around USD 25 million as of end-2006 – rank 24 in Africa)	Sinopec	Oil	It signed two offshore agreements for the Marine XII and high Sea C blocks in 2005 with the government and acquired a 27% stake in the joint-venture with ONGC and Oil India to explore a deep water oil field off the coast in 2004.
Democratic Republic of the Congo (China's FDI stock around USD 38 million as of end-2006 – rank 16 in Africa)	Wambao Resources	Cobalt and Copper	Through its joint venture with the Congolese company Comide, it opened a plant to produce cobalt-copper alloys in Likasi in 2005.
Equatorial Guinea (China's FDI stock around USD 30 million as of end-2006 – rank 19 in Africa)	CNOOC	Oil	It signed a production sharing contract for an offshore oil field with GEPetrol in 2006.
Gabon (China's FDI stock around USD 51 million as of end-2006 – rank 12 in Africa)	Sinopec	Oil	It signed a technical evaluation deal for three onshore oilfields in 2004 for a possible production sharing contract.
Kenya (China's FDI stock around USD 46 million as of end-2006 – rank 14 in Africa)	CNOOC	Oil	It signed an offshore oil exploration deal in six blocks in 2006.
Libya (China's FDI stock around USD 29 million as of end-2006 – rank 21 in Africa)	CNPC	Oil	It won a 45% production share in Block 2 in 2005; and holds an exploration licence in Block 17-4.
Nigeria (China's FDI stock around USD 216 million as of end-2006 – rank 4 in Africa)	CNOOC	Oil	It bought a 45% stake in the Akpo field from South Atlantic in 2006 for USD 2.3 billion in 2006. It was given preferential access for up to 7 oil blocks in exchange for a USD 2.5 billion loan package in 2007.

Box 3.8. China's Resource-seeking OFDI projects in Africa (cont.)

South Africa (China's FDI stock around USD 168 million as of end-2006 – rank 5 in Africa)	Zijin Mining Group Company	Gold	It bought a 20% state in Ridge Mining for ZAF 120 million which is developing ZAF 1 billion Blue Ridge mine and larger Sheba's Ridge.
	Sinosteel	Chrome	It has a joint-venture to operate a chrome ore mine and a smelting plant with Limpopo Province Development Corp.
Sudan (China's FDI stock around USD 497 million as of end-2006 – rank 1 in Africa)	CNPC	Oil	It acquired a 40% stake in the Greater Nile Petroleum Operating Company in 1996; and owns most of a field in southern Darfur and a 41% of a field in the Melut Basin.
Zambia (China's FDI stock around USD 268 million as of end-2006 – rank 2 in Africa)	China Nonferrous Metals Industry	Copper	It established Foreign Engineering & Construction Company in 1998 to develop Chambishi Copper Mine and owns a majority stake in Chambishi copper operation. It plans to expand the Chambishi mine and build a new smelter with the Yunnan Copper Group to ship copper blister back to China with total investment of USD 500 million.

Source: Various articles from *Financial Times*, *International Herald Tribune*, *International Petroleum Finance*, *People's Daily* and *Xinhua*.

cheap equipment available from China. Furthermore, the African market for Chinese construction services is effectively created by the Chinese government itself, which imposes the condition that the bulk of China's concessional loans and grants be used to procure goods and services from Chinese suppliers/contractors. These advantages allowed Chinese enterprises to overcome the high risks commonly perceived by foreign investors for infrastructure development projects in Africa.

China's ODA has been aligned with its OFDI policy

China has had an African aid programme since the mid-1950s. Its programme consists of grants, zero-interest loans and concessional loans often carrying a flexible repayment schedule. In addition, China provides technical assistance, scholarships, medical missions and labour co-operation programmes. Between 1960 and 1989, China provided an estimated cumulative sum of USD 4.7 billion to Africa, accounting for nearly a half of China's total aid flows worldwide⁹¹ for this period. By May 2006, China's contribution to assistance in Africa had reached USD 5.7 billion (CNY 44.4 billion) since the beginning of its African aid programme.⁹² With approximately 800 aid projects, China has established its aid programmes in nearly every country in Africa.⁹³

Given the accumulated sum of China's OFDI in Africa at USD 2.6 billion by end-2006, the official aid flows have clearly constituted a large share of bilateral capital flows from China to Africa. Though the actual figures for China's ODA are hard to pin down due to lack of transparency in data collection and publication,⁹⁴ China's annual ODA has been accelerating in parallel with other economic relationships with Africa and is likely to have surpassed USD 1 billion per annum.⁹⁵ The size of China's official aid flows to Africa is more than twice as large as that of China's FDI flows to Africa. At the third summit of FOCAC in November 2006, China further promised to double the size of aid to Africa in 2006 by 2009.

In addition to the official aid programme, China has been providing debt relief to many African countries. Since 2000, China has cancelled more than USD 1.3 billion (CNY 10.5 billion) of official debts owed by African countries. Furthermore, China is currently committed to a debt cancellation programme worth another USD 1.3 billion (CNY 10.5 billion) for 31 African countries as pledged at the third summit of FOCAC.⁹⁶ In spite of this increase in China's ODA flows to Africa, the size has been modest in comparison with the OECD member countries (see Table 3.A1.18).

China's aid programme has been always used as an instrument to achieve political, strategic and economic goals. In contrast to the early years of channelling aid for the purpose of gaining international support for China's political agenda,⁹⁷ China's contemporary aid policy has been increasingly guided by an economic and commercial rationale. Recent aid packages have been effectively targeted to complement other, more dynamic, economic relationships between China and Africa. In particular, trade and access to energy and mineral resources have become central interests. The distribution pattern of China's aid among African countries may provide a good indication of the importance of countries as perceived by China (see Table 3.A1.19).⁹⁸

As the "going out" of Chinese enterprises has become an official goal of the government, China's OFDI in Africa has been actively facilitated by the government aid programmes: for example, construction projects to build politically important public buildings and basic infrastructure are offered under the aid programme arguably in the expectation of winning political support for large natural resources-related FDI deals between African governments and Chinese SOEs; and many of these construction projects financed through the aid programmes have been carried out by Chinese contractors, encouraging them to establish a long-term base in Africa in the form of branches, subsidiaries and/or joint-ventures (see Box 3.6).

However, China's pragmatic approach to ODA has been often criticised by other donor countries. They often argue that China's ODA approach, especially its principle of "no interference in internal affairs", undermines harmonised

efforts of the international community to eliminate human rights abuses and corruption, to promote democratic governments and to keep debt levels sustainable in Africa.⁹⁹

Financial support to Chinese investors in Africa powerfully encouraged China's OFDI there

In addition to the government financial support to African countries through ODA programmes mentioned above, direct financial support to Chinese investors has been especially important for China's OFDI in Africa. Many of the surveyed Chinese enterprises¹⁰⁰ which were already investing in Africa stated that government support was a key factor in making investment in Africa, much more important than for investment in any other region. Chinese enterprises, as consistent with the global view, perceive Africa as the riskiest region to invest in, and hence require a relatively low cost of capital to overcome the high risks associated with investment projects there.

Direct financial support is available in the form of preferential access to below-market-rate loans from state-owned policy banks and commercial banks for Chinese enterprises which work in the priority sectors identified by government policy. The natural resources sector is a prominent example: investment projects in the natural resources sector typically require large and long-term financial commitments and are characterised by enormous uncertainty in profitability; and the government actively promotes OFDI projects in the natural resources sector as high priority projects by providing the needed financial support. In the government's African Policy Paper (2006), China promised its continued practice of providing preferential loans and buyer credits to support Chinese enterprises' investment in Africa.

Among Chinese banks, China Export and Import Bank (Exim Bank) and China Development Bank (CDB) are the two state-owned policy banks actively financing Chinese enterprises in Africa, as elsewhere.

Exim Bank is the world's third largest export credit agency with annual disbursements of USD 17 billion (CNY 132 billion),¹⁰¹ and had reached CNY 100 billion for the total value of loans signed with an outstanding loan portfolio of CNY 50 billion¹⁰² for African projects as of June 2007, accounting for 20% of the bank's total business volume.¹⁰³ The majority of projects financed by Exim Bank are directed to infrastructure development including dams, hydropower, thermal power plants, oil facilities, copper mines, and railways.¹⁰⁴ Exim Bank is also assigned the responsibility of implementing a USD 5 billion preferential credit programme to Africa which was pledged at the third FOCAC in Beijing for 2007-09. On top of this commitment, it was reported that the bank plans to make available about USD 20 billion in infrastructure and trade financing to Africa in 2008-10.¹⁰⁵

Box 3.9. Case study: A Chinese construction SOE in Africa: COMPLANT

China Complete Plant Import and Export Corporation (COMPLANT) was established as the body responsible for organising and managing all China's aid projects as a government agent, and at the same time operated as a general construction contractor overseas. In 1993, COMPLANT was reorganised into a comprehensive foreign trade conglomerate with an independent financial accounting system, and since then it has undergone a series of reforms to modernise its management and governance structures. Currently under the supervision of State-Owned Assets Supervision and Administration Commission (SASAC), it not only continues to be engaged in China's aid projects and general overseas construction projects, but also invests and leases business at home and abroad, and imports and exports technology and complete plants. Its subsidiary company, Complant Import and Export Company Ltd., established in 1999, is listed on the Shenzhen Stock Exchange.

COMPLANT is a symbolic example of how China's investment is interrelated with government aid programmes and trading activities. While it started as a government agent to execute all ODA projects, through reform efforts to restructure SOEs COMPLANT has become increasingly involved in other investment projects and trading business on a profit-making basis. Historically, it has executed a number of construction projects in developing countries, especially in Africa, which were financed under China's ODA programmes. Most prominently, it participated in the massive Tanzania-Zambia Railway construction during 1967-76 with other Chinese construction companies. Other projects in Africa executed by COMPLANT include the Cairo International Conference Centre in Egypt, the Palace of the Congress and the Lagdo Hydropower Station in Cameroon, the Palace of the People in Guinea, the Theatre in Côte d'Ivoire, the Airport Hotel in Algeria, the Islamic Cultural Centre in Mali, the Nouakshott Friendship Port in Mauritania, the Fanole Water Conservancy Plant in Somalia, the Mbarali Farm in Tanzania, the Bangui Stadium in Central Africa, the National Stadium in Zimbabwe, and the Cotonou Sports Complex in Benin. On the other hand, it has also invested in sugar plant joint-ventures and subsidiary companies in Madagascar, Togo, Sierra Leone and Benin.

As a result of its long engagement in Africa, COMPLANT has the largest number of overseas branches in Africa than any other regions with 11 branches in Sierra Leone, Benin, Madagascar, Togo, Guinea, Zambia, Eritrea, Côte d'Ivoire, Mauritania, Ethiopia, and Morocco.

CDB is responsible for managing the China Africa Development Fund (CADFund)¹⁰⁶ worth USD 5 billion which was also announced at the third FOCAC in 2006. In June 2007, the CADFund started its business with first-phase funding provided by CDB. It aims to promote economic co-operation between China and Africa and advance Africa's economic development by investing directly in Chinese enterprises which have already set up operations in Africa or plan to invest in Africa. Its focus is in: agriculture and manufacturing industries; infrastructure, such as power, transport, telecommunications and urban water supply and drainage; natural resources; and industrial parks set up by Chinese enterprises in Africa. In addition to managing the fund specifically targeted to China's outward investment projects in Africa, CDB has been actively supporting individual firms' expansion plans in Africa.¹⁰⁷

Despite the large size of financing operations in Africa, the majority of the financing from Exim Bank to African projects does not translate into direct investment flows from China to Africa on a one-to-one basis. Exim Bank not only provides commercial loans to projects in Africa via its main financing facilities (i.e. export seller's credits and export buyer's credits) but also channels concessional loans under China's ODA programmes. Only a small part of the export seller's credit lent to Chinese enterprises or joint-ventures for their overseas investment projects¹⁰⁸ may be directly linked to China's OFDI and the rest of credits may be categorised under other financial flows including portfolio investment and transactions in private financial claims. Although the direct contribution to China's OFDI may not be as large as the bank's financing portfolio in Africa seems to indicate, the bank's vast engagement in Africa has clearly had an externality effect on China's expanding OFDI flows to the African continent. By financing Chinese enterprises' various operations, the Exim Bank has contributed to the development of an environment more conducive to China's OFDI.

A large contribution to the African economy can be expected from Chinese investments...

China's contribution to the African economy is potentially very large. In addition to the commonly agreed benefits of FDI including employment creation, capital deepening, technology transfer, trade promotion, and efficiency improvement, China's specific contribution may include the following:

- China's strong comparative advantage in infrastructure projects in Africa has been providing basic services such as water supply, transport, communications and power supply at relatively low cost. All these services are fundamental for African countries' economic growth and poverty reduction.

- China's technology tends to be more labour-intensive than that of developed countries, and hence may be easier and more suitable to transfer to African countries, given the current development stages of China and Africa. More generally, Africa can learn important lessons from China's experiences in opening and modernising the economy. For example, China can provide an opportunity for Africa to participate in the global value chain, especially in the textile and apparel sector.
- China's investment in Africa has strong complementarities with trade between the two regions. China's expanding share in total exports from Africa is driven by China's resource-seeking investment in Africa, reflecting the increasing demand for resources within China. Similarly, China's growing share in Africa's total imports is linked to China's market-seeking investment in Africa, especially in the manufacturing sector which requires raw materials, intermediate inputs and capital goods from China.

... but challenges lie ahead for Chinese enterprises investing in Africa

In the context of China's growing role as an investor in Africa, concerns over China's investment behaviour are being raised and large Chinese enterprises operating in Africa are under increasing pressure to be more responsible global players. Though similar concerns have been heard for China's outward investment in other regions, China's investment in Africa has invited the most intense debate on China's business conduct in the light of Africa's weak governance capacity.

Criticisms raised against China's investment in Africa include: unfair subsidy provided by Chinese government to Chinese enterprises; poor implementation of social and environmental safeguards in China's investment projects; and lack of harmonisation with international efforts to tackle human rights abuses, corruption, and repressive regimes. They are compounded by the involvement of large SOEs which are perceived to be close to the Chinese government; the lack of transparency and accountability mechanisms; and Chinese investors' seeming ignorance of codes and principles set in international instruments such as the *OECD Guidelines for Multinational Enterprises*, the Extractive Industries Transparency Initiative and the UN Global Compact. While some of these criticisms are legitimate, they cannot be generalised. Characteristics and impacts of China's investment projects in Africa vary from case to case. However, Chinese enterprises will be increasingly confronted with the demands and needs to adhere to international standards of business conduct in their overseas investment activities as they strive to "go out".

Discussions on future prospects for China's OFDI

The emergence of China as an outward investor has caused a mixture of enthusiasm and concern among both host countries and other FDI source countries. While host-country governments in the developing world generally welcome the availability of an alternative source of long-term capital from China, various questions have been raised regarding the impact of China's OFDI. The questions worth further discussions include:

- How can we best ensure Chinese enterprises' adherence to the internationally-recognised standards of business conduct in their overseas investment projects? How can the importance of implementing these standards be understood by Chinese enterprises investing abroad?
- What can be done to maintain a level playing field for international investments vis-à-vis various supports and subsidies provided by the government to enterprises investing overseas?
- Is there any evidence that would make China's OFDI more threatening to the home country's national security than OFDI from other countries? If so, what is required to eliminate the excessive threat perceived for China's OFDI projects?
- How can we best co-operate to agree on and fulfil governments' responsibilities for enterprises' operations in the countries beset with political instability, weak governance, corruption and human rights abuses?

Notes

1. Inclusive of China's OFDI stock in the financial sector. MOFCOM started collecting OFDI figures in the financial sector only from 2006.
2. This is the average figure over the period from 1982 to 1989, based on the OFDI statistics published by UNCTAD.
3. MOFCOM (2004), *Regulations on Matters Subject to Approval for Establishing Invested Enterprises*, and *Regulations on Matters Subject to Approval for Establishing Invested Enterprises in Hong Kong and Macao*.
4. This figure does not include OFDI in the financial sector comparable with OFDI figures published in earlier years as MOFCOM started inclusion and publication of OFDI in the financial sector only in 2006. Including OFDI in the financial sector, the total OFDI from China amounted to USD 21.16 billion in 2006, making China the 3rd largest in outward flows among developing and transitional countries, ahead of Russia.
5. This figure does not include OFDI in the financial sector compatible with OFDI figures published in earlier years as MOFCOM started inclusion and publication of OFDI in the financial sector only in 2006. If OFDI in the financial sector is included, China's OFDI stock in 2006 is USD 90.6 billion.
6. UNCTAD (2007), *World Investment Report 2007*, Annex B. The ratio for China is OECD Investment Division's estimate based on the OFDI figure from MOFCOM.

7. World Bank (2002), Global Development Finance 2002.
8. Qian, X (2007).
9. Buckley, P., L. Clegg, A. Cross, X. Liu, H. Voss and P. Zheng (2007).
10. Lunding, A. (2006). The figure from January 1999 to January 2005.
11. Among the existing OFDI projects, M&A was only ranked 5th as a chosen mode of investments after establishment of own sales office, setting up of equity joint ventures with local firms, opening of own retail stores and distribution networks, and setting up of wholly-owned new manufacturing facility. However, for the future OFDI projects, M&A is ranked 3rd after establishment of own sales office and setting up of equity joint ventures with local firms.
12. China Minsheng Bank is buying a 20% stake in UCBH, a small local US bank; China Merchants Bank has obtained approval from Federal Reserve Bank to set up a branch in New York City.
13. *Financial Times*, 9 October 2007.
14. In 2007, the Industrial and Commercial Bank of China (ICBC) acquired a stake of about 20% in Standard Bank, the largest bank in Africa by assets, for USD 5.5 billion. It will be the largest banking deal in South Africa since Barclays bought Absa Group, the country's largest retail bank, in 2005.
15. Cheng, L. and Z. Ma (2007).
16. This figure may be over-estimated since the OFDI statistics tend to capture activities by non-SOEs less comprehensively than those by SOEs.
17. The remaining share is divided among other forms of enterprises including privately-owned enterprises (13%), limited-stock enterprises (12%), foreign-invested enterprises (5%), joint-stock enterprises (4%), collectively-owned enterprises (2%), Hong Kong, Macao and Chinese Taipei-invested enterprises (2%) and jointly-operated enterprises (1%).
18. Asia Pacific Foundation of Canada (2006).
19. To encourage China's outward portfolio investment outflows, the Qualified Domestic Institutional Investor (QDII) scheme was initiated in April 2006.
20. MOFERT was formed from the merging of 4 government departments in 1982, re-named the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) in 1993, and was most recently reorganised into the Ministry of Commerce (MOFCOM) in 2003.
21. Now part of the National Development and Reform Commission (NDRC).
22. Hong, E. and L. Sun (2006).
23. The China State Construction Engineering Co. Ltd., the China Civil Engineering and Construction Corporation, the China Road and Bridge Engineering Co. Ltd., and the China Complete Set Equipment Import and Export Co. Ltd.
24. Hong, E. and L. Sun (2006).
25. Between 1991 and 1997, the State Council assembled a national team of 120 state-owned industry groups selected from "strategic" sectors such as power generation, mining, automobiles, electronics, iron and steel, machinery, chemicals, construction, transport, aerospace, and pharmaceuticals. The government expected them to spearhead the internationalisation of Chinese enterprises and assisted them with preferential access to financing, high levels of

protection and special rights in management autonomy, profit retention and investment decisions. Some large SOEs even enjoyed the government's support in recruiting top executives and corporate matchmaking.

26. Zhu Rongji (2001).
27. Bajpae, C (2005). However, little progress has been made on the USD 100 billion pledge so far.
28. The main documents issued by the government on reform of OFDI administration are: *Interim Measures for the Administration of Examination and Approval of the Overseas Investment Projects* by the NDRC and *Provisions on the Examination and Approval of Investment to Run Enterprises Abroad* by MOFCOM (2004).
29. Cities directly under the central government, i.e. Beijing, Chongqing, Shanghai, Tianjin, and the 10 provinces of Fujian, Guangdong, Guangxi, Hainan, Heilongjiang, Hubei, Jiangsu, Shandong, Sichuan and Zhejiang.
30. Xiaohong, C., M. Jung and Y. Dongming (2007).
31. The original ceiling of foreign exchange for the projects which can be delegated to the local branches was USD 1 million, later raised to USD 3 million in 2002 and to USD 10 million in 2005.
32. This quota had been gradually raised from the original level of USD 1 billion, to USD 3.3 billion in 2004 and further to USD 5 billion in 2005.
33. The plan was released in the *Notice of the NDRC and the Export Import Bank of China on Giving Credit Support to the Key Overseas Investment Projects Encouraged by the State* on 27 October 2004. The loans will be available from the Export Import Bank of China under the overall direction of the NDRC.
34. *Circular of the General Office of MOFCOM on Setting Up an Information Bank of Overseas Investment Intention of Enterprises* issued on 28 November 2003.
35. A *Reporting System for Obstacles of Outward Foreign Direct Investment and Operations* was announced in November 2004 by MOFCOM.
36. The list was supplemented in May 2005 to add a catalogue list for 28 more countries. Furthermore, MOFCOM promulgated *Guiding Catalogue on Investment in Processing Trade of Textiles and Clothing for Latin America and Asia* in 2005.
37. This section on policy development for China's OFDI at SAFE has significantly benefitted from Stender, N., X. Yin, N. Sheets and L. Cui (2006).
38. Certain projects are submitted to the NDRC rather than MOFCOM for approval. However, it is not clear if SAFE's opinion on the source of the fund to be used in overseas investment has to be submitted to the NDRC as it is not mentioned in the requirements listed by the NDRC.
39. The number of pilot branches was increased from 6 in 2002 to 14 in 2003 and then to 24 in 2004. Nationwide application was finally realised in 2005.
40. Bidding deposits were included in a list of permissible preliminary expenditures in the 2006 Circular.
41. For preliminary and final approval to obtain and remit foreign exchange for early stage expenses for OFDI projects, Chinese enterprises must submit the following documents to SAFE: an application form; business licence; documents related to biddings, mergers or joint ventures; a written letter of commitment ensuring the use of foreign exchange in connection with the approved projects; foreign bank account information; and other relevant materials as requested by SAFE.

42. SAFE has also dropped the system of regional foreign exchange quotas that limited annual OFDI flows from any one administrative unit of China to USD 200 million.
43. NDRC website: www.en.ndrc.gov.cn. The NDRC has succeeded in developing new functions as its old powers of mandatory planning of output have been removed with the move to a more market-oriented economy. Some central planning habits persist nonetheless.
44. NDRC (2004), *The Interim Measures for the Administration of Examination and Approval of the Overseas Investment Projects*.
45. To apply for approval, a Chinese enterprise must submit: an application form, the company charter, contracts/agreements with the overseas enterprises, certificate of the source of foreign exchange issued by SAFE, assessment of project feasibility by the Chinese embassy in the respective host country, a certificate of domestic operation and other certificates and documents required by law and regulations.
46. MOFCOM (2004), *Regulations on Matters Subject to Approval for Establishing Invested Enterprises*, and *Regulations on Matters Subject to Approval for Establishing Invested Enterprises in Hong Kong and Macao*.
47. Mulcahy, N. (2007).
48. Yao, Y. and Y. He (2005).
49. In December 2004, Huawei and CDB signed a development financing agreement with a credit facility of USD 10 billion to help finance Huawei's international expansion in the following five years (Huawei, 2004, *Annual Report*).
50. Lernon, S. (2004).
51. CNOOC's receipt of a USD 7 billion intercompany loan from ICBC consisted of a noninterest USD 2.5 billion loan and a USD 3.5 billion soft loan with a 3.5 per cent interest and 30 year maturity. The bid was eventually withdrawn by CNOOC.
52. Lunding, A. (2006).
53. The minimum size of the projects is normally CNY 20 million or USD 2.4 million and at least 50% of the project cost must be used to purchase Chinese goods or services.
54. *Circular on the Supportive Credit Policy on Key Overseas Investment Key Overseas Investment Project Encouraged by the State*, issued by the NDRC and Exim Bank in October 2004.
55. *Notice on Printing and Distributing the Measures for the Administration of Special Funds for Foreign Economic and Technical Co-operation* (2005) by the MOF and MOFCOM.
56. Government aid funds (both grants and loans) are administered by Exim Bank which requires at least 50% of funds to be disbursed to Chinese enterprises.
57. Of this, 88 BITs have been in force by the mid-2007.
58. China is currently ranked the second most common BIT signatory country in the world after Germany.
59. UN (2007), *Asian Foreign Direct Investment in Africa: Towards a New Era of Co-operation among Developing Countries*.
60. Australia and New Zealand; East Asia; and North America were the three top regions for which lack of knowledge of local laws and regulations was chosen as a political risk in the survey.

61. Yao, Y. and Y. He (2005).
62. China imported about 43% of its total oil consumption in 2006 and the dependency ratio may rise to 60% and 76% by 2010 and 2020 respectively, according to International Energy Agency.
63. In North America, China purchased a sawmill (Sundance Forest Industries Ltd. by CITIC) and an oil extraction project; in Australia, China acquired the Channar Mine (by China National Metals and Minerals Import & Export Corporation for USD 180 million) and the Portland Aluminum Smelter Company (by China International Trust and Investment Corporation (CITIC) for USD 140 million).
64. The two countries won a joint bid in 2004 to buy PetroCanada's 37% stake in Syrian oilfields for USD 573 million, and jointly invested USD 850 million in 2006 to buy half of Omimex de Colombia Ltd. which has oil and gas assets in South America.
65. Asia Pacific Foundation of Canada (2005 and 2006).
66. Asia Pacific Foundation of Canada (2006) also confirmed that existing OFDI by the majority of Chinese investors is targeted to seeking foreign markets, including through manufacturing and sales in the invested foreign markets and through re-exports from the invested countries to other foreign markets.
67. One analysis estimates that the overcapacity within China's home-appliance may run at over 30% for washing machines, 40% for refrigerators, 45% for microwave ovens, and 87% for televisions. The automobile industry had an estimated overcapacity of 3 million units in 2004, driving prices down and squeezing profits for the entire industry, especially for low-end models.
68. The acquisition, costing USD 1.7 billion, allowed Lenovo to use the IBM brand for five years and to have access to IBM's marketing and corporate sale support.
69. Huaneng's first-ever foreign acquisition, costing USD 246 million.
70. Examples include the Hisense, Changhong, Skyworth, Haier and TCL groups, which have established overseas production bases and joint-ventures in countries such as Mexico, Hungary, the Czech Republic, and Poland.
71. Examples include three domestic companies (Dongfeng Motor Corporation, Chery Automobile and Guangzhou Panyu Huanan Motors Group) investing in an automobile production base in Ghana, Chang An Automobile Group establishing a factory in Vietnam, Lifan Company establishing a joint-venture in Vietnam and factories in Cambodia, Malaysia, Thailand and Pakistan.
72. Examples include Wuxi Huanyuan Garment Co. Ltd., operating a textile processing factory in Vietnam with outputs targeted at European and American markets and Ningbo Shenzhou Knitting Co. Ltd., investing in a garment factory in Cambodia from which it directly exports clothing to the United States.
73. Examples include New Hope Group establishing three factories in Vietnam and the Philippines in 2001 and Liaoning Hefeng Stock Raising Co. Ltd., establishing a forage manufacture in North Korea and another in Nepal.
74. SASAC was established in 2003 to supervise the SOEs that had previously belonged to various ministries and reports directly to the State Council. Its website is www.sasac.gov.cn.
75. China pledged an assistance package including debt relief of CNY 10 billion owed by African countries, establishment of a special fund to encourage and support China's OFDI in Africa, and setting-up of an African Human Resources Development Fund to train more professionals from Africa.

76. The data before 2003 are based on MOFCOM's approval record of OFDI projects in Africa and are not consistent with the international standards of measuring OFDI flows, while the data since 2003 are collected according to international standards. Hence, the figures before 2003 and those after 2003 are not, strictly speaking, comparable.
77. However, this figure may be an underestimate. One analysis estimates aggregated investments made by three major Chinese oil SOEs around USD 8 billion accumulated over 1995-2006. (Paik, K., V. Marcel, G. Lahn, J. Mitchell, and E. Adylov, 2007).
78. Xinhua, 2 February 2007.
79. Chen, C., P. Chiu, R. Orr and A. Goldstein (2007).
80. The terms of the loan stipulate that 70% of construction projects are assigned to Chinese enterprises and that China can import 10 000 barrels per day of oil from Angola.
81. Aguilar, R. and A. Goldstein (2007).
82. However, China's NDRC took Sudan off the list of resource-rich countries that were eligible for concessional loans from EXIM Bank in March 2007, showing its policy alignment with the international community towards Sudan (Ellis, L., 2007).
83. Chan-Fishel, M. and R. Lawson (2007).
84. These are the most recent data available from MOFCOM which are based on its approval record.
85. Goldstein, A., N. Pinaud, H. Reisen and X. Chen (2006).
86. The Akpo field was discovered in 2000 and is operated by Total. CNOOC bought a stake from South Atlantic Petroleum, Ltd. Other partners in the field are Nigerian National Petroleum Corporation and Petrobras.
87. ECOWAS-SWAC/OECD (2006).
88. Kaplinsky, R. and M. Morris (2007).
89. For example, Chinese contractors won a third of all public works contracts funded by the African Development Bank in 2006.
90. According to Xinhua, at least 750 000 Chinese were working or living for the extended period in Africa (*New York Times*, 18 August 2008).
91. Brautigam (2007), based on the *Handbook of Economic Statistics* (1990) published by the Central Intelligence Agency. The total cumulative sum of China's aid worldwide is estimated to be USD 9 655 million for the same period.
92. Wengping, H. (2006) and Hongming, Z. (2006).
93. Brautigam, D. (2007).
94. China does not regularly publish development assistance figures by recipient and it is not clear if China uses the same definition of ODA as the *OECD/DAC Guidelines*.
95. Taylor (1989) estimated the average aid flows to be around USD 310 million per annum for 1989-1992 and USD 290 million per annum for 1980-1987. Brautigam (2007) estimates that China's aid budget for Africa is approximately USD 263 and USD 616 million in 2006 and 2007, respectively; but notes that the budget does not include the face value for China's concession loans and only include the interest subsidy offered by the government to concessional loans. By adding the concessional loans from ExIm Bank, Brautigam (2007) put an estimate of China's ODA in 2007 at USD 1.6 billion. On the other hand, Wang (2007) estimated that, based on the data on contracted projects financed under the aid programmes, China's ODA to Sub-Saharan Africa could be around USD 1.0-1.5 billion per annum for 2004-2005.

96. It includes 168 interest-free official loans that had matured by the end of 2005 owed by 33 African countries.
97. Up to 1971, China had wrestled to win diplomatic recognition with the objective of securing the seat held by Chinese Taipei in the UN Security Council.
98. In Table 3.A1.19, total turnovers of economic co-operation between China and 10 African countries for 2005 are shown. This figure is inclusive of China's ODA programmes as well as other contracted projects undertaken by Chinese contractors in each African country. Hence, the figure is likely to be correlated with China's ODA in each country, but is an over-estimate.
99. Reisen, H. and S. Ndoye (2008), however, argue that China actually helps growth and debt sustainability in Africa through debt relief, infrastructure investment and higher exports.
100. Yao, Y. and Y. He (2005).
101. 2006 *Annual Report of ExIm Bank*.
102. Only a portion of these are lent on concessional terms, and the rest lent on commercial terms. ExIm Bank reports that as of end-2005 its concessional loans to Africa consists of 55 projects with accumulated loans of USD 800 million. (Wang, J., 2007).
103. China Exim Bank (2007), news release, 24 July 2007.
104. According to Ellis (2007), as of September 2006 there were 259 ExIm Bank projects in 36 African countries and 79% of them are for infrastructure. Broadman, H. (2007) estimates that Exim Bank's loan portfolio to Africa in the infrastructure sector amounts to USD 12.5 billion as of mid-2006.
105. Financial Times, 18 May 2007, "China Pledges USD 20 billion for Sub-Saharan Africa".
106. www.cadfund.com.
107. These include Yunnan Copper and China Nonferrous Metal Mining operating the Chambishi copper mine in Zambia; Zijin mining company investing in iron mining in South Africa; and China International Water and Electric Corporation building the Merowe dam in Sudan.
108. Exim Bank may lend to Chinese enterprises in Africa for resources development projects; processing and trading projects; construction of plants or mills; infrastructure building projects; research and development centres; product marketing and sales centres and post-sales service centres; acquisitions, mergers, share-holding and other ventures. Loans to overseas investment projects and construction projects combined accounted for 28% of export seller's credit (about CNY 29 billion) in actual disbursement for 2006. (Annual Report 2006 of Exim Bank).

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ANNEX 3.A1

*Statistical Tables*Table 3.A1.1. **China's OFDI flow**

	1982-89 (average)	1990-99 (average)	2000-06 (average)	2003	2004	2005	2006
Amount (USD million)	453	2 323	6 938	2 855	5 498	12 261	17 634
As a share in the world OFDI (%)	0.4	0.8	0.8	0.5	0.6	1.5	1.5
Rank in the world	22	22	23	25	22	17	18
As a ratio in China's GDP (%)	0.1	0.3	0.3	0.2	0.3	0.5	0.7

Source: OECD calculation based on the data from IFS, MOFCOM and UNCTAD.

Table 3.A1.2. **FDI statistics (stock): OECD (inward) vs. China (outward)**

	Latest year	OECD inward FDI from China (USD million)	MOFCOM outward FDI from China (USD million)	OECD minus MOFCOM
Austria	2004	0.17	0.70	(0.53)
Canada	2005	1 169.55	103.29	1 066.26
Czech Republic	2005	0.19	1.38	(1.19)
Denmark	2005	147.35	96.59	50.76
Finland	2005	12.98	0.90	12.08
Denmark	2005	147.35	96.59	50.76
Finland	2005	12.98	0.90	12.08
France	2004	200.23	21.68	178.55
Germany	2004	222.02	129.21	92.81
Greece	2005	3.08	0.35	2 073
Hungary	2003	15.08	5.43	9.65
Italy	2005	69.52	21.60	47.92
Japan	2005	101.72	150.70	(48.98)
Korea	2005	1 102.10	882.22	219.88
Netherlands	2005	96.74	14.95	81.79
Poland	2005	65.00	12.39	52.61
Slovak Republic	2005	0.63	0.10	0.53
Turkey	2005	3.00	4.23	(1.23)
United Kingdom	2005	203.18	107.97	95.21
United States	2005	481.00	822.68	(341.68)
Total		3 893.53	2 376.37	1 517.163

Source: OECD and MOFCOM.

Table 3.A1.3. **China's OFDI – stock**

	1985	1990	1995	2003	2004	2005	2006
Amount (USD million)	900	4 455	17 768	33 222	44 777	57 206	75 026
As a share in the world OFDI (%)	0.1	0.2	0.6	0.4	0.4	0.5	0.6
Rank in the world	32	25	21	25	27	24	23
As a ratio in China's GDP (%)	0.3	1.1	2.3	2.0	2.3	2.5	2.9

Source: OECD calculation based on the data from IFS, MOFCOM and UNCTAD.

Table 3.A1.4. **FDI stock and flow from the OECD member countries**

	FDI outward stock 2006 (USD million)	As a share in FDI outward stock from world (%)	As a per capita (USD)	FDI outward flows (average 2003-06, USD million)	As a share in FDI outward flows from World (%)	FDI outflow per capita (USD)
China	75 026	0.6	57	9 562	1.0	7.3
Australia	226 764	1.8	11 005	3 750	0.4	182
Austria	77 310	0.6	9 335	6 976	0.8	842
Belgium	462 032	3.7	43 803	39 589	4.5	3 753
Canada	449 035	3.6	13 764	36 024	4.1	1 104
Czech Republic	5 058	0.0	493	908	0.1	89
Denmark	150 082	1.2	27 616	2 068	0.2	380
Finland	90 878	0.7	17 254	-160	0.0	-30
France	1 080 204	8.7	17 606	85 214	9.8	1 389
Germany	1 005 078	8.1	12 202	33 280	3.8	404
Greece	17 521	0.1	1 572	1 765	0.2	158
Hungary	12 693	0.1	1 260	1 782	0.2	177
Iceland	13 190	0.1	43 341	3 514	0.4	11 545
Ireland	124 987	1.0	29 509	14 098	1.6	3 329
Italy	375 756	3.0	6 430	27 510	3.2	471
Japan	449 567	3.6	3 519	38 950	4.5	305
Korea	46 760	0.4	968	4 881	0.6	101
Luxembourg	35 658	0.3	77 602	2 344	0.3	5 100
Mexico	35 144	0.3	335	4 404	0.5	42
Netherlands	652 633	5.2	39 926	50 902	5.8	3 114
New Zealand	12 806	0.1	3 093	-125	0.0	-30
Norway	120 568	1.0	25 818	10 873	1.2	2 328
Poland	10 705	0.1	281	1 705	0.2	45
Portugal	54 850	0.4	5 181	5 185	0.6	490
Slovak Republic	1 282	0.0	238	99	0.0	18
Spain	507 970	4.1	11 527	54 148	6.2	1 228
Sweden	262 951	2.1	28 956	23 151	2.7	2 549
Switzerland	545 401	4.4	72 876	41 660	4.8	5 567
Turkey	8 866	0.1	121	843	0.1	12
United Kingdom	1 486 950	11.9	24 542	84 401	9.7	1 393
United States	2 384 004	19.1	7 963	138 922	15.9	464
Total OECD	10 706 683	85.8	9 111	718 639	82.3	612

Source: MOFCOM; OECD, *International Direct Investment Statistics*; and UNCTAD.

Table 3.A1.5. **OFDI stock and flow from emerging countries**

	FDI outward stock 2006 (USD million)	As a share in world FDI outward stock (%)	FDI outward flows (average 2003-06, USD million)	As a share in world FDI outward flows (%)
China	75 026	0.6	9 562	1.0
Hong Kong, China	688 974	5.5	31 806	3.6
Russia	156 824	1.3	13 654	1.6
British Virgin Islands	123 512	1.0	7 531	0.9
Singapore	117 580	0.9	6 450	0.7
Chinese Taipei	113 910	0.9	6 564	0.8
Brazil	87 049	0.7	10 194	1.2
Korea	46 760	0.4	4 881	0.6
South Africa	43 499	0.3	2 165	0.2
Cayman Islands	40 395	0.3	3 441	0.4
Mexico	35 144	0.3	4 404	0.5
Malaysia	27 830	0.2	3 111	0.4
Chile	26 787	0.2	2 039	0.2
Argentina	24 047	0.2	1 095	0.1
Panama	21 176	0.2	1 726	0.2
Indonesia	17 350	0.1	2 476	0.3
India	12 964	0.1	3 597	0.4
United Arab Emirates	11 830	0.1	2 744	0.3

Source: MOFCOM and UNCTAD.

Table 3.A1.6. **Top ten OFDI destinations – flow**

% share of total OFDI from China

2003			2004		2005		2006	
1	Hong Kong, China	40.2	Hong Kong, China	47.8	Cayman Island	42.1	Cayman Island	44.4
2	Cayman Islands	28.3	Cayman Islands	23.4	Hong Kong, China	27.9	Hong Kong, China	39.3
3	BVI	7.3	BVI	7.0	BVI	10.0	Russia	2.6
4	Korea	5.4	Sudan	2.7	Korea	4.8	United States	1.1
5	Denmark	2.6	Australia	2.3	USA	1.9	Singapore	0.7
6	USA	2.3	USA	2.2	Russia	1.7	Saudi Arabia	0.7
7	Thailand	2.0	Russia	1.4	Australia	1.6	Algeria	0.6
8	Macao, China	1.1	Indonesia	1.1	Germany	1.0	Australia	0.5
9	Russia	1.1	Singapore	0.9	Kazakhstan	0.8	Zambia	0.5
10	Australia	1.1	Nigeria	0.8	Sudan	0.7	Mongolia	0.5
Total – Top 5		83.8	83.1		86.7		88.2	
Total – Top 10		91.4	89.6		92.5		90.8	

BVI = British Virgin Islands.

Source: MOFCOM.

Table 3.A1.7. Top ten OFDI destinations – stock
% share of total OFDI from China

2003			2004		2005		2006	
1	Hong Kong, China	74.1	Hong Kong, China	67.9	Hong Kong, China	63.8	Hong Kong, China	56.3
2	Cayman Islands	11.1	Cayman Islands	14.9	Cayman Islands	15.6	Cayman Islands	18.9
3	BVI	1.6	BVI	2.4	BVI	3.5	BVI	6.3
4	United States	1.5	United States	1.5	Korea	1.5	United States	1.6
5	Macao, China	1.3	Macao China	1.4	United States	1.4	Korea	1.3
6	Iraq	1.3	Korea	1.3	Macao, China	1.0	Russia	1.2
7	Australia	1.3	Australia	1.1	Australia	1.0	Australia	1.1
8	Korea	0.7	Iraq	1.0	Russia	0.8	Macao, China	0.8
9	Singapore	0.5	Singapore	0.5	Iraq	0.8	Sudan	0.7
10	Thailand	0.5	Bermuda Is.	0.4	Sudan	0.6	Germany	0.6
Total – Top 5		89.7	88.1		85.9		84.5	
Total – Top 10		93.9	92.3		90.1		88.9	

BVI = British Virgin Islands.

Source: MOFCOM.

Table 3.A1.8. FDI to and from three offshore financial centres (2005)

	Value of FDI from China (USD million)	As a share of total FDI from China (%)	Value of FDI to China (USD million)	As a share of total FDI into China (%)
Hong Kong, China	3 420	27.9	17 949	29.8
British Virgin Islands	1 226	10.0	9 022	15.0
Cayman Islands	5 163	42.1	1 948	3.2
Total – 3	9 809	80.0	28 918	47.9

Source: MOFCOM, National Bureau of Statistics of China.

Table 3.A1.9. **Regional distribution – flow: 2003-06**

USD millions

	2003	2004	2005	2006
Asia	1 505 (52.7%)	3 014 (54.8%)	4 484 (36.6%)	7663 (43.5%)
Hong Kong, China (as a share of Asia)	1 149 (76.3%)	2 628 (87.2%)	3 420 (76.3%)	6931 (90.4%)
Latin America (LA)	1 038 (36.4%)	1 763 (32.1%)	6 470 (52.8%)	8469 (48.0%)
3 Offshore Financial Centres (as a share of LA)	1 015 (97.8%)	1 715 (97.3%)	6 412 (99.1%)	7889 (93.2%)
Europe	145 (5.1%)	158 (2.9%)	395 (3.2%)	598 (3.4%)
Western Europe (as a share of Europe)	107 (74.0%)	70 (44.4%)	185 (46.7%)	111 (18.5%)
Central and Eastern Europe (as a share of Europe)	38 (26.0%)	88 (55.6%)	211 (53.3%)	487 (81.5%)
Africa	75 (2.6%)	317 (5.8%)	392 (3.2%)	520 (2.9%)
North America	58 (2.0%)	126 (2.3%)	321 (2.6%)	258 (1.5%)
Oceania	34 (1.2%)	120 (2.2%)	203 (1.7%)	126 (0.7%)
Total	2 855 (100.0%)	5 498 (100.0%)	12 265 (100.0%)	17 634 (100.0%)

Source: MOFCOM

Table 3.A1.10. **Regional distribution – stock: 2003-06**

USD millions

	2003	2004	2005	2006
Asia	26 603 (80.1%)	33 480 (74.8%)	40 954 (71.6%)	47 978 (63.9%)
Hong Kong, China (as a share of Asia)	24 632 (92.6%)	30 393 (90.8%)	36 507 (89.1%)	42 270 (88.1%)
Latin America (LA)	4 619 (13.6%)	8 268 (18.5%)	11 470 (20.0%)	19 694 (26.3%)
3 Offshore Financial Centres (as a share of LA)	4 268 (92.4%)	7 829 (94.7%)	10 934 (95.3%)	18 977 (96.4%)
Europe	487 (1.5%)	677 (1.5%)	1 273 (2.2%)	2 270 (3.0%)
Western Europe (as a share of Europe)	383 (78.7%)	496 (73.2%)	708 (55.7%)	1 050 (46.3%)
Central and Eastern Europe (as a share of Europe)	104 (21.3%)	181 (26.8%)	565 (44.3%)	1 220 (53.7%)
Africa	491 (1.5%)	900 (2.0%)	1 595 (2.8%)	2 557 (3.4%)
North America	548 (1.7%)	909 (2.0%)	1 263 (2.2%)	1 584 (2.1%)
Oceania	472 (1.4%)	544 (1.2%)	650 (1.1%)	939 (1.3%)
Total	33 222 (100.0%)	44 777 (100.0%)	57 206 (100.0%)	75 026 (100.0%)

Source: MOFCOM.

Table 3.A1.11. **Sectoral distribution – flow: 2003-06**

USD millions

	2003	2004	2005	2006
Primary sector	1 460 (51.1%)	2 089 (38.0%)	1 781 (14.6%)	8725 (49.5%)
Agriculture, forestry, husbandry and fishery	80 (2.8%)	289 (5.3%)	105 (0.9%)	185 (1.0%)
Mining, quarrying and petroleum	1 380 (48.3%)	1 800 (32.7%)	1 675 (13.7%)	8540 (48.4%)
Secondary sector (manufacturing)	620 (21.7%)	756 (13.7%)	2 280 (18.6%)	907 (5.0%)
Tertiary sector	775 (27.1%)	2 654 (48.3%)	8 200 (66.9%)	8003 (45.4%)
Lease and business services	280 (9.8%)	749 (13.6%)	4 942 (40.3%)	4522 (25.6%)
Wholesale and retail	360 (12.6%)	800 (14.5%)	2 260 (18.4%)	1114 (6.3%)
Transport and storage	80 (2.8%)	829 (15.1%)	577 (4.7%)	1377 (7.8%)
Others	55 (1.9%)	276 (5.0%)	422 (3.4%)	991 (5.6%)
Total	2 854 (100.0%)	5 498 (100.0%)	12 261 (100.0%)	17634 (100.0%)

Source: MOFCOM.

Table 3.A1.12. **Sectoral distribution – stock: 2003-06**

USD millions

	2003	2004	2005	2006
Primary sector	6 370 (19.2%)	6 786 (15.2%)	9 163 (16.0%)	18 718 (24.9%)
Agriculture, forestry, husbandry and fishery	470 (1.4%)	834 (1.9%)	512 (0.9%)	807 (1.1%)
Mining, quarrying and petroleum	5 900 (17.8%)	5 951 (13.3%)	8 652 (15.1%)	17 902 (23.9%)
Secondary sector (Manufacturing)	2 070 (6.2%)	4 538 (10.1%)	5 770 (10.1%)	7 530 (10.0%)
Tertiary sector	24 782 (74.6%)	33 454 (74.7%)	42 272 (73.9%)	48 778 (65.0%)
Lease and business services	2 070 (6.2%)	16 428 (36.7%)	16 554 (28.9%)	19 464 (25.9%)
Wholesale and retail	6 530 (19.7%)	7 843 (17.5%)	11 418 (20.0%)	12 955 (17.3%)
Transport and storage	2 020 (6.1%)	4 581 (10.2%)	7 083 (12.4%)	7 568 (10.1%)
Others	14 162 (42.6%)	4 602 (10.3%)	7 218 (12.6%)	8 791 (11.7%)
Total	33 222 (100.0%)	44 777 (100.0%)	57 206 (100.0%)	75 026 (100.0%)

Source: MOFCOM.

Table 3.A1.13. **Trade with Africa: China vs. the OECD member countries**

	Trade volume with Africa (USD million in 2006)	As a share in Africa's total trade volume with the world (%)	Average annual FDI flow to Africa (USD million for 2003-05)	As a share in total FDI flow into Africa from the world (%)
China	48 575	8.6	261	1.2
Australia	4 089	0.7	132	0.6
Austria	2 529	0.4	-10	-0.0
Belgium	12 800	2.3	461	2.1
Canada	8 602	1.5	NA	NA
Czech Republic	817	0.1	137	0.6
Denmark	1 126	0.2	184	0.8
Finland	1 960	0.3	-6	-0.0
France	47 623	8.4	1 671	7.6
Germany	28 532	5.0	-309	-1.4
Greece	1 109	0.2	23	0.1
Hungary	1 110	0.2	0	0.0
Iceland	107	0.0	-3	0.0
Ireland	1 792	0.3	-21	-0.1
Italy	30 081	5.3	81	0.4
Japan	21 030	3.7	79	0.4
Korea	12 199	2.1	37	0.2
Luxembourg	114	0.0	117	0.5
Mexico	1 062	0.2	21	0.1
Netherlands	17 876	3.1	1 089	4.9
New Zealand	852	0.1	2	0.0
Norway	1 029	0.2	n.a.	n.a.
Poland	1 454	0.3	15	0.1
Portugal	5 859	1.0	58	0.3
Slovak Republic	249	0.0	3	0.0
Spain	27 127	4.8	1 244	5.6
Sweden	3 254	0.6	58	0.3
Switzerland	6 432	1.1	330	1.5
Turkey	6 529	1.1	3	0.0
United Kingdom	20 238	3.6	9 348	42.2
United States	86 404	15.2	2 029	9.2

Source: IMF; MOFCOM; and OECD, *International Direct Investment Statistics*.

Table 3.A1.14. **FDI in Africa: China vs. major OECD member investors in Africa**

	Year of data for FDI stock	FDI stock in Africa	As a share in total FDI stock held by the world in Africa (%)	As a share in total FDI stock held by each country in the world (%)	Average annual FDI flow to Africa (2003-05) ¹	As a share in total FDI flow from the world to Africa (%)	As a share in total FDI flow from each country to the world (%)
China	2005	1 595	0.6	2.8	261	1.2	3.8
Austria	2004	365	0.2	0.5	-10	0.0	-0.1
Canada	2005	2 606	1.0	0.7			
France	2004	18 377	7.7	2.2	1 671	7.6	2.2
Germany	2004	6 271	2.6	0.7	-309	-1.4	-1.7
Greece	2005	427	0.2	3.2	23	0.1	2.4
Italy	2005	4 318	1.6	1.5	81	0.5	0.6
Japan	2005	1 326	0.5	0.3	79	0.4	0.2
Korea	2004	593	0.2	1.8	37	0.2	0.9
Netherlands	2004	8 084	3.4	1.4	1 089	4.9	1.8
Norway	2004	5 731	2.4	1.6			
Portugal	2003	974	0.5	2.7	58	0.3	1.0
Spain					1 244	5.6	2.9
Switzerland	2003	2 672	1.3	0.8	330	1.5	1.2
United Kingdom	2005	43 807	16.6	3.5	9 348	42.2	10.9
United States	2005	24 257	9.2	1.2	2 029	9.2	1.8
Total FDI in Africa	2005	264 495	100		22 128	100	

1. For Italy and Korea, FDI flow data are available only for 2003 and 2004.

Source: MOFCOM; OECD, *International Direct Investment Statistics*; and UNCTAD.

Table 3.A1.15. **Top African recipients of China's OFDI by stock**

As of end-2006

		China's OFDI stock (USD million)	Rank as China's OFDI destinations in the world	As a share in China's total OFDI stock in Africa (%)	As a share in total FDI stock in each African country (%)
1	Sudan	497	9	19.4	4.4
2	Zambia	268	16	10.5	7.1
3	Algeria	247	18	9.7	2.4
4	Nigeria	216	22	8.4	0.5
5	South Africa	168	26	6.6	0.2
6	Tanzania	112	36	4.4	1.8
7	Egypt	100	39	3.9	0.3
8	Ethiopia	96	41	3.7	3.1
9	Republic of Congo	63	47	2.5	1.8
10	Guinea	55	49	2.1	8.0
Top 5		1 396		54.6	1.0
Top 10		1 821		71.2	0.9
Total Africa		2 557		100.0	0.8

Source: MOFCOM and UNCTAD.

Table 3.A1.16. **Top African recipients of China's OFDI by flow**

As a share of China's total OFDI flows to Africa (%)

2003			2004		2005		2006	
1	Nigeria	32.6	Sudan	46.2	Sudan	23.3	Algeria	19.0
2	Mauritius	13.7	Nigeria	14.3	Algeria	21.7	Zambia	16.8
3	South Africa	11.8	South Africa	5.6	Nigeria	13.6	Nigeria	13.0
4	Zambia	7.4	Guinea	4.5	South Africa	12.1	Sudan	9.8
5	Algeria	3.3	Benin	4.3	Guinea	4.2	South Africa	7.8
Top 5		68.9	75.1		74.8		66.5	
Top 10		78.3	89.1		85.8		88.2	

Source: MOFCOM.

Table 3.A1.17. **Sectoral composition of China's OFDI in Africa**
1979-2000

Sector	No. of projects	Investment value (USD million)	As a share in China's total investment in Africa (%)
Agriculture	22	48	7.0
Resource extraction	44	188	27.6
Manufacturing	230	315	46.2
Machinery	20	16	2.3
Home appliances	36	25	3.7
Light industry	82	87	12.8
Textile	58	102	15.0
Other manufacturing	34	86	12.6
Services	200	125	18.3
Others	3	6	0.9
Total	499	681	100.0

Source: World Bank (2004), *Asian Foreign Direct Investment in Africa*, Table 7.6 (based on MOFCOM data).

Table 3.A1.18. **ODA to Africa: China vs. the OECD member countries**

	ODA (USD millions)	Year of data	As a share in total ODA from each country to developing countries (%)
China (estimate)	1 000-1 600¹	2005/2006/2007	44²
Australia	60	2005	4.2
Austria	551	2006	50.5
Belgium	850	2006	62.6
Canada	1 005	2005	35.5
Czech Republic	7	2006	9.5
Denmark	762	2006	52.1
Finland	156	2005	26.2
France	4 646	2005	64.2
Germany	2 658	2005	35.7
Greece	17	2006	9.0
Hungary	0	2006	0.0
Iceland	6	2005	34.3
Ireland	308	2005	63.9
Italy	920	2005	40.6
Japan	1 102	2006	10.6
Korea	39	2005	8.4
Luxembourg	89	2005	48.1
Netherlands	1 422	2005	38.6
New Zealand	18	2005	8.1
Norway	715	2005	35.2
Poland	93	2006	78.8
Portugal	125	2006	59.1
Slovak Republic	16	2006	65.8
Spain	474	2006	22.7
Sweden	798	2005	35.4
Switzerland	316	2005	22.6
Turkey	11	2005	2.2
United Kingdom	3 795	2005	46.5
United States	4 570	2005	18.1

1. From estimates including Brautigam (2007) and Wang (2007).

2. The share of aid to African countries between 2000 and 2003 as reported by Minister of Foreign Affairs Li Zhaoxing, in 2003.

Source: OECD, *International Development Statistics* (net ODA flows in disbursements in current prices).

Table 3.A1.19. China's economic co-operation with Africa
USD million in 2005

	Total turnover of economic co-operation ¹	As a share in total turnover in Africa (%)
Sudan	1 343	21.4
Algeria	1 065	17.0
Nigeria	800	12.7
Angola	306	4.9
Egypt	277	4.4
Botswana	265	4.2
Tanzania	212	3.4
Ethiopia	183	2.9
Mali	177	2.8
Libya	132	2.1
Total Africa	6 274	100.0

1. This includes: 1) overseas contracted projects undertaken by Chinese contractors which are financed by foreign investors, China's ODA funds, or themselves jointly with foreign contractors as well as contracted projects in China financed by foreign investments; 2) services co-operation contracts providing Chinese labour to employers and contractors overseas; and 3) overseas design and construction projects undertaken by Chinese contractors providing technical services as well as similar projects in China financed by foreign investments.

Source: National Bureau of Statistics of China.

Chapter 4

Encouraging Responsible Business Conduct in China

China's promotion of a code of responsible business conduct can help build the harmonious society that the country's leaders have espoused as a top priority and can also encourage more and better FDI inflows to China by improving the business environment for foreign investors. This chapter provides the first detailed and comprehensive analysis of the Chinese government's efforts to encourage responsible business conduct by enterprises in China and by Chinese enterprises operating abroad, highlighting in particular efforts to strengthen environmental protection and respect for core labour standards by enterprises.

Overview

Encouraging responsible business conduct is a shared objective of the OECD and China

All countries are facing the challenges of promoting sustainable development and conditions which facilitate responsible conduct on the part of business. As the world economy becomes more integrated, OECD countries, together with China and other emerging countries, have a shared responsibility to meet these challenges. OECD countries have taken steps to do this, including the adoption of the *OECD Guidelines for Multinational Enterprises*, to ensure that their companies work in harmony with the local societies everywhere they operate.

China can benefit from policies encouraging responsible business conduct

Improved conduct by businesses operating in China can help address domestic challenges, including environmental pollution and occupational health and safety. It can also support China's export industries by helping to relieve concerns of international consumers, such as those over product safety. Responsible business conduct (RBC) can facilitate sustainable overseas investment by Chinese enterprises. Policies to encourage RBC can produce both tangible and intangible net benefits for Chinese enterprises, including order retention, reduced staff turnover, increased productivity and improved product quality.

China is adopting policies to encourage responsible business conduct

The Chinese government is strongly encouraging companies to adhere to high standards of behaviour. RBC is enshrined in the latest version of the Company Law, which requires companies to comply with laws and regulations, social morality and business morality. A code of conduct has been established for the textiles sector which may be extended to cover other sectors and the government has reportedly prepared RBC guidelines for all industries. The proponents of RBC are making a business case for it based on the notion of "soft competitiveness".

At the same time, the Chinese government is developing framework conditions to enable RBC in China. It has put in place a series of measures to ensure disclosure by enterprises of both financial and non-financial information.

It has enacted laws to protect the rights of workers, including women workers and children, and is taking measures to protect the environment. Responding to concerns of domestic and international consumers, the Chinese government is taking measures to improve product safety.

The Chinese government is striving to ensure corporate compliance with laws relating to RBC. Further development of the capacities of the legal system that better ensures judicial competence and independence would facilitate these efforts. Stakeholder and public consultation in the development of legislation is improving. Consultation and arbitration procedures are available. The Chinese government is using RBC as an instrument to ensure legal compliance.

The Chinese authorities are also promoting RBC in overseas operations of Chinese enterprises. The main Chinese bank providing loans for investment overseas has started to implement environmental lending criteria.

China has signed and ratified international agreements relevant to promoting RBC, including United Nations and some core ILO conventions. China has signed a Memorandum of Understanding on Corporate Responsibility Co-operation with Sweden.

Chinese companies are seeking to learn about RBC standards. The Shenzhen Stock Exchange has published an instruction on social and environmental standards for listed companies. The *OECD Guidelines for Multinational Enterprises* were reportedly used as references in the development of this instruction. Chinese suppliers are working with OECD-based and other foreign enterprises to improve corporate conduct in a number of areas.

Remaining challenges

While the Chinese government has made efforts to encourage responsible business conduct, Chinese enterprises are still largely unaware of what RBC entails and have not organised themselves to promote it. This is not surprising, considering the short history of RBC initiatives in China, but the situation is not enhanced by the disparate nature of these initiatives. The lack of co-ordination of government agencies' approaches hinders communication of the government's expectations to Chinese companies. One result of the amorphous nature of RBC work in China at present is the lack of a set of nationally-recommended standards of corporate conduct and of effective reporting systems at enterprise level. However, the central government is understood to be preparing a set of such standards and is also considering designating a government department as the national co-ordinating body for RBC. Such steps to improve co-ordination of RBC policy are to be encouraged. Legislation and regulations establishing framework conditions for responsible

business conduct, for example in such areas as environmental protection and occupational health and safety, have been put in place in recent years, but have yet to be consistently and effectively implemented at local level.

1. Background

China's promotion of a code of responsible business conduct (RBC) embodying concepts like those contained in the *OECD Guidelines for Multinational Enterprises* (see Box 4.1) can help build the harmonious society that the country's leaders have espoused as a top priority and can also encourage more and better FDI inflows to China by improving the business environment for foreign investors.

This *Report* focuses on core labour standards and environmental protection as two policy areas in which the Chinese government has in recent years made considerable progress in developing framework policies enabling enterprises to improve their conduct, but where substantial implementation challenges persist. The other areas of the *Guidelines* alluded to above remain to be researched separately.

The *Policy Framework for Investment* provides a checklist of important policy issues for consideration by any government interested in creating an environment that is attractive to both domestic and international investors and in enhancing the development benefits of investment to society, especially the poor. Developed by a task force of officials from some 60 OECD and non-OECD governments from all continents, the *Policy Framework for Investment* covers a range of policies that together have a direct bearing on the investment climate: investment policy; investment promotion and facilitation; trade policy; competition policy; tax policy; corporate governance; policies for promoting RBC; human resource development; infrastructure and financial sector development; and public governance.

Chapter 7 of the *Policy Framework for Investment* specifically addresses RBC. Chapter 3 of the present *Report* follows the structure of Chapter 7, with section headings consisting of the six questions comprising that chapter. RBC entails above all compliance with laws such as those on respecting human rights, environmental protection, labour relations and financial accountability, even where these laws are poorly enforced, and also responding to societal expectations communicated by channels other than the law, e.g. intergovernmental organisations, within the workplace, by local communities and trade unions, via the press). Private voluntary initiatives addressing this latter aspect of RBC are often referred to as CSR (see Box 4.2).

The first *OECD Investment Policy Review of China: Progress and Reform Challenges* published in 2003¹ highlighted the role of environmental and social policies in attracting FDI. It pointed out that enterprises operating in

Box 4.1. **The OECD Guidelines for Multinational Enterprises**

The *Guidelines for Multinational Enterprises* are recommendations addressed by governments to multinational enterprises. They provide voluntary principles and standards for RBC consistent with applicable laws and which are grounded on shared values expressed in international agreements to which China has subscribed, including United Nations conventions. The *Guidelines* aim to ensure that the operations of enterprises are in harmony with government policies, to strengthen the basis of mutual confidence between enterprises and the societies in which they operate, to help improve the foreign investment climate and to enhance the contribution to sustainable development made by multinational enterprises. The *Guidelines* are part of the OECD Declaration on International Investment and Multinational Enterprises, the other elements of which relate to national treatment, conflicting requirements on enterprises, and international investment incentives and disincentives. The 30 OECD member and 10 non-member countries have adhered to the Declaration and the *Guidelines*.

The *Guidelines* encourage enterprises to respect human rights, including workers' rights, women's rights and children's rights. They call upon enterprises to encourage local capacity building and support capital formation by creating employment opportunities and facilitating training opportunities for employees. They charge enterprises with upholding and applying good corporate governance principles, and with making effective disclosure of relevant information. The *Guidelines* also encourage enterprises to: protect the environment and public health and safety; combat bribery; protect consumer interests; contribute to the development of innovative capacity; conduct their activities in a competitive manner; and contribute to the public finances of host countries by making timely tax payments.

Relative to other major instruments that promote RBC, the *Guidelines* engage government responsibilities in a unique way – they are the only comprehensive code of conduct involving recommendations by governments to business. In addition, the *Guidelines* are promoted via a government-backed follow-up mechanism. The National Contact Points (NCPs, government offices located in each adhering country that promotes observance of the *Guidelines* among companies operating in or from their territories) are the most concrete sign of adhering government commitment to the *Guidelines*. The NCPs are expected to further the effectiveness of the *Guidelines* in accordance with the core criteria of viability, accessibility, transparency and accountability. The NCPs report annually on their activities. Among other responsibilities, the NCP is asked to provide conciliation and mediation in which companies and other interested parties may discuss concrete issues of business ethics by means of the “specific instances procedure” – the only international conciliation and mediation facility that can be used to address a broad range of business ethics issues.

Box 4.2. OECD members and China face similar challenges in encouraging RBC

Responsible business conduct (RBC) goes hand in hand with government responsibility. Public policies that promote RBC include: providing an enabling environment that clearly defines the respective roles of government and business; promoting dialogue on norms for business conduct; providing for adequate disclosure so that investors can be held accountable for their actions; supporting companies' efforts to comply with law; encouraging RBC through partnership and promotion; and participating in inter-governmental co-operation to promote agreed concepts and principles for RBC.

The OECD experience is that these policies are complex and require significant effort on the part of governments and publics to formulate these and put them into practice. They are not put into place automatically by the mere action of adhering to the *Guidelines*. For each example of corporate misconduct by Chinese enterprises mentioned in this report (see below) one can cite similar examples in other countries, including those adhering to the *Guidelines*.

Governments adhering to the *Guidelines* are engaged in a constant effort to develop and implement a system of policies to address the many challenges that present themselves and to promote responsible conduct of their companies, not only in their own economies but also when they operate abroad. Against this background the present report considers the efforts of the Chinese government to meet similar challenges by developing policies to apply high standards of corporate conduct. International co-operation in efforts to encourage RBC is particularly important in view of the increasingly cross-border *modus operandi* of modern enterprises.

accordance with relatively high social and environmental standards favour host locations with regulatory frameworks that are consistent with internationally-agreed principles.

The 2003 *Review* noted that enterprises operating on relatively high RBC standards may feel inhibited from investing in China if their competitors are not observing similar standards. If the differences are large, investors will have concerns about the evenness of the playing field.

The 2003 *Review* commended the Chinese government for its commitment to improving framework conditions for RBC, particularly in the area of environmental policy. The Chinese authorities were encouraged to continue with these efforts.

In September 2005, the Chinese government invited the OECD to co-operate with it in work to improve the understanding of Chinese

enterprises, including state-owned enterprises (SOEs), of RBC standards. Such understanding is necessary, the Chinese government emphasised, because an increasing number of Chinese enterprises are responding to the policy of “going global” and are investing abroad; however, they lack experience and understanding of internationally-recognised principles of business conduct. The Chinese government invited the OECD to share knowledge with Chinese SOEs of such standards in particular based on the OECD Guidelines for Multinational Enterprises.

In December 2005, in conjunction with the China-OECD December 2005 Multi-Stakeholder *Symposium on China’s Policies towards Cross-Border Mergers and Acquisitions*, the OECD participated in a seminar organised by the United States Council for International Business (USCIB) on Corporate Social Responsibility in China. The seminar was attended by representatives of major Chinese corporations and US-owned foreign-invested enterprises. Attendees voiced support for initiatives to encourage responsible business conduct.

In February 2006, the then OECD Secretary-General Donald J. Johnston delivered a presentation at the keynote session of the Global Social Responsibility Forum in Beijing, *inter alia* outlining the benefits of responsible business conduct (RBC) for China and introducing the *Guidelines for Multinational Enterprises*. He explained that the OECD is happy to co-operate with China in developing good RBC standards and sharing experiences on OECD and Chinese government approaches to RBC.

On 8 September 2006, the project on Chinese and OECD Government Approaches to Encouraging Responsible Business Conduct was launched at a joint China-OECD seminar at the 10th China International Fair for Investment and Trade in Xiamen. High-level officials of the Ministry of Commerce of the People’s Republic of China (MOFCOM) and the OECD spoke at this event, along with representatives of Chinese and OECD-based multinational enterprises. The OECD presented the *OECD Guidelines for Multinational Enterprises*.

In December 2006, the Business and Industry Advisory Committee to the OECD (BIAC) and the Trade Union Advisory Committee to the OECD (TUAC) issued a joint statement supporting the China-OECD project on Chinese and OECD Government Approaches to Encouraging Responsible Business Conduct. The consultative body to the OECD representing OECD-based NGOs, OECD Watch, also voiced strong support for the project.

The OECD Secretariat conducted a research mission to Beijing and Hong Kong in April 2007. The purpose of the mission was to consult stakeholders, including Chinese and OECD governments, international organisations, multinational enterprises, chambers of commerce, civil society organisations, labour representatives and academics regarding their experience

of policies to encourage responsible business conduct. In November 2007, the Secretariat conducted a further research mission to factories in Guangdong, a province in South China, to study the implementation of CSC9000T, China's first sectoral corporate conduct standard.

This Report was discussed at the Multi-Stakeholder Symposium on Chinese and OECD Approaches to Encouraging Responsible Business Conduct held at the OECD in Paris on 26-27 June 2008. The Symposium brought together a wide variety of stakeholders, including the Chinese government, OECD member governments, the Business and Industry Advisory Committee to the OECD (BIAC), the Trade Union Advisory Committee to the OECD (TUAC), OECD Watch, Chinese and international NGOs, and the OECD Secretariat. The Report has been revised to take account of this discussion. The project was conducted under the aegis of the OECD's Investment Committee, which provided guidance and direction to the development of the Report.

2. The case for encouraging responsible business conduct in China

China can benefit from policies to encourage responsible business conduct (RBC)

China can benefit from adopting and implementing effective policies to encourage responsible business conduct (RBC). Problems have arisen in the course of the country's rapid industrialisation, some of them capable of threatening social stability or damaging relations with other countries. While the Chinese government has primary responsibility for solving such issues, enterprises can contribute to solutions, both by complying with laws and regulations and also by striving to meet societal expectations that are not expressed as legal obligations. RBC is to be encouraged on economic as well as societal grounds, as it can render investment by Chinese enterprises more competitive and sustainable both at home and abroad. More broadly, it can play a key role in the government's initiative to create a harmonious society. The Chinese government strongly encourages enterprises to comply with the law and to behave responsibly, both in China and in their overseas activities (see Box 4.3).

Effective policies to encourage RBC can help address serious problems

The Chinese government's decision in recent years to adopt policies to encourage business to behave more responsibly came after more than two decades of rapid economic development resulting from reforms initiated in 1978. Since then, rapid economic growth has raised living standards nationwide. As in other countries, this rise in living standards has been accompanied by unwelcome side-effects such as environmental degradation and increasing inequality. While at an earlier stage of development many

Box 4.3. **How the OECD Guidelines already apply to companies in China and to Chinese enterprises**

The *OECD Guidelines for Multinational Enterprises* are one manifestation of broader co-operation on initiatives in which governments participate to develop and promote internationally-agreed norms for business, including various United Nations processes (e.g. the International Labour Organisation, the United Nations Office on Drugs and Crime, the United Nations Environment Programme) and the OECD anti-bribery convention, as well as regional initiatives (e.g. under the European Union, North American Free Trade Agreement consultation mechanisms, Asia-Pacific Economic Co-operation). China is already closely involved in many of these initiatives.

The common aim of the governments adhering to the *Guidelines* is to encourage the positive contributions that multinational enterprises can make to economic, environmental and social progress and to minimise the difficulties to which their various operations may give rise. In working towards this goal, governments find themselves in partnership with the many businesses, trade unions and other non-governmental organisations that are working in their own ways toward the same end.

While many businesses in both OECD and non-member countries have developed their own codes of conduct in recent years, the *OECD Guidelines* are the only multilaterally endorsed and comprehensive code that governments are committed to promoting through their network of National Contact Points. They apply to their companies' business operations world-wide.

Paragraph 2 in Section I, *Concepts and Principles*, states: "Since the operations of multinational enterprises extend throughout the world, international co-operation in this field should extend to all countries. Governments adhering to the *Guidelines* encourage the enterprises operating on their territories to observe the *Guidelines* wherever they operate, while taking into account the particular circumstances of each host country." Therefore, multinational enterprises based in countries and territories adhering to the Declaration on International Investment and Multinational Enterprises are expected to observe the *Guidelines* when operating in China, as elsewhere. This expectation extends also to Chinese-owned enterprises established in adherent countries and territories. Paragraph 10 in Section II, *General Policies* requires companies to encourage, where practicable, business partners, including suppliers and sub-contractors, to apply principles of corporate conduct compatible with the *Guidelines*. By extension, the *Guidelines* therefore apply to Chinese suppliers of multinationals sourcing their products in China. This report contains references to relevant sections of the *OECD Guidelines* as an indication of internationally-accepted practices in each policy area.

people expressed a willingness to tolerate these as the inevitable costs of social progress, a new generation of Chinese people is now calling for the rise in incomes to be matched by improvements in other areas of life. Some newly affluent city dwellers, for example, are campaigning to protect the country's architectural heritage from property developers, or to breathe clean air and eat clean food. At the other end of the social spectrum, farmers resist land seizures by officials and workers protest against non-payment of wages. As a result, the government is concerned that illegal and/or anti-social behaviour of officials and companies may threaten the social and political order.

Such problems are not unique to China. OECD countries faced similar challenges in an industrialisation process that, for many, started in earnest several centuries before that in China. The Industrial Revolution brought rises in living standards only at terrible social cost. Countries that have now adopted enlightened standards of corporate conduct took many years to address such challenges as slavery, child labour, racial and religious discrimination, sexism, differential social class access to education and healthcare, slum housing, sub-standard – often dangerous – consumer products, and poisoned air and water. Older citizens in these countries can attest to great improvements during their lifetimes. Nevertheless, such problems, though massively diminished, still persist in some form.

OECD countries have found that business can play an important role in helping to address the challenges resulting from economic growth and development. Laws are important, but so is a culture of compliance. These countries are happy to share the lessons learned from decades of policy development with countries that are now industrialising, so that they may have an opportunity to avoid or at least alleviate the harsh by-products of economic change. At the same time, they are ready to learn from the good experiences of non-OECD countries, including China, that are facing up to common challenges.

China is today under international and internal pressure to move far faster in addressing these challenges than the industrialised countries did. Now that China, with one of the most open economies in the world, is integrating into an increasingly globalised world economy, it has become dependent on international investment and trade. Its exporters must take heed of consumer concerns in overseas markets just as its large enterprises must learn the rules to be observed in countries in which they wish to invest. China's rapid industrialisation is causing it to become a large and wasteful user of energy and raw materials and to rank among the world's leading polluters. At the same time, China's internal social strains (one indication of which is the alarming rise in the Gini coefficient, see Box 4.4) have inevitably become a major focus of government attention.

Box 4.4. A major challenge: How to combine growth with equity

Rapid economic growth has reduced poverty in China to such an extent that the World Bank cites China as a model for other countries to follow. The number of people living in poverty is estimated to have fallen from 250 million in 1978, when economic reforms began, to under 24 million by 2001, using China's national poverty standard, which is currently CNY 680 per capita net income per year, much lower than the USD 1 per day used as the reference limit for extreme poverty in the Millennium Development Goals. The total number of poor people was estimated at 20 million in 2007,¹ though some economists cite higher totals (for example, as a result of the recalculation in 2007 of purchasing power of the Chinese yuan in the World Bank's International Comparison Project).

Other measures also indicate significant human development. Life expectancy has continued to rise, reaching 71.4 years in the 2000 national population census and 71.8 years in 2005 according to World Bank figures.² Infant mortality³ (which fell during the central planning phase from 195 in 1955 to 61 by 1975) decreased from 52 in 1980 to 35 in 2005, according to United Nations estimates.⁴ The illiteracy rate fell from 22.8% in the 1982 census to 15.9% in 1990 and 6.7% in 2000.⁵ The Engel coefficient (i.e. the proportion of family income spent on food) fell from 57.5% in 1978 to 36.7% in 2005 in urban areas and from 67.7% to 45.5% in rural areas in the same period.⁶

However, this does not mean that poverty is not still a serious policy challenge in China. Government officials admit that the national poverty standard is now too low and that the effect of its application to poverty relief measures is to deny them to many people who lack the basic amenities of life. Using the internationally standard poverty measure of USD 1 per day would, they say, add another 100 million people to the total of those in poverty.⁷

While absolute poverty has been greatly reduced, inequality has increased markedly during the reform period. As a result of collectivist economic policies in the central planning phase, the Gini coefficient⁸ is estimated by one source to have plummeted from 0.561 in 1953 to 0.286 in 1975.⁹ Another source shows the Gini coefficient then rising from 0.295 in 1980 to 0.363 in 1992.¹⁰ Subsequent estimates from different sources vary, but agree in indicating a rise above 0.4 at the turn of the century: 0.403 in 1998,¹¹ 0.448 in 2000,¹² 0.454 in 2001¹³ and 0.449 in 2002.¹⁴

A static comparison of Gini coefficients shows that China is still far from being the most unequal society in the world. However, the Chinese authorities are more concerned about the dynamic picture. For example, World Bank statistics show Brazil as having a Gini coefficient of 0.5699 in 2004, compared to one of 0.3809 in rural China and 0.3398 in urban China. But the Brazilian figure shows no significant change from the 0.5757 recorded in 1981, when China had a coefficient of only 0.1846 in urban areas and, the year before, 0.2499 in rural areas.¹⁵

Box 4.4. A major challenge: How to combine growth with equity (cont.)

The largest contributor to income inequality in China is the rural-urban divide, which has persisted during the reform period, though there has been some narrowing of the gap.¹⁶ In 1978, per capita annual disposable income in urban areas was CNY 343.4 compared to per capita annual net income in rural areas of CNY 133.6, 38.9% of urban income. By 2005, urban income had risen to CNY 10 493 and rural income to CNY 3 254.9, 31% of urban income.¹⁷ Recorded total Gini coefficients in several data sets tend to be higher in most years than the separate coefficients for urban and rural areas, indicating that the rural-urban disparity was the main cause of income inequality in those years.¹⁸

The second most important factor in income inequality is the disparity between the coast and the poorer hinterland. In 2005, per capita GDP in the Eastern Region was CNY 23 768, 69.3% above the national average of CNY 14 040, compared to CNY 15 982 in the North East Region (the country's old industrial base), CNY 10 608 in the Central Region and CNY 9 338 in the Western Region.¹⁹

Income disparities in urban areas have intensified with the steady migration of the rural population to seek work in the cities. Migrant workers typically enjoy a far lower living standard than the possessors of household residence permits (*hukou*), not only because they receive lower wages but also because they and their families are not generally entitled to housing, education and healthcare. Inequality of opportunities therefore constitutes a major social divide between urban and rural workers.

1. *People's Daily*, 28 September 2007.
2. *China Statistical Yearbook* (2006) and World Bank website.
3. The infant mortality rate is defined as the ratio of deaths of children under one year of age in a given year to the total number of live births in the same year.
4. United Nations Statistics Division website.
5. *China Statistical Yearbook* (2006).
6. *China Statistical Yearbook* (2006). Caution should be observed in interpreting these data: in Chinese culture, a major form of conspicuous consumption (and doing business) is entertaining guests in restaurants, so higher income groups may increase, not decrease, the proportion of income spent on food.
7. Wu Zhong, an official of the State Council Leading Group Office of Poverty Alleviation and Development, cited in *Xinhua* on 23 August 2006.
8. The Gini coefficient is a standard measure of inequality, ranging from a value of 0 (perfect equality, everyone has the same income) to 1 (perfect inequality, one person has all the income, everyone else has zero income).
9. Dowling and Soo (1983).
10. Ying (1995).
11. World Bank, *World Bank Poverty Monitoring Database* (2002).
12. World Bank, *World Development Report* (2004).
13. Li (2005).
14. Chotikapanich, Rao and Tang (2005).
15. The World Bank, PovcalNet website.
16. Rural-urban income comparisons need to be interpreted in the light of rapid urbanisation. At the beginning of the reform period, 20% of the population lived in urban areas; this proportion has recently passed 40%.
17. *China Statistical Yearbook* (2006).
18. Bramall (2001); Chotikapanich, Rao and Tang (2005); Khan and Riskin (1998); Li (2005); Zhang.
19. *China Statistical Yearbook* (2006).

Below are cited examples of major problems on both domestic and international levels to which the Chinese government seeks assistance from business in implementing its chosen solutions. This list is indicative, not exhaustive.

Domestic problems that may be addressed by improving corporate conduct

Environmental pollution²

Pollution remains a serious problem in China.³ Its large cities suffer some of the most severe air pollution in the world. Poor urban air quality continues to affect public health, as well as causing large economic and environmental losses. Acid rain falls on about 30% of China's territory. Water pollution is also of high concern.⁴ Many water courses, lakes and coastal waters are severely polluted as a result of agricultural, industrial and domestic discharges. This pollution has severely degraded aquatic ecosystems, is a major threat to human health, and may limit economic growth. Nearly half of China's major cities are not fully compliant with drinking water quality standards. China also has very low water resources per capita (one quarter of the world average), and they are highly unevenly distributed.⁵ Among the 600 larger cities, 400 suffer from water shortages. Rapid industrialisation has also contributed to an overwhelming quantity of waste. The amounts of municipal waste, industrial waste and hazardous waste far exceed what can be safely treated and disposed of, putting human health and the environment at risk. Pollution, energy and material intensities of the Chinese economy remain high, as well as its water use intensity; China generates more pollution and consumes more resources than OECD averages.

As well as damaging health, environmental pollution is harming China's economic growth. A study produced in 2007 jointly by the World Bank and China's State Environmental Protection Agency (SEPA) estimated that air and water pollution cost China 5.8% of GDP in 2003.⁶ Official statistics show real GDP as having grown by 10.6% in 2003,⁷ so adjustment for the effects of air and water pollution would roughly halve economic growth for that year.

China's pollution problems also affect other countries. For example, an explosion at a petrochemical plant in Jilin in November 2005 released benzene into the Songhua River. The resulting pollution was so severe that the water supply in the major down-river city of Harbin (a provincial capital) was cut off for several days. Soon afterward, the chemical slick floated down the Amur River to the Russian city of Khabarovsk.⁸ China has been identified as a "hot spot" of regional trans-boundary pollution in North-East Asia.⁹ Pollutants from China have been found in the air as far away as New England.¹⁰

Health and safety at work¹¹

One Chinese writer states that disregard for the safety of employees is “the most notable manifestation of the lack of corporate social responsibility”, citing in particular the high number of deaths in mine accidents.¹² In a speech to a national work meeting on small coal mines in July 2007, Li Yizhong, head of the State Administration of Work Safety (SAWS), said that small coal mines were a “disaster area” for coal mine safety. Township and village coal mines accounted for 182 of the 257 accidents involving more than ten deaths and 3 649 of the 6 026 deaths in those accidents during the 10th five-year plan period (2001-05). In 2006, small coal mines produced 37.9% of national coal output while accounting for 72.3% of accidental deaths, with a 3.885 deaths per million tonnes of coal, 6.2 times the rate observed in key state-owned coal mines, and more than double the rate in local state-owned coal mines.¹³ Li Yizhong stated in November 2006 that “With local governments as backstage supporters, unscrupulous mine owners just keep operating illegally”.¹⁴

Problems in overseas operations that may be addressed by improving corporate conduct

Hiring local labour, transferring skills and technology¹⁵

There is a widespread perception that Chinese companies operating abroad, particularly in Africa, employ little local labour, preferring to bring in skilled workers, or even unskilled prison labour, from China. Chinese companies operating abroad are also widely perceived as being reluctant to transfer technology, train workers or otherwise ensure that local spillover effects result from Chinese investment.

Such perceptions, based on anecdotal evidence, are not fully supported by research. For example, a study conducted by Stellenbosch University for DFID of the market entry models of Chinese construction firms in four African countries found that, in most instances, “Chinese construction companies regularly engage significant numbers of local labour and sub-contractors transferring skills and technology in the process”. Except in Angola, local personnel accounted for 85-95% of the total workforce of most of the Chinese construction companies examined in the survey. While predominantly employed as unskilled casual labourers, there were many instances of locals employed in administration and managerial positions – a phenomenon more common in companies with a longer in-country presence. No evidence was found to support rumours of the employment of prison labour from China.¹⁶

Similarly, a recent World Bank study reports that while the majority of professional staff in Chinese construction firms surveyed in its business case studies were from China, the majority of unskilled labour was African. The

Box 4.5. **Global responsibilities of Chinese corporations: A Chinese view**

“Our corporations are facing serious challenges from the eco-economy characterised by clean production and the recycling economy characterised by saving resources and recycling resources.”

“It is notable that with more and more Chinese corporations stepping out of China and investing across the world, the responsibility idea and ethical standards of Chinese corporations also extend to the world, along with these deep-rooted problems. The China Aviation Oil incident,¹ the boycott encountered by Wenzhou shoemakers² and the explosion accident that happened in Zambia³ all reflect that problems existing in shareholder, social and environmental responsibility in Chinese corporations have been exposed in overseas markets. International society will not apply lower standards to Chinese corporations overseas simply because they are from a developing country. Chinese corporations must rapidly promote their idea of corporate responsibility. Only when they make it can they really walk towards the world.”⁴

1. China Aviation Oil (Singapore) Corporation, a company supplying fuel to China's airlines, overseen by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC 国务院国有资产监督管理委员会), was judged by SASAC to have seriously violated the decision-making process and made wrong judgments on oil futures trading, leading to losses totalling approximately USD 550 million. The company's general manager and deputy general manager were convicted by a Singaporean court in 2004 and the general manager ordered to resign by SASAC in February 2007 (*People's Daily Online*, 11 December 2004; *Xinhua*, 7 February 2007).
2. Wenzhou (温州) is the shoe-making centre of China. European shoe producers have supported anti-dumping actions to check large inflows of cheap shoes from Wenzhou. In September 2004, residents of Spain's main shoe production centre, Elche, demonstrated against Chinese shoe imports and set fire to a Chinese-owned shoe warehouse, destroying its contents (*China Daily*, 30 September 2004).
3. In April 2005, a mining explosives factory belonging to BGRIMM Explosives (Zambia) Ltd., a joint venture between Beijing General Research Institute of Mining and Metallurgy and the Chinese-owned NFC Africa Mining Company blew up at the Chambezi copper mine. Over 50 people were reported killed in the explosion.
4. Wang Zhile, ed. (2006).

World Bank survey also found that Chinese firms sub-contract services to local firms, providing opportunities for acquisition of experience and access to technology for developing country firms. However, such opportunities were found to vary according to the country studied. In Angola, Chinese firms were found to import all materials, technology and staff from China, partly due to the high cost of local materials and the lack of skilled labour. A Chinese firm in Senegal was reported as including only nominal local content in sub-contracting, for example sub-contracting drawings but not engineering services such as structural engineering, which provides opportunities for acquisition of experience and technology. On the other hand, the transfer of skills, technology and work practices to workers and sub-contractors in

Tanzania was found to be increasing as Chinese firms use new construction methods there.¹⁷

Nevertheless, the persistence of negative perceptions of the activities of Chinese enterprises operating overseas suggests that more efforts need to be made to correct such perceptions where they are incorrect and, where they have some basis in fact, to improve the performance of the enterprises.

Fair labour standards

There is also a perception reflected frequently in print and electronic media that Chinese employers in countries like those in Africa pay low wages, offer poor working conditions and observe lax safety standards.¹⁸

Product safety¹⁹

An increasing problem (or at least one that is becoming increasingly apparent, perhaps also because of stronger media coverage) is that of unsafe products. Such products may affect purchasers of Chinese exports in other countries, for example in June 2007, US, Canadian and European governments warned consumers not to use Chinese-made toothpaste containing diethylene glycol, a dangerous chemical used in anti-freeze, which had been found on sale in several countries.²⁰ In September 2006, EU consumer commissioner Markos Kyprianou, announced: “Nearly half of the dangerous consumer products detected in the EU, especially toys, are imported from China. This has to change.” Of the products listed each week on the EU’s product safety site, RAPEX, a high proportion – usually the majority – are made in China. A typical listing in October 2007, nearly thirteen months after the signing of an agreement between the EU and China to restrict dangerous imports, includes 21 products from China out of a total of 39 that can, variously, cause electric shock, burns, fire, injuries, choking, poisoning and chemical hazard.²¹ In 2001, several companies produced soy sauce found by UK authorities to contain high levels of 3-MCPC, a chemical suspected of being linked to liver cancer, under the well-known brand name of a reputable soy sauce company, Pearl River Bridge.²²

However the worst cases usually affect Chinese domestic consumers, in some cases causing mass outbreaks of ill health and even deaths. For example:

- The HIV/AIDS virus was spread to an unofficially estimated 200 000 people in Henan province in the 1990s as a result of sales of dirty blood products by irresponsible firms.²³ The government banned blood sales in 2003, but the effects persist.

- In April 2004, more than 100 babies in Fuyang city, Anhui province were found to have enlarged heads as a result of being fed fake baby milk powder; 171 infants were found to be malnourished, 13 of these died.²⁴
- In January 2007, the State Food and Drug Administration charged the Guangdong Biyyee Pharmaceutical company with illegal production of products such as immunoglobulin, causing *hepatitis C* infections in patients.²⁵

In July 2007, the head of the food safety department at the State Food and Drug Administration admitted that food security problems had “impeded Chinese agriculture products and food many times in international trade” and damaged “national credibility and image”. He further warned that “hidden threats will gradually emerge and diseases will likely occur due to the harmful ingredients in food” and that “food safety accidents or events will not only affect the healthy development of the entire [food] industry, but also possibly affect the local economy and social stability”.²⁶

The Chinese media frequently report seizures of a wide variety of useless or harmful medicinal products. In the first three quarters of 2006, 11 000 “irregular” medical advertisements (i.e. for products that may not have been efficacious) were reported to the Ministry of Health. In 2005, one company produced a fake bird flu vaccine that was sold throughout China and is believed to have been responsible for spreading the disease in Liaoning Province.²⁷

In June 2007, Zheng Xiaoyu, the former head of the State Food and Drugs Administration (SFDA), was executed after having been found guilty of accepting bribes from eight pharmaceutical companies for approving sales of fake medications that in some cases led to multiple deaths.²⁸ The head of the food safety department of the SFDA stated in the same month that the food safety situation was not optimistic and that food safety accidents would not only affect the healthy development of the food industry but could also affect the economy and social stability.²⁹

Policies to encourage responsible business conduct can produce net benefits for enterprises

Policies to encourage responsible business conduct (RBC) can produce net benefits from enterprises, reducing major risks and enabling sustainable investment. However, the business case for RBC has not yet been widely accepted by businesses in China. Regular collection and analysis of relevant data is necessary to establish a causal link between RBC and its expected benefits.

Widespread misunderstandings about CSR persist among Chinese companies

The existence of widespread misunderstandings about CSR has been confirmed by Chinese researchers. For example, the China CSR Survey 2006 conducted by Peking University's Market Economy Academy³⁰ found that while most Chinese firms claimed to realise the importance of corporate social responsibility (CSR), very many of them failed to understand what it really means. The study, the first of its kind in China, surveyed attitudes towards CSR at 890 companies in China, including state-owned enterprises, privately owned enterprises and multinationals. Most companies, according to the study, equated CSR with charitable activities, though it was not necessarily clear that donations were always appropriately spent. Most companies, including large ones, reported that they regarded CSR as a burden and that CSR is a distraction for Chinese firms, which they thought should focus exclusively on building their business. The study also found that more than half of the small- and medium-sized firms surveyed thought CSR had little or nothing to do with their business development or strategy.

However, the Peking University study also discovered that an increasing number of Chinese companies were volunteering to co-operate in establishing NGOs to tackle social problems. It also noted that many firms had started to issue annual corporate CSR reports, citing those published by State Grid and the Pudong Development Bank (see below).

According to a specialist in the Ministry of Labour and Social Security, Zhang Junfeng, the biggest challenge to enterprises is awareness of RBC, which the government needs to promote further. Mr. Zhang points out that the private sector in particular is challenged by a lack of management skills, technical knowledge and money to implement RBC. He also stresses that the government is working to implement relevant laws but is hampered by lack of manpower for stricter monitoring due to tight budget constraints.³¹

Costs and benefits of investing in RBC need to be measured and analysed

The primary duty of business is to comply with the law. However, Chinese enterprise managers themselves report – and other commentators concur – that most enterprises in China do not meet this basic standard of corporate conduct. Many enterprises report that they cannot afford to meet legal obligations such as paying taxes or paying wages on time. For example, multiple book-keeping software for the purposes of defrauding the tax authorities is widely available and understood to be in widespread use. *A fortiori*, meeting societal expectations that go beyond legal compliance is not generally regarded as a major goal of Chinese companies.

The *Policy Framework for Investment* points out that the “business case” for responsible behaviour is “often clear-cut”, for example, environmentally friendly production processes can decrease costs. The existence of a business case depends on particular circumstances. In China, it is arguable that there is a very strong case for many types of RBC, but that this case is not widely understood by enterprise managers.

The limited evidence available suggests that there remains a widespread underestimation among Chinese enterprises of the benefits of RBC and a consequent reluctance to spend on RBC initiatives. A FIAS study of the information and communications technology (ICT) sector in Shenzhen³² reports that “the most consistent challenge articulated by suppliers is that the costs of implementing CSR standards are immediate, while potential benefits are long term” and that most factories do not have the systems in place to track relevant data and measure the costs and benefits of their RBC investments, so it is therefore difficult for suppliers to make strategic decisions on such investments.

The few companies that FIAS reported as tracking data on CSR standards reported anecdotal evidence of the following benefits:³³

- Securing more orders from international customers.
- Establishing a strategic partnership with key customers.
- Increased retention of workers (a major benefit due to the high turnover rate in the ICT industry).
- Increased productivity and quality.

However, there appears to be a more widespread perception by suppliers that there is not a demonstrable business case for making social and environmental improvements and that the costs of such improvements tend to outweigh the benefits. This perception stems from the fact that RBC costs tend to be quantifiable and short-term, while benefits are generally intangible, long-term and risky. In addition, suppliers do not collect and measure the necessary data to make informed decisions. The FIAS study concludes that incentives for CSR investment are lessened as the time horizon for returns on investments in areas such as personnel, systems and equipment is longer than usual customer contract lengths.³⁴ Therefore there is a need for increased management education to increase awareness of long-term benefits and also for the development of regular data collection and analysis mechanisms within enterprises.

Potential tangible benefits

Order retention. In view of the problems cited above concerning the reputation for quality of products manufactured in China, particularly in

regard to product safety, and the need to address concerns over allegations of worker maltreatment frequently voiced by international media and NGOs, multinationals may prefer to source items from suppliers deemed capable of implementing international standards of corporate conduct. Enterprises based in or operating from OECD member countries and from non-member countries and territories adhering to the OECD Declaration on International Investment and Multinational Enterprises are required by the *OECD Guidelines for Multinational Enterprises* to “encourage, where practicable, business partners, including suppliers and sub-contractors, to apply principles of corporate conduct compatible with the Guidelines”. Co-operation with foreign corporate customers to adopt and observe high RBC standards can therefore help Chinese companies retain orders and receive extra orders from OECD countries and from other countries and territories that export into OECD markets. While there is evidence that some Chinese managers have not hitherto felt confident that their enterprises will receive such benefits,³⁵ it is likely that increased international publicity for product recalls and other problems will prompt reconsideration of the cost/benefit equation.

An enterprise may therefore benefit directly from an improvement in its reputation as a result of more responsible behaviour. Such an improvement may also help improve the reputation of other firms in the same sector, providing beneficial externalities to the industry as a whole. The converse is also true: negative perceptions of one enterprise resulting from that enterprise’s bad behaviour may harm the image of all enterprises in the same sector, or even of all enterprises in a country. For example, the recall of some Chinese exports deemed to be harmful to consumers in the summer of 2007 prompted a rash of deprecatory comments in the media in OECD countries concerning other, or all, Chinese exports. These effects are larger for some types of business than for others (*e.g.* companies that have brand capital at risk or that are exposed to adverse regulation or to negative sentiment in local populations). It is for this reason that business associations frequently undertake RBC initiatives that reflect the collective stake in proper conduct of all members of a particular business community.

Reduced staff turnover. With many millions of job-seekers moving to its coastal urban areas, China would appear to have a classic “unlimited supply of labour” economy, with the marginal productivity of labour in sectors such as agriculture zero or negligible and the price of labour a subsistence-level wage.³⁶ The sources of surplus labour in China remain broadly those cited by W. Arthur Lewis for such an economy: farmers (because of the tremendous growth of agricultural productivity unleashed by reforms in the early 1980s), population growth and improved industrial efficiency (due to the reform of

state-owned enterprises, which has resulted in multiple lay-offs). Wage pressures might therefore be expected to be weak in Chinese industry.

While there is an element of truth in this characterisation, particularly for the early part of the period of economic reform, the picture is now changing. Living standards have improved in China's countryside over the past three decades of economic reform, albeit more slowly than in urban areas. The gap may be narrowing between the economic returns to migrant labour, discounted for the hardship of working long hours in factories providing limited accommodation,³⁷ and potential economic and social returns to remaining in the home village. An indication of this is anecdotal evidence of a recent tendency for an increasing proportion of migrant workers to remain in their villages after returning home for the annual spring festival (Chinese New Year).³⁸ In Guangdong (广东), where there is a heavy concentration of manufacturing staffed by migrant workers, this trend has been particularly noticeable and was recognised in 2006 when the government raised the minimum wage more rapidly to encourage workers to return after the spring festival.³⁹

Another problem reported by enterprises is a chronic skills shortage. Chinese vocational education is world-class, and has, especially during the past quarter of a century of economic reform, been available to a large number of students from the higher secondary stage upward, especially in the big cities. However, education opportunities remain skewed towards urban residents and many children in the countryside, especially girls, lack even basic education, though the government is now starting to address this problem (see below). Skilled workers can therefore command a premium and are likely to job-hop.

Retaining skilled and unskilled workers is therefore a challenge for enterprises. Initially, employers may meet this challenge by increasing wages. However, as wages rise above subsistence level, workers may also seek to improve their conditions of work, for example by choosing to work in a safer, cleaner environment, and to invest in their human capital, for example by choosing to work in an enterprise that provides training opportunities. Studies of turnover in OECD countries suggest that the factors that cause it are within the power of management to control.⁴⁰

At the same time, there are other, mainly institutional, factors which may not be directly under the control of enterprise managements but may be susceptible to the exercise of their influence on policy decisions. For example, employers may be in a position to put pressure on local authorities to give local *hukou* (residence permits) to their workers.

During the visits made by the OECD to textile factories in Guangdong in November 2007 high turnover and difficulties with staff retention were cited

by managers as key motivators of efforts to study and implement RBC standards in their enterprises (see Annex 4.A3).

Increased productivity. Meeting RBC standards can increase productivity. A safe workplace is less subject to accidents that can stop production and cause injuries, with attendant medical and compensation costs. Keeping the workforce healthy minimises absenteeism and productivity loss,⁴¹ and reduces medical expenses.⁴² As excessive overtime working can lower productivity,⁴³ reducing the long hours worked in many Chinese factories is likely to raise productivity. Creating a pleasant work environment can raise morale and reduce frictions, minimising disputes. Improved environmental performance may also result in improved productivity.⁴⁴ At one factory visited by the OECD in Guangdong in November 2007, for instance, the management explained that it had built a low-emission coal-fired combined heat and power plant and a water treatment plant mainly to lower production costs (see Annex 4.A3). To trace the relationship between these factors on a more systematic basis it is necessary to establish and maintain an integrated and effective reporting system in all enterprises.

Improved product quality. As labour costs start to rise and as lower-cost producers in Asia begin to follow China in opening their economies and developing export manufacturing, China is losing its low labour cost competitive advantage. Chinese enterprises are therefore seeking to move up the value chain and adopt advanced technology. The government is actively engaged in promoting scientific and technological innovation and encouraging enterprises to take advantage of it,⁴⁵ it also seeks to attract foreign investment involving technology transfer to China and the establishment by foreign-invested enterprises of R&D centres in China. As noted above, the government is also sensitive to threats to the reputation of goods bearing the “Made in China” mark.

Implementing RBC can contribute to improvements in product quality as a result of the retention of good workers (see above); improved worker morale; production of healthy and safe products; good customer service;⁴⁶ and respect for customer confidentiality.⁴⁷

Benefits of complying with the law. Companies which comply with law avoid the major risk of being prosecuted for illegal behaviour and the legal, financial and reputational damages to the company that might ensue. State-owned and private companies which have a proven track record for behaving responsibly are more likely to be welcome by host governments and communities when they invest abroad.

3. China's policies for promoting responsible business conduct

This part first highlights historical factors that impinge upon current policies to encourage RBC, including a tradition of paternalism that has been expressed via both government and non-government agencies. It then describes the developing legal framework for RBC, covering: workers' rights, women's rights and sex equality, children's rights, environmental protection and sustainable development, product safety and human capital formation in enterprises. The Review then examines the Chinese government's promotion of communication on RBC and protection of the rights framework, and also the measures taken by the Chinese government to support financial and non-financial disclosure, to support companies' efforts to comply with the law and to promote the business case for RBC. The Chinese government participates in inter-governmental co-operation to promote RBC. The chapter concludes with an indicative account of what Chinese enterprises and civil society organisations are doing to improve business conduct.

Each section of Part III is prefaced by one of the six questions in Chapter 7, Policies for promoting responsible business conduct, of the Policy Framework for Investment. The immediately following text is in each case based on relevant annotations in the PFI.

Government assumption of responsibilities

PFI Question 7.1. How does the government make clear for investors the distinction between its own role and responsibilities and those ascribed to the business sector? Does it actively assume its responsibilities (e.g. by effectively enforcing laws on respecting human rights, environmental protection, labour relations and financial accountability)?

The core mission of business is to identify and manage investment projects that yield competitive returns to suppliers of capital. In fulfilling this core function, responsible business conduct also consists above all of complying with legal and regulatory requirements; in addition, it includes responding to societal expectations that might be communicated through channels other than law). The role of governments is to look after the collective interests of their citizens. As part of this role, they work with companies, trade unions and other civil society organisations to create enabling environments for responsible business conduct. If this enabling environment is well designed, including through a clearly communicated distinction between the respective roles and responsibilities of government and business, uncertainty over expectations concerning responsible business

conduct are lowered, thus encouraging investment, and private and public sector actors will be encouraged to play mutually-supporting roles in enhancing economic, social and environmental wellbeing. Government and business roles need to remain distinct and they cannot substitute for one another – each sector needs to assume its responsibilities.

The Chinese government strongly advocates responsible business conduct

The Chinese government has recently adopted policies strongly encouraging responsible business conduct (RBC) by Chinese enterprises, including laws to compel improvements in corporate conduct in areas such as labour standards and environment and measures to encourage voluntary adoption of CSR norms. Before the beginning of the century, officials and the official media in China were highly sceptical of CSR advocacy, regarding it as a “green trade barrier”⁴⁸ or “disguised protectionism”.⁴⁹ However, many Chinese exporters and suppliers to foreign-invested enterprises in China became exposed to CSR standards from the mid-1990s when they started to be asked to comply with them by customers through auditing procedures. One Chinese RBC specialist describes the 1996-2000 period as the “CSR 101 introduction period”. During this time, the government, general public, media and domestic Chinese enterprises had little exposure to the topic. This was followed by a period from 2000 to 2004 when Chinese enterprises felt under increasing pressure to implement CSR but the government chose to take a wait-and-see approach, neither completely accepting CSR nor rejecting it outright.

The same specialist concludes that from 2004 onward the Chinese government’s attitude has shifted from passive (i.e. fearing economic sanctions and trade barriers) to active and participatory.⁵⁰ Official recognition of the importance of RBC has been strengthened, in particular following the official espousal of the goal of creating a “harmonious society” (*héxié shèhuì* 和谐社会) in September 2004.⁵¹ Chinese government and non-government bodies have held conferences on CSR in recent years, some of them involving international organisations [for example, the Global Corporate Social Responsibility Forum in held Beijing on 22 February 2006, at which OECD Secretary-General Donald J. Johnston delivered a keynote presentation (see Annex 4.A2)].

The new policy is explicitly incorporated in relevant legal enactments. Article 5 of the Company Law of the People’s Republic of China, added in the most recent revision of the law in October 2005, states: “When undertaking business operations, a company shall comply with laws and administrative regulations, social morality and business morality. It shall act in good faith, accept the supervision of the government and the general public, and bear social responsibilities.”⁵² This wording is evidently intended as a preamble indicating the intention of the Law, as the terms “social morality”, “business

morality” and “social responsibilities” are not rigorously defined in the Law itself, not is there any indication how compliance with such moralities and responsibilities will be monitored or non-compliance punished.

The State Council is understood to be currently considering a draft set of corporate responsibility guidelines.

RBC with Chinese characteristics: the historical background

Tradition of paternalism

Chinese enterprises have inherited a tradition of paternalism from two sources: family businesses and state-owned enterprises (SOEs). Each form of business faces competitive threats which are forcing it to change its *modus operandi*. As enterprises attempt to adapt their internal structures, they also face the challenge of complying with a body of relatively new law that is continuing to expand rapidly. To the – albeit still limited – extent to which NGOs, the media and individuals are permitted to criticise their behaviour, enterprises also are increasingly challenged to comply with the law and respond to societal expectations which are communicated by other means than law.

Chinese family businesses. The traditional form of enterprise in China before the establishment of the People’s Republic of China in 1949 was the family business. Some of the most highly-developed Chinese family businesses have been built over several decades by Overseas Chinese in South-East Asia, where, with some exceptions, their activities were not interrupted by confiscations of the scale of those in China in the early 1950s. With the *de facto* privatisation of much of the economy, family businesses have been re-emerging in China since the 1980s.

Chinese family businesses learned to thrive in hostile, or potentially hostile, environments such as those in South-East Asia, by developing operating networks known as *guanxi* (关系 “connections”) linking them with business partners and government agencies. Maintaining control in the hands of family members allowed the enterprise to profit from minimal transparency and disclosure, for example *vis-à-vis* competitors or tax collectors. Such a structure emphasises social cohesion based on kinship within the management echelon. It also fosters, at best, a paternalistic attitude, and, at worst, a lack of family feeling towards hired labour.⁵³

State-owned enterprises (SOEs). After economic reforms were initiated in the late 1970s, industries which were formerly part of the government structure were made into state-owned enterprises (SOEs) and encouraged to develop independent accounting systems to enable them to become profitable. One reason for the lack of profitability of many SOEs was that they

had by then become responsible not only for making products but also for providing housing, healthcare, education and other services to workers and their families. In the 1990s, the government decided to divest SOEs of these responsibilities. For example, the government reformed the housing market by forbidding enterprises from providing subsidised housing and by encouraging banks to lend for home purchases. These reforms are largely complete, but there are areas (such as social security) where the state has not yet been able to take over the full burden of responsibilities.

Managers of existing and former SOEs may therefore need training (and time) to adjust to demands from government and society that they take on new responsibilities, some of which may appear similar to those they have recently shed. At the same time, SOEs are having to fend for themselves in a competitive environment in which they are subjected to conflicting demands. For example, in trying to satisfy foreign customers and NGOs that it is providing adequate facilities for its workers, a factory may have to raise prices to cover the increased cost of production, discouraging foreign purchasers who expect China to be a minimum-cost supplier. The change from plan to market has not by itself sufficiently altered incentive structures to encourage socially-responsible behaviour. In the past, SOEs had to maximise output with little or no regard for their environment. Now they have to maximise profits, often showing a similar disregard for negative externalities.

Confucianism and compliance with social norms

The Confucian value system that dominated China for over two millennia stresses reliance on leadership by example, not on compliance with formal rules, which have, in the absence of an independent legal system, been associated not with the rule of law but with harsh punishments imposed by a domineering state power. One reflection of this is the tendency of the central government over many centuries to enact vague legislation, with the explicit intention of allowing local authorities the flexibility to interpret it according to time and place. Although Chinese law-making is now more sophisticated, not least because of the increasingly open process of preparing legislation and a greater readiness to learn from foreign experience, elements of this tradition of deliberate vagueness persist.

Corporate philanthropy is not RBC, but it can be a channel for it under the right conditions

In countries at the early stages of promoting responsible business conduct (RBC), it is normal for companies initially to select charitable giving as the vehicle of their responsible behaviour towards society. China is no exception, not least because there is already a well-established tradition of generosity by successful Chinese entrepreneurs, including Overseas Chinese

tycoons who have founded a number of major public establishments in China and elsewhere.⁵⁴ Rich individuals in China continue to make large donations to a wide variety of public services (see Box 4.6). Such largesse is frequently ascribed to Confucian values.⁵⁵

Box 4.6. Corporate donations

In the Hurun 2006 *China Corporate Givers List*, Chinese entities made up 26 of list of 50 providers of charitable cash donations (of the others, 10 were based in Hong Kong, China, three in Chinese Taipei, two in Japan and one each in Indonesia, Korea, Singapore, Thailand, UK and USA). However, there were only three Chinese enterprises in the top ten, fewer than those from Hong Kong, China, which comprised four out of the top five givers. The Hurun 2007 *Private Philanthropy List* includes the largest 100 donations from those reported by China's 800 richest individuals.* The largest donation is USD 260 000 and the average donation USD 23 093. The main beneficiary sectors were: education (64), social public welfare establishments (37), poverty relief (21), health (17), culture (11), disaster relief (6), sports (5) (donors typically reported making donations to more than one).

* Source: www.hurun.net.

Corporate philanthropy is not a substitute for RBC. In some cases, it is used as a mere public relations tool, giving “face” to enterprises and their leaders. When this is done to divert attention from irresponsible conduct, negative consequences may counteract any social benefit. Internationally-recognised standards of corporate conduct such as the *OECD Guidelines for Multinational Enterprises* and the Ten Principles of the UN Global Compact do not include sections explicitly endorsing charitable giving as a form of responsible business conduct.

At the same time, corporate philanthropy can constitute one channel among others for enterprises' endeavours to behave in a socially responsible way. Internationally-recognised business conduct standards such as the *OECD Guidelines* can provide criteria for judging the appropriateness of charitable activities. For example, they can encourage the provision of endowments and gifts in a transparent way that accords with sustainable development and other goals, such as engaging in partnerships or initiatives that will enhance environmental awareness and protection (*Guidelines*, V.8).

While rich Chinese individuals are evidently successful in identifying targets for their charitable donations, the proprietors of small and medium-sized enterprises (SMEs) and individuals disposing of smaller sums may be less likely to donate to charity in China than elsewhere because of the lack of a

developed infrastructure to ensure that donations are well spent. Establishing a charitable organisation is procedurally difficult, there is a shortage of searchable information on potential recipients, and, crucially, a lack of independent oversight and auditing of such organisations. The Ministry of Civil Affairs is reportedly drafting a Charity Law to remedy these deficiencies, but there is no indication of when this may be promulgated. Tax allowances for corporate donations to licensed non-profit welfare organisations were introduced in January 2007. However, these are limited to only 20 such organisations and claiming procedures are complex.⁵⁶

Box 4.7. A Chinese academic view of RBC

While many enterprise managers have only a limited understanding of RBC concepts, China's academic community is developing a deeper and more forward-looking approach. A leading exemplar is Wang Zhile, Director of the Research Centre on Transnational Corporations in CAITEC (China Academy of International Trade and Economic Co-operation, MOFCOM's research arm). Wang points out that "intensifying corporate responsibility is neither a show nor an additional burden on a corporation but the core of corporate values, the conduct code, the strategic guideline and the soft competitiveness for a corporation".^{*} According to Wang, Chinese corporations have developed in three stages: 1) from the 1980s to the early 1990s, the introduction of hardware facilities; 2) from the early 1990s to the beginning of the century, the establishment of a modern corporate system; 3) the current phase, beginning with China's WTO accession in 2001, the strengthening of corporate philosophy. This viewpoint is based on the results of research visits by CAITEC staff to the headquarters of over 30 transnational corporations in OECD countries. On the basis of this research, CAITEC examined the varied development of RBC concepts in these countries and developed its own "soft competitiveness" strategy.

* Wang Zhile, ed. (2006).

The Chinese government's approach to human rights⁵⁷

The Chinese government is now seeking to develop explicit policies to expand human rights and is no longer limited to the defensive approach it developed previously in response to criticism from abroad. China's state constitution was amended in 2004 to include for the first time a provision to respect and safeguard human rights.⁵⁸ In 2005, the State Council, China's cabinet, published a *White Paper on China's Progress in Human Rights in 2004*,⁵⁹ in which human rights were classified into: people's rights to subsistence and development; civil and political rights; judicial guarantees for human rights;

economic, social and cultural rights; equal rights and special protection for ethnic minorities; and the rights and interests of the disabled. The *White Paper* also included a report on international exchanges and co-operation in the field of human rights. Several domestic NGOs are active in the human rights area in China, including the China Society for Human Rights Studies, the largest such NGO in China and a member of the United Nations Conference of Non-government Organisations (CONGO).⁶⁰

China participates actively in international fora on human rights. As indicated by the list of rights categories in the *White Paper*, the Chinese authorities place emphasis on a variety of human rights, though this list appears not to be as wide-ranging as that set out in the Universal Declaration of Human Rights.⁶¹ Since 1993, China has submitted many reports to the committees under the Office of the United Nations High Commissioner for Human Rights, including the Committee on the Elimination of Discrimination against Women, the Committee on the Elimination of Racial Discrimination, the Committee against Torture and the Committee on the Rights of the Child (China is a member of all four committees).⁶² China signed the International Covenant on Economic, Social and Cultural Rights (ICESCR) in 1997, ratifying it in 2001 (though entering a reservation on Article 8.1(a) effectively nullifying the commitment to independent trade unions), and the International Covenant on Civil and Political Rights (ICCPR) in 1998.⁶³

The developing legal framework for workers' rights

The role of workers in promoting responsible business conduct

The OECD's *Policy Framework for Investment: A Review of Good Practices* points out: "Trade unions and other elements of civil society also have a role to play in fostering and monitoring responsible business conduct. Like the business sector, they control resources that they can use to improve the quality of the dialogue relevant to the formation of both business and government policy. In particular, they can contribute their knowledge of situations in specific locations and workplaces and bring a wider array of perspectives (other than those of government or business)."⁶⁴

The role of workers in promoting responsible business conduct by exercising their right of supervision in areas such as health and safety is recognised by leading Chinese officials. For example, Li Yizhong, head of the State Administration of Workplace Safety (SAWS) told a meeting of coal miners in Henan Province in July 2007: "Implementing coal mine safety first of all depends on the workers. You are the ones who know best where the dangers are, and, once discovered, you can raise them with the mine director. You have to protect your own rights, only thus can [the principle of] workers being the masters be put into practice. You have the right to know and the

right of supervision.”⁶⁵ (This of course in no way can be taken as a detraction from the responsibility of employers for ensuring workplace safety, as detailed in ILO Convention 155, which China ratified in January 2006.)

Major laws protecting workers' rights have been enacted in recent years

The Labour Contract Law of 2007 provides increased protection for workers.

The Labour Contract Law adopted by the Standing Committee of the National People's Congress on 29 June 2007 after unprecedented public consultation (see below) came into force on 1 January 2008.

The new law places responsibility for signing a written labour contract on the employer. If the employer has failed to do so for over a month after the worker has started work, the employer must pay the worker a double wage (Article 82). If a written employment contract has not been concluded after one year, the employer and the worker are deemed to have concluded an open-ended employment contract (Article 14).

The law provides protection against abuse of probationary periods. Probation periods of less than three months are not permitted in an employment contract, and are limited to one month for contracts of up to one year, two months for contracts of up to three years and six months for open-ended contracts. A worker may not have more than one probation period. Probation periods must be included in the contract of employment. The wages of a worker on probation may not be less than the lowest wage level for the same job with the same employer or less than 80% of the wage agreed upon in the employment contract, and may not be less than the minimum wage rate in the place where the employer is located (Article 19).

The new law also provides greater security of employment by stipulating that an open-ended contract shall be concluded when a worker renews his or her employment contract if, at the time of renewal, the worker has been working for the same employer for at least 10 years or has concluded a fixed-term contract with the same employer on two consecutive occasions (so a third consecutive contract must be open-ended, not fixed-term) (Article 14).

A worker may terminate a contract on 30 days' prior written notice to the employer. During the probationary period this is reduced to three days (Article 37). A worker may terminate the contract without notice if the employer uses violence, threats or unlawful restriction of personal freedom to compel a worker to work, if a worker is instructed in violation of rules and regulations or peremptorily ordered by the employer to perform dangerous operations which threaten the worker's personal safety (Article 38). The employer may terminate the contract immediately if the worker fails probation, materially breaches rules and regulations, commits serious dereliction of duty, is involved in corruption, causes substantial damage to the

employer, or has criminal liability pursued in accordance with law (Article 39). The employer may terminate a worker's contract with 30 days' prior written notice or one month's wages in lieu of notice if the worker becomes incapacitated, remains incompetent after training or adjustment of position or if there is a major change in circumstances and the two sides are unable to reach agreement on amending the contract (Article 40).

The law states that, after bargaining on an equal basis, enterprise employees may conclude a legally binding collective contract with the employer on such matters as labour compensation, working hours, rest, leave, work safety and hygiene, insurance and other benefits. The draft of the collective contract shall be presented to the employee representative congress or all the employees for discussion and approval. This can be done with a trade union, if a branch exists; if not, the employer can conclude the contract with a representative of the workers under the guidance of the trade union at the next higher level (Article 51). Industry-wide or area-wide collective contracts may be concluded between a trade union and sectoral enterprise groups within areas below county level (Article 53). Collective contracts become effective 15 days after submission to the labour administration authority if the latter raises no objection (Article 54). Wages and conditions stipulated in a collective contract may not be lower than the relevant legal minima (Article 55). In the case of a dispute arising from performance of a collective contract, the union may apply for arbitration or institute legal action against the employer (Article 56).

These provisions appear to accord with those in the *OECD Guidelines for Multinational Enterprises* that encourage enterprises to respect "the right of their employees to be represented by trade unions and other *bona fide* representatives of employees, and engage in constructive negotiations, either individually or through employers' associations, with such representatives with a view to reaching agreements on employment conditions".

The Labour Contract Law also protects workers from victimisation arising from efforts to protect health and safety. Article 32 (see below) stipulates that workers shall not be held in breach of their employment contracts if they refuse to perform dangerous operations that are instructed in violation of regulations or peremptorily ordered by management staff, and that workers have the right to criticise, report to the authorities or lodge accusations against their employers in respect of working conditions that endanger their lives or health.

Anecdotal evidence suggests that implementation of the Labour Contract Law has begun in earnest: thousands of factories are reported to have closed in the first few months of 2008 as a result of rising labour costs widely

attributed to new wage contracts (although other factors, notably yuan appreciation, are also likely to be involved).

At the same time, it is possible that some employers have used creative procedures to minimise the impact of the law. It remains to be determined whether other employers have followed the example of Huawei, in Guangdong province, which in late 2007 encouraged 7 000 of its employees to resign before the new law came into force and then re-hired many of them on new contracts.

The Employment Promotion Law of 2007 strengthens existing anti-discrimination legislation... On 30 August 2007, the National People's Congress passed an Employment Promotion Law that came into force on 1 January 2008, at the same time as the Labour Contract Law.⁶⁶ The new law requires employers to provide equal employment opportunities and fair conditions for workers, and forbids employment discrimination. The law standardises and reiterates non-discrimination provisions in a number of previous legal documents, under which discrimination has been prohibited on grounds of disability since 1991, on grounds of race, ethnicity, sex and religion since 1995, against HIV carriers, AIDS sufferers and their family members since 2006, and against hepatitis B carriers since early 2007. Specifically forbidden acts include refusal to hire women or subject them to higher recruitment standards. Limitations based on women's marital or childbirth status may not be included in labour contracts. The law requires that special care should be provided to ethnic minorities when necessary.

The new law greatly strengthens existing law against employment discrimination. First of all, it widens the scope of anti-discrimination legislation. In addition to previous categories of worker who may not be subject to employment discrimination, it adds migrant workers and carriers of any infectious disease, not just HIV/AIDS and hepatitis B, who are otherwise healthy and whose employment does not violate health and safety regulations. Secondly, it for the first time grants explicit rights to individual workers to sue employers alleged to have discriminated illegally against them. There will thus be a sounder legal basis for claims in court against employers who have dismissed, or refused to hire, workers on unfair grounds.

The new law also contains a provision which could help eliminate middlemen who exploit information asymmetries to levy unnecessary and excessive fees from rural migrants seeking jobs in urban areas. Intermediary employment agencies not approved and registered by labour and social security authorities and industrial and commercial authorities will be closed down and fined between CNY 10 000 and CNY 50 000.

... and can form the basis for a more comprehensive and effective framework. While the new law is a significant forward step, it does not yet provide a comprehensive and fully effective framework to deal with workplace discrimination. Age discrimination (included in earlier drafts) is omitted from the law. Penalties and remedies in the form of reinstatement, back pay or punitive damages are not specified in the law, making it uncertain that the law can be effectively implemented, since courts will not have a firm basis for assessing these. Lawyers have commented that it is unclear whether employment discrimination claims will be treated as labour disputes or ordinary civil claims – an important distinction because the statutes of limitations for labour disputes and civil claims differ markedly.⁶⁷

The Trade Union Law protects the right of workers to join official trade unions. The Trade Union Law of the People's Republic of China was adopted by the National People's Congress in 1992 and amended by the Standing Committee of the National People's Congress on 27 October 2001. This law replaced the 1950 Trade Union Law.

Under Article 3, all “manual and mental workers in enterprises, institutions and government departments within the territory of China who rely on wages or salaries as their main source of income, irrespective of their nationality, race, sex, occupation, religious belief or educational background, have the right to organise or join trade unions according to law”, without obstruction or restriction by any organisation or individual. Article 10, which specifies that the All-China Federation of Trade Unions (ACFTU) shall be “established as the unified national organisation”, indicates that trade unions belong to the ACFTU structure.

The ACFTU is explicitly affiliated to the party-state. Article 4 of the 2001 Trade Union Law stipulates that trade unions “shall observe and safeguard the Constitution, take it as the fundamental criterion for their activities, take economic development as the central task, uphold the socialist road, the people's democratic dictatorship, leadership by the Communist Party of China, and Marxism-Leninism, Mao Zedong Thought and Deng Xiaoping Theory, persevere in reform and the open policy, and conduct their work independently in accordance with the Constitution of trade unions”.⁶⁸

To ensure the effectiveness of union representation, the OECD Guidelines for Multinational Enterprises enjoin enterprises to provide facilities to employee representatives as may be necessary to assist in the development of effective collective agreements; provide information to employee representatives which is needed for meaningful negotiations on conditions of employment; and promote consultation and co-operation between employers and employees and their representatives on matters of common concern.

The right to strike was added to China's state constitution in 1978 and excised in 1982. It is not clear whether such a right exists in practice. Article 27 of the Trade Union Law states that when there is a "work stoppage or slow-down strike" in an enterprise or institution, the trade union "shall, on behalf of the workers and staff members, hold consultation with the enterprise or institution or the parties concerned, present the opinions and demands of the workers and staff members, and put forward proposals for solutions". The main role of the trade union is set out in Article 27 as that of helping the enterprise or institution to "help restore the normal order of production and other work as soon as possible".

The ACFTU monopoly implied by the Trade Union Law is not strictly compatible with free trade unionism as enunciated in the OECD *Guidelines for Multinational Enterprises*, which state that enterprises should, within the framework of applicable law, regulations and prevailing labour relations and employment practices, respect "the right of their employees to be represented by trade unions and other *bona fide* representatives of employees". Nor does it accord with Article 42 of the ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy, which holds that "Workers employed by multinational enterprises as well as those employed by national enterprises should, without distinction whatsoever, have the right to establish and, subject only to the rules of the organisation concerned, to join organisations of their own choosing without previous authorisation". However, the law does not explicitly prohibit workers from establishing their own representative system outside the ACFTU structure, though the practical ability to do so is limited. Workplace units of 25 workers or more have the right to elect a committee which does not have to be affiliated to the ACFTU. Nevertheless, ACFTU affiliation is a precondition for obtaining legal protection and status as a negotiating partner. This effectively renders collective bargaining impossible by a non-ACFTU union.

Enforcement of laws on respecting workers' rights

As in other policy areas, enforcement at local level continues to lag behind the rapid accumulation of national legislation. The official media frequently cite cases in which workers' rights have been flouted, sometimes with the complicity or connivance of local government officials.

In June 2007, for example, following the posting on the Internet of a letter from 400 parents seeking their children, who they believed to have been sold into slavery, 359 enslaved workers, including 65 mentally retarded people and at least 12 children, were freed at a brick kiln in Yongji, Shanxi Province and an team appointed from the Ministry of Labour and Social Security, the Ministry of Public Security and the All-China Federation of Trade Unions (ACFTU) to investigate a variety of abuses there. The released workers alleged that they

had been confined at the brickworks and forced to work for over 15 hours a day without pay. One mentally retarded worker had allegedly been beaten to death at the kiln in November 2006 by a member of staff. Of the brick kilns in Shanxi, 2 036 out of 3 347 were found to be operating without licences; 315 were closed and 358 put under investigation.

The dozens arrested and sought by police on various charges relating to slavery at the kiln in Yongji included not only its managers but also the head of the labour inspection team of the city labour and social security bureau. A number of local officials had allegedly turned a blind eye to these abuses and even profited from slave labour. The case was widely publicised by government media and the prime minister chaired a State Council conference which pledged severe punishment of those who use child or forced labour or who maliciously injure workers.⁶⁹

An important sectoral initiative: CSC9000T

In 2005, the Chinese National Textile and Apparel Council published CSC9000T, a set of principles and guidelines for the textile and apparel industry.⁷⁰ The CSC9000T website describes these guidelines as “a social responsibility management system based on the Chinese laws and regulations, international conventions and practices, as well as China’s special needs”.⁷¹ They appear to be a pilot for future guidelines applying to other industries. CSC9000T was drafted by the China Textile Information Centre (CTIC) in consultation with companies and other bodies.

CSC9000T was drawn up after the Chinese government considered adopting SA8000 during negotiations on textile trade with Europe and the United States. Although several Chinese experts recommended strongly that this be done,⁷² the Chinese authorities responded that SA8000 was not in accordance with China’s “national essence” (*zhōngguó guóqíng* 中国国情). (SA8000 is a private standard on which there is not complete agreement in the OECD area.) With the exceptions of the sections on working hours and on child labour and young workers, CSC9000T is relatively undemanding.

Domestic normative references cited as the basis for CSC9000T⁷³ include China’s constitution and laws on labour, trade union, women’s rights, protection of minors, production safety, disability, clean production, collective contracts, prohibition of child labour, work-related injury insurance, minimum wage and working hours. International conventions cited include the Universal Declaration of Human Rights, the United Nations Convention on the Rights of the Child, the United Nations International Covenant on Civil and Political Rights, the United Nations International Covenant on Economic, Social and Cultural Rights, the United Nations Convention on the Elimination of all Forms of Discrimination against Women and the Global Compact,

together with 13 ILO Conventions. These ILO Conventions do not, however, include 29 and 105 on forced and bonded labour, 87 on freedom of association, 98 on the right to collective bargaining, or 135 on workers' representatives.

Child workers are defined in CSC9000T as any person less than 16 years of age who provides service for pay in an enterprise. This is a relatively high standard. In CSC9000T a juvenile or young worker is defined as being above the child worker age and below 18. CSC9000T requires that the enterprise shall guarantee that juvenile workers receive physical examinations at least once a year.

CSC9000T specifies a maximum working day of eight hours and a maximum work week of 40 hours. The relatively short work week specified in CSC9000T corresponds to the change from a six-day to a five-day week decreed by the Chinese government in 1995. Overtime is limited to three hours per day and 36 hours a month in CSC9000T, which also requires enterprises to pay extra for overtime. The principle that overtime should always be voluntary is not explicit in CSC9000T.

CSC9000T does not include an unconditional right to join any trade union. It states the principle that "the enterprise shall respect the right of employees to form and join the trade union and bargain collectively", while elsewhere specifying that "the All-China Federation of Trade Unions [ACFTU] and all the trade union organisations under it represent the interests of all employees and safeguard the legitimate rights and interests of employees". This definition circumscribes the choice of representation to exclude trade unions other than the ACFTU. Nor does CSC9000T provide scope for parallel means of independent and free association and bargaining, where the right to freedom of association and collective bargaining are restricted under law (as in China). It does, though, stipulate that all employees may join or organise trade unions and that trade union representatives may not be obstructed or restricted in carrying out their duties.

A major difference between the CSC9000T and the *OECD Guidelines for Multinational Enterprises* is the omission from CSC9000T of any requirement to ensure and monitor compliance on the part of suppliers and sub-contractors.

CSC9000T is intended as a national standard which will satisfy demands from external purchasers for more responsible conduct on the part of Chinese textile exporters. It is also largely limited to encouraging compliance with legal obligations and does not reference societal expectations in addition to those obligations. It may therefore be regarded as a halfway house towards adopting an internationally-recognised standard such as the *OECD Guidelines for Multinational Enterprises*.

Findings of the OECD research mission to Guangdong factories engaged in implementing CSC9000T

In November 2007, the OECD conducted a research mission to a number of textile factories in the South China province of Guangdong, adjoining Hong Kong. These factories are preparing to implement – and in one case have already started to implement – CSC9000T. All are part of the China National Textile and Apparel Council (CNTAC) 10 + 100 + 1 000 programme, which began in May 2007. This programme is explained in Annex 4.A3, which contains a fuller account of the research mission findings.

The factories were selected by CNTAC as examples of good practice. The workplaces all appeared well-equipped, clean and highly organised. Nevertheless, even these factories did not all comply fully with existing law, let alone RBC standards embodying societal expectations above the law. From this small sample it was clear that there are examples of Chinese enterprises that can be held up as models of good practice in some respects, while in other respects there is room for improvement.

Measures to promote women's rights and gender equality

The Chinese government has taken numerous measures to promote sex equality,⁷⁴ starting with the Marriage Law of 1950 that abolished the “feudal” marriage system, which allowed polygamy, concubinage, child betrothal and other abuses, with one embodying free choice of partners, monogamy, equal rights for both sexes and protection of the lawful interests of women and children. Efforts to achieve equality were given further impetus with the adoption of an *Outline for the Development of Chinese Women (1995-2000)* based on the Platform for Action approved at the Fourth UN World Conference on Women held in Beijing in 1995. In 2001, the government further adopted an *Outline for the Development of Chinese Women (2001-10)* designed to meet the requirements of the United Nations Millennium Development Goals. The 2001 Outline sets 34 major goals and 100 policies and measures in six fields: women and the economy; women's participation in decision-making and administration; women and education; women and health; women and the law; and women and the environment.

Despite these measures, the traditional prejudice against girls, motivated by economic considerations, persists, and is practised from, or even before, birth. The one-child family policy practised since 1980 has led in rural areas to a revival of female infanticide, and more recently, following the introduction of ultrascanning technology, to abortions of female foetuses. As a result, in 2005, boys aged 0-4 years outnumbered girls by 22.7%.⁷⁵ Prejudice against girls is manifested in differential access to education, particularly in rural areas. In the 2005, 1% national sample population survey, women accounted

for 49.8% of the total population over six years old, while making up 72.7% of those with no education whatsoever, 51.2% of those with primary school education, 45.5% of those with junior secondary education, 43.2% of those with senior secondary education and 42.7% of those with tertiary education. The sample survey also showed that 73.6% of illiterates were women. Even in the largely urban municipality of Beijing, 71.5% of illiterates were women.⁷⁶

Sexual discrimination subsequently extends from education to the workplace. Surveys of women graduates in China in recent years suggest that sexual discrimination in recruitment remains widespread. Many employers openly state that they prefer to hire men, even in published job advertisements. For example, a random search for jobs in all categories in all areas of China by the OECD on the recruitment website *www.zhaopin.com* on 9 October 2007 with the search item “male sex” (*nánxing* 男性) resulted in 7 777 results, most of them citing “men only”, “males required” or similar limitations. This is a small but nonetheless significant proportion of the advertisements on the site: when the search item “work” was input, there were 183 624 results. Other employers do not state a preference, but discriminate against women in practice. Hiring rates for female graduates are below those for males, and women generally earn less than men in the same jobs.

A 2001 joint survey of 48 192 people throughout China by the All-China Women’s Federation and the National Bureau of Statistics found that Chinese women’s social status was still lower than that of men. The survey included separate questionnaires for four groups consisting of migrant women farmers, women entrepreneurs, women workers in state-owned enterprises and women from minority nationalities. The survey found women to have a lower employment rate than men and more difficulty finding another job after being laid off. It also noted an increasing gap between the average wages of women and men. The survey found that girls in rural areas were less likely to receive education than boys. According to the survey, women still performed 85% of household duties.⁷⁷

According to a survey published in 2007 of several hundred women conducted by the South-West University of Political Science and Law, nearly 70% of Chinese women college graduates face sexual discrimination when applying for employment. The survey found that many employers ask only for male applicants in advertisements; others who do not advertise a gender preference refuse in practice to interview female applicants. Such discrimination was found to be worst in government organs, state institutions and state-owned enterprises. Most respondents chose to tolerate the discrimination, according to the survey. A survey conducted by the Ministry of Labour and Social Security, which covered 62 cities, shows that 67% of employers set gender restrictions against women or required in employment contracts that female employees not become pregnant for a certain number of years.⁷⁸

Measures to promote children's rights⁷⁹

China ratified ILO Convention 138 on the minimum age of work in 1999 and Convention 182 on the worst forms of child labour in 2002.⁸⁰ Regulations that took effect on 1 December 2002 ban the employment of children under the age of 16 years, imposing fines for violations and requiring employers to check workers' identification cards for age. There are other indications that China is increasingly willing to address the issue of child labour. During the consideration by the United Nations Committee on the Rights of the Child of China's second report in September 2005, there was official recognition that there were children in need of special protection measures, including street children, children of migrants and those vulnerable to trafficking. China still faces multiple challenges in child protection owing to visible disparities between urban and rural areas and a traditional culture favouring boys over girls. Since the proportion of children working is low, the challenge is to reach out and identify the isolated pockets of child labour. One group that is receiving greater attention are the children of migrant workers left behind with family members or those living with their parents in cities but not necessarily having access to education. Moreover, the problem of child labour may spread with the rapid growth of labour-intensive industries. The International Programme on the Elimination of Child Labour (IPEC), launched in 1992, has been working in Yunnan Province since 2000 as part of the Mekong sub-regional project to combat trafficking in children and women and in 2004 launched a new project to prevent trafficking in girls and young women for labour exploitation within China. China was also represented at the first regional capacity building training course on child labour data collection organised by the ILO, together with the inter-agency research project Understanding Children's Work (UCW), held in Bangkok in November 2004. This reflects a growing willingness by China to learn from experience in other countries.

Measures to protect the environment and promote sustainable development

The 11th Five-Year Plan for National Economic and Social Development⁸¹

The Chinese authorities replaced the system of central planning of production by one of "socialist market economy" in 1994. Five-year plans are now indicative, setting general goals for the whole economy that no longer involve annual production targets for enterprises. The 11th Five-Year Plan, covering 2006-10, is intended to clarify the national strategic intention, define the key emphasis in government work and guide the behaviour of market participants. It is frequently referred to as a "five-year guidance" to distinguish it from earlier mandatory plans.

The 11th Five-Year Plan gives a higher priority to sustainable development than earlier plans and specifies more, and stricter, targets for energy conservation and environmental protection.

Drafters of the 11th Plan note persistent difficulties, including: shortages of farmland, fresh water, energy and other important mineral resources; vulnerability of ecosystems; irrational economic structure; rural issues; unemployment; and the weakness of China's independent scientific and technological innovative capacity. They also identify new major problems that emerged during the 10th Five-Year Plan period (2001-05) as: a lack of co-ordination between investment and consumption; "blind" expansion of some industries, leading to superfluous capacity; slow transformation of economic growth mode (see below); excessive energy resource consumption; aggravated environmental pollution; and a continuous widening of the development gap between urban and rural areas and between regions, and a widening of income differentials in society as a whole.

A major focus of the 11th Plan is on accelerating the change of "economic growth mode" to one of sustainable development by making resource conservation a basic national policy, developing a recycling economy, protecting the ecological environment, accelerating the construction of a resource-saving and environmentally friendly society, and promoting the co-ordination between economic development and population, resources and environment.

Another major focus is that of constructing a "harmonious society", co-ordinating the development of economy and society to promote overall human development. This involves increased emphasis on social equity and enabling all people to share the achievements of reform and development, as well as paying more attention to the construction of democratic and legal systems, while maintaining social stability and solidarity.

Specific targets for energy conservation and environmental protection are not more extensive in the 11th Five-Year Plan than in the 10th Plan; there are fewer quantitative targets in the 11th Plan. There are specific targets to reduce emissions of sulphur and nitrogen oxides by 10% below the 2005 figure during the period 2006-10, but these are unlikely to be met.⁸² Energy consumption per unit of GDP is to be reduced by 20% during this period, water consumption per unit of industrial value added is to be cut by 30% and comprehensive utilisation of industrial solid wastes to be increased to 60% from the 2005 figure of 55.8%.

Sustainable development targets include reducing total discharge of major pollutants by 10%, increasing forest coverage from 18.2% in 2005 to 20% by 2010 and controlling greenhouse gas emissions by an unspecified amount. Rural domestic wastes and waste water treatment is to be promoted, along with

improved sanitation. Industrial solid wastes, hazardous wastes, town refuse and other pollutants are prohibited from being transferred to rural areas.

The energy strategy of the 11th Five-Year Plan gives priority to conservation, but is based on coal, which has hitherto been a major source of both pollution and deaths from mining accidents. The 11th Plan continues the government's drive to consolidate coal production in a few large mines with a production capacity of 100 million tonnes and close down the numerous small and dangerous mines. Clean production and utilisation are encouraged, for example through coal liquefaction.

The emphasis in thermal power development is on large-scale, high-efficiency environmental protection units, using clean coal in 60 MW fluidised bed power plants and integrated coal gasification gas-steam combined cycle power plants, as well as natural gas power plants. The elimination of small and backward thermal power units is to be accelerated. Several large hydropower projects are to be developed on the basis of ecological protection and proper resettlement of affected residents, environmental governance, flood prevention and navigation. Pumped storage stations are also planned. Nuclear power is also to be expanded, using advanced pressurised water reactors.

The production and consumption of renewable energy resources is to be encouraged by preferential financial, taxation and investment policies and by mandatory market share policies. The 11th Five-Year Plan includes the construction of 30 large-scale wind power generation projects of over 100 000 kW each and the formation of wind power generation bases of one million kW in several provinces. The development of biomass energy is to be accelerated and the use of stalks, waste incineration, bio-diesel and ethanol in power stations promoted. By 2010, installed wind power generating capacity is planned to reach 5 million kW and biomass power generating capacity 5.5 million kW. Solar, geothermal and ocean energy will also be developed.

Raw materials industries are required to reduce consumption and pollution, upgrade product quality and increase the industrial concentration ratio. The iron and steel industry is particularly urged to restructure to eliminate overcapacity and backward technology, equipment and products so that it can use less energy and less waste, including by increased waste recycling. The building materials industry is encouraged to develop energy efficient and environmentally friendly new building materials, insulation materials and green decoration materials. Light industries, including textiles, are encouraged to innovate with new technologies so as to reduce water consumption and pollution discharges.

Infrastructure construction plans are also guided by principles of sustainable development. While continuing to expand road and rail transport networks, the 11th Five-Year Plan gives priority to the development of public

transport, making rail the preferred mode of transport. Urban water supply and drainage is to be made safer and based more on recycling.

While areas where resource environmental bearing capacity is relatively strong are designated as key development zones, others are restricted development zones where activities such as logging and reclamation are prohibited and afforestation, headwater conservation, wildlife protection and/or other measures are required. The Plan also makes provision for prohibited development zones, including national nature reserves, 31 world cultural and natural heritage sites, natural key famous scenic sites and natural forest parks. The maintenance and development of the various zones is to be supported by financial, investment, industrial, land and population management policies (see Box 4.8).

Box 4.8. The 2007 government work Report: Re-orienting China's growth strategy

In his annual report on the work of the Chinese government delivered at the opening of the 2007 session of the National People's Congress,^{*} Premier Wen Jiabao reiterated the government's basic approach, including the building of a harmonious socialist society, the strengthening of resource conservation and environmental protection, the promotion of social development and the resolution of issues related to the people's well-being. In outlining major policies for 2007, he stated that the government needed to improve the quality and efficiency of economic growth by attaching greater importance to saving energy and resources, protecting the environment and using land intensively, pay close attention to improving product quality, strengthen the competitiveness of the economy and better ensure the sustainability of economic development. He also stressed the need to put people first, promote faster progress in social programmes, work energetically to solve the most practical problems of greatest concern to the people and most directly affect their interests, safeguard social fairness and justice, and ensure that all of the people share in the fruits of reform and development.

Environmental conservation is at the heart of a new economic strategy described in Premier Wen's report, which stresses that: "We must make conserving energy, decreasing energy consumption, protecting the environment and using land intensively the breakthrough point and main fulcrum for changing the pattern of economic growth." The main elements of this strategy are:

- A tightening of energy consumption and environmental protection standards, including compulsory environmental impact assessments and closure of enterprises that do not meet standards after corrective steps have been taken.

Box 4.8. **The 2007 government work Report: Re-orienting China's growth strategy (cont.)**

- Resolute closure of backward production facilities, including thermal power plants, iron foundries, steel mills and facilities in the cement, electrolytic aluminium, ferrous alloy, coke and calcium carbide industries.
- Concentration on key industries and enterprises, especially key energy-saving projects such as upgraded boilers and furnaces, combined heat and power facilities, and urban public transport systems
- Giving full play to the role of the market and using price reforms, government finance, taxation and credits to promote energy saving and environmental protection.
- Accelerated development of energy-saving and environmentally-friendly technologies, stressing comprehensive resource utilisation, clean production and recycling.
- Bringing pollution under control and protecting the environment, using government funds to build urban sewage treatment and waste disposal facilities. The government will prohibit the relocation of urban polluting enterprises and dispersal of urban polluting materials in the countryside.
- Strengthening oversight and management of compliance with the law.
- Implementation of a responsibility system for fulfilling energy-saving and environmental protection targets.

Premier Wen stressed that these policies were not just for the government to apply. "We strongly advocate," he said, "conservation-oriented, environmentally friendly and civilised patterns of production and consumption throughout society so that conserving resources and protecting the environment become second nature for every enterprise, village, organisation and individual member of society. We need to work hard to build a resource-conserving and environmentally friendly society."

* Wen Jiabao, Report on the Work of the Government, Delivered at the Fifth Session of the Tenth National People's Congress on 5 March 2007.

While the central government has a well-defined strategy on environmental protection and has evidently allocated it a high priority, implementation at local level lags far behind. The 2007 *OECD Environmental Performance Review of China* states: "Overall, environmental efforts have lacked effectiveness and efficiency, largely as a result of an *implementation gap*." It points out that "The biggest obstacles to environmental policy implementation are at the *local level*". The *Review* makes over fifty recommendations for improving implementation, all of which have been accepted by the Chinese government.

To the extent that environmental problems are linked to industrial activity, enterprises can play an important role in implementing environmental policies – although RBC complements, and cannot be a substitute for, effective government action. For enterprises to play this role, appropriate incentives are needed. Incentives could be provided by using mechanisms like public disclosure of environmental information to mobilise community pressure on enterprises, and prizes and awards for good corporate environmental practices. Internationally there are both positive and negative incentives. RBC in the environmental sphere can enhance the brand and sales, and provide some competitive advantage. Conversely, sales and reputation can be damaged by poor environmental practices overseas when highlighted by NGOs and the media.

The 2007 OECD *Environmental Performance Review of China* points out that “In general the environmental awareness and performance of domestic Chinese enterprises is weak. Exposure to foreign markets with well-established environmental regimes, and commerce with multinational companies based in China that have strong corporate environmental policies, are probably the main drivers at this time”.

Chinese companies have started to respond positively to national initiatives in the area of environmental protection and energy conservation. The government has implemented a variety of approaches to promote cleaner production and adoption of environmental management systems. These provide win-win opportunities to save costs by using energy and materials more efficiently, thereby decreasing pollution. Some 8 000 Chinese companies have been certified under the ISO 14001 environmental management system, the second highest number after Japan.⁸³

The Review also recognises the dramatic increase in China’s engagement with other countries in addressing environmental challenges, reflecting a growing recognition across the spectrum of Chinese institutions of the important economic, social and ecological stakes that China has in meeting these challenges, and also of its shared interests with the international community. China is now an active, constructive participant in a broad array of regional and global economic conventions, institutions and programmes, and is drawing heavily on international financial institutions and special mechanisms to augment its own resources and ensure that China’s international commitments are met.

Measures to ensure product safety

Reacting to strong criticism in overseas markets (see above), the Chinese government has recently strengthened regulations to ensure product safety. The State Food and Drug Administration announced in July that from

September 2007, all food exported from China must carry an inspection and quarantine symbol to guarantee safety. Small-scale producers will also have to take measures to meet hygiene standards or face closure. At the same time, the government has banned the use of diethylene glycol in toothpaste.⁸⁴

The development of civil society in China

During the period of economic reform that began in 1978, economic decentralisation has been accompanied by a partial loosening of the control exercised by the party-state over society since the establishment of the People's Republic of China in 1949. This is particularly evident in the relaxing of controls on individual consumption as a result of both policy change and a widening of consumer choice resulting from rapid GDP growth. However, the reluctance of the country's leaders to cede power has ensured that the development of autonomous social organisations has not kept pace with the proliferation and expansion of productive units.

In recent years academic discourse in China began to include discussion of the application of the concept of "civil society" to China in the 1990s.⁸⁵ Government consideration of the positive role of a "third sector" (i.e. non-government, non-business) stemmed from various motivations, including a recognition of the role of professional associations, a need to hive off functions to streamline the government, and a desire to recruit "social forces" (*shèhuì lìliang* 社会力量) to help fill gaps in social services provision.⁸⁶ Favourable mention of the development of "civil society" (*gōngmín shèhuì* 公民社会 or *shìmín shèhuì* 市民社会) in the media appeared in the period of preparation for the 17th National Congress of the Communist Party of China in 2007, when this began to be cited as the basis for constructing a harmonious society.⁸⁷

Over the past two decades a parastatal non-profit sector has been created by the central authorities to advance charitable, research, information and policy objectives. These are commonly referred to as "government organised NGOs" (GONGOs).⁸⁸ While not wholly independent of government, many are sufficiently removed from it to be able to play an advocacy role on behalf of interest groups. They often also provide access to international non-governmental fora. One commentator notes that they are "steadily acquiring a more independent identity and developing a sense of themselves as belonging to a distinctive, non-government community" and notes that the government evidently wants them to become financially independent, as it is "progressively withdrawing budgetary support and hidden subsidies from many organisations".⁸⁹

In addition to NGOs there are *ad hoc* groupings formed around specific issues. While these do not have the authority of official or semi-official bodies, they may have a strength of purpose and rationale that enable them to affect

public policy. This is particularly the case with regard to environmental issues, where the government allows significant room for criticism and dissent in the media. For example, in June 2007 a campaign to block the construction by a Chinese Taipei owned company of a large plant to produce P-Xylene (PX), a carcinogenic chemical, near a residential sector of the South China city of Xiamen succeeded after the project location was criticised by an academician of the Chinese Academy of Sciences and another 104 members of the Chinese People's Political Consultative Conference (CPPCC) and by 10 000 people who attended a demonstration in Xiamen. The local government effectively cancelled the project, which was estimated as potentially increasing Xiamen's GDP by approximately 70%.⁹⁰

Promotion of communication on RBC and protecting the rights framework

PFI Question 7.2. What steps does the government take to promote communication on expected responsible business conduct to investors? How does the government endeavour to protect the rights framework that underpins effective communication?

Law-making is the key channel for communicating societal expectations to companies, thus creating a stable, predictable environment conducive to investment. Expectations concerning responsible business conduct are also communicated through a multitude of other channels and these also affect the quality of the investment environment. Such communication can take place within the workplace, with local communities, with trade unions in the course of industrial relations and collective bargaining, through discussions with investors, dialogue with other civil society organisations, via the press and so forth. These two-way communication channels provide inputs that can be valuable for setting company policies and evaluating performance. These other channels complement the information communicated to companies through formal legal and regulatory processes.

Governments play several roles in ensuring that these other communication processes work well. While the protection of human rights (*e.g.* political, social, civil, labour and property) is a fundamental objective in itself, it is also a precondition for effective communication to take place. This removes threats of rights violations so that many voices, including those of investors, can be heard. Thus, the protection of the rights framework is a key responsibility of governments.

The revised Company Law promotes elements of RBC

The Company Law of the People's Republic of China stipulates that companies shall protect the lawful rights and interests of their employees, conclude employment contracts with the employees, contribute to social insurance, and strengthen labour protection so as to realise safe production. It also requires companies to reinforce vocational education and in-service training of employees.

The Company Law supports the right of employees of a company to organise a trade union to carry out union activities and safeguard the lawful rights and interests of the employees according to the Labour Union Law of the People's Republic of China. Companies are required to provide the necessary conditions for trade union to conduct their activities. The Company Law entrusts trade unions to conclude collective contracts with companies on behalf of employees on remuneration, working hours, welfare, insurance, work safety and sanitation, and other matters. Pursuant to the Constitution and other relevant laws, the Company Law states that a company shall implement democratic management in the form of meeting of the representatives of the employees or any other ways. Companies shall solicit the opinion of trade unions before making decisions on restructuring or any important issue related to business operation, or to formulate any important regulation, and shall solicit the opinions and proposals of the employees through the meeting of the representatives of the employees or in any other way (see Box 4.9).

China has published RBC guidelines for major state-owned enterprises

In addition to law-making, government-backed instruments for responsible business conduct – such as the *OECD Guidelines for Multinational Enterprises* – are also important channels for communicating with business. The Chinese government has started to issue sets of national guidelines for enterprises, distinguished by form of ownership. The first of these, the *Guiding Opinion on Fulfilling Social Responsibilities by Central Enterprises*, was issued by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) on 29 December 2007 (full text in Annex 4.A1).

The *Guiding Opinion* is addressed to “Central Enterprises”, i.e. the major state-owned enterprises under SASAC jurisdiction. It does not therefore cover private enterprises or foreign-invested enterprises (FIEs). A separate set of guidelines for FIEs is reported to be in preparation.

The *Guiding Opinion* sets out a number of requirements on central enterprises:

- Legal operation on the basis of honesty and creditworthiness.
- Continuous improvement of sustainable profit-making capability.

Box 4.9. Environmental Conditions in the Lending Policies of the Export-Import Bank of China¹

The Export-Import Bank of China (China Exim Bank 中国进出口银行) is solely owned by China's central government and acts as a state policy bank responsible to the State Council (China's cabinet). It provides financial support to exports of machinery, electronic products, high-tech products, construction projects and overseas investment projects. It is also the sole lending bank for the Chinese government's concessional lending.²

China Exim Bank pays a high level of attention to the environmental impact of projects which it funds, emphasising environmental monitoring and management before, during and after project implementation.

Before – Project Review. China Exim Bank considers a project's environmental impact assessment a basic requirement for project review. It requires funded projects to conduct a feasibility study on environmental impacts and obtain endorsement or approval from the recipient country's environmental administration. Projects which are harmful to the environment or are not endorsed or approved by the environmental administration will not be funded. This policy has been thoroughly implemented in the thousands of projects funded by Exim Bank.

During – Project Examination. China Exim Bank conducts regular examinations during project implementation, including examinations of the project's environmental impact. Should any unacceptable negative environmental impact occur during project implementation, China Exim Bank will require the implementing unit to take immediate remedial or preventive measures. Otherwise, it will discontinue financial support.

After – Post-Project Review. After the project has been stopped or completed, China Exim Bank will conduct a post-project review. Environmental impact assessment is an essential part of post-project review. China Exim Bank will revise measures taken before and during other similar projects on the basis of the results of the post-project review. If necessary, relevant requirements and policies will be fully revised.

1. This box includes an unofficial summary of the environmental policy guidelines of the China Export-Import Bank as supplied in May 2007 by the Bank (in Chinese) to Pacific Environment, an international NGO and member of ECA Watch, which monitors the environmental and social standards set by export credit agencies. The original text sets these guidelines in the context of a detailed list of central government policies on environmental protection by enterprises.

2. <http://english.eximbank.gov.cn>.

- Earnestly improving product quality and level of service.
- Strengthening resource conservation and environmental protection.
- Promoting autonomous innovation and technological progress.

- Ensuring safe production.
- Protecting the legal rights of employees.
- Participating in public welfare activities.
- Establishing and deepening awareness of social responsibility.
- Establishing and improving a social responsibility performance system.
- Establishing a social responsibility reporting system.
- Strengthening communication between enterprises and international co-operation.
- Strengthening the leadership of Party organisations over social responsibility work.

The aim of fulfilling social responsibility is defined in the *Guiding Opinion* as implementation of the concept of “scientific development”, i.e. sustainable development. Responsibility, though labelled “social responsibility”, is defined more widely, i.e. to the enterprise, society and the environment. Fulfilling social responsibility is, the document states, “a requirement by the entire society”.

As well as a means for achieving the largely domestic goal of sustainable development, fulfilling social responsibility is also described in the *Guiding Opinion* as “an objective requirement for international economic co-operation”. With globalisation, it says, “the international community shows great concern for CSR, and social responsibility performance has become an important indicator by which the international community evaluates an enterprise”. Fulfilling social responsibility, it continues, is not only good for establishing a “responsible” image for central enterprises, it can also help establish a good image for China as a responsible developing country.

Supporting financial and non-financial disclosure

PFI Question 7.3. Does the government ensure that an adequate framework is in place to support the financial and non-financial disclosure that companies make about their business activities? Is this framework flexible enough to allow scope for innovation, for tailoring practices to the needs of investors and their stakeholders?

Clear and complete information on enterprises is important to a variety of users ranging from shareholders and the financial community to other constituencies such as employees, business partners, local communities, special interest groups and society at large. Disclosure can be a powerful tool for influencing the behaviour of companies. However, weak disclosure and non-transparent practices can contribute to unethical behaviour and to a loss

of market integrity at great cost, not just to the company and its shareholders but also to the economy as a whole.⁹¹ Governments can enhance the quality of the investment environment by ensuring that an adequate framework is in place, whether through legislation or self-regulation, to support clear communication of all relevant rules and guidance for both financial and non-financial disclosures. When disclosures are mandatory, governments need to ensure that the application and enforcement of these requirements is non-discriminatory. At the same time, governments should seek to avoid unnecessary regulatory burdens and to allow innovation and adaptation to particular company circumstances to take place.

The Chinese government has in recent years put in place a framework of laws and regulations requiring financial and non-financial disclosure by companies about their business activities. Moreover, since 2002, China has undertaken crucial reforms and initiatives to enhance both corporate governance and the management of state-owned assets of which disclosure is only a part.

The Securities Law of the People's Republic of China was passed by the Standing Committee of the National People's Congress on 29 December 1998 and came into force on 1 July 1999. This law sets out listing requirements that include notification of information to the securities regulator. The Securities Law was revised in 2005 and came into effect on 1 January 2006. One of the key concerns that the government sought to address with this law was to improve the accountability and performance of listed companies.

The Company Law of the People's Republic of China was adopted by the Standing Committee of the National People's Congress in December 1993 and revised in December 1999, August 2004 and October 2005. In 2005, significant modifications were made to the Company Law and these came into effect on 1 January 2006. One of the major objectives of the revisions was to strengthen the protection of minority shareholders' rights, clarify fiduciary duties and improve corporate governance in China. The law prescribes fixed penalties for false reporting of capital contribution, the keeping of more than one account book, making false records, concealing information in reports submitted to the authorities, not informing creditors of changes in capital, and other financial disclosure failures.

The Accounting Law of the People's Republic of China was adopted by the Standing Committee of the National People's Congress on 21 January 1985 and revised in December 1993 and October 1999. The 1999 revision came into force on 1 July 2000. In February 2006, the Ministry of Finance released the Accounting Standards for Business Enterprises (ASBE), consisting of 39 standards to be applied to all listed Chinese companies. The Ministry also issued 48 auditing standards for certified public accountants. The aim of this

initiative is to facilitate further development of a market economy in China, raise the quality of financial information and boost investor confidence. The new ASBE standards are intended to bring Chinese accounting practices largely in line with the International Financial Accounting Standards (IFRS). Although there are concerns that these new Chinese standards do not completely replicate the IFRS as intended by the international standard setters, they have incorporated many of its key principles.

A “Code of Corporate Governance for Listed Companies in China” was issued by the China Securities Regulatory Commission (CSRC) and the then State Economic and Trade Commission (SETC)⁹² in January 2002. This Code is based on the OECD Principles of Corporate Governance and the Chinese authorities have been taking steps to strengthen its enforcement through inspections.

In parallel, the 16th Communist Party Congress in late 2002 concluded that better management of state-owned assets would be one of the top priority areas for the government and a new commission, the State Assets Supervision and Administration Commission (SASAC), was set up in April 2003 to manage state-owned assets. The establishment of SASAC represents a crucial step towards separating the ownership function from the regulatory function within the Chinese administration in respect to state-owned assets. As set out in the OECD Guidelines on Corporate Governance of State-Owned Enterprises, priorities for moving forward include: ensuring a level playing field with the private sector; reinforcing the ownership function within the state administration; improving the transparency of SOEs’ objectives and performance; strengthening and empowering SOE boards; and providing equitable treatment of minority shareholders.

This is also emphasised in the Shanghai Stock Exchange’s 2006 annual report on corporate governance of listed SOEs, which states that while there has been progress with improving corporate governance mechanisms in SOEs, this is mainly in form and not in substance. For example, there is still a blurred line between the role of government and enterprises. Administrative interference continues in a few key areas of corporate operations by government, outside its scope of responsibilities as the capital provider. Also, the boardroom is more of a mere formality. The problem of “insider control” still exists in some companies.

Key to disclosure integrity, in 2006 the Shanghai Stock Exchange released *Guidelines of the Shanghai Stock Exchange on Internal Control of Listed Companies*, which provided a guide for listed companies to establish and implement an internal control system and also placed a requirement on information disclosure regarding internal control systems. In February 2007, the CSRC issued Measures on the Administration of Information Disclosure of Listed

Companies, requiring listed companies to make institutional arrangements to strengthen corporate governance and enhance disclosure of accurate information.⁹³

However, despite these encouraging reforms on paper, stake-holders are in broad agreement that information disclosure in practice lags behind the pace of enactment and promulgation of disclosure-related rules and standards. Therefore, the quality of disclosure can not be guaranteed. For example, abusive related party transactions between listed companies and state-owned companies are widespread, leading to tunnelling and misappropriation of funds. Also, considerable financial mis-reporting aimed at tax evasion needs to be dealt with not only to ensure compliance with tax laws but also to provide a firm basis for the enforcement of social insurance provisions.

In order to support China in its efforts to translate policy reforms on paper into action and enforcement, the OECD-China Policy Dialogue on Corporate Governance was established in 2004. Previous meetings focused, among other issues, on corporate governance of state-owned enterprises, and the OECD Guidelines on Corporate Governance of State-Owned Enterprises were presented for the first time outside the OECD at one of these. The most recent meeting took place on 29-30 March 2007 in Shanghai. Senior representatives from the CSRC, the Shanghai Stock Exchange, the Development Research Centre of the State Council (DRC) and SASAC, and their counterparts from some OECD member countries as well as Chinese and international business leaders discussed challenges in the boardroom. The next policy dialogue meeting in the autumn of 2008 is planned to focus on transparency and disclosure, a priority issue in China. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and voting of shares. Insufficient or unclear information may hamper the ability of the markets to function, increase the cost of capital and result in a poor allocation of resources.

Supporting companies' efforts to comply with the law

PFI Question 7.4. How can the government support companies' efforts to comply with the law?

Effective and transparent enforcement of the law motivates compliance in a particularly straightforward way – by creating costs for non-compliance (e.g. the costs of investigations, legal costs, fines, imprisonment and damage to reputation) and by having a “deterrent” effect. Complying with law can be a

challenge and requires the knowledge of specific business circumstances and deployment of managerial expertise and of formal management systems.

Governments can facilitate and motivate companies' efforts by seeking out companies' views on laws and enforcement practices. They can also provide conciliation and ombudsman facilities so that investors and others have the right to complain about government decisions that they believe are unjust. In addition, governments can acknowledge and support private initiatives to enhance compliance by providing guidance on appropriate compliance management practices.

Government can strengthen RBC with effective enforcement mechanisms

A key feature of economic reform in China since 1978 is decentralisation of control, starting with the breaking up of the rural communes, then proceeding through enterprise autonomy to formal dismantling in the 1990s of the central planning machinery built up since 1953. But effective decentralisation can require more, not less, regulation and regulation needs to be effective. The Chinese government can still play an important role in encouraging RBC by enforcing its legislation throughout the economy. Confronted with strong government implementation of laws on, for example, labour conditions, companies are likely to respond more positively than if implementation is lax.

In one study of differential behaviour of a company based in Chinese Taipei with factories in both Vietnam and China, researchers found that the company operated far higher labour standards in Vietnam, where abuses were less likely to be tolerated by local government, unions were stronger and the human rights awareness of workers was higher. These findings from surveys and interviews with workers were confirmed by frank admissions from the company managers.⁹⁴

China's legal system is still at an early stage of development

China's legal and regulatory framework is still at a relatively early stage of development compared to those of most OECD member countries. Before economic reforms began at the end of 1978, the country was governed at national level by decrees of the leaders of the Communist Party of China rather than by legislative enactment, although some major reforming laws, including the Marriage Law and the Labour Law, were passed in the early 1950s. The rudimentary "socialist" legal system developed in the 1950s was, along with other state institutions, undermined and largely destroyed during the Great Proletarian Cultural Revolution of 1966-69. Consequently, by the time China's constitution was amended in 1982 to stipulate that all state organs would

henceforth be subject to the rule of law, the country lacked a body of law, functioning independent courts, trained judges and lawyers.

In the past quarter of a century, strenuous efforts have been made to address legal deficiencies

Another constitutional amendment in 1999 further emphasised the rule of law. The current version of the state constitution, last amended in 2004, states, *inter alia*, that: the people administer state affairs and manage economic, cultural and social affairs in accordance with the law (Article 2); the People's Republic of China governs the country according to law and makes it a socialist country ruled by law (Article 5); all state organs, the armed forces, all political parties and public organisations and all enterprises and institutions must abide by the Constitution and the law (Article 5); no organisation or individual is privileged to be beyond the Constitution or the law (Article 5); the state protects the lawful rights and interests of the individual, private and other non-public sectors of the economy (Article 11); all citizens of the People's Republic of China are equal before the law (Article 33); every citizen is entitled to the rights and at the same time must perform the duties prescribed by the Constitution and the law (Article 33).⁹⁵

Over the past 30 years, over 300 laws and many thousands of regulations have been promulgated in China in similar policy areas to those in OECD jurisdictions. A high proportion of these cover economic affairs. Commitments undertaken by China for its accession to the WTO at the end of 2001 resulted in a major pruning and updating of the expanded body of economic law.⁹⁶

Since 1978, the training of lawyers has been greatly expanded. By the end of 2002, there were 123 855 licensed lawyers in China.⁹⁷ By June 2007, there were over 119 000 practising legal practitioners, including 103 389 full-time lawyers, 6 841 part-time lawyers, 1 817 lawyers holding official positions, 733 corporate lawyers, 1 750 army lawyers, and 4 768 auxiliary lawyers. Of these, 64.6% held first degrees in law and 10 000 had postgraduate qualifications. In addition, there were also over 30 000 legal support staff. Chinese lawyers worked in 11 691 legal offices, of which 8 024 were partnerships, 1 746 were legal co-operatives and 1 742 were supported by stated funding.⁹⁸

The official media report that there are now 300 000 people working in courts at all levels, and that 180 000 of these are judges – one of the highest totals in the world.⁹⁹ However, China's judges are notoriously under-qualified. Many were previously recruited from decommissioned military personnel or court clerks and lacked formal legal education. Until the mid-1990s, no educational qualification was needed: any Chinese citizen over the age of 23 who had not been deprived of political rights was eligible to become a

judge. The Judges Law, revised in 2001, now requires judicial candidates to have a law degree or to have passed the state judicial examination.¹⁰⁰ From 2002, all judges have been subject to professional examination, with dismissal for all who fail.¹⁰¹ However, the pass rate in the judicial examination has reportedly been extremely low, at around 10%.¹⁰² The continuing shortage of qualified judges has prompted analysts to suggest solutions such as the recruitment of legal academics, the appointment of circuit judges and the delegation of non-essential duties to lower ranking court officials.

Efforts to maintain judicial independence need to be intensified

A major problem confronting the Chinese central authorities in their efforts to ensure the impartial application of law nationwide has been the lack of independence of judges at local level. This problem is in part a legacy of the “rule of man” that preceded the legal development of recent decades: numerous cases reported in the Chinese media attest to the authoritarian habits that persist at township and village level, in particular in dealing with complaints against alleged illegal actions by local officials.¹⁰³ Another factor militating against judicial independence is the lack of legal competence of many judges (see above), which motivates them to rely on advice from influential officials, themselves often interested parties in legal actions. The President of the Supreme People’s Court, Xiao Yang, said in July 2002 that “incompetent judges” were “one of the most vital factors in judicial inequity” and that judges are frequently “viewed as civil servants who have to follow orders from superiors, which prevents them from exercising mandated legal duties”.¹⁰⁴

The OECD in 2003 recommended that current efforts to improve the functioning and independence of the legal system could be intensified by: training and appointing legally-qualified judges to all courts; raising the pay of judges and other key legal personnel to reduce their vulnerability to offers of bribery; enhancing the status of judges vis-à-vis local government and party officials; and establishing at national and regional level mechanisms to guarantee the execution of court judgments.¹⁰⁵ It remains to be determined how far these actions have been taken and to what extent they have been effective.

Consultation on draft laws is improving...

The Chinese government has begun to consult companies, including foreign invested-enterprises, in drafting and implementing legislation. In earlier years, such consultation has not always been timely, complete and effective. The OECD recommended in 2003 that China increase the scope of stakeholder consultation with regard to FDI-related legislation, starting with more consistent and comprehensive consultation involving all major players

in an industry and moving towards an open public debate on proposed legislation.¹⁰⁶

The most recent such legislation, the Labour Contract Law (detailed above), was released for public comment on 20 March 2006, over a year before it was passed on 29 June 2007. By 20 April 2006, the government had received 191 849 comments, over 65% of them from “ordinary workers”, according to the official media.¹⁰⁷ More comments – some of them adverse – were subsequently submitted from a wide range of stakeholders, including detailed proposals from foreign chambers of commerce in Beijing. The final version of the law included amendments that responded to the concerns expressed so effectively that it was welcomed by some of the strongest critics of the draft law. This procedure is a major step towards achieving legislative transparency and should be regarded as a provisional benchmark against which to measure the transparency of future law-making.

... and measures are being taken to make government more open

This approach is consistent with the Chinese government’s recent active espousal of more open government. On 24 April 2007, the State Council (China’s cabinet) issued Decree 492, the *People’s Republic of China Ordinance on Openness of Government Information*, which will go into effect on 1 May 2008. This aim of the ordinance is to ensure that “citizens, legal persons and other organisations may obtain government information in accordance with the law, to raise the transparency of government work, promote legal governance, and thoroughly bring into play the service function of government information in the productivity and lives of the masses and in economic and social events”. Government at all levels is charged with setting up comprehensive systems to ensure such openness. State organs should “keep to the principles of impartiality, fairness and convenience for citizens in openness of government information” and “release government information in a timely and accurate manner”. Detailed procedures for the release of such information are listed in the ordinance.¹⁰⁸

Conciliation and arbitration procedures are available in China

The Chinese legal system contains an element of conciliation that is not present in many other jurisdictions. Although litigation is becoming more common in Chinese society, usage of local conciliation procedures remains popular, since it offers a quicker, cheaper and less vituperative method of dispute resolution.¹⁰⁹ However, the cases concerned tend to be limited to the domestic sphere. Of the 4 486 825 cases handled by local mediation committees in 2005, 23.4% were family disputes, 18.7% were neighbour disputes, 8.7% were in the area of housing and housing sites and 7.4% involved compensation for damage.¹¹⁰

A more specific conciliation procedure is available for disputes relating to the economy, trade, finance, security, investment, intellectual property, technology transfer, real estate, construction contracts, transport, insurance and other commercial and maritime business. In 1987, the China Council for Promotion of International Trade (CCPIT) and the China Chamber of International Commerce (CCOIC) set up the CCPIT Conciliation Centre in Beijing for this purpose and in the 1990s this was expanded to form a national network of over 30 conciliation centres. Such centres are not restricted to cases involving foreign investors or enterprises. The CCPIT Conciliation Centre has signed co-operation agreements with similar centres outside China, including the Hamburg and New York centres. In 1995, it joined the International Federation of Commercial Arbitration Institutions (IFCAI) and in 1997 it joined the London Court of International Arbitration (LCIA).¹¹¹

Disputes that are international or “foreign-related”, or are between a foreign-invested enterprise (FIE) and another FIE or between an FIE and a Chinese legal person, or involve the use by Chinese legal persons of foreign capital, technology or services, may be taken to the China International Economic and Trade Arbitration Commission (CIETAC). Arbitration can also be carried out through an arbitration agency in the country where the sued party is located or in a third country. China is a member of the International Centre for the Settlement of Investment Disputes (ICSID), so arbitral awards by ICSID in disputes involving China and the 135 other contracting states can be enforced under the terms of the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, which China joined in 1987 (for commercial disputes only).¹¹²

Local centres established under such bodies as municipal service centres for foreign investment and municipal foreign economic and trade committees deal with complaints against government departments. These appear to be becoming more systematic. Under this system, local governments down to county level are charged with setting up centres to handle complaints from FIEs and report them to the municipal centre within three days of receiving them. There are similar time limits for dealing with or otherwise handling such complaints, and the complainant must be informed of the result within 15 days.¹¹³

The Chinese government is using “CSR” as a tool to support legal compliance

The Chinese government has developed a substantial body of law relating to enterprise responsibilities. In endeavouring to ensure implementation of such laws, the government, as well as using available tools of line management, engages in extensive media publicity to mobilise public support. In recent years, an additional weapon in the government’s armoury is the campaign to encourage enterprises to behave responsibly. For example,

the CSR initiative of the Ministry of Health is designed to make enterprises comply with health and safety law. In a speech in February 2006 outlining the rationale for this approach, the then Minister of Health, after outlining the serious health and safety risks faced by workers in China, pointed out that the government did not have the capacity to monitor and enforce compliance with its health and safety at work legislation throughout China, so it was necessary to engage the enterprises themselves in actively promoting compliance with the law.¹¹⁴

Strengthening the business case for responsible business conduct

PFI Question 7.5. How does the government through partnership (e.g. by participating in the development of standards that lower costs of designing responsible business policies) and through promotion (e.g. by improving the information on responsible business practices to customers and the public) help to strengthen the business case for responsible business conduct?

The business case' for responsible behaviour is often clear-cut. For example, environmentally friendly production processes can decrease costs. Likewise, careful control of labour practices in supply chains can boost productivity at production sites and protect brand capital in consumer markets (i.e. it can improve profitability and help the company to manage business risks). The existence of a business case depends very much on particular circumstances (for example, the desire to protect brand capital would not be relevant for companies positioned in non-branded market segments). To the extent that the business case exists, private initiatives are self-enforcing (that is, government intervention is not required to make them happen).

Governments can act to reinforce the business case by providing information about responsible practices (e.g. good performance in the environmental field) and by lowering the costs of developing and adopting responsible practices, such as through support for industry initiatives (e.g. the International Association of Oil and Gas Producers Guidelines on Reputational Due Diligence). They can also promote internationally accepted concepts and principles, such as those embodied in the OECD Guidelines for Multinational Enterprises. The numerous initiatives and experiences of governments aimed at developing closer partnerships with investors on issues relating to the promotion of responsible business conduct, including through their purchasing, contracting and other business relations with private companies, provide a rich source of policy guidance.

A number of leading Chinese experts reporting to government emphasise the business case for RBC.

Professor Wang Zhile (王志乐), director of the Research Centre on Transnational Corporations in the Chinese Academy of International Trade and International Co-operation (CAITEC) belonging to the Ministry of Commerce (MOFCOM), has written and spoken extensively on the need to develop “soft competitiveness” (*ruǎn jìngzhēng lì* 软竞争力), following a study launched in 2003 involving visits to the headquarters of over 30 transnational corporations based in Japan, Korea, Europe and the US and to 30 Chinese transnational corporation headquarters, and the holding of three seminars in China attended by more than 80 world-renowned transnational corporations with branches or subsidiaries in China.¹¹⁵

Professor Wang describes the “first enhancement” of Chinese corporations: that of introducing hardware facilities, as taking place from the 1980s to the early 1990s. In this period, he says, many of them imported a great number of technologies, products, equipment and production lines from other countries. The “second enhancement”, from the early 1990s, focused on the establishment of a modern corporate system. Meanwhile, a large group of transnational corporations set up foreign-funded businesses in China, offering a demonstration for Chinese corporations in building modern corporate systems.

Since China’s accession to the WTO in 2001, says Professor Wang, Chinese corporations have commenced the “third enhancement”, strengthening corporate philosophy, i.e. “to improve corporate responsibility philosophy and ethical level to be a responsible corporation”.

As a result of his study of OECD-based transnational corporations, Professor Wang identifies advantages of companies that implement RBC strategies as being that “companies with advanced ideas”:¹¹⁶

- Are more likely to attract top talents, who would prefer working for employers with better ideas than for those with “inequitable conduct”.
- Are more likely to promote employee loyalty and to encourage initiative and creativity in their employees.
- Are more likely to get support from investors and financial institutions, thereby accessing more stable and lower-cost capital.
- Are more likely to build good relationships with suppliers and customers, thus gaining stable and large profits.
- Are more likely to build mutual trust with the public and with host governments, rewarding them with more understanding and support.

Yin Gefei (殷格非), Vice President of the WTO Tribune, also under MOFCOM, speaks of the concept of Responsible Competitiveness,¹¹⁷ in which a company actively integrates social and environmental issues into its

business operation, not only to satisfy stakeholder demands, but also increase its competitive advantage.¹¹⁸ His book (with colleagues) on this subject contains case studies in the areas of environmental protection, sustainable products and services, recycling economy and conservation economy, protection of customer and consumer rights and interests, maintaining employees' rights and interests, stakeholder engagement, "supporting the bottom of the pyramid" and CSR management systems. The enterprises examined include both Chinese and foreign companies.¹¹⁹ Mr. Yin and his colleagues recognise that while in China RBC (CSR) is often considered to be limited to legal compliance, in other countries it is divided into two levels, legal compliance and compliance with societal expectations beyond the law.¹²⁰

Participation in inter-governmental co-operation to promote responsible business conduct

PFI Question 7.6. Does the government participate in inter-governmental co-operation in order to promote agreed concepts and principles for responsible business conduct, such as the *OECD Guidelines for Multinational Enterprises*, the *ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policies* and the *United Nations Global Compact*?

Governments are co-operating with each other and with other actors to strengthen the international legal and policy framework in which business is conducted. The post-war period has seen the development of the framework, starting with the adoption in 1948 of the Universal Declaration of Human Rights. Multilateral instruments dealing with responsible business conduct, such as the *OECD Guidelines*, the *ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policies* and the *United Nations Global Compact*, draw on this broader framework of international declarations and conventions. They communicate and promote agreed concepts and principles for appropriate business conduct. Forty countries have committed to promoting responsible business conduct of their multinational enterprises – wherever they operate in the world – under the *OECD Guidelines for Multinational Enterprises*. While the *Guidelines* recommendations are addressed to business, governments through their network of National Contact Points are responsible for promoting the *Guidelines*, handling enquiries and helping to resolve issues that arise in specific instances. OECD has encouraged non-member economies to adhere to the *OECD Declaration on International Investment and Multinational Enterprises*, which the *OECD Guidelines* are part of.

By promoting inter-governmental co-operation in this field, governments can help to broaden awareness of basic principles for appropriate conduct. Increased global acceptance of common principles for business conduct also helps to reduce the likelihood that observing appropriate responsible business conduct principles could become a competitive disadvantage for investors (see Box 4.10).

Box 4.10. China's adoption of United Nations conventions

China has acceded to, signed or ratified the following United Nations conventions:

- Convention on the Prevention and Punishment of the Crime of Genocide, signed 1949, ratified 1983.
- International Convention on the Elimination of All Forms of Racial Discrimination, acceded 1981, with reservations.
- International Covenant on Economic, Social and Cultural Rights, signed 1997, ratified 2001.
- International Covenant on Civil and Political Rights, signed 1998, not yet ratified.
- International Convention on the Suppression and Punishment of the Crime of Apartheid, acceded 1983.
- Convention on the Elimination of All Forms of Discrimination against Women, signed and ratified 1980.
- Convention against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment, signed 1986, ratified 1988.
- International Convention against Apartheid in Sports, signed 1987, not yet ratified.
- Convention on the Rights of the Child, signed 1990, ratified 1992.
- Optional Protocol to the Convention on the Rights of the Child on the involvement of children in armed conflict, signed 2001, not yet ratified.
- Optional protocol to the Convention on the Rights of the Child on the sale of children, child prostitution and child pornography, signed 2000, ratified 2002.
- Slavery Convention, acceded 1937.
- International Convention Against the Taking of Hostages, acceded 1993.
- Convention on the Prevention and Punishment of Crimes against Internationally Protected Persons, including Diplomatic Agents, acceded 1987.

Box 4.10. China's adoption of United Nations conventions (cont.)

- International Convention for the Suppression of Terrorist Bombings, acceded 2001.
- United Nations Convention against Corruption, signed 2003, ratified 2006.
China has not acceded to, signed or ratified the following United Nations conventions:
 - Second Optional Protocol to the International Covenant on Civil and Political Rights, aiming at the abolition of the death penalty.
 - Convention on the Political Rights of Women.
 - Convention on the Nationality of Married Women.
 - Convention on Consent to Marriage, Minimum Age for Marriage and Registration of Marriages.
 - Convention on the International Right of Correction.
 - International Convention Against the Recruitment, Use, Financing and Training of Mercenaries.
 - Protocol against the Smuggling of Migrants by Land, Sea and Air, supplementing the United Nations Convention against Transnational Organised Crime.

China has signed a bilateral CSR agreement with Sweden

China has begun to enter into international commitments to encourage responsible business practices. The first of these is the Memorandum of Understanding on Corporate Responsibility Co-operation between the Ministry of Commerce of the People's Republic of China and the Ministry of Foreign Affairs of the Kingdom of Sweden signed on 10 June 2007.¹²¹ This MoU expresses a shared view that “responsible business practices can facilitate social and economic development” and that “the demand for responsible business practices comes from many social quarters, including governments, consumers, business partners, shareholders, investors, employees, societal actors, etc., and as such is an important part of strengthening competitiveness”. The MoU seeks “long-term, socially and environmentally sustainable and cost-effective solutions in addressing these issues through international co-operation and joint activities”. It commits China and Sweden to conducting dialogues and exchanges of experience involving companies, national and local governments, and academic and research institutions.

The Chinese government is working with the ILO on labour standards

The Chinese government is working with the International Labour Organisation (ILO) on a range of labour issues, but has not committed itself to observe all ILO standards. The ILO works mainly with the WTO Department of the Ministry of Commerce (MOFCOM) and the Ministry of Labour and Social Security (MOLSS). It is also developing tools with UNIDO for training factory managers in China's textiles sector designed to improve CSR capacity building and factory management; after testing in this sector, the training material will later be used in other sectors. The ILO promotes its own standards in China and also exchanges information on other standards, including CSC9000T.¹²²

China has ratified four out of the eight fundamental labour Conventions of the ILO identified in the 1998 Declaration on Fundamental Principles and Rights at Work.¹²³ These are Conventions 138 and 182 on the abolition of child labour and Conventions 100 and 111 on the elimination of discrimination in respect of remuneration and employment. China has also ratified many of the other Conventions (see Table 4.1).

China has not ratified ILO Convention 87 on freedom of association and Convention 98 on the effective recognition of the right to collective bargaining. Nor has it ratified Convention 29 on the elimination of forced labour or Convention 105 on the elimination of compulsory labour, though it has discussed adopting these conventions with the ILO. However, China notified that it would continue to respect existing ILO labour Conventions in both Hong Kong, China and Macao, China after their respective handovers to Chinese sovereignty in July 1997 and December 1999. It remains to be determined to what extent practices in both territories have been consistent with this intention.

China is co-operating with OECD Member countries on RBC projects and meetings

Several bilateral RBC projects have been organised between China and OECD member countries.

An early co-operative RBC project was the China State-Owned Enterprise Restructuring and Enterprise Development (SOERED) Project launched in 1999 by the United Kingdom Department for International Development (DFID) in the two Chinese provinces of Liaoning, in North East China, and Sichuan, in the West. An innovative feature of the project was its focus on developing "the concepts and practice of Corporate Social Responsibility in China".¹²⁴ One output at the end of the project in 2004 was a reference guide in Chinese containing a compilation of RBC-relevant laws and regulations, an assessment of the progress of CSR in China, an account of China's international agreements

Table 4.1. **ILO Conventions ratified by China**

ILO Convention	Ratification date and status
C7 Minimum Age (Sea) Convention, 1920	Ratified on 2 December 1936, denounced on 28 April 1999
C11 Right of Association (Agriculture) Convention, 1921	Ratified on 27 April 1934
C14 Weekly Rest (Industry) Convention, 1921	Ratified on 17 May 1934
C15 Minimum Age (Trimmers and Stokers) Convention, 1921	Ratified on 2 December 1936, denounced on 28 April 1999
C16 Medical Examination of Young Persons (Sea) Convention, 1921	Ratified on 2 December 1936
C19 Equality of Treatment (Accident Compensation) Convention, 1925	Ratified on 27 April 1934
C22 Seamen's Articles of Agreement Convention, 1926	Ratified on 2 December 1936
C23 Repatriation of Seamen Convention, 1926	Ratified on 2 December 1936
C26 Minimum Wage-Fixing Machinery Convention, 1928	Ratified on 5 May 1930
C27 Marking of Weight (Packages Transported by Vessels) Convention, 1929	Ratified on 24 June 1931
C32 Protection against Accidents (Dockers) Convention (Revised), 1932	Ratified on 30 November 1935
C45 Underground Work (Women) Convention, 1935	Ratified on 2 December 1936
C59 Minimum Age (Industry) Convention (Revised), 1937	Ratified on 21 February 1940, denounced on 28 April 1999
C80 Final Articles Revision Convention, 1946	Ratified on 4 August 1947
C100 Equal Remuneration Convention, 1951*	Ratified on 2 November 1990
C111 Discrimination (Employment and Occupation) Convention, 1958*	Ratified on 12 January 2006
C122 Employment Policy Convention, 1964	Ratified on 17 December 1997
C138 Minimum Age Convention, 1973*	Ratified on 28 April 1999
C144 Tripartite Consultation (International Labour Standards) Convention, 1976	Ratified on 2 November 1990
C150 Labour Administration Convention, 1978	Ratified on 7 March 2002
C155 Occupational Safety and Health Convention, 1981	Ratified on 25 January 2007
C159 Vocational Rehabilitation and Employment (Disabled Persons) Convention, 1983	Ratified on 2 February 1988
C167 Safety and Health in Construction Convention, 1988	Ratified on 7 March 2002
C170 Chemicals Convention, 1990	Ratified on 11 January 1995
C182 Worst Forms of Child Labour Convention, 1999*	Ratified on 8 August 2002

* Fundamental Convention.

Source: ILO website.

and activities related to CSR, Chinese CSR materials, CSR tools for enterprise managements and CSR experiences of foreign-invested enterprises in China.¹²⁵

The German Technical Development Cooperation (GTZ) is working with China's Ministry of Commerce (MOFCOM) on the use of a multi-stakeholder approach to project implementation. Core activities include a research and policy dialogue to facilitate information exchange between relevant stakeholders and to identify and set priorities in addressing CSR issues. The main goal of the dialogue will be to influence policy makers to establish an enabling environment for Chinese companies to adopt more sustainable business practices. The programme involves the establishment of pilot projects through a public-private partnership facility to serve as best practice case studies.¹²⁶

China is co-operating with the European Union (EU) in a project entitled EU-China Interdependencies on Energy and Climate Security. Project partners include the Chinese Academy of Social Sciences (CASS), the Chinese Energy Research Institute (ERI), Third Generation Environmentalism (E3G), the Institut du Développement Durable et des Relations Internationales (IDDRI), the Potsdam Institute for Climate Impacts Research (PIK), the Global Opportunities Fund (GOF) of the UK government, and the Royal Institute for International Affairs. The project is aimed at dealing with the challenges of global climate change, securing stable supplies of energy resources to advance national economic development and generating innovative market solutions to foster the potential of emerging technologies in meeting climate and energy security needs.¹²⁷

A number of RBC conferences and seminars have been held jointly between Chinese and OECD partners, both governmental and non-governmental, including, up to the end of 2005:¹²⁸

- September 2003, *Make Money with Moral: Seminar on Corporate Social Responsibility and Corporate Governance in China and the UK*, China Enterprise Corporation and the British Embassy in China, held in Shanghai and Beijing.
- March 2004, *Corporate Governance and Social Responsibility*, Chinese Institute of Certified Public Accountants (CICPA) and the Association of Chartered Accountants (ACCA), held in Beijing.
- September 2004, *Contest of Sustainable Development Campaigns in China: Participation, Co-operation and Innovation*, Economic Observer newspaper and Shell China.
- November 2004, *Seminar on Social Responsibility and Corporate Interest*, Sinopec Beijing Yanshan Chemical Corporation, COSCO Logistics, Tongxiang Lamp Factory, Tetrapak, IDEA, Ericsson and the Swedish Ministry of Foreign Affairs, held in Beijing.
- January 2005, *Scientific View of Development and Social Responsibility of Transnational Corporations in China*, Research Centre of Transnational Corporations of CAITEC and 100 representatives of transnational corporations, including Du Pont, Shell, Motorola and Ericsson.
- May 2005, *Social Responsibility of Transnational Corporations*, CEO Round Table, China Daily and Bayer Group, held in Beijing.
- May 2005, *The Role and Responsibility of Transnational Corporations: Social and Environmental Responsibility*, workshop held at the Fortune Global Forum in Beijing.
- June 2005, *Forum on Strengthening Management of Global Supply Chain: Promote Strategic Capability of Chinese Suppliers*, US Government, Kenan Institute of Private Enterprise and Shanghai Enterprise Council.

- June 2005, *China Responsible Care' Promotion Convention*, China Petroleum, Chemical Industry Association and the Association of International Chemical Manufacturers.
- September 2005, *2005 Sino-European CSR International Forum*, China WTO Tribune, CSR Europe, China International Centre for Economic and Technical Exchanges, China Institute of Industrial Relations, Institute of Chinese Economy and WTO Studies of Peking University and the China Asia-Pacific Association for Promoting Economic and Trade Co-operation, held in Beijing.
- September 2005, *Corporate Citizenship Forum and Reporting Conference on "Survey on the Development of Chinese Corporate Citizenship"*, China Charity Federation and China Trade News, held in Beijing.
- October 2005, *CSR Forum*, China Europe International Business School (CEIBS), BASF and Deutsche Bank, held in Shanghai.
- October 2005, *Harmonious Society Construction and Corporate Social Responsibility International Summit*, Chinese Productive Forces Academic Society.
- November 2005, *Corporate Citizenship Responsibility Forum*, Corporate Citizenship Committee of the China Association of Social Workers, held in Beijing.
- November 2005, *Seminar on the Impact of the BASF Nanjing Project on Local Environment, Economy and Society*, BASF, held in Shanghai.
- November 2005, *Global Compact Summit: China*, United Nations Global Compact, Shanghai Municipal Government and the State-owned Assets Supervision and Administration Commission (SASAC), held in Shanghai.
- December 2005, *Opening Ceremony of Recycling Economy Commission and 2005 International Forum on Packaging Waste Recycling Economy*, China Packaging Federation and Tetrapak.

Proposals from the 26-27 June 2008 Multi-stakeholder Symposium

At the 26-27 June 2008 Multi-stakeholder Symposium, participants made proposals for increased co-operation between China and OECD members to encourage RBC. In particular, they recommended that the RBC practices of OECD-based enterprises could be spread more widely in China via their supply chains. External experts (including the OECD) could be engaged to help build capacity, for example by developing incentive mechanisms such as an award for RBC performance. One example cited by participants was a multinational enterprise that had established worker-elected committees to address issues such as occupational health and safety. Another was that of a collaborative initiative by New Zealand and the United Kingdom to deliver technical training in occupational health and safety in China. Participants also

recommended direct government-to-government dialogue between OECD members and China on standards for Chinese state-owned enterprises operating abroad.

Chinese companies are actively learning about RBC, but misunderstandings persist

One NGO working with Chinese companies to support the implementation of responsible business practices reported to the OECD Secretariat during the April 2007 mission that all large companies in China are aware of the need for responsible business conduct and are willing to learn from best practices abroad. This appears to be particularly the case with major state-owned enterprises (SOEs).

Chinese companies' CSR/RBC reports are at an early stage of development

Annual CSR/RBC reports produced by Chinese corporations are at a relatively early stage of development, so it is not surprising that they vary in quality (Table 4.2).

Table 4.2. Domestic and foreign-invested enterprises reportedly publishing RBC reports in 2007

Domestic enterprises	Foreign-invested enterprises
BaoSteel	Alcoa
CHALCO	CNOOC Shell
China Mobile	Dongfeng Peugeot Citroën
CNOOC	Ford China
COSCO	Pfizer
Haier	Shell (China)
Jiangxi Mobile	Sony China
OMRON	Toshiba China
PetroChina	
PingAn Insurance	
Pudong Development Bank	
Shenyang Water Supply	
Sinochem	
State Grid	
Xizi UHC	
Zhejiang Mobile	

Source: Chinese Enterprise Confederation.

Chinese enterprises' CSR/RBC reports usually include active initiatives that clearly contribute to the fulfilment of social and environmental goals. For example, China Mobile, which in January 2007 produced the first CSR/RBC

report issued by a domestic telecommunications company in China, mentioned that it had partnered with major mobile phone makers, including Nokia and Motorola, to start a nationwide “Green Box” mobile phone recycling campaign at the end of 2005.

Such reports also contain elements of social responsibility which are limited to legal compliance, notably punctual tax payment.¹²⁹ CNOOC, in its 2005 CSR report, stated that an important measure of contributing to society is paying tax on time and in full and that it in 2005 it had paid CNY 14.546 billion, of which CNY 13.935 billion was paid in China. China Mobile claimed in 2007 that it had met its economic responsibilities by paying more than CNY 164 billion in tax.

At the same time, these reports also include achievements which it is not recognised international practice to cite as CSR/RBC. For example, China Mobile, in the report cited above, state that had created 2 million jobs over the past six years and that it had contributed to GDP growth. These are solid business and economic achievements, but they do not in themselves constitute responsible business conduct.

Corporate philanthropy continues to play a large part in annual CSR/RBC reports by major Chinese corporations. For example, the widely-praised 2005 *State Grid CSR Report*, which does contain important sections on such issues as environmental protection and sustainability, nevertheless largely concentrates in the chapter entitled “Be a Good Corporate Citizen” on poverty alleviation, aid to Tibet, supplying power to the 2008 Beijing Olympic Games, donating to South-East Asian tsunami relief and establishing charitable foundations and scholarships.

Some Chinese companies are rapidly developing an understanding of RBC issues

Some Chinese corporations have from the outset adhered to international standards of RBC reporting. The China Ocean Steamship Corporation (COSCO), a signatory to the United Nations Global Compact, constructed its *COSCO Sustainable Development Report 2005* in line with the Global Reporting Initiative (GRI) Guidelines. This report is the only one from a Chinese domestic enterprise to date (October 2007) to be noted on the Global Compact website as a Notable Communication on Progress (the other Notable COP listed in China is for William E. Connors, a foreign-invested enterprise). Currently (October 2007) 113 businesses and 17 non-business organisations are listed as active current Global Compact participants in China on the Global Compact website; several others are listed as non-communicating or inactive (see Box 4.11).¹³⁰

Box 4.11. Chinese oil company activity in Peru

It was reported in October 2006 that a Chinese oil company, SAPET, exploring for oil in the Peruvian Amazon had announced that it would not enter the territory of isolated Indians, even though the land was inside its concession. SAPET was awarded the concession, known as Lot 113, in November 2005. Lot 113 was superimposed over an existing reserve for uncontacted Indians. After pressure from local Indian organisations, SAPET asked for the boundary of Lot 113 to be modified to exclude the uncontacted Indians' reserve. The Peruvian government complied with this request.¹

At the same time, Andes Petroleum, a partnership between China National Petroleum Corporation (CNPC) and Sinopec, two Chinese state-owned oil majors, was reported to be conducting a massive 3D seismic operation and considering drilling two exploratory wells in Yasuni National Park, a wildlife conservation area.²

1. Survival website: www.survival-international.org, October 2006.

2. Yasuni Rainforest Campaign website: www.yasuni.ws, October 2006.

The Shenzhen Stock Exchange has adopted guidelines on socially responsible conduct

In September 2006, the Shenzhen Stock Exchange published guidelines on socially responsible conduct for listed companies (in Annex 4.A1) and has since been actively training the 488 companies listed on the Exchange in how to apply them. As a result, 21 companies listed on the Shenzhen main board published CSR reports in 2006 and more were reportedly preparing to do so in 2007. The Exchange is currently trying to develop a social responsibility index. The new guidelines were adopted in direct response to the inclusion of responsible business conduct in the latest revision of the Company Law. References consulted in preparing the guidelines include the *OECD Guidelines for Multinational Enterprises*.¹³¹

Chinese government and companies work with OECD-based corporations to improve practices

An example of co-operation on sustainable development between the Chinese central government, local governments, Chinese companies and OECD-based multinationals exists in the mining sector. The China International Mining Group (CIMG) comprises 97 foreign mining companies, mostly from OECD member countries, operating in China.¹³² The organisation is funded entirely by membership subscriptions and sponsorship from members and receives no government funding. CIMG was formed in Beijing in the 1980s and became a semi-formal organisation under the Australian Chamber of

Commerce in 2002. Its original function was to press for improved market access, but its focus changed in 2005 to promoting sustainable mining. CIMG works with the Chinese government on the regulatory framework for mining in China. It produces a white paper every year on mining in China. CIMG submitted 65 suggestions for China's draft mining law. In 2006, it produced a position paper on the coal law, in collaboration with the Department of Safety of the Coal Ministry. CIMG is now working more in provinces, even in prefectures, exchanging ideas to find the "best fit" for each locality. CIMG promotes long-term investment strategies and brings together Chinese academics to produce case studies. On 23 May 2007, CIMG held an environmental dialogue with the government of Sichuan province on sustainable development in South-West China. CIMG translates into Chinese and promotes toolkits produced by its partner, the International Council of Minerals and Metals (ICMM). CIMG has increasing interaction with domestic companies, and reports that Chinese companies are only interested in foreign M&A if it increases their overseas activities.

NGOs in OECD countries have frequently criticised home-country companies for not observing fair labour standards in the operations of their Chinese suppliers, although such criticism has become less strident as companies have intensified efforts to improve supplier conduct.¹³³ Some of the companies that have been targeted by NGOs are now among the most active in seeking to enforce RBC compliance along their supply chain. During its mission to China in April 2007, the OECD received reports from OECD-based clothing and footwear manufacturers operating RBC strategies in co-ordination with local governments in China, as well as from NGOs involved in similar initiatives.

Chinese NGOs are working to improve understanding of RBC issues

Non-governmental organisations (NGOs) are a relatively recent phenomenon in China, where many are not yet fully independent of government or business. A report by China Development Brief in 2001 listed 250 active NGOs in China.¹³⁴ The report charted the recent development of civil society in China via the formation of a parastatal non-profit sector commonly referred to outside China as GONGOS (government organised NGOs) or SONGOS (state-owned NGOs). It suggested that such organisations may be evolving into more independent social actors as they succeed in accessing non-governmental funds, including donations from individuals, from domestic, overseas Chinese and international corporations, and from aid agencies. Many of these organisations deal directly with social and environmental problems faced by enterprises; a few work directly on RBC issues. This background report only has space to cite a few examples to illustrate the rich variety of NGOs operating in these policy areas in China.

The Global Environment Institute (GEI) is a Chinese NGO established in Beijing in 2004 with the aim to provide market-based models for solving environmental problems in order to achieve development that is economically, ecologically and socially sustainable.¹³⁵ GEI's approach links primarily non-profit environmental conservation and community development with for-profit business management skills and market access channels. In December 2006 GEI attended an international NGO meeting about Chinese enterprises abroad (mainly in Africa) with a focus on extractive industries but also including the financial sector. The next step is to include more Chinese civil society organisations. GEI runs a project with the Chinese timber industry that operates overseas in areas such as Indonesia, Russia and Burma. In this field challenges are environmental degradation, forced migration and illegal logging. Since these companies are involved in state-run plantations in China, GEI works together with state forestry officials. This co-operation is fruitful. There is now a serious concern within the Chinese government to have a good image abroad. State forestry has developed a policy framework and guidelines, but awareness-raising is key. GEI has developed training materials on these guidelines for sustainable business practice. GEI is looking for funding for projects which balance economic and ecological impacts of Chinese overseas enterprises. GEI suggests that another important focus should be the financial sector and responsible investment promotion there. GEI has a good relationship with Chinese government departments which welcome information sharing and learning from best practices. GEI points out that, in general civil society in China still lacks capacity and there are hardly any funding possibilities in China. GEI partners with World Watch/ Earth Institute. Friends of Nature is the first environmental NGO in China.

The China water pollution map,¹³⁶ launched on 14 September 2006, is published by the China Institute of Public Environmental Affairs. It gathers together in one place fragmentary official information to map water pollution in various parts of China and publishes the names of 2 500 companies whose discharges exceed statutory levels.¹³⁷

4. Remaining challenges

As detailed above, the Chinese government has taken numerous measures to establish framework conditions for RBC. In recent years, it has directly encouraged enterprises to improve their conduct and is co-operating with international organisations, including the OECD, to develop policies and standards to encourage RBC. Chinese enterprises and business representative organisations have responded positively, publishing annual RBC reports and engaging in local and sectoral initiatives to improve conduct. At the same time, the Chinese government recognises that much more needs to be done.

Despite the widespread publicity initiated by the Chinese government, many, including large, enterprises, in China are still unaware of the need for RBC. There is a general perception that RBC is an unnecessary diversion from doing business, and that short-term costs far outweigh less tangible long-term benefits. The government can counter these misperceptions of RBC by strongly and repeatedly expounding the multifaceted business case for it, based on the steady accumulation of evidence. At the same time, effective enforcement of the law can help companies to appreciate the financial risk of non-compliance, thereby encouraging them to build much higher short-term costs incurred by illegal business conduct into their cost-benefit calculations.

The Chinese government has put major efforts into establishing sectoral corporate conduct codes, beginning with CSC9000T, that embody existing law. This is understandable, given widespread non-compliance. However, while such voluntary codes can play an important part in raising awareness of new laws and the specific requirements they make on enterprises, they can not be a substitute for effective enforcement of laws by the proper authorities.

The State-owned Assets Supervision and Administration Council of the State Council (SASAC) has also produced guidelines for central state-owned enterprises that go beyond CSC9000T in requiring fulfilment of societal expectations in addition to legal compliance (see Annex 4.A1).

The Ministry of Commerce is currently in the process of developing draft guidelines for trans-national corporations (TNCs). It remains to be determined whether these will apply only to foreign-invested enterprises in China and to what extent they will be compatible with the *OECD Guidelines*.

Enterprise efforts to ensure RBC can be effective if RBC is built into the enterprise's operating strategy and if structures are developed to promote it. At present, even those few enterprises in China that have embraced RBC have frequently done so only to the extent of commissioning audits and/or reports designed primarily to demonstrate compliance to external stakeholders such as foreign customers or the Chinese government. In evaluating enterprise responses to the government's efforts to encourage RBC, it is important to examine: the extent to which enterprises have made necessary institutional changes and worked to change the enterprise culture; the conformity of RBC content with accepted standards; and actual enterprise performance in fulfilling stated RBC objectives.

While legislation on framework conditions such as workers' rights and environmental protection has been greatly expanded and systematised, compliance remains problematic. Measures taken by national government are not consistently implemented at local level. Efforts to perfect the legislative framework need to be continued, but it is just as important to put in place effective enforcement and incentive measures to ensure compliance. As

pointed out above in regard to CSC9000T, corporate conduct codes can play an important supporting role, but they are no substitute for effective enforcement of laws by the government itself.

As explained above, various sets of RBC guidelines have been or are in the process of being developed by different branches of government or by semi-governmental bodies (CNTAC, SASAC, MOFCOM), each one concentrating on its own area of responsibility. It is not clear to what extent these are mutually compatible. Incompatibility could present practical problems in, for example, a Sino-foreign joint venture clothing manufacturing enterprise that may be covered simultaneously by CSC9000T and the forthcoming TNC guidelines. Conversely, there may be large domestic enterprises that are not yet covered by any RBC guidelines.

More effective “whole of government” co-ordination of the various efforts to promote RBC could: prevent incompatibility; ensure full coverage; avoid duplication and achieve economies of scale; and present a consistent, unified vision of RBC from which businesses can learn.

China’s increasing integration into the world economy can also be made easier if the various RBC codes and guidelines developed by the Chinese government are in line with internationally-recommended standards such as the *OECD Guidelines for Multinational Enterprises*.

Notes

1. OECD (2003).
2. The *OECD Guidelines for Multinational Enterprises* include a detailed list of steps to be taken by enterprises so that they can, “within the framework of laws, regulations and administrative practices in the countries in which they operate, and in consideration of relevant international agreements, principles, objectives, and standards, take due account of the need to protect the environment, public health and safety, and generally to conduct their activities in a manner contributing to the wider goal of sustainable development”.
3. This paragraph condenses the description of China’s pollution in OECD (2007a).
4. Economy (2004) traces the worsening of water pollution in China and examines possible solutions in the light of international experience.
5. Ma (2004) explains the genesis of this problem in extensive detail.
6. World Bank and SEPA (2007).
7. National Bureau of Statistics website: www.stats.gov.cn.
8. Xinhua, 16 December 2005.
9. OECD (2007a).
10. Ebbert (2004), citing a study conducted by researchers, including Daniel Jacob of Harvard University and Robert Talbot, director of the Atmospheric Investigation,

- Regional Modeling, Analysis and Prediction Program of the University of New Hampshire.
11. The *OECD Guidelines for Multinational Enterprises* encourage enterprises to take “adequate steps to ensure occupational health and safety in their operations”.
 12. Wang Zhile, ed. (2006).
 13. www.coalinfo.net.cn (in Chinese).
 14. *Xinhua*, 28 November 2006.
 15. For example, the *OECD Guidelines for Multinational Enterprises* encourage enterprises investing abroad to “employ local personnel and provide training with a view to improving skill levels, in co-operation with employee representatives and, where appropriate, relevant government authorities”.
 16. Stellenbosch (2007).
 17. Broadman (2007).
 18. See, for example, Robyn Dixon, *Africans Lash out at Chinese Employers*, *Los Angeles Times*, 6 October 2006.
 19. The *OECD Guidelines for Multinational Enterprises* encourage enterprises to ensure “that the goods or services they provide meet all agreed or legally required standards for consumer health and safety”.
 20. However, not all problems are the result of malfeasance by Chinese enterprises. In August 2007, the US toy producer Mattel recalled 20 million toys from the world market because of safety fears relating to lead paint and small magnets that could be shaken loose and swallowed by children, alleging fault on the part of a Chinese sub-contractor. Mattel later retracted its allegations against the Chinese supplier, took responsibility for design and verification problems, and issued a public apology to China.
 21. Weekly overview report of RAPEX notifications for week 42, 2007, on the European Commission Consumer Affairs website <http://ec.europa.eu>.
 22. *People's Daily Online*, 5 July 2001.
 23. Kaufman, Kleinman and Saich (2006).
 24. Wang Zhile, ed. (2006).
 25. *Xinhua*, 6 April 2007.
 26. *Financial Times*, 9 July 2007.
 27. *Reuters*, 30 November 2005.
 28. *Financial Times*, 10 July 2007.
 29. *Financial Times*, 9 July 2007.
 30. *People's Daily Online*, 27 October 2006.
 31. Zhang Junfeng, Deputy Director-General, Institute for International Labour Studies, Ministry of Labour and Social Security of the People's Republic of China, presentation to the 2006 BSR Conference in New York.
 32. FIAS (2007).
 33. FIAS (2007).
 34. FIAS (2007).

35. FIAS (2007).
36. Lewis (1954).
37. Documented in detail in Pun Ngai (2005). Pun Ngai is a sociologist who, as part of her field work, worked full-time on an assembly line in a Shenzhen electronics factory from November 1995 to June 1996.
38. E.g. Olivia Chung, *Booming Chinese province faces labour shortage*, Asia Times Online (www.atimes.com), 9 March 2007.
39. The Hong Kong Trade Development Council website (www.tdctrade.com) noted that the increase in minimum wage across the Pearl River Delta on 1 September 2006 averaged 17.8% and reached as high locally as 32.6%. Previous periodic increases had been much lower.
40. Barak, Nissly and Levin (2001), from a metanalysis of 25 articles concerning the relationship between demographic variables, personal perceptions and organisational conditions and either turnover or intention to leave, found that burnout, job dissatisfaction, availability of employment alternatives, low organisational or professional commitment, stress, and lack of social support are the strongest predictors of turnover or intention to leave. They concluded that there may be a great deal that both managers and policy makers can do to prevent turnover.
41. Boles, Pelletier and Lynch (2004), conducted a cross-sectional analysis of 2 264 employees of a large national employer in the North-East United States. They found a direct association between health risks and productivity loss. Michie and Williams (2003) found from a review of the literature that key work factors associated with psychological ill health and sickness absence in staff were long hours worked, work overload and pressure; lack of control over work; lack of participation in decision making; poor social support; and unclear management and work role. There was some evidence that sickness absence was associated with poor management style. Successful interventions that improved psychological health and levels of sickness absence used training and organisational approaches to increase participation in decision making and problem solving, increase support and feedback, and improve communication. It concluded that many of the work related variables associated with high levels of psychological ill health are potentially amenable to change.
42. Goetzel *et al.* (1998), in a study of 46 026 employees from six large health care purchasers, concluded that common modifiable health risks are associated with short-term increases in the likelihood of incurring health expenditures and in the magnitude of those expenditures.
43. Shimizu, Horie, Nagata and Marui (2004). This study of 94 randomly-sampled workers at a Japanese manufacturing company suggests a relationship between overtime working and self-reported low productivity due to cold-like symptoms and sleep loss. Van Der Hulst and Geurts (2001), in a study of 535 full-time employees of the Dutch Postal Service, show an association between the combination of involuntary overtime and low rewards on the one hand and, on the other, elevated risks of health complaints, emotional exhaustion and negative home-work interference.
44. Gray and Shadbegian (1995), considering 1979-90 total factor productivity levels and growth rates in the paper, oil and steel industries, showed plants with higher abatement costs to have significantly lower productivity levels.
45. For a full stocktaking and evaluation of China's innovation policies, see OECD (2007b).

46. For example, the *OECD Guidelines for Multinational Enterprises* require enterprises to “provide transparent and effective procedures that address consumer complaints and contribute to fair and timely resolution of consumer disputes without undue cost or burden”.
47. For example, the *OECD Guidelines for Multinational Enterprises* require enterprises to “respect consumer privacy and provide protection for personal data”.
48. For example, “Green Barrier” Stifles China’s Agro Exports, *People’s Daily*, 31 March 2002. An article in the *People’s Daily* of 19 July 2002, *China Subject to Most Restriction by US Trade Barriers*, charges that “China’s agricultural and animal products have been plagued by ‘green trade barriers’ since the country entered into the WTO”.
49. Response to a question on the Chinese government’s attitude to RBC by a representative of an official Chinese government research body at the Seminar on Governance in China at the OECD in Paris, 3 February 2005.
50. Zhou Weidong, Director, BSR China, presentation to the 2006 BSR Conference in New York and GTZ 7th Round Table on Social Standards and CSR in China, *From CSR in China to Chinese CSR*, 15 November 2006, Beijing.
51. The concept of “harmonious socialist society” was first launched at the Fourth Plenary Session of the 16th Communist Party of China (CPC) Central Committee in September 2004 and further interpreted by President Hu Jintao at a high-level Party seminar held prior to the sessions of National People’s Congress (NPC) and the National Committee of the Chinese Political Consultative Conference (CPPCC) in March 2005.
52. China Daily website, www.chinadaily.com.cn.
53. The Economist Intelligence Unit (2000).
54. For example, Xiamen University, founded by Tan Kah Kee of Singapore in 1919 and Shantou University, opened in 1981 with an endowment of HKD 2 billion by Li Ka-shing of Hong Kong, China. Both men also subscribed to numerous other charitable endeavours both inside and outside China.
55. For example, Yin (2006a) , while seeing “Western” CSR as springing from Protestantism, ascribes Chinese CSR values to the somewhat innovative concept of the “Confucian merchant” (*rúshāng* 儒商).
56. David Wolf, China’s Creaking Philanthropy Infrastructure, China CSR website, 6 July 2007.
57. The *OECD Guidelines for Multinational Enterprises* encourage enterprises to respect “the human rights of those affected by their activities consistent with the host government’s international obligations and commitments” (II. General Policies).
58. “The state respects and guarantees human rights.” In Chapter Two, The Fundamental Rights and Duties of Citizens, Article 33, Chinese government website: www.gov.cn.
59. Available on the website of the China Society for Human Rights Studies www.humanrights-china.org/cn/index.htm.
60. www.humanrights-china.org/cn/index.htm.
61. Available on the United Nations website: www.un.org/Overview/rights.html.
62. United Nations Human Rights website: www.unhchr.ch. These also cover Hong Kong, China and Macau, China.

63. Office of the United Nations High Commissioner for Human Rights website: www.ohchr.org.
64. OECD (2006), p. 151.
65. www.coalinfo.net.cn, 10 July 2007 (in Chinese).
66. Chinese government website, www.gov.cn, 30 August 2007.
67. Lauffs, Andreas and Isaacs, Jonathan (Baker & McKenzie, Hong Kong), *Viewpoint: Workers to get right to sue employers*, *Financial Times*, 25 September 2007.
68. Chinese government official website, <http://english.gov.cn>.
69. *Xinhua*, 22 June 2007.
70. China National Textile and Apparel Council (2005).
71. www.csc9000.org.cn.
72. For example, China Enterprise Confederation (2004).
73. China National Textile and Apparel Council (2005).
74. Details are in a government *White Paper on Gender Equality and Women's Development in China* published in August 2005 and available at www.humanrights.cn.
75. National Bureau of Statistics website.
76. National Bureau of Statistics website.
77. *People's Daily*, 4 September 2001.
78. *Xinhua News Agency*, 18 January 2007.
79. The OECD *Guidelines for Multinational Enterprises* encourage enterprises to contribute to the effective abolition of child labour.
80. ILO website, www.ilo.org, especially ILO (2006), from which the material in this paragraph is taken.
81. This exposition is limited to the main areas of the 11th Five-Year Plan related to sustainable development.
82. See China Council for International Co-operation on Environment and Development (2007) for details.
83. For details, see OECD (2007a), pp. 213-4.
84. *China Economic Review*, 12 July 2007.
85. Brook and Frolic (1997) and China Development Brief (2001).
86. China Development Brief (2001).
87. For example, 和谐社会须以公民社会为根基 (Take Civil Society as the Foundation of a Harmonious Society), www.sina.com.cn, 11 October 2006.
88. China Development Brief (2001). The term used in official Chinese media is official-run people's organisations (guanban minjian zuzhi 官办民间组织).
89. China Development Brief (2001).
90. *China Daily*, 30 May 2007.
91. OECD Methodology for Assessing the Implementation of the OECD Principles of Corporate Governance (2007).

92. The SETC disappeared when it was merged into MOFCOM in March 2003.
93. Presentation on “Recent Progress of China’s Corporate Governance Reform and China Corporate Governance Report 2006” by Zhou Qinye, Vice President of Shanghai Stock Exchange at the OECD Steering Group on Corporate Governance in April 2007.
94. Chan and Wang (2003).
95. Chinese government website, <http://english.gov.cn>.
96. OECD (2005).
97. Ministry of Justice website, www.legalinfo.gov.cn, English section.
98. Ministry of Justice website, www.legalinfo.gov.cn, Chinese section.
99. *China Daily*, 1 August 2007.
100. China Law and Governance website, www.chinareview.info.
101. OECD (2003).
102. *China Daily*, 1 August 2007.
103. See, for example, the egregious examples investigated in Anhui province, in Chen Guidi and Wu Chuntao (2006).
104. OECD (2003).
105. OECD (2003).
106. OECD (2003).
107. *Xinhua*, 22 April 2006.
108. *Xinhua*, 24 April 2007.
109. OECD (2003).
110. *China Statistical Yearbook*, 2006 edition.
111. OECD (2003).
112. OECD (2003).
113. OECD (2003).
114. Speech by Minister of Health Gao Qiang at the Global Corporate Responsibility Forum in Beijing, 22 February 2006.
115. Wang (2006). The book’s main argument is summarised in the next two paragraphs.
116. Wang (2006).
117. Yin (2006b).
118. Yin Gefei, Vice President of the WTO Tribune, GTZ 7th Round Table on Social Standards and CSR in China, *From CSR in China to Chinese CSR*, 15 November 2006, Beijing.
119. Yin (2006b).
120. Yin (2006a).
121. English version supplied by MOFCOM.
122. OECD Secretariat discussions with ILO and UNIDO officials in Beijing, 9 and 12 April 2007.

123. Adopted in 1998, the ILO Declaration on Fundamental Principles and Rights at Work is an expression of commitment by governments, employers' and workers' organisations to uphold basic human values. It covers four areas: freedom of association and the right to collective bargaining; the elimination of forced and compulsory labour; the abolition of child labour; the elimination of discrimination in the workplace.
124. Faint (2005).
125. Environment and Development Research Institute (2004).
126. Presentation of Ms. Vera Scholz, Director of the Programme Office for Social and Ecological Standards of GTZ at the GTZ 7th Round Table on Social Standards and CSR in China, *From CSR in China to Chinese CSR*, 15 November 2006, Beijing.
127. www.eu-china-energy-climate.net.
128. This partial list is based on that in Wang (2006). It is indicative, not exhaustive.
129. This is an internationally-standard feature of RBC norms, e.g. *OECD Guidelines for Multinational Enterprises*: "It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities."
130. www.unglobalcompact.org.
131. Information supplied to the OECD during an interview with Shenzhen Stock Exchange officials on 2 November 2007.
132. Information in this paragraph is based on a Secretariat interview with Auslan Ishmael, General Secretary of CIMG, in Beijing on 11 April 2007.
133. For example, Oxfam Australia (2006) chides OECD-based clothing manufacturers for not doing enough to protect workers' rights in factories operated by their suppliers in China, although it acknowledges that companies have made serious efforts to do this.
134. China Development Brief (2001).
135. This paragraph is based on an interview with GEI conducted by the OECD Secretariat during its mission to China in April 2007.
136. www.ipe.org.cn.
137. www.chinadialogue.net.

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- PetroChina, www.cnpc.com.cn [English version available].

ANNEX 4.A1

*Guidelines for State-owned Enterprises Directly under the Central Government on Fulfilling Corporate Social Responsibilities**

These Guidelines are proposed to implement comprehensively the spirit of the 17th CPC National Congress and the Scientific Outlook on Development, and give the impetus to state-owned enterprises (SOEs) directly under the central government (referred to hereafter as CSOEs) to fulfil earnestly corporate social responsibilities (CSR), so as to realise co-ordinated and sustainable development of enterprises, society and environment in all respects.

1. Fully understand the importance of fulfilling CSR by the CSOEs

1) Fulfilling CSR is a practical action taken by the CSOEs to apply the Scientific Outlook on Development. Fulfilling CSR requires the CSOEs, insisting on the principle of human-oriented and the Scientific Outlook on Development, to be responsible to stakeholders and environment, so as to achieve a good balance among the growth of enterprises, social benefit and environmental protection. This is not only an important measure for promoting the socialist harmonious society and also an embodiment of the CSOEs to thoroughly implement the China's new ideas about economic development, social progress and environment protection.

2) Fulfilling CSR is an overall social requirement for CSOEs. CSOEs, big enterprises in China's key industries, are the backbone of the country's economy and have a vital bearing on national security. Their production and operation involve all aspects of the entire economy, society and people's

* English translation from SASAC website: www.sasac.gov.cn, adapted only for grammatical accuracy.

livelihood. Therefore, fulfilling CSR is not only their mission and responsibility, but also an ardent expectation and requirement from the public.

3) Fulfilling CSR is the necessary condition for realising sustainable development of the CSOs. Performing CSR and embedding the concepts and requirements of CSR into their business strategies, operation and corporate culture will help update their idea innovation and transformation of the pattern of growth, inject vitality and creativity to the enterprises, add value to their brand and image, improve their staff qualification and enhance cohesion of the CSOs. All of these will definitely bring about a dramatic progress to CSOs in development quality and level.

4) Fulfilling CSR is the need for the CSOs to participate in international economic co-operation. As the progress of economic globalisation, the international community is more and more concerned about the performance of an enterprise in social responsibilities. By fulfilling CSR, it is either helpful in establishing a “responsible” public image by Chinese enterprises and more internationally influential, or significant for China to spread an image as a responsible nation.

2. Guidelines, requirements and principles

5) Guidelines: CSOs should take Deng Xiaoping Theory and the Important Thought of Three Represents as the guiding principles, thoroughly apply the Scientific Outlook on Development, adhere to the demands of a human-oriented policy and the sustainable development strategy of the Central Government of China, enhance their awareness of social responsibility and sustainable development, make overall planning with due consideration of every aspect. They should actively embody their responsibilities and set up good examples for other enterprises in fulfilling CSR so as to promote the construction of a harmonious and well-off society.

6) Requirements: CSOs should enhance their awareness of CSR; actively implement CSR, setting an example of lawful and honest business operation, resource-saving and environmental protection. CSOs should also be a model in building human-oriented and harmonious enterprises, and become the backbone of China not only in economy but also in CSR.

7) Principles: CSOs should integrate CSR with their own reform and development, and regard the implementation of CSR as an important content of setting up modern enterprise system and enhancing their competitiveness. By transforming the pattern of growth and achieving sound and rapid development, they should implement CSR according to the practical situation of the country and the circumstances of themselves, highlight key issues and make concrete plans, so as to strive for a substantial effect in implementing their CSE. In addition, CSOs ought to give top priority to ensuring work safety,

safeguarding the lawful interests of employees and promoting the career development of employees. These, as measures to build a harmonious relationship between the enterprise and its employees, will also contribute to the China's continuing programme of building a harmonious society.

3. Main content of fulfilling CSR by CSOEs

8) Insisting on a lawful and honest way of operating a business. CSOEs are asked to comply with regulations and laws, public ethics and commercial conventions, and trade rules. They should also fulfil their tax obligations, undertake the interests of investors and creditors, protect intellectual property rights, maintain creditworthiness, oppose improper competition and eradicate corruption in commercial activities.

9) Constantly improving ability of making sustainable profits. They should improve corporate governance, and advocate scientific and democratic decision-making. They should optimize their development strategy, focus on and strengthen their core businesses, reduce management layers and distribute resources in a reasonable way. Business administration and capability of control and supervision are enforced, such as minimizing operational costs, strengthening risk precaution, increasing investment profit ratio, and enforcing market competitiveness as well.

10) Improving product quality and service. CSOEs should try to ensure the safety of products and quality of services, update product performance and service systems aiming at providing well-qualified products and service to consumers. They should protect consumer interests, properly handle consumer complaints and suggestions and try their best to meet the demand of consumers. Only by this way can CSOEs establish a good image in consumers.

11) Strengthening resource conservation and environmental protection. The large state-owned enterprises should take their responsibilities and lead in energy saving and emissions reduction. Enterprises have to upgrade their technology and equipment and engage in the recycling economy, so as to develop energy-conserving products and improve resource utilisation efficiency. What is more, they should invest more in environmental protection, rationalise production procedures, try to decrease pollutant emissions with a target lower energy consumption and less pollution but higher production efficiency and output.

12) Promoting independent innovation and technological advance. CSOEs are required to complete mechanisms of technological innovation, increase investment in research and development so as to enforce independent innovation capability. They should accelerate the development of high and new technologies, especially making new breakthroughs in key technologies of the industry and fundamental research, and the

readjustment of traditional industries. They also need to attach more attention to intellectual property rights, and by implementing IP strategy to promote technical innovation, to achieve some core technologies and brands, and foster industry upgrading and restructure.

13) Ensuring production safety. A Responsibility System for Safe Production should be established and more investment in production safety. Serious accidents ought to be strictly prevented and forbidden. CSOs should also complete their emergency management system; continuously improve the emergency management and emergency handling capacity. Safe and healthy working conditions and living environment are necessary to ensure the health of employees, prevent any harm of occupational and other diseases to employees.

14) Protecting legal rights of employees. Employment contracts with employees should be signed and respected, adhere to the principle of equal pay for equal work, build up the mechanism of salary increasing, and buy social insurance regulated by the government. All employees ought to be respected and treated equally. Any discrimination of sex, nationality, religion and age is prohibited. In addition, enterprises should provide on-duty education and training, as well as equal opportunities of personal development. CSOs should further their efforts to implement the employee representatives' convention system, to publicise corporate affairs, and to advance democratic management. Employees' livelihood should be fully considered, especially to those having difficulties and anxieties.

15) Participating in social public welfare programmes. CSOs ought to encourage their employees to volunteer for social services, and actively to participate in community and social welfare program, such as charity, donations, and giving support to schools, cultural or hygiene activities. Upon the occurrence of major natural disasters and emergency accidents, CSOs also need to provide financial, material and manpower support.

4. Main measures to fulfil CSR

16) Establishing awareness of CSR. The CSOs should well understand the significance of CSR, attach great importance to CSR in their working plan and daily business activities. Enterprise leaders ought to arrange CSR promotion within their enterprise, adopt new ideas and methods in management, striving to establish the corporate culture with CSR as the centre.

17) Completing system and mechanism for fulfilling CSR. CSR should be integrated into corporate governance and business strategy, and implemented on all levels of their daily operations. CSOs should also identify a department to cope with CSR affairs; gradually build a statistical index and assessment

system for CSR. For those enterprises that are at leading position in CSR, a formal CSR performance evaluation system can be set up.

18) Building the CSR information releasing system. Enterprises having experienced in CSR work, should establish an information releasing mechanism, providing update and regular information about CSR performance and sustainable development, plans and measures in carrying out CSR. Meanwhile, a regular communication and dialogue mechanism concerning CSR should be established, so that the enterprise can have feedback from its stakeholders and give its response quickly. All the information and feedback should be publicised to receive supervision from stakeholders and society.

19) Enforcing inter-enterprise communication and international co-operation. CSOs are encouraged to exchange concepts and experience in fulfilling CSR with other enterprises at home and abroad, benchmark with the best CSR practices and summarise their own experience, so as constantly to improve their work. They should conduct more dialogues and communications with relevant international organisations and take part in international CSR standard formulation.

20) Strengthening Communist Party of China (CPC) organisations' role in leading the CSR work of enterprises. The CSOs should give full play to the political core role of CPC branches in the enterprise; encourage CPC members to take the lead in performing CSR. Trade union, Communist Youth League (CYL) and the Women's Federation are also required to contribute their efforts in fulfilling CSR, and strive to create a good environment for the enterprise to fulfil CSR.

ANNEX 4.A2

Shenzhen Stock Exchange Social Responsibility Instructions to Listed Companies

*25 September 2006**

Chapter I. General Provisions

Article 1. These Instructions have been formulated in accordance with the Company Law, the Securities Law and other laws, administrative regulations and the rules of competent authorities for the purpose of implementing scientific outlook of social development, building social harmony, accelerating sustainable economic and social development and promoting commitment to social responsibilities.

Article 2. For the purpose of these Instructions, social responsibilities refer to the obligations listed companies should assume for the social development, for natural environment and resources, and for the interested parties including their shareholders, creditors, employees, customers, consumers, suppliers and communities.

Article 3. While pursuing economic results and protecting shareholders' interests, listed companies (hereinafter, Companies) should proactively protect the legitimate rights and interests of their creditors and employees, be honest and trustworthy towards their suppliers, customers and consumers, and commit themselves to social welfare services like environmental protection and community development in order to achieve social harmony.

* Published with kind permission of the Shenzhen Stock Exchange.

Article 4. In business operations, Companies should follow the principles of free will, fair trade and good faith, observe moral and business ethics, and be subject to the supervision of the government and the public. They should not seek improper benefits by bribery, smuggling and other unlawful activities, nor infringe upon other people's intellectual properties like trademark, patent and copyright for the purpose of unfair competition.

Article 5. Companies shall, as required by these Instructions, perform their social responsibilities, make regular evaluation and issue voluntary disclosure on the performance.

Article 6. These Instructions apply to the companies whose shares are listed on Shenzhen Stock Exchange (hereinafter, Exchange).

Chapter II. Protection of the Interests of Shareholders and Creditors

Article 7. Companies shall improve their corporate governance structure, treat their shareholders fairly and ensure that their shareholders enjoy all the rights and interests as provided in laws, regulations and rules.

Article 8. Companies shall select appropriate time and venue for convening the shareholders' meeting. Online voting is advocated, in a view to facilitate shareholder participation in shareholders' meeting for the exercise of their rights.

Article 9. Companies shall fulfil their information disclosure obligations in strict accordance with laws, regulations, rules and the Exchange's rules. Voluntary disclosure is advocated with respect to information that may have an impact on the decision-making of shareholders and other investors. All investors shall be treated in a fair manner. Selective disclosure is prohibited.

Article 10. Companies shall formulate long-term and consistent profit distribution policies and methods and work out viable and reasonable bonus plans in return for the shareholders.

Article 11. Companies shall ensure that they are financially sound and their assets and capital are safe. Due regard shall be paid to creditors' interest. Maximisation of shareholder interests shall not be made at the expense of creditor interests.

Article 12. In business operations and decision-making process, Companies shall give ample consideration to the legitimate rights and interests of their creditors and inform the creditors in a timely manner of the material information relating to the creditors' rights and interests. Companies shall furnish co-operation and support when the creditors seek access to Companies' financial, operational and management information for the purpose of protecting their interests.

Chapter III. Protection of Employee Interests

Article 13. Companies shall strictly abide by the Labour Law, protect the legitimate rights and interests of their employees in accordance with law, establish and improve employment systems such as remuneration and incentives, and ensure that employees enjoy their rights and fulfil their obligations.

Article 14. Companies shall respect the dignity of the employees and guarantee their legitimate rights and interests, care for them, promote harmonious and stable relations between employee and employer, and provide special labour protection to female employees in accordance with State regulations. They shall not unlawfully force employees to work, nor shall they inflict corporal punishment, physical or mental intimidation, verbal humiliation or any other form of abuse.

Article 15. Companies shall establish and improve the system of occupational safety and health, strictly implement relevant rules and standards of the State, educate the employees accordingly, provide them with healthy and safe working and living environment, minimise the chance of accidents, and reduce occupational hazards.

Article 16. Companies shall follow the principles of pay based on work and equal pay for equal work. Pay shall not be deducted or delayed without justification. It is prohibited that temporary contracts or any other disguised probation contracts be signed with employees to reduce their wages and social security.

Article 17. Companies shall not interfere with employees' freedom of religious belief. No discrimination shall be imposed regarding employment, remuneration, training, promotion, dismissal or retirement due to ethnic community, race, nationality, religious belief, gender or age.

Article 18. Companies shall establish a vocational training system, mobilise and use the funds for vocational training in accordance with State regulations, make great efforts to train employees, encourage and support on-the-job training and continuing education for the purpose of providing more career development opportunities.

Article 19. Companies shall, in accordance with the provisions in the Company Law and their articles of association, establish a system for selecting and appointing directors and supervisors from among the employees so as to ensure that employees have full rights in corporate governance. Companies shall support the trade union to conduct legitimate activities. They shall solicit opinions, through the employee representative meetings or union meetings, on matters related to the interests of employees such as wages, welfare, occupational safety and health, and social insurance and pay due regard to employees' reasonable needs.

Chapter IV. Protection of the Interests of Suppliers, Customers and Consumers

Article 20. Companies shall be honest and trustworthy towards their suppliers, customers and consumers. They shall not seek profits by means of false advertisement or promotion, nor shall they infringe upon the intellectual properties of their suppliers and customers like copyright, trademark and patent.

Article 21. Companies shall guarantee that the commodities or services they provide are safe. With regard to commodities and services that may threaten personal or property safety, a truthful explanation, plain warning as well as user instruction shall be provided.

Article 22. In case serious defects are found in the commodities and services they provide, which may impose a threat to the personal or property security of customers even with proper usage, companies shall immediately report to the competent authorities and make public announcement. In the meantime, preventive measures shall be taken against any possible damage.

Article 23. Companies shall urge their customers and suppliers to comply with business code of conduct and moral ethics or stop partnership with customers or suppliers who refuse to make improvement in this regard.

Article 24. Companies shall establish appropriate procedures to strictly monitor and prevent commercial bribes between the Companies/employees and the customers or suppliers.

Article 25. Companies shall keep confidential the personal information of their suppliers and customers and, without authorise or permission, may not use or sell such information for profit.

Article 26. Companies shall provide excellent after-sales services and properly handle complaints and suggestions submitted by suppliers, customers and consumers.

Chapter V. Environmental Protection and Sustainable Development

Article 27. Companies shall formulate environmental protection policies based on their impact on the environment. There shall be dedicated human resources in charge of the establishment, implementation, maintenance and improvement of their environmental protection system, and furnish necessary manpower, resources as well as technical and financial support to environmental protection.

Article 28. Companies' environment protection policies normally cover the following areas:

1. to comply with all the laws, regulations and rules that govern environmental protection;
2. to reduce resource consumption, including raw materials and fuels;
3. to reduce waste generation and make every effort to recover wastes for recycling;
4. to avoid, to the greatest extent, waste generation that pollutes the environment;
5. to apply environmentally-friendly materials and energy-saving, waste-reducing design, technology and raw materials;
6. to minimise the adverse impact of corporate performance on environment;
7. to provide training to employees for the purpose of enhancing environmental protection awareness; and
8. to create an environment for sustainable development.

Article 29. Companies shall implement, as far as they can, facilities and processes that allow the greatest utilisation of resources and lowest discharge of pollutants, as well as economical and rational technology for comprehensive utilisation of wastes and pollutant treatment.

Article 30. Companies shall report to and file with the competent authorities regarding pollutant discharge. In case the discharge exceeds the national or regional standards, companies shall pay a fee in accordance with the State regulations and assume the responsibility for the elimination.

Article 31. Companies shall allocate dedicated human resources for regular inspection of implementation of environmental protection policies. Behaviours in breach of environmental protection policies shall be rectified.

Chapter IV. Public Relations and Social Welfare Services

Article 32. Companies shall pay due regard to the interests of their communities in business operation. The Exchange encourages that dedicated unit be set up and dedicated personnel be allocated to harmonise the relations between companies and communities.

Article 33. Companies shall, as much as they can, take part in public welfare activities in their regions relating to environment protection, education, culture, science, public health, community development and poverty relief in the best interest of the regions.

Article 34. Companies shall accept the supervision and inspection of the competent authorities and pay due regard to the public comments and media reports on themselves.

Chapter VII. Institutional Building and Information Disclosure

Article 35. The Exchange advocates that Companies should establish the social responsibility mechanism as required by these Instructions and work out social responsibility reports on a regular basis based on their review and evaluation of the *status quo*.

Article 36. Companies may release their social responsibility reports along with their annual reports. The social responsibility report shall include, but not limited to, the following:

1. implementation of social responsibility relating to employee protection, impact on environment, product quality and community relationship;
2. assessment of implementation of these Instructions and reasons for the gap, if any; and
3. measures for improvement and the timetable.

Chapter VIII. Supplementary Provisions

Article 37. The power of interpreting these Instructions rests with the Exchange.

Article 38. These Instructions come into effect as of the date of promulgation.

ANNEX 4.A3

Speech by the OECD Secretary-general at the Global Corporate Social Responsibility Forum in China

**Speech by the Hon. Donald J. Johnston,
Secretary-general of the OECD
Corporate Social Responsibility Forum
Beijing, China – 22 February 2006**

I would like to thank China Newsweek, under the guidance of the Overseas Chinese Affairs Office of the State Council and the China News Service, for inviting me to speak at this Forum. I would also like to thank our master of ceremonies, Director Lin Yifu. I would add that I am especially honoured to appear alongside Minister of Health Gao Qiang, with whose ministry the OECD is pursuing active co-operation, and other leading Chinese officials, together with Franny Léautier of the World Bank and leaders of both business and NGOs.

Origins of the OECD

As Secretary-General of the Organisation for Economic Co-operation and Development, I should perhaps begin by saying a few words about the Organisation that I head. The OECD is often referred to as the only living legacy of the Marshall Plan, having evolved from the Organisation for European Economic Co-operation, the OEEC, which was created to administer the Marshall Plan in 1948.

As historians among you will know, the Marshall Plan was the cradle of economic development and security in post-war Europe. It established within a continent that had been ravaged by bloody conflict, both economic interdependence and security. This experience demonstrates that economic development and security have to go hand in hand, and that one cannot exist without the other.

A great deal of physical infrastructure was created under the Marshall Plan, through investments of approximately 14 billion dollars, made to rebuilding modern Europe in the wake of the devastation of World War II. But too many people make an error in thinking that the Marshall Plan was primarily about money. In fact, there was just as much financial assistance was given to Europe before the Marshall Plan. The genius of the Marshall Plan derived from the foresight of those who realised that while lasting peace, prosperity and security can be defended through military strength, they can only be secured through economic development and co-operation, indeed through economic interdependence brought about by institutional frameworks, not bricks and mortar. And the remarkable success of the Marshall Plan is clear for all to see: instead of exchanging bombs and bullets, Europeans now exchange goods, services and people.

This is the real legacy of the Marshall Plan, and it must be carried forward to future generations all over the planet. With the right combination of policies and international co-operation nations can build successful and secure economies and societies. Indeed, in recent years, we have seen examples inspired in part by the Marshall Plan. We have seen growing regional co-operation in Asia and the Pacific, in Southeast Asia, and in North and South America. We have seen the nations of Africa beginning to take control of their own destiny in forming the New Economic Partnership for African Development (NEPAD). We have the Stability Pact for South East Europe, where the OECD is an active partner, and I have just been in Jordan where Middle East and North African countries and the OECD have launched a regional investment initiative known as the MENA/OECD Investment Programme.

What the OECD is and what it does

The OECD has a mandate to promote economic growth and development throughout the world. It has 30 members and engagements with over 70 economies. The OECD promotes market-based economies and open, rules-based and non-discriminatory trading and financial systems, supported by good governance, or in other words, effective administration by a government accountable to its people.

OECD work, which covers just about every government policy area, except defence, falls into 4 broad categories. I would describe these as follows: firstly, we develop guidelines for economic or business activity which are agreed by a consensus among our membership. There are many examples and in a moment I will discuss in more detail the one which deals with responsible business conduct, namely the OECD Guidelines for Multinational Enterprises.

The second area of work addresses objectives shared by critical mass of members; examples include some of the work I have already mentioned, such

as OECD support for the Stability Pact for South-Eastern Europe, the MENA project to contribute to Middle East peace and stability, and our work in Africa with NEPAD.

The third area of work is to help members and non-OECD economies meet domestic challenges through international comparisons of best practice, supported by in-depth analysis based on reliable data to develop national policies. Examples include our work on health systems, environment, education, pension plans, innovation policies and so on.

Finally, the OECD also has the capacity to identify important challenges that lie beyond the horizon but for which governments must start preparing in the near future. In this category, we examine issues such as the energy mix in 30 years time, the commercialisation of space and the potential and risks of nano-technology and so on.

Before I discuss OECD's guidelines contributing to responsible business conduct in a moment, let me first say a word about the increasing work we carry out here in China with our Chinese partners.

OECD's co-operation with China

The OECD's work with China is of crucial importance to our Organisation, as China is a key player in the world economy.

In fact, China and the OECD have been co-operating for many years across just about the whole range of the policy areas we cover, from economic surveillance to public and corporate governance, from agriculture and trade to taxation and labour market issues; from science, technology and education to anti-corruption and financial system reform. In just this last year, we published our first ever *Economic Survey of China*, an agricultural review as well as a major report on *Governance in China*, all prepared in close collaboration between OECD experts and the Chinese Authorities. And, amongst other things, we are now embarking on an environmental review of China, a regulatory reform review and an innovation review.

China is also taking part directly in the work of the OECD. China participates as an observer in two OECD Committees: the Committee on Science and Technology Policy and the Committee on Fiscal Affairs. We are pleased to note China's intention to co-operate directly in other committees.

China-OECD co-operation on investment policies has been continuing since 1995, leading to the 2003 *Investment Policy Review of China* and subsequent follow-up activities. The 2006 *Investment Policy Review of China* is about to be published. We will launch the publication here in Beijing in April this year.

Turning to the specific subject of this forum, namely global corporate social responsibility, the OECD is playing a central role.

Corporate social responsibility or CSR as it is known is not a term I like to use at the OECD. If you do a Google search you will find that there are no less than 38 or 39 million entries for corporate social responsibility.

At the OECD we prefer to talk about “responsible business conduct”. The difference? The reality is that business is conducted by individuals within corporations, not by the corporations themselves, and it is people who choose the legal framework in which they wish to undertake their business whether it be through partnerships, sole proprietorships or, as is most often the case, through corporations with limited liability. The exceptions to creating corporations tend to be found among some professional service firms such as lawyers, auditors, etc. I will return to the role of individuals.

The OECD first established and published guidelines for the behaviour of multinational enterprises in 1976. These enjoyed a moderately high profile for several years but, as far as I can determine, had little impact during the latter part of the 1980s and 1990s.

However, with the phenomenon of globalisation and the growth and expansion of enterprises with a global reach, the importance of responsible business conduct emerged as a major challenge. By 1999, we had completed major revisions to the *Guidelines*. They had been strengthened and reinforced with mechanisms designed to expose unethical conduct and to subject offenders to pressures to conform to the agreed standards.

These *Guidelines* now constitute recommendations by governments on business conduct, covering such areas as combating corruption, disclosure, the environment, science and technology, competition, taxation, human rights and labour relations.

Thirty-nine governments – representing the 30 OECD members and nine non-OECD economies – have agreed to these guidelines as part of a broader, balanced package of rights and commitments called the “OECD Declaration on International Investment”, which includes the principle of non-discriminatory treatment of foreign-controlled enterprises.

The objectives of the *OECD Guidelines* are “to strengthen the basis of mutual confidence between enterprises and the societies in which they operate; to help improve the foreign investment climate; and to enhance the contribution to sustainable development made by multinational enterprises”.

Responsible Business Conduct (RBC) benefits China

As this high-profile meeting attests, I am very pleased to note that the Chinese government is giving increasing attention to promoting RBC.

Indeed, as we have seen, public opinion in China is increasingly supportive of more demanding RBC standards. Good RBC performance by all enterprises,

both domestic and foreign-owned, brings huge benefits to Chinese workers, consumers and citizens, for example more disclosure of company information, good environmental management and core labour standards.

RBC also benefits Chinese business in two ways:

- First, Chinese companies are increasingly “going global”. To operate abroad, they need to understand the RBC standards adopted in other countries. Subscribing to international “good RBC practices” will open doors for Chinese companies, as host societies will have increased confidence and trust in these companies, thereby making it easier for them to form business alliances with other major companies.
- Second, good RBC performance can contribute to a company’s long-term growth and profitability. For example, it can make it easier to compete for capital and labour, it can boost productivity and it allows companies to minimise reputational risk and damage to brands.

Finally, I would note that China has made rapid progress in establishing a market enterprise system. Encouraging good RBC performance is a logical next step.

OECD findings on Chinese companies

I would now like to say a few words about our findings about Chinese companies. OECD surveys of international business practices show that Chinese multinationals have made some progress in aligning their management practices with global trends. For example, we have noted the rapid uptake by Chinese companies of international environmental management systems. However, we consider that there remains much room for improvement, as is evident from the Chinese media. In this regard, we believe that the *OECD’s Guidelines for Multinational Enterprises* warrant careful consideration by the Chinese Government and corporations.

The contribution of the *OECD Guidelines for Multinational Enterprises*

One of the factors that make the *Guidelines* unique is the way they are implemented. *Guidelines* implementation is mainly the responsibility of so-called National Contact Points. These are government offices that are charged with promoting observance of the *Guidelines* among “their” companies, regardless of where they operate.

Guidelines implementation involves a mediation and conciliation facility that considers whether or not a particular investment project adheres to the *Guidelines* recommendations. This facility involves voluntary discussions between governments and companies on concrete ethics issues that arise in connection with international investment projects. This facility has been

used more than seventy times since its creation in June 2000 to explore many questions – for example, a Korean company’s labour management practices in a Guatemalan export processing zones and a Canadian company’s resettlement of people in the vicinity of a mine in the Zambian copper belt. This dialogue can reassure companies that what they are doing meets international standards. Or they can help companies identify areas where they can improve. The OECD views this as a positive and pragmatic service that is both useful to businesses and enhances the contribution of international investment to host societies.

Moving co-operation ahead

The OECD is happy to co-operate with China in developing good RBC standards and sharing experiences on OECD and Chinese government approaches to RBC. China officially adheres to 10 of the 14 United Nations standards cited in the *Guidelines*. On 13 January 2006, China ratified the UN Convention against Corruption. All of this indicates that our RBC discussions can build upon a core of shared values.

Business, of course, is not alone in determining whether a country reaps the full benefits of investment. Governments are also important and RBC goes hand in hand with government responsibility. A good regulatory environment is needed to facilitate responsible business behaviour. China, like other developing countries, can benefit from the OECD *Policy Framework for Investment*, which aims to help governments create an environment that is attractive to domestic and foreign investors and that enhances the benefits of investment to society. And China’s participation in the PFI Task Force is an important part of ongoing China-OECD co-operation.

Whether we speak of business, governments or NGOs, we are addressing ourselves to individuals. Individuals in a position to influence the behaviour of the entities they direct, or work with or work for. I have noticed in my relatively long professional life that some individuals are capable of acting in the name of a corporation in ways that they would never contemplate doing as individuals on their own account. Sometimes this even includes criminal behaviour, which they would never condone personally, except as promoting the interests of their corporations and improving in theory the lot of their shareholders. Am I wrong in this? I do not think so, but I have never conducted a serious investigation of the issue but perhaps others have.

This brings me to the conclusion that individuals must be directly involved and personally accountable for RBC. Otherwise it is likely to exist only in resounding declarations in Annual Reports and other corporate public documents. This may be important but it is not where the answer lies to ensuring RBC. Boards of Directors, Management and employees must all be

aware of and commit themselves to the principles found in the MNE *Guidelines*. The *Guidelines* should be taught in law schools and business schools. They should be widely disseminated and discussed and debated at conventions of lawyers, auditors and similar professional bodies in all countries.

In other words, they become part of the international business culture. In pursuing responsible business conduct, people should be guided by the principle of the “golden rule”: “Do not do unto others that which you would not want done unto you.” This doctrine indeed finds itself well imbedded in the philosophies of all major religions including Confucius, Islam, Buddhism and Christianity.

Look at it this way: would you pollute rivers if you knew that in turn your rivers would be polluted? Would you deplete your forests and fisheries if you knew that in turn yours would be depleted? Would you render the air unsuitable to breathe if the same were to be done to your atmosphere? Individuals with daily lives to lead, children to rear and a future to look forward to for their communities must each take on the challenge of RBC.

In closing, I would just reiterate that the OECD looks forward to expanding its work with China in sharing experience on RBC standards and practices in the years to come. Later this year, the OECD will hold a meeting with Chinese representatives to share Chinese and OECD member country government approaches to RBC. This will provide a firm foundation for follow-up activities in specific areas of RBC.

ANNEX 4.A4

OECD Visit to Textile Factories in Guangdong

On 31 October and 1 November 2007, the OECD conducted a research mission to four factories in Guangdong province.* The Pearl River Delta is a relatively rich area which has benefited in the past three decades from investment from and/or via nearby Hong Kong. In addition, it has a widespread and prosperous diaspora in the rest of the world, and has benefited from investment flows originating in this community.

The visits were to:

- 31 October: Company A, Kaiping.
- 31 October: Company B, Kaiping.
- 1 November: Company C Clothing Factory, Kaiping.
- 1 November: Company D, Gaoming.

The first three factories are in the process of preparing to implement the national standard for corporate conduct in the textile and apparel industries, CSC9000T. Company D has already started implementation. All four factories are part of the 10 + 100 + 1 000 programme. This programme refers to the selection of about 100 key companies from about 10 textile clusters to establish the CSC9000T management system while providing CSR awareness training to 1 000 small and medium-sized enterprises (SMEs). The programme is aimed at assisting Chinese textile manufacturers in raising productivity, creating a fair trade environment and building a responsible supply chain. So far 114 key companies from 11 textile clusters have become involved in the programme.

* * In conformity with standard OECD practice, the companies remain anonymous.

The visits were organised by the China National Textile and Apparel Council (CNTAC). The OECD team was accompanied by a lawyer from CNTAC and an official of the Europe-China Trade Project based in Beijing. Discussions (all in Chinese) took place with managements and workers.

Company A is a large company producing chemical fibre and polyester chips. It is listed on the Shenzhen Stock Exchange and is one of the 300 largest shareholding companies in China. It has an annual independent production capacity of 680 000 tonnes of chips and yarn, including 150 000 tonnes of polyester yarn, 10 000 tonnes of Nylon 6 yarn, and 100 000 tonnes of bottle grade or high I.V. chips. It also produces 420 000 tons of polyester chips for outside contracts. The company's website emphasises customer service and states that the company's guideline is to "respect the employees, serve the customers, advocate more practices, encourage innovation".

Out of four Company A factories in Kaiping, the OECD visited the one with the oldest machinery and the smallest workforce. The 900 workers there are represented by 7 official union representatives who meet regularly. The average net monthly wage including overtime and bonuses was reported to be CNY 1 500, indicating that the company pays only the minimum wage.

The four workers interviewed by the OECD were all local, except for one from neighbouring Guangxi province. All had entered the factory immediately after leaving school. The factory operates an 8-day shift, with 2 days rest after 6 days work. Overtime appeared to be unsystematic, resulting from such events as typhoons or illness. As in the other three factories visited, workers were allowed only the national 10 days of annual holiday, i.e. 1 day for New Year (1 January), 3 days for Chinese New Year (a moveable feast, in January or February), 3 days for Labour Day (1 May) and 3 days for National Day (1 October).

One of the workers lived in the dormitory located in front of the factory, sharing a space similar to that of the small meeting room in which the interview took place with two other workers, free of charge. As in the other factories, a key attractant was the company's practice of paying wages on time. Company A also supplies a shuttle bus for transport to work. The factory has a health centre and a sports centre. Regular training, mainly in healthcare and safety, is conducted, reportedly following ISO guidelines.

The company reported that there were 8-10 export customer inspections of the factory each year, mainly focusing on machinery, management systems and quality control, but also sometimes including CSR. There is reportedly one product quality inspection by local government each year. There is also an annual safety inspection. Management said there was no need for a labour inspection because the company observes labour laws.

Company B is a wholly-foreign-owned enterprise (WFOE) established in 1995 with sole funding totalling USD 52 million from a company based in

Hong Kong, China. The company imported internationally advanced OEM-spinning equipment, looms and ready-made garment production lines from Germany, Switzerland, Belgium and Japan to form a complete, streamlined production line including spinning, weaving, dyeing and printing and ready-made garments. The annual production capacity of cotton yarn is 30 000 tonnes, various kinds of grey goods 18 million yards and bleached and dyed cloths 15 million yards. The export volume of denim ready-made garments is 600 thousand dozens a year. The sales income of the company in 2001 was CNY 380 million, including USD 30 million in export earnings, and taxes paid by the company in that year totalled CNY 40 million. The company is, together with the municipal government, establishing a Chemical Fibre Textile Industrial Town, which will cover an area of 494 acres.

The OECD interviewed a group of 6 workers at Company B with management not present. One of the workers was from Guangxi, the rest local. Three of them work a 12-hour day, i.e. a regular 8-hour day plus 4 hours overtime, for 26 days in 30-day months and 27 days in 31-day months. As a result, they earn CNY 1 700-1 800, of which CNY 500-600 is overtime pay. The other three interviewed do not have overtime. Overtime working is clearly compulsory for those who have it.

Workers do not know how their wages were calculated, though they seem to be aware that they are being paid no more than the legal minimum. None of the workers has so far signed or been offered a labour contract.

There is no trade union or other system of worker representation. As at Company A, the main attraction of the company for these workers is that their wages are paid punctually. (They pointed out that in some factories wages are paid up to three months late.) They stated that they see inflation as a big problem.

The OECD visited one of the dormitories accommodating non-local Company B staff. The rooms visited included some on a floor reserved for men and others on a floor reserved for women. All rooms held bunk space for 12 people (two rows of three two-level bunks, hardboard on metal rails), with a tiny balcony outside. The actual number of persons sharing such a room seems to vary from 6 upward. Personal possessions are kept in a cardboard box, one per person. In one room the residents had placed two ageing fans for cooling. The bathroom in each case is a small yellow-tiled room on the balcony with traditional Chinese toilet and a wall tap, presumably used to fill a nearby bucket for a "shower". The room offers neither privacy nor cooking facilities. The corridors and staircases are of bare concrete and dark, the only decoration being notices warning against thieves or making excessive noise. The multi-storey building also holds a social centre with a room containing a

single television set for some 100 or so people, and another room for sports such as table tennis.

Company C in Kaiping is relatively small, with a staff of 700. It has featured in China's official media and in the international press as a workplace with relatively high labour standards. It produces jackets for Company X, a major OECD clothing brand specialising in outdoor clothing. The factory began working on improving labour conditions in 1998 in response to supply chain requirements from Company X. The managers report that investment in training and employee insurance has increased and that overall revenue has grown even faster as the factory has attracted more orders from Western buyers. Satisfied employees reportedly refer their friends to the factory. Company C's partner in its work of improving labour conditions is the Institute for Contemporary Observation, based in the nearby city of Shenzhen; ICO is the leading Chinese NGO working to improve labour conditions in Guangdong province.

According to the manager, improvements in labour representation at Company C occurred in response to a loss of staff coming from other areas noticeable by 2003. This is attributed to four causes: skilled workers retiring or returning to their places of origin to start new businesses; people in their 30s and 40s returning to their villages to look after their children's education; cultural differences and discrimination against outsiders; the hard life of a worker in the textile industry. In addition, there is a problem with job-hopping, because Company C has limited room for wage increases.

The first elections to a workers' committee took place in 2004. Company C has chosen to allow workers to elect their representatives to a committee rather than to encourage the establishment of an official trade union branch. One reason was that management considered official unions to be inadequately representative, for example with only 7 or 8 union officials typically speaking for as many as 40 000 workers. The Company C workers' committee is reportedly more effective than the official union, with high workforce participation – incidentally at lower cost to the management than a union branch.

The OECD spoke to many of the workers on the shop floor, including worker representatives. The atmosphere was unusually relaxed and open. As with other factories visited, the OECD was informed that workers had brought their friends to work in the factory. There were also many family groupings, *e.g.* husband and wife, mother and daughter. The positive atmosphere in the factory appears not to be attributable to remuneration, which appears to be as low as in the other sites visited. The OECD was shown evidence not only of frequent participation in meetings by what appears to be most of the workforce, but also of regular safety training, social and sports activities.

The Company D weaving mill was opened on 20 October 2007 by the Company D Group, which, since its foundation in 1978, has grown to become a leading cotton shirt maker with over USD 500 million in annual revenue. Employing over 47 000 people worldwide, it supplies 60 million shirts each year to leading clothing brands around the world and major international retail chains. The company is vertically integrated from cotton growing in Xinjiang province to yarn spinning, weaving, knitting, trims and accessories manufacturing and garment making. The factory is equipped with yarn dyeing equipment from Italy and Switzerland, weaving looms from Japan and Italy and finishing equipment from top brands in Europe and Japan. It has a capacity of 3.5 million yards of cotton yarn dyed fabric a month. The new USD 150 million factory is designed to be both efficient and environmentally friendly. By weaving/knitting 90 million yards a year, Company D is China's largest manufacturer of cotton yarn dyed woven fabric. The Gaoming factory alone produces 13 000 tons of cotton knit fabric annually. Its garment manufacturing facilities are located in mainland China, Hong Kong, Malaysia, Mauritius, Sri Lanka and Vietnam. The final process of garment packaging and retailing (Company D also has its own label) enables Company D to control quality from raw material to final product realising the benefit of vertical integration, a concept much advocated in MBA textbooks.

The Company D factory in Gaoming was far larger than the others visited by the OECD, employing 27 000 workers. Working conditions appear to be similar to those in the other factories in this study. Work sites are well ordered and clean, and safety equipment carries completed inspection cards.

The OECD visited Company D's combined heat and power plant, built in 2004 at a cost of USD 29 million, which provides steam and electricity for use in textile and garment production in the factory. The plant is coal-fired, using fluidised bed combustion. Emissions of pollutants is minimised by a number of processes: each of the three boilers is equipped with an electrostatic precipitator to remove particulates, lime is injected into the boilers for desulphurisation. The plant uses low-sulphur coal (sulphur content 0.4%-0.7%). The engineer in charge of the plant noted that while this results in low pollution, the incentive for this clean process was cost reduction.

The OECD also visited the water treatment plant at Company D. This plant treats waste water resulting mainly from the dyeing process. After undergoing treatment in a number of tanks the water is returned to the Pearl River, from which it originated, adding far less pollution than untreated water from other factories.

The four factories were selected for observation by CNTAC as pilot projects participating in the 10 + 100 + 1 000 programme and should not be seen as typical of Chinese factories. The intention of visiting them was to

see what is possible in existing Chinese conditions. To the extent that high standards of responsible business conduct are exhibited in these workplaces, they may serve as models for other Chinese enterprises to follow. They also demonstrate the need to strengthen enforcement of existing law.

ANNEX 4.A5

*Summary of Discussions at Multistakeholder Symposium**

A Multi-stakeholder Symposium on Government Approaches to Encouraging Responsible Business Conduct was held at the OECD in Paris on 26-27 June 2008. The Symposium was attended by stakeholders from OECD member countries and China. Participants were divided into two groups to discuss three topics; 1) ; 2) the means by which enterprises can organise themselves to ensure responsible business conduct; and 3) essential measures to be taken by government to encourage responsible business conduct.

Conclusions of discussion group A

1. Main objectives of encouraging responsible business conduct

A definition of what we understand by the term RBC was put forward: RBC as an umbrella concept comprising legal compliance and voluntary initiatives. Some participants disagreed that it was as clear-cut as this. A key starting point was that the group noted that China has a large array of good regulations but there is an implementation gap. This could be an opportunity to use voluntary mechanisms to support RBC. There is also an opportunity for OECD companies operating in China to demonstrate good practices to Chinese enterprises operating both in China and abroad.

The OECD might look at addressing the lack of a level-playing field through activities such as i) capacity building, ii) raising awareness, and iii) promotion of the business case underpinning RBC. It was noted that in China's case there is a degree of urgency but we have to recognise that such things may take a little time to become embedded.

* The Summary was prepared by the discussion groups and has been edited only for grammatical accuracy.

It was acknowledged that efforts to encourage RBC are under way in China, such as the development of new policies and laws and the efforts by home grown academics and NGOs to do research and support this. The OECD *Guidelines* have potential to be guiding principles which support all these efforts. Care needs to be taken, however, that the promotion of RBC should not be top-down but through use of practical tools which can be applied by companies at an operational level. For example, in the context of the difficulties of ensuring legal compliance, OECD companies' RBC practices in the supply chain could be spread more widely.

2. The means by which enterprises can organise themselves to ensure responsible business conduct

Four key questions to guide the discussion were selected.

1. To whom should enterprises be accountable?

We noted that accountability requirements for business in China are no different from those elsewhere. There are 3 broad groups: i) shareholders; ii) employees, customers and other stakeholders; and iii) government and communities.

2. How do companies manage their efforts to be responsible?

Firstly these efforts need to be embedded in the company from the highest level down. What is ideal is the establishment of a culture of improvement featuring such elements as: i) agreed values and pragmatic objectives; ii) the need to identify key stakeholders to understand their expectations; iii) the need to identify and operationalise the legal frameworks and societal expectations as a risk management exercise and good business practice; iv) implementation of management systems to undertake RBC; and v) external benchmarking, and internal monitoring against objectives.

An important aspect of achieving RBC is a commitment to transparency. For example, environmental policies and impact assessment are made public and mechanisms for community consultation are developed. Consideration might also be given to including workers and management within a collaborative process such as participatory workshops in the area of occupational health and safety (OH&S).

Branded companies can positively affect RBC through their supply chains. External experts such as the OECD should also be engaged to help build capacity. One example noted was the OECD developing incentive mechanisms such as an award for RBC.

It was noted that SMEs may have particular challenges when much of their focus can be on day-to-day legal compliance issues. However, it should not be forgotten that the Chinese government has an important role in encouraging RBC through: i) awareness raising; ii) showcasing best practices; iii) leading by example and especially in relation to SOEs; and iv) using international standards and tools such as the OECD Guidelines as the base framework in the case where it favours the development of its own guiding principles.

3. How is reporting and monitoring being done and is it effective?

It was noted that auditing and monitoring has become a business in itself in China. For example, CSR reports can be ordered on-line and software for customised auditing responses is readily available. However, mechanisms to help address the audit issue are emerging as Chinese companies go global: For example, corporate ratings agencies and foreign stock exchange are requiring CSR reporting in order to be listed. Nevertheless, limitations to audits exist. It may be necessary to acknowledge the fact that non-compliance in the short term may persist and it is more practical to concentrate on investment in such things as training and worker engagement in order to achieve long term improvements.

The fact that an audit system is not failsafe does not undermine its potential value. It may be desirable to move from a culture of compliance audits to one of effective management systems.

It was felt that while the Chinese government has an important role to play in monitoring RBC, monitoring is in fact everybody's responsibility including host countries where Chinese investment is significant. It was noted that the OECD has been very effective to date in China in areas such as encouraging improved environmental practices and that the principles contained in the Guidelines (e.g. taxation, disclosure and consumer protection) are very similar to the stated goals of the Chinese government. It was suggested that inter-governmental channels between the OECD and China could be used to push for better compliance.

4. What is the role of workers and other stakeholders in ensuring RBC?

It was felt that a culture of improvement in a company could be achieved through participatory engagement between workers and management in respect of developing new ideas for sustainable and economically prosperous enterprises. The example was provided of one MNE operating in China which had established worker-elected committees to address issues such as occupational health and safety. It was also noted that companies need to take account of trade union rights and the ILO core labour standards, the latter being an internationally recognised basis for RBC

practice. Workers may also contribute to helping monitor legal compliance. However this would require safeguard to protect workers raising concerns. The view was expressed that RBC is ultimately a management system which is not dependent on workers' agreement.

It was also acknowledged that NGOs can play an important role in helping improve RBC through in China NGOs are currently very weak. It was suggested that the OECD might help facilitate strengthening of civil society. There are also opportunities for NGOs to collaborate globally to contribute to improvement in RBC of enterprises operating both in China and abroad.

3. Essential measures to be taken by government to encourage responsible business conduct

We considered three broad areas:

1. Why should governments be responsible for promoting RBC?

Setting the context: whilst the market underpins economic activity, governments need to have a role in certain areas such as human rights, labour law and environmental issues by framing agreed principles and addressing expectations. Then, at the national level, governments' primary responsibility is to enforce the law. They have the sole legitimacy and power to do this.

Governments have a supplementary role in promoting soft law and instruments to encourage RBC. However, the role of governments is not to cherry pick what they do. There must be coherence and consistency in their activities. For example, some may be more eager to apply WTO principles than those of the ILO.

2. How can governments ensure that enterprises comply with the law?

A prior reflection is the issue of what kind of laws can be put forward. The example was given of recent UK legislation requiring disclosure of environmental and social risk management in addition to disclosure of financial information to stakeholders and shareholders.

A key issue to emerge is the need to build capacity. This can be adopted through a sector-based approach. Examples included capacity building for mining safety. In this case, it was a global collaboration bringing technical assistance from New Zealand and resources from the UK to deliver technical training in occupational health and safety in China.

Opportunities exist for the ILO, UN and other multilateral organisations to collaborate in providing technical assistance to developing countries. There are numerous examples of this such as FAO and WHO joint works. It should be noted that this requires dedicated resources.

In the context of capacity building, RBC is not the foundation of law. It is the fundamental responsibility of government to protect its citizens. Capacity building needs to ensure a holistic approach to the challenges of a globalised economy. We need to improve interdepartmental collaboration to avoid inconsistent policy responses whilst ensuring there is no duplication of efforts. For example, it is not helpful to develop trade policy without taking account of labour issues. In China, this is especially important.

A role of government is also to define the specifics of its laws and communicate them. Currently in China, there is uneven enforcement, regional disparities and lack of access to legal process. This can result in provincial and local officials simply reversing national laws. Caution was expressed that China may create its own RBC principle while it could simply be reversed and rendered meaningless at a provincial and local level

A critical question for the Chinese government is that of the impact of Chinese investments abroad and how is poor business conduct reported back to Chinese officials and how will problems be resolved.

One major impediment to effective implementation of national law at the local level is corruption. For example, local officials may become shareholders in mining operations resulting in a conflict of interest when addressing critical issues such as addressing occupational health and safety.

A recommendation put forward was that the OECD engage Chinese SOEs in a discussion of the merits of international standards, principles and tools. The discussion reinforced the need for engagement with China on these issues and looked forward to continuing them in China at the earliest opportunity within a multi-stakeholder framework.

3. Principles/behaviour norms for RBC

It was noted that we needed clarity on whether we were referring to the legal base on initiatives beyond law. The ILO core conventions are fundamental and the OECD *Guidelines* are an example of an operational tool. Given the sphere of influence and global reach of Chinese SOEs, we should engage directly with them on these issues. As the government is the major shareholder of SOEs this is an obvious starting point for practical dialogue.

Standards are very important and the Chinese government should be encouraged to adopt international standards to enable companies wanting to adopt more aspirational practices to do so and to pull others along.

In dialogue we need to bear in mind that the fact that China is still an economy in transition and it is not always easy to reach consensus on what needs to be done. But the *Guidelines* are still a useful framework and could contribute to the goal of achieving RBC. It may not always be appropriate to simply transfer systems from abroad but nonetheless international standards are recognised as the basis for any RBC framework.

Conclusions of discussion group B

1. Main objectives of encouraging responsible business conduct

1. Participants saw the discussion in Paris as only the first step in developing a process of dialogue with China on responsible business conduct. We appreciated the interventions of the Chinese participants in the Group but the discussion crucially lacked the voice of several important Chinese constituents who for understandable reasons were not present at the seminar. We therefore urge the organisers to move forward with the programme of work on RBC and look forward to a further discussion being held in China with all of the relevant actors present.

2. Responsible Business Conduct should be seen as a means to an end, not an end in itself. The common objective that we all share is ensuring Sustainable Development in China and beyond; this includes all three pillars of Sustainable Development – the economic development necessary to move out of poverty; the need for environmental sustainability; and the social sustainability of creating decent work and fair distribution. These goals have also been recognised in the Chinese government's own notions of balanced development.

3. It was recognised that there was considerable disagreement and lack of clarity over definitions of Corporate Social Responsibility and RBC. For the purposes of our discussion we used Responsible Business Conduct as a compromise concept that includes both compliance with law and voluntary action going beyond compliance. It was clear that there is a need for a more common understanding of the role of guidelines in the Chinese context. Many in the Group (though not all) saw the *OECD MNE Guidelines* as providing a benchmark allowing discussion of specific problems.

4. It was said that several assertions in the background OECD document required more substantiation through inclusion of the results of existing empirical research and recommended that the OECD carry out further work in this direction.

5. With regard to the reported benefits of CSR, in addition to those set out in paragraph 51 of the OECD document the Group noted that RBC could help clarify the respective roles of the State and companies in the “socialist market economy”. It could help reduce corruption, help build up civil society institutions including unions, and bring about a closer alignment of interest of companies and local communities. It was also recognised as covering the role of OECD companies investing in China and what society expected of these firms and brands in a situation where legal implementation might be weak.

6. With Chinese corporations appearing as major new investors internationally it could also help develop a common understanding of what

doing business internationally requires in terms of societal expectations and obtaining a “licence to operate”. This was seen as particularly urgent in areas of mineral extraction, and infrastructure work, where some corporations were seen to be competing on different standards compared to others.

2. The means by which enterprises can organise themselves to ensure responsible business conduct

1. Agreed international norms and standards play an important role as a benchmark for Responsible Business Conduct. Whilst many initiatives are under way it was felt that multiplication of standards also presented a risk of confusion as to what was expected of companies. Many members of the Group felt that despite frustration with enforcement, the *OECD MNE Guidelines* were useful as an agreed benchmark of governmental expectations for business conduct, together with their unique implementation system. However two of the civil society representatives felt that failure by some NCPs to treat cases had called into question the credibility of the instrument from their point of view.

2. Transparency and non-financial reporting and disclosure of information were seen as important in several respects: pre-establishment disclosure of the likely impact of investments on local communities; supply chain issues; sourcing, etc.

3. A particular example was given in the area of pollution emission disclosure – where some Chinese companies were in advance of some major foreign investors – it was felt that the sectoral approach to emissions being discussed in the G8 process could advance responsible conduct in key emitting sectors.

4. For RBC to be improved it was essential to strengthen civil society organisations as whistleblowers and stakeholders in corporate conduct in China. Particular attention was drawn to the role of trade unions as worker representatives capable of ensuring compliance with labour laws and worker rights.

5. Progress was still needed to achieve greater enforcement of laws and application of the Labour Code in China and the recent changes in labour legislation reinforced the need to ensure that responsible conduct contributed to this end.

3. Essential measures to be taken by government to encourage responsible business conduct

1. There is a state duty to protect the human rights of its citizens including freedom of association and trade union rights. The Chinese government is moving ahead and has now ratified 5 out of 9 UN Human Rights Covenants.

2. For RBC to be effective there is a need for a well functioning legal system that is accessible to its citizens.

3. We exchanged information on some of the many bilateral programmes that exist with China in areas that include human rights and RBC. There is a need to learn of the strengths and weaknesses of different approaches – but some were leading to promising outcomes and it was felt necessary to now bring together and coordinate this experience. A priority should be exchange between key actors inside and outside China: business, civil society and trade unions.

4. A key priority is the need to allow and develop civil society through independent organises, not under State influence, that can challenge conduct. Capacity building is essential at a decentralised level. Examples were given in resolving disputes over land at the community level, disputes caused by environmental pollution and labour disputes in workplaces. Processes need to be developed in all these areas that can handle the conflict that is inevitable in a market economy.

5. Good practice experience in RBC conduct could be developed through a web portal – and information was given on at least one international project underway.

6. The government has a particularly important role to ensure RBC through, for example: transparency in state-owned enterprises; through transparency of its development aid; and its conditions for public procurement. The government needs to ensure enforcement of its laws at all levels, for example through effective labour inspections. These were all areas where the State could lead by example. The moves to encourage transparency as a part of RBC for financial investors were also noted.

7. A more co-ordinated government approach to RBC between government departments would also be welcome.

Chapter 5

Environmentally Responsible Corporate Conduct in China

Economic growth and industrialisation in China, characterised by heavy reliance on coal as the main energy source and rapid urbanisation, have been accompanied by negative impacts on the environment which have been increasingly visible in recent years. This has raised environmental awareness and concerns among political leaders, government officials and the public in China. This chapter outlines the challenges faced by the Chinese government in encouraging environmentally responsible conduct on the part of Chinese enterprises and possible policy options to address these challenges.

Overview

Economic growth and industrialisation in China, characterised by heavy reliance on coal as the main energy source and rapid urbanisation, have been accompanied by negative impacts on the environment. These impacts have been increasingly visible in recent years. This has raised environmental awareness and concerns among political leaders, government officials and the public in China.

After a series of serious environmental incidents, there seems to be a consensus at the central government level that addressing issues of environmental degradation is a high priority as stated in the State Council's *Decision on Implementing the Scientific Concept of Development and Strengthening Environmental Protection*. Consistent with policy statements to commit to environmental protection, the government has accelerated its efforts to develop the legal framework and standards for environmental protection, and has harnessed such concepts as Cleaner Production, Circular Economy, Environmental Impact Assessment and Renewable Energy to shift its approach from “end-of-pipe” management to entire process management. As a result, China now has a fairly comprehensive system of environmental laws and regulations coupled with environmental standards, some of which even exceed those in OECD member countries.

Despite China's comprehensive system of environmental laws and standards, implementation and enforcement are facing formidable challenges. 1) The capacity of environmental regulatory authorities, especially at local level, is still weak and local government administrations continue to give entire priority to economic growth over environmental protection. 2) The legal apparatus, including lawyers and judges conversant with environmental litigation and civil society groups experienced in class action suits against industries for pollution damages, is still underdeveloped. 3) A market-based incentive mechanism for environmental protection and pollution reduction has not yet been adopted. While the government has been introducing measures to tackle these challenges, it is important that the non-government sector, especially the business sector, needs to play a bigger role in environmental protection.

The business case for environmentally responsible conduct is multi-faceted. The case may include a reduction in production costs due to improvements in resource use efficiency and reduction in waste discharge,

increased sales and demand from “green” customers and environmentally conscious retailers, lower staff turnover costs, lower capital costs, and better reputation and company image. The business case for environmentally responsible conduct is expected to grow stronger as more Chinese enterprises expand their operations abroad, as the environmental awareness of the general public in China rises, and as the Chinese government introduces further environmental protection measures and improves its enforcement capacity.

Chinese enterprises have been gradually recognising the value of being environmentally responsible. There is, however, a wide variation in implementation of these responsible environmental conduct tools among enterprises in China. Large enterprises with global operations are more likely to obtain environmental certifications such as ISO14001 and enterprises in industries considered most environmentally damaging are more likely to disclose environmental information. So are enterprises with foreign capital or joint-venture enterprises, as they may be instructed to do so by the foreign parent enterprise.

Voluntary corporate efforts to improve environmental performance, though emerging, are still limited in China. Few Chinese enterprises have set up internal units dedicated to environmental management and conducted regular environmental audits. It is not uncommon to find enterprises taking advantage of the weak enforcement capacity of environmental authorities, and local administrations ignoring the environmentally harmful operations of enterprises that are contributors to local economic growth and government revenue. Since many Chinese enterprises and sectors still operate at far lower energy and resource efficiency than the international average, the marginal gain from improving corporate environmental performance may be very large. Such enterprises can learn from practices and experiences of environmentally responsible conduct from foreign enterprises, for example via business partnerships.

Aware of the potentially important role of the business sector in protecting the environment, the government not only has strengthened its law enforcement capacity but also has made progress in encouraging enterprises’ voluntary efforts. It has awarded honorary titles to enterprises with excellent environmental performance, publicised good enterprise practices in the media, developed a system to evaluate corporate environmental performance and provided guidelines¹ for enterprises on how to conduct business in an environmentally responsible manner.

As more Chinese enterprises are “going global”, they are facing the challenge of meeting the standards and expectations of the international market. In some cases, Chinese enterprises operate in countries and territories where environmental regulation enforcement is much weaker than in China, while at

the same time they have to deal with a wider array of stakeholders and a more diverse range of expectations. Enterprises failing to understand and respect the local business environment including laws and regulations, market expectations and community demands are increasingly under pressure to modify their practices in host countries. One enterprise's irresponsible behaviour may tarnish the country's image, creating a negative externality for other Chinese companies operating in the same host country or region. For Chinese enterprises to expand and sustain their operations abroad successfully, collective commitments to conduct business in a responsible manner are crucial.

In this context, international standards such as those reflected in the *OECD Guidelines for Multinational Enterprises* are particularly useful, as they provide a common frame of reference for enterprises to help ensure that their operations are compatible with expectations by host countries. The *Guidelines* can also serve as a tool for interpreting the meaning and guiding the application of other international instruments and domestic laws. Adoption of voluntary codes of responsible business conduct reflecting the principles of the *Guidelines* can reassure the public by relieving anxieties about enterprises' business models, intentions and impacts on the environment. Finally, implementation of these voluntary codes by enterprises will contribute to poverty reduction and sustainable development.

1. The regulatory framework for the environment in China

As China's economy has rapidly industrialised and expanded, heavy reliance on coal for industrial production and home heating and, more recently, increasing demand for automobiles, have caused severe air pollution. Water usage and the discharge of wastewater from agricultural, industrial and domestic sources have polluted water courses, lakes and coastal waters. The increase in total waste generation has exceeded the increase in capacity to treat and dispose of waste safely, resulting in a proliferation of uncontrolled dumps surrounding the cities.

Negative environmental impacts of China's industrialisation have been aggravated by the weak enforcement capacity of environmental authorities, a low awareness of environmental rights and conditions by the public, artificially-set low prices of industrial inputs such as energy, land and water, and insufficient investment in environmental infrastructure.

Concerned with the deteriorating environmental situation, the Chinese government now promotes a more balanced model of economic development, expressed by such concepts as "harmonious society"² and the "scientific concept of development".³ The government has been actively introducing measures to arrest environmental degradation. For example, in 2007 China increased the percentage of coal-fuelled power plants with desulphurisation facilities and the

rate of urban sewage treatment, and reduced total chemical oxygen demand (COD) discharge and CO₂ emission.⁴ Despite recent improvements, China still faces enormous challenges in developing a resource saving and environmentally friendly society.

The 2007 OECD *Environmental Performance Review of China* (EPR China) provided a fuller account of China's environmental situation and policies and made a series of recommendations, including to "improve governmental oversight and environmental performance in the overseas operations of Chinese corporations (in the spirit of the *OECD Guidelines for Multinational Enterprises*)". Building on *EPR China*, this section summarises and updates the overall efforts of the Chinese government in environmental protection and focuses on the approaches of the government to encourage enterprises' responsible environmental conduct.⁵ Consistent with earlier findings of *EPR China*, it identifies an "implementation gap" as the major issue in improving enterprises' environmental performance and explains the factors behind this "implementation gap".

Development of China's environmental policies and legislation

China has developed a comprehensive system of environmental laws and regulations coupled with various environmental standards (for a list of major environmental laws, regulations and policies, see Annex 5.A1). While the Environment Protection Law (EPL) promulgated in 1979 remained a trial law for the following ten years,⁶ since the second half of the 1990s China has accelerated the enactment of new environmental legislation and strengthened existing environmental laws.⁷ The Chinese government has formulated 9 laws on environmental protection, 15 laws on the protection of natural resources, 50 administrative regulations by the State Council on the environment, and more than 600 environmental rules and regulations by various departments under the State Council and local governments. These are complemented by more than 800 national and local environmental standards including environmental quality standards, pollutant discharge standards and standards for environmental samples. Over the years, the scope of environmental policies has become more specific and policy objectives clearer, detailing both the priority geographical areas for environmental protection and the priority topics. The Tenth Five-Year Plan (2001-05) contained for the first time concrete objectives and quantitative targets for environmental performance improvement.

After a series of serious environmental incidents and related public protests, the government expressed its clear policy to commit itself to environmental protection and pollution reduction in the *Decision of the State Council on Implementing Scientific Concept of Development and Strengthening Environmental Protection* (2005). This represents the government's

acknowledgement that environmental degradation and pollution are leading causes of social unrest. It aims to give environmental protection a more important strategic position in implementing “the scientific concept of development”, accelerating the development of what it terms a “socialist harmonious society” and achieving the goal of building a “well-off society”.

In recent years the government has quickly harnessed such concepts as Cleaner Production,⁸ Environmental Impact Assessment⁹ (EIA), Renewable Energy¹⁰ and Circular Economy¹¹ and has shifted its approach from “end-of-pipe” management to entire process management. The current Eleventh Five-Year Plan (2006-10) supports the transformation of economic growth model from one ignoring environmental protection to one emphasising both growth and environmental protection, from one of environmental protection lagging behind economic growth to one of synchronising the two, and from main use of administrative methods to use of comprehensive application of legal, economic, technical and administrative methods to address environmental problems. The Plan continues to set the quantitative environmental targets including a 20% reduction in energy consumption per unit of GDP, a 10% reduction in total COD discharge and sulphur dioxide (SO₂) emission, a 30% reduction in water consumption per unit of industrial value-added, and a 60% recycling rate of industrial solid waste by 2010.

Recognising the role of responsible business conduct in environmental protection

In developing a legal framework for environmental protection, the Chinese government has also recognised the role of enterprises in advancing its environmental agenda. For example, the China National Environmental Protection Plan in the Eleventh Five Years (2006-10) spelled out its intention to promote corporate responsibility by introducing incentive mechanisms, encouraging environmental disclosure, and enhancing a public supervision system.

In December 2007, the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) issued the *Guidance on Fulfilling Social Responsibilities*¹² for large state-owned enterprises (SOEs) under its supervision to: 1) enhance awareness of social responsibility; 2) establish a division responsible for social responsibility; 3) publish a report regularly on social responsibility or sustainable development and conduct stakeholder consultations; and 4) learn from foreign companies’ best practices and experiences on social responsibilities.

Environmental Impact Assessment (EIA)¹³

The Environmental Impact Assessment (EIA) is the main regulatory instrument for environmental protection in China and a requirement for all

development projects under the EIA Law 2002.¹⁴ Under this law, construction firms are obliged to obtain approval for environmental impact assessment of their projects from relevant administrative departments before starting construction, and to implement the environmental protection and impact mitigation measures detailed in the assessment during the construction period. The EIA Law provides for a strategic environmental assessment to complement the project-oriented EIA process in regional and sector plans and programmes.

The Ministry of Environmental Protection (MEP, upgraded from the State Environmental Protection Administration, SEPA, in March 2008) conducts nationwide checks on the implementation of EIAs and publishes the results on an annual basis. The rate of EIA enforcement increased from 61% in 1991 to 98.3% in 2002 and has exceeded 90% since 1998.¹⁵ To encourage public participation in the EIA process, SEPA issued guidelines¹⁶ in 2006 specifying the scope, procedure and form of public consultation during the EIA process as well as requiring disclosure of environmental information to the public.

Market-based instruments to promote environmental protection

To complement environmental laws and regulations, the Chinese authorities use market-based policy instruments to promote environmental protection and pollution reduction. These include a system of charging for pollutant and waste discharge, a discharge permit system (DPS) to limit the quantity and concentration of pollutant discharge, and a tax and subsidy structure geared towards environmental improvements.

A comprehensive pollution levy system was in place in nearly all counties and cities in China by 1996.¹⁷ The system includes discharge fees on major pollutants, urban sewerage, urban solid wastes, and hazardous wastes. Discharge fees are charged for total amounts of pollution discharge and a higher rate is prescribed for amounts exceeding the national standards as opposed to the past formula under which discharge fees were only applied to amounts exceeding the national concentration standards. 80% of funds collected from discharge fees are returned to enterprises for pollution control investments. However, the fees are still too low to encourage enterprises to install pollution control and treatment, and local environmental protection bureaus (EPBs) in charge of the administration of the levy system tend to exercise considerable discretion over implementation and enforcement of the system.

The DPS is implemented by local EPBs, which issue permits limiting both the quantity and the concentration of pollutants in wastewater and air emission to each enterprise. Hence, an EPB allocates allowable pollution loads to each enterprise under its jurisdiction and monitors compliance. Though the central

government provides guidance to local EPBs, the design and implementation of DPS are not uniform, showing substantial variation at the local level.

The tax and subsidy structure also incorporates environmental considerations.¹⁸ For example, the government has annulled the tax rebate entitlement on exported products for polluting industries such as iron and steel, electrolytic aluminum and iron alloy. Consumption tax has been reduced for automobile producers who have achieved the low pollution emission standard ahead of schedule. General tax reductions or exemptions have been extended to enterprises engaged in renewable resources, cleaner production, production of environmental protection equipment, and in the use of wastes as main inputs of production.

The government has initiated use of financial markets for the purpose of environmental improvement. In July 2007, SEPA, the People's Bank of China (PBOC) and the China Banking Regulatory Commission (CBRC) jointly issued a green credit policy.¹⁹ This established a co-ordination mechanism between environment protection agencies and credit administration institutions in an effort to limit the expansion of high energy consumption and highly polluting industries and promote projects for energy saving and emissions reduction. SEPA subsequently provided more than 30 000 pieces of information on violation of environmental laws to the Credit Information System Bureau so that commercial banks could use this information to suspend or limit loans to enterprises violating environmental laws. The PBOC and its branches are expected to guide commercial banks to include environmental performance in their credit risk management and lending criteria.²⁰ Following the policy, several financial institutions and local governments suspended loans, cut down credit lines, and withdrew loans to enterprises which violated environmental laws and regulations.

SEPA and the China Insurance Regulatory Commission (CIRC) jointly issued a green insurance policy²¹ in 2007 which presented a road map for establishing an environmental liability insurance system in China by 2015. Given a large and increasing number of environmental incidents in the country,²² the policy is a step forward to introduce market forces to manage and share the risks and costs of environmental damage. If the environmental insurance system works well, insurance companies would monitor enterprises' environmental conduct, compensate victims in a timely manner, and relieve the government's financial burden.

In February 2008, SEPA promulgated a green securities policy²³ which made an environmental audit one of the prerequisites for IPO or refinancing through the securities market by enterprises in thirteen heavily polluting industries²⁴ and required environmental information disclosure by listed companies. This policy aims to restrict an increase in capital raised by heavily

polluting companies through the securities market as well as to protect investors from the capital risks associated with government sanctions on enterprises violating environmental regulations and tightened environmental regulations. SEPA conducted environmental performance reviews of 37 companies applying for an IPO in 2007,²⁵ and refused applications from 10 companies which had constantly failed to meet waste discharge standards or had experienced major pollution incidents.

Trade and FDI policies have also been adjusted to fit the environmental agenda. In October 2007, SEPA and the Ministry of Commerce (MOFCOM) announced a “green trade policy”.²⁶ Under this policy, the government does not grant export quotas and licences, approval of processing trade contracts or projects, participation in national and regional export fairs, and approval of export business establishment to enterprises which violated environmental laws and regulations. In December 2007, MOFCOM revised *the Catalogue for Guiding Foreign Direct Investment* with environmentally friendly investment projects newly added to the encouraged categories.²⁷

Enforcement of environmental laws and regulations by the Chinese government

The government has been making continuous efforts to enforce environmental laws and regulations by strengthening the legal framework of penalising violation of environmental laws and regulations and exercising administrative sanctions on polluting industries.

The legal basis for pollution damage liability and related compensation claims can be found in the General Principles of Civil Law 1986²⁸ and the EPL 1989,²⁹ while a number of specialised environmental protection statutes on air, water, solid waste, and noise also contain provisions concerning liability for pollution.³⁰ In addition, China’s criminal law was amended in 1997 to address the crime of impairing the protection of the environment and resources. In 2006, the government promulgated *the Interim Regulations on the Punishment of Violations of Environmental Protection Laws or Regulations* which made the responsibility of environmental law enforcement clearer for local administrative officials. Though China’s legal framework is in theory sufficient to claim compensation for damages caused by violation of environmental laws, legal procedures are yet to be of common use in China.

The government often issues decisions or guidelines concerning environmental protection which trigger administrative sanctions on polluting enterprises and industries. For example, the State Council issued decisions concerning environmental protection issues in August 1996 which led to the closure of 15 categories of township and village enterprises that were considered particularly harmful to the environment including pulp and paper

mills, tanneries and zinc smelters. In July 2007, SEPA carried out a watershed permit restriction programme under which it denied permits to new industrial projects in 13 cities and development zones that suffered from serious pollution in the major watersheds of the Yangtze, Yellow, Huai and Hai Rivers.³¹

Constraints in the government's implementation of environment laws and policies

While China currently possesses an extensive regulatory framework that in theory should safeguard its environment, effective law enforcement has been a challenge for the government.

Major constraints faced by the government in implementing its environmental regulations include:

- Lack of detail in implementation procedures and absence of strictly-defined and effective penalty clauses under the laws: for example, the Law on Renewable Energy sets a target of 15% of electricity coming from renewable sources by 2020, but it remains non-operational without implementing rules and regulations. In many cases, interpretation of the laws is left to local EPBs' discretion, but without the legal basis defining the responsibilities and powers of local EPBs they cannot enforce the laws effectively.
- Conflict of interest at the local level:³² EPBs operate in a so-called dual-leadership system where they are not only reporting to higher-level EPBs, and ultimately to the MEP, but also are subordinate to local government instructions. Local governments can exert influence on EPB operations as they have control over EPBs' financial and human resources³³ while the MEP has limited direct influence over EPBs. Hence, when the local governments prioritise economic growth over environmental performance,³⁴ it is difficult for EPBs to carry out their mandate.
- Inter- and intra-co-ordination problems: At the central level, the MEP shares its responsibility for protecting environment with other government bodies such as the Ministry of Agriculture, the Ministry of Communications and Transport, the Ministry of Land Resources, the Ministry of Supervision, the Ministry of Water Resources and the State Oceanic Administration. The unco-operative attitude of these government bodies has hampered the MEP's (and before that, SEPA's) execution of its mandate and made policy co-ordination difficult.³⁵ At the local level, environmental protection duties are also distributed across many sectors including those that have also a responsibility for environmental protection, water conservancy, transport, land resources and public security. Hence, a lack of clear distinction in duties and co-ordination mechanism has undermined effective environmental protection.

- Insufficient resources and capacities of environment protection authorities: About 2 500 local EPBs which have been delegated day-to-day responsibility for enforcing environmental regulation compliance often lack the proper technology and manpower to conduct thorough monitoring of enterprises and enforce emission standards.
- Lack of assistance to local communities to mitigate the impact of environmental protection measures makes it difficult for local governments to take strict measures on polluting enterprises as they are concerned about the job losses that may result.
- Lack of sufficient incentives for enterprises to comply with the laws: Pragmatic enforcement of laws by EPBs discourages enterprises from rigorously respecting the law. For example, the discharge fees whose basis is prescribed in the regulation are in reality negotiable with EPBs or local governments.

Efforts to raise the effectiveness of government enforcement of laws and regulations should continue. However, even when the government's law enforcement is weak, the responsibility of enterprises is to comply with environmental regulations and to respond to societal expectations which may be communicated by other channels than laws.

2. Role of the business sector in environmental protection

Business case for environmentally responsible conduct³⁶

The business case for environmentally responsible conduct is multi-faceted and is getting stronger in China. Chinese enterprises are learning from global experiences that the long term profitability and sustainability of business operations are likely to be secured with enterprises' commitments to responsible business conduct. Enterprises can increase or maintain their profits in the long term by listening to, engaging and responding to stakeholder groups including shareholders, employees, customers and communities.

The business case for environmentally responsible conduct includes the following arguments:

- More efficient use of energy and resources and less discharge of waste contribute to production cost reduction, hence to increased profitability. This case is getting stronger as the prices of resources as well as the fees of waste discharge are increasing.
- Enterprises may be able to charge a price premium on environmentally friendly products by attracting "green" customers, the number of which is increasing world-wide. In the international market, more consumers may choose suppliers based on their green practices, and more downstream

retailers in the supply chain may require their suppliers to achieve a certain level of environmental protection and safeguards.³⁷

- By anticipating new markets, products or services which are increasingly characterised by society's desires for a cleaner, safer and more sustainable world, enterprises can capture new business opportunities and differentiate themselves from competitors. Innovation and the search for new technologies may be promoted by trying to understand and respond to the business opportunities arising from changing environmental values.³⁸
- By being environmentally responsible, enterprises can improve as well as protect their reputation and brand image. According to one survey of Chinese enterprises,³⁹ "improving corporate image and contributing to corporate market competition" was cited as the main reason for conducting business responsibly by 73% of the surveyed enterprises.
- Environmentally responsible enterprises may attract employees with higher work ethics, motivate employees better and retain them longer, leading to higher labour productivity and lower staff turnover costs.
- Enterprises may reduce the costs of capital by having access to environmentally conscious investors and financial institutions.
- Responsible enterprises can pre-empt advocacy groups from organising to press the political forces for stricter regulations and to hold demonstrations harmful to business such as product boycotting. With significantly lower internal and external communication costs, civil societies can now mobilise the public for action in a much easier manner.
- Enterprises viewed by regulators as environmentally responsible are likely to be monitored less frequently, and hence can reduce the costs of regulation compliance.
- Enterprises can also benefit from various incentive schemes provided by the government.

As business practices become more transparent, environmentally responsible conduct will become not a luxury but a requirement for many enterprises. It is an integral part of risk management strategy for enterprises, especially those with environmentally sensitive operations. In China energy and resource efficiency is still lower than the international average⁴⁰ and many cost-effective interventions that have been adopted in industrialised countries have not yet been tried there. This implies that enterprises' responsible environmental conduct can greatly boost social welfare as the marginal benefits from adopting environmental interventions exceed the marginal costs in China.

Environmentally responsible conduct by business in China: Example

As summarised in *Environment and the OECD Guidelines for Multinational Enterprises* (2005), enterprises have “a growing number of off-the-shelf environmental management tools, reporting and information codes and sectoral guidelines and recommendations”. The prominent tools include: environmental audit, external certification of environmental management system (EMS),⁴¹ reporting of environmental information in accordance with widely accepted reporting standards,⁴² obtaining or developing eco-labels, partnerships with civil society groups in conducting stakeholder consultation, adhering to voluntary environmental codes of conduct,⁴³ environmental education and training programmes for staff, contractors and local communities, and contribution to the development of environmental policy via dialogue and policy advocacy.

Typically observed practices in environmentally responsible business conduct in China include: 1) publishing environmental or sustainability reports;⁴⁴ 2) implementing environmental management systems, many of which are certified for or compatible with ISO14001;⁴⁵ 3) negotiating agreements with local governments on environmental performance improvements; 4) upgrading equipment and technology to be more energy efficient and environmentally friendly; 5) installing on-line monitoring systems to address the shortage of monitoring staff, reduce monitoring costs and increase monitoring efficiency; 6) conducting employee education and training programmes; and 7) constructing green facilities in corporate premises such as gardens, lakes and green walls.

A substantial variance, however, exists in implementation of these responsible environmental conduct tools among enterprises in China. Enterprises that are more likely to implement the tools are large enterprises that have global operations. According to one survey,⁴⁶ enterprises in the industries which are traditionally seen as most environmentally damaging including mining, paper and printing, power and fuel are more likely to disclose environmental information. So are enterprises with foreign capital or joint-venture enterprises as they may be instructed by the foreign parent enterprise.

The growing attention to responsible business conduct in China is also demonstrated by the launch of China Business Council for Sustainable Development (CBCSD) in early 2004⁴⁷ as a coalition of Chinese and international enterprises with a shared commitment to maintain and promote sustainable development through environmental protection, corporate responsibility, economic growth and social equity. There are emerging domestic efforts at sector and industry level to promote sustainable development principles and self-regulating guidelines on environmental

protection. These sector- or industry- specific efforts are led by industry-specific business associations as well as regional chamber of commerce.⁴⁸

Enterprise A⁴⁹

Enterprise A is a state-owned enterprise with oil and gas business in China and abroad. It owns 30 international exploration and production projects with operations in Azerbaijan, Canada, Indonesia, Kazakhstan, Myanmar, Oman, Peru, Sudan, Thailand, Turkmenistan, and Venezuela. Enterprise A started publishing a sustainability development report in 2006.

Enterprise A is currently implementing the three-year plan (2008-10) of pollution control and energy conservation that includes ten major energy saving projects, ten major pollution reduction projects and three demonstration units of circular economy. It partnered with the State Forestry Administration and China Green Foundation in 2007 to establish the Green Carbon Fund that can be used by businesses, civil society groups and individuals for voluntary activities in tree plantation and forest protection.

As a large enterprise with global operations and subsidiaries, enterprise A has adopted effective measures to implement its environmental accountability system. For example, the President of enterprise A signed safety and environment accountability agreements with the heads of 128 enterprises affiliated with enterprise A that specified various aspects of the accountability system. In turn the affiliated enterprises signed accountability documents internally at various levels to define responsible personnel and the range of responsibilities and incorporated a responsibility performance index in the annual performance evaluation of managers. To manage its global operations better, enterprise A formed three regional companies based in South America, Sudan and Kazakhstan with a health, safety and environment (HSE) business manager at each regional company⁵⁰ so that the routine HSE management functions could be transferred to these regional companies.

Enterprise A regularly monitors and publishes progress in conserving energy and water and reducing discharge of pollutants. It has invested in sewage treatment stations, cleaner technologies, ecological restoration and gas recovery projects, and has devoted resources to the R&D of developing energy efficient equipment.

Enterprise B⁵¹

By end-2005, enterprise B had invested USD 3.5 billion on the Chinese mainland and established some 21 wholly-owned or joint ventures with 1 600 staff in the field of exploration and production, gas and power, oil

products and chemicals, and renewable energy. It actively partners with all three of China's main oil and gas enterprises.

As part of a multinational grouping, enterprise B ensures an environmental and social impact assessment to be made at each project level. The assessment standards meet both Chinese and international standards. Enterprise B has transferred environmentally friendly technology such as the technology in sulphuric acid plants⁵² and coal-gasification technology through a strategic alliance with a Chinese oil major⁵³ and via licensing agreements with eleven other Chinese enterprises.

Implementation constraints faced by business in China

Despite emerging enterprise attempts to improve environmental performance, voluntary industry efforts are still limited in China. There is a tendency for enterprises to take advantage of the weak enforcement capacity of environmental authorities. For example, it is not uncommon for enterprises and local environmental authorities to negotiate downwards the environmental standards or penalties. Many enterprises may superficially comply with environmental regulations by putting pollution control plants into operation only when inspectors are expected. Only a minority of Chinese enterprises have set up a specific unit in charge of corporate social responsibility or environmental management. Supply chain audit is not commonly undertaken by Chinese enterprises. Where there are no environmental laws or regulations in host countries, Chinese enterprises operating in these countries are likely to adopt lowest cost investment plans.

There are three main reasons why Chinese enterprises are constrained in taking up environmentally responsible conduct. First, the awareness of environmental issues and the commitment to address environmental degradation are generally low among Chinese managers and employees. There remains a widespread underestimation among Chinese enterprises of the benefits of responsible business conduct and a consequent reluctance to take the initiatives.⁵⁴ Many still share the misconception that standards of responsible business conduct are used by the industrialised countries to restrict access to the market against Chinese enterprises.

Secondly, many Chinese enterprises have focused on price competitiveness and performance evaluation has emphasised short-term profitability.⁵⁵ Foreign companies sourcing their retail products from China continue to impose onerous price and delivery schedules which may limit the suppliers' capacity to improve performances other than cost competitiveness. Hence, a major shift in operation mode and strategy will be required for these enterprises to start seriously considering environmental performance.

Thirdly, incentives to support enterprises' voluntary efforts to engage in environmentally responsible conduct such as expectations regarding enterprises' environmental behaviours on the part of civil society or local government have not been sufficient.

The government role in encouraging environmentally responsible conduct in China

To realise the potential role of enterprises in achieving environmental goals, the government can not only enact and enforce environmental laws and regulations. But it can also strengthen the business case for enterprises to conduct operations in an environmentally responsible manner.

The simplest way to strengthen the business case for environmentally responsible conduct is to increase the costs of non-compliance with environmental regulations and increase the rewards for good environmental performance as part of efforts to strengthen the government law enforcement capacity. For example, the government can raise discharge fees for pollutants and penalties for non-compliance, at the minimum, to the extent that the cost of polluting or non-compliance exceeds the cost of controlling pollution or compliance. When pollution-related damages are internalised in accordance with the polluter-pays principle, enterprises will be encouraged to take pollution mitigation measures in response to the price signal.

The government can support the development of grassroots environmentalism by allowing civil society groups to play a greater role in environmental protection.⁵⁶ International experience shows that environmental movements can bring about changes through pressuring enterprises to operate in an environmentally responsible manner. The Chinese government is making some progress in this aspect as consistent with the agenda put forward by the *Decision of the State Council on Implementing Scientific Concept of Development and Strengthening Environmental Protection*.⁵⁷ Public consultation in environmental protection and disclosure of environmental information are required in certain circumstances under the EIA Law and more generally under the Administration Licence Law.⁵⁸ The MEP (then SEPA) subsequently issued implementation measures for these both laws to guide EPBs and local governments.⁵⁹

However, activities of civil society groups in the environmental field remain over-regulated in China⁶⁰ and there will be a long way before civil societies can act as the effective watchdog for enterprises' environmental conducts⁶¹ and the government's enforcement duties. At a more general level, the government may wish to support environmental education though either its own programmes or civil society groups' campaigns so that public consultation and participation become more effective in environmental protection.

The government can also encourage further disclosure of environmental information as disclosure may lead to improved compliance and enforcement due to increased public scrutiny.⁶² The media can play an influential role in environmental protection by exposing cases of environmental law violation, providing environmental information to the public and reporting pollution incidences and accidents.

The government has made some progress in information disclosure by publishing a list of enterprises violating environmental laws and regulations since 1996.⁶³ SEPA issued national implementation guidelines⁶⁴ on how to rate and disclose enterprise environmental performance in 2007. It not only recommends EPBs to disclose the government environmental information to the public including a list of enterprises in violation of environmental laws and regulations but also encourages enterprises to disclose environmental information voluntarily by providing certain incentives.⁶⁵ However, a systematic mechanism for environmental information disclosure and a credible environmental performance rating system that are required to influence the environmental behaviour of enterprises have not yet been well-established in China.

The government can support an increased use of administrative and civil law cases against environmental law violation so that a legal penalty could become an effective deterrent for polluting enterprises.⁶⁶ The Chinese court system, if supported with adequate capacity and independence from political pressures, should be able to check the weak enforcement of environmental laws and regulations at the local level. Lawsuits can be made also against EPBs for not sufficiently enforcing environmental protection laws.

Although the number of environmental lawsuits has been increasing,⁶⁷ China has traditionally resorted to administrative sanctions more than legal sanctions. EPBs rarely make recourse to courts as they prefer mediation and conciliation and do not possess adequate technical capacity to gather evidence required to support their claims. Class action lawsuits against local industries for pollution damage often face obstacles in the courts, whose decisions may be influenced by local governments wishing to protect local industries. Furthermore, the Chinese legal system has too few judges trained in environmental litigation.⁶⁸

The government can develop a systematic and credible mechanism to evaluate and recognise enterprises' environmental performance. This mechanism can help enterprises gain public recognition for their environmental efforts, leading to increases in sales and profitability. Financial institutions and investors can use this information to decide which enterprises or projects to finance and invest in, adding to economic pressures on enterprises. Although the government has introduced environmental awards and labels⁶⁹ such as the

National Advanced Enterprises on Environmental Protection and China Environmental Label, the effectiveness of these awards and labels has been limited. The government aims to spread its pilot programme of appraising enterprises' environmental conduct to all cities by 2010.⁷⁰

Finally, the government can benefit from international co-operation in the environmental field by exchanging experience and learning from international good practices. The China Council for International Cooperation on Environment and Development (CCICED)⁷¹ was established in 1992 as a high-level advisory body consisting of both domestic and international experts. It has provided policy recommendations and advice to decision makers in the government and worked to raise public awareness in China on environmental issues.

International co-operation is particularly valuable in helping the government guide Chinese enterprises operating abroad with regard to their environmental responsibilities. The government has already issued some guidance to certain Chinese enterprises operating abroad including *Nine Principles on Encouraging and Standardising Foreign Investment*,⁷² the *Guideline on Sustainable Management of Overseas Forests for Chinese Enterprises*⁷³ and the *Guidelines on Fulfilling Social Responsibility by Central Enterprises*. Currently, however, there are no explicit policies or regulations in place to reward or penalise Chinese enterprises operating abroad based on their environmental performance.⁷⁴ To complement its "go global" strategy which encourages Chinese enterprises to make investment abroad, the government may wish to ensure that Chinese enterprises with global ambition operate in a manner consistent with international standards.

Role of international standards

By the end of 2006, China had accumulated USD 90.6 billion of outward foreign direct investment (OFDI) stock, realised through the remarkable surge of outward investment flows from China during 2000-06 at an average annual growth rate of over 60%. China's OFDI flow and stock now stand the 4th largest and the 6th largest, respectively, among developing countries.⁷⁵

As more and more Chinese enterprises are going global, they are increasingly under pressure to meet the standards and expectations of the international market. In some cases, Chinese enterprises operate in countries and territories where environmental regulation enforcement is much weaker than in China while at the same time they have to deal with a wider array of stakeholders and a more diverse range of expectations. Enterprises failing to understand and respect the local business environment including laws and regulations, market expectations, and community demands are unlikely to develop sustainable business operations in host countries. One enterprise's

irresponsible behaviour may tarnish the whole country's image, spreading a negative externality to other Chinese companies operating in the same host country or region. For more Chinese enterprises to expand and sustain their overseas operations successfully, collective commitments to conduct business in a responsible manner are crucial.

In this context, international standards as those reflected in the *OECD Guidelines for Multinational Enterprises* (the *Guidelines*)⁷⁶ can be particularly useful in providing a common frame of reference for enterprises to ensure that their operations are compatible with the expectations of host countries. The *Guidelines* can also serve as a tool for interpreting the meaning and guiding the application of other international instruments and domestic laws.

Adoption of voluntary codes of environmentally responsible conduct reflecting international standards such as the *Guidelines* can reassure a public which is growing anxious about Chinese enterprises' business models, intentions and impacts on the environment. By encouraging enterprises to observe such voluntary codes, the government may maintain a country's reputation as a good business partner and investor in international markets and may avoid some of the costs of making and applying formal regulations. By adhering to the OECD Declaration on International Investment and Multinational Enterprises, the government can demonstrate its commitment to promote the *Guidelines* among enterprises of its nationality or operated in its territory down to the end of their supply chain, and benefit from the specific implementation mechanism available through National Contact Points (NCPs).⁷⁷ Finally, implementation of these voluntary codes by enterprises can contribute to poverty reduction and sustainable development.

Notes

1. Examples include *Guidance on Central Government Owned Enterprises Fulfilling Social Responsibilities* and *Guidelines on Sustainable Management of Overseas Forests for Chinese Enterprises*.
2. The concept of "harmonious society" was first introduced at the Fourth Plenary Session of the 16th Communist Party of China Central Committee in 2004 as the ultimate goal. It aims to achieve a balance between economic growth, social equity and environmental protection.
3. The "scientific concept of development" was also initiated by the 16th Communist Party of China Central Committee as the major strategic concept guiding China's economic and social development and socialist modernisation. It calls for people-centred development that is comprehensive, balanced and sustainable.
4. Ministry of Environmental Protection (2008), *The State of the Environment of China 2007*.

5. Background material for this chapter was provided in a report prepared for the OECD by the Global Environment Institute: *Chinese government approaches to encouraging environmentally responsible business conduct* (2008).
6. The formal EPL came into effect in 1989 and now constitutes the main legal basis for China's environmental protection system. The EPL established the basic principle for co-ordinated development between economic growth, social progress and environmental protection, and defined the rights and duties of governments at all levels and other agents with regards to environmental protection.
7. The Fourth National Conference on Environmental Protection in 1996 was the turning point in the reform of environmental policies in China as it described explicit environmental objectives, duties and plans, and for the first time placed pollution control and ecological conservation as two major tasks.
8. The Cleaner Production (CP) Promotion Law was enacted in June 2002 (effective since January 2003), requiring full control over the entire production process to reduce pollution. CP is now being promoted by MEP through CP centres set up across the country.
9. The Environmental Impact Assessment Law was enacted in 2002.
10. The Law on Renewable Energy was enacted in 2005.
11. The term "circular economy" denotes an alternative economic growth model that is not based on the intensive use of energy and other primary resources and the generation of waste and pollution. In July 2005, the State Council announced, in *Several Opinions on Accelerating the Development of Circular Economy*, its commitment to make efforts to develop Circular Economy. Following this policy statement, the draft Law on Circular Economy was submitted for deliberation to Standing Committee of NPC in 2007.
12. SASAC (2007), *The Guidance on Fulfilling Social Responsibilities by Central Enterprises*.
13. See Chapter 7, "Environmental-economic Integration of OECD", *EPR China 2007*.
14. The concept of EIA was introduced at the first conference for national environmental protection in 1973 and the first example of an official EIA, for a copper mine, was carried out in 1979. The EPL also provides a legislative basis for EIA, requiring projects with potentially negative environmental effects to be subject to environmental impact assessment. EIA was made compulsory for all construction projects under the *Ordinance of Environmental Management for Construction Projects* 1998. The EIA law 2002 further strengthened the legal status of EIA in China and improved effectiveness of the EIA system.
15. However, the statistics published by SEPA may be misleading since agencies conducting assessment are known to falsify EIA reports to obtain approval.
16. SEPA (February 2006), *the Provisional Measures for Public Participation in EIA*.
17. See Chapter 4, "Water management of OECD", *EPR China 2007*.
18. See Chapter 7, "Environmental-economic Integration of OECD", *EPR China 2007*.
19. SEPA, PBOC and CBRC (July 2007), *Opinions on Implementing Environmental Protection Policies and Rules and Preventing Credit Risk*.
20. The Industrial and Commercial Bank of China (ICBC) took the lead in issuing its own green credit policy in September 2007, refusing to lend to projects not in compliance with environmental policies. It also formed a database for the clients'

- environmental risks. The China Export Import Bank also released a code of environmental conduct in 2007.
21. SEPA and CIRC (2007), *Guiding Opinions on Environmental Pollution Liability Insurance*.
 22. For example, the then SEPA handled 108 major environmental incidents, an average of one in every two days, in 2007.
 23. SEPA (February 2008), *Guide to Strengthening Environmental Regulation on Listed Companies*. Shenzhen Stock Exchange published its own set of social and environmental instructions for listed companies in 2006 (see Chapter 4, Annex 4.A2).
 24. The thirteen industries include thermal power generation, iron and steel, cement, electrolytic aluminium, and high energy consumption and high pollution industries.
 25. According to *Circular on Further Regulating Environmental Review of Production and Trading Companies Involved in Heavy Pollution Industries for IPO or Refinancing* issued by SEPA in 2007.
 26. SEPA and MOFCOM (2007), *Circular on Enhancing Environmental Monitoring over Export Enterprises*.
 27. For more information, see Chapter 1.
 28. Article 124 states that any person who pollutes the environment and causes damage to others in violation of state provisions for environmental protection and the prevention of pollution shall bear civil liability in accordance with the law.
 29. Article 41 states that a unit that has caused an environmental pollution hazard shall have the obligation to eliminate it and make compensations to the unit or individual that suffered direct losses.
 30. For example, the 2008 amendment to the *Law on Prevention and Control of Water Pollution* raised the liability of corporate executives for causing serious water pollution who previously faced only administrative penalties. Under the amended law, corporate executives and others responsible for causing severe water pollution incidents will be fined up to half of their income of the previous year.
 31. These selected cities and development zones were given 3 months to address pollution problems during which no permission would be given to new industrial projects regardless of pollution levels.
 32. See Chapter 7, "Environmental-economic Integration of OECD", *EPR China 2007*.
 33. Appointment of heads of sub-national EPBs must now be endorsed by a higher-ranking environmental administration and lower-level EPBs have been given independent administrative status.
 34. This is often the case, since: i) local government leaders' awareness of environmental values is still low; ii) the promotion criteria for local government officials have been based on performance in narrowly defined economic development and employment creation; iii) polluting firms may constitute vital revenue sources for local governments; and iv) village and township enterprises may have a very close connection with local government in regard to tax, employment and personal links.
 35. In 2008 SEPA was elevated to the full status of ministry as the MEP and given full membership in the State Council (China's cabinet). Furthermore, an environmental protection team was established at the State Council under the direct leadership of the Premier with a Secretariat set up within the MEP. This

institutional progress is expected to facilitate co-ordination of environmental and other policies, maximise synergies between the work of different bodies and reduce overlaps and contradictions.

36. For the case for encouraging responsible business conduct in general, see Chapter 4.
37. Many multinationals are adopting environmental policies that extend through their supply chains in the form of requirements for suppliers to adhere to sustainability certifications such as ISO 14001.
38. For the linkage between environmental efforts and innovation, see Chapter 4.
39. The survey was sponsored by China Council for International Cooperation on Environment and Development, Environmental Defence (US) and GTZ (Germany) [Lu, X., D. Dudek and Q. Hu (2006), *Survey of China's environmental law enforcement capacity building and problem analysis*].
40. While China's energy intensity is now comparable to the most energy-intensive OECD countries, the overall material intensity of China's economy is higher than that in OECD countries (OECD, *EPR China* 2007).
41. ISO 14001 is the most popular standards internationally for EMS. The European Union has also developed Eco-Management and Audit Scheme. There are sector-specific EMSs such as the Responsible Care for the chemical sector and UNEP's Finance initiative and the "Equator Principles" for the finance sector.
42. Such standards include the Sustainable Reporting Guidelines by the Global Reporting Initiative, AA1000 Assurance Standard by AccountAbility, and ISO 14063 (still in draft).
43. Such codes include the Coalition for Environmentally Responsible Economies Principles, the OECD Guiding Principles for Chemical Accident, Prevention, Preparedness and Response, and the Responsible Care.
44. For the general characteristics of Chinese companies' sustainability reports, see Chapter 4.
45. By 2004, the number of certified companies in China reached over 8 000, which is the second highest number after Japan.
46. Xiao, S. and W. Hu (2004), *Environmental Information Release of Chinese Listed Companies*, Journal of Beijing Institute of Technology 10, Vol. 6, No. 5, Beijing.
47. <http://english.cbcsd.org.cn>.
48. Examples are China interior decoration association's self-regulation in environmental protection 2007, China rubber industry association's guidelines on recycling waste rubber 2007, China plastic recycle industry self-regulation in Guangzhou 2007, and China coal industry's self-regulation 2009.
49. Enterprise A, (2008), *Corporate Social Responsibility Report 2007*.
50. These three regional companies have a total of 327 Chinese and foreign HSE professionals.
51. Enterprise B (2006), *Sustainable Development Annual Report 2006*.
52. With the new technology in sulphuric acid production, using elemental sulphur as the feedstock, the converted plant could reduce CO₂ emission, air pollutants, wastewater, and solid waste significantly, and at the same time could improve its operating efficiency by over 20%.

53. This alliance formed joint ventures to construct and operate coal gasification plants using enterprise B's technology that allows more efficient use of coal and lower environmental impact than plants using the traditional technology.
54. See Chapter 4.
55. The government is introducing measures to change the performance criteria for government and party officials as well as managers of SOEs so that their career prospects will be linked to their performance in achieving environmental goals.
56. See Chapter 8 on the environmental-social interface of OECD of *EPR China 2007*.
57. It promised perfecting a social supervision mechanism for environmental protection.
58. It requires administration agencies to inform citizens of their right to express their opinions at public hearings regarding any government projects that might have an impact on them.
59. SEPA (2004), *Provisional Measures for Environmental Protection Administrative Licensing Hearings* and *Provisional Measures for Public Participation in Environmental Impact Assessment*.
60. Registration of an NGO in China requires sponsorship from a government agent and no two groups can be registered for the same kind of work within the same city or province.
61. An example of successful campaign by civil society groups against a polluting project is described in Chapter 4.
62. Chapter 4 of this *Review* includes discussion on the overall government framework of laws and regulations requiring financial and non-financial disclosure by enterprises about their business activities.
63. The 1996 Decision by the State Council on Certain Environmental Issues strongly encouraged the media and citizens to expose illegal actions that cause environmental damage.
64. SEPA (2007), *the Measures for the Disclosure of Environmental Information*.
65. Incentives may include publicity on local media and priority given in allocation of various environment protection funds and subsidies administered by the government.
66. See Chapter 8, "Environmental-social Interface of OECD" of *EPR China 2007*.
67. A small but growing number of environmental NGOs and lawyers provide legal representation in environmental litigation. Notable examples include Centre for Legal Assistance for Pollution Victims (CLAPV) and Green Earth Volunteers.
68. OECD (2007a) contains general discussion on the evolution of China's legal system.
69. The government is also encouraging enterprises to obtain ISO 14001 certification. For example, the government made the certification a prerequisite for setting up a unit in certain economic development zones, high-tech development zones and scenic areas which were designated as national demonstration areas.
70. SEPA (2005), *Opinions on Accelerating the Evaluation of Corporate Environmental Behaviour*.
71. www.cciced.org.

72. Issued by the State Council in October 2007, it called on Chinese investors to fulfil the necessary social responsibility to protect the legitimate rights and interests of local employees, pay attention to environmental resource protection, care and support of the local community and people's livelihood and to preserve our good image and a good corporate reputation.
73. This is intended to provide industrial standards and self-disciplinary criteria for Chinese enterprises engaged in forestry activities overseas.
74. Chapter 9, "International Co-operation of OECD" of *EPR China 2007*.
75. For more discussion, see Chapter 3 of the *2008 Investment Policy Review of China* (draft).
76. The *Guidelines* have been adopted by 41 governments to date. Chapter 5 on environment refers to general standards of environmental protection and provides a list of specific tools for fulfilling corporate environmental responsibility such as environment management systems, life-cycle assessment and EIA, contribution to the development of environmentally meaningful and economically efficient public policies, risk prevention and mitigation, communication of information on environmental impacts to the public through environmental reporting and eco-labeling and through consultation with communities.
77. The NCP is a government office responsible for encouraging observance of the *Guidelines* in a national context and for ensuring that the *Guidelines* are well known and understood by the national business community and by other interested parties. The NCP gathers information on national experiences with the *Guidelines*, handles enquiries, discusses matters related to the *Guidelines* and assists in solving problems that may arise in this connection. Setting up the NCP is an obligation of each adhering government.

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ANNEX 5.A1

A List of Environmental Laws, Regulations and Policies in China

List of environmental laws, regulations and policies in China

	Date	Issued by
Environmental Protection Law (trial until 1989, amended in 2001)	1979	NPC
Law on Prevention and Control of Water Pollution (amended in 1996)	1984	NPC
Law on Prevention and Control of Environmental Pollution by Solid Waste (amended in 2004)	1995	NPC
Law on Prevention and Control of Air Pollution (amended in 2000 and 2002)	1995	NPC
Decision on Certain Environmental Issues	1996	SC
Law on Energy Conservation (amended in 2007)	1997	NPC
Cleaner Production Promotion Law (amended in 2003)	1998	NPC
Environment Impact Assessment Law	2002	NPC
Law on Administrative Permission	2003	NPC
Provisional Measures for Environmental Protection Administrative Licensing Hearings	2004	SEPA
Provisional Measures for Public Participation in Environmental Impact Assessment	2004	SEPA
Decision on Implementing Scientific Concept of Development and Strengthening Environmental Protection	2005	SC
Several Opinions on Accelerating the Development of Circular Economy	2005	SC
Opinions on Accelerating the Evaluation of Corporate Environmental Behaviour	2005	SEPA
Law on Renewable Energy	2005	NPC
Interim Provisions on the Punishment of Violations of Environmental Protection Laws and Regulations	2006	Ministry of Supervision, SEPA
Provisional Measures of Public Participation in EIA	2006	SEPA
Opinions on Implementing Environmental Protection Policies and Rules and Preventing Credit Risk (green credit policy)	2007	SEPA, PBC, CBRC
Guiding Opinions on Environmental Pollution Liability Insurance (green insurance policy)	2007	SEPA, CIRC
Measures for the Disclosure of Environmental Information (trial implementation)	2007	SEPA
Guidance on Central Government Owned Enterprises Fulfilling Social Responsibilities	2007	SASAC
Guidelines on Sustainable Management of Overseas Forests for Chinese Enterprises	2007	SEPA, State Forestry Department
Nine Principles on Encouraging and Standardising Foreign Investment	2007	SC
Circular on Further Regulating Environmental Review of Production and Trading Companies Involved in Heavy Pollution Industries for IPO or Refinancing	2007	SEPA
Circular on Enhancing the Environmental Monitoring over Export Enterprises	2007	SEPA, MOFCOM
Guide to Strengthen Environmental Regulation on Listed Companies (green security policy)	2008	SEPA

CBRC = China Banking Regulatory Commission; CIRC = China Insurance Regulatory Commission; MOFCOM = Ministry of Commerce; NPC = National People's Congress; PBC = People's Bank of China; SASAC = State-owned Assets Supervision and Administration Commission; SC = State Council; SEPA = State Environment Protection Administration, since renamed the Ministry of Environmental Protection.

English Glossary

ACFTU	All-China Federation of Trade Unions
BIAC	Business and Industry Advisory Committee to the OECD
CNTAC	China National Textile and Apparel Council
CSC9000T	China's national standard for corporate conduct in the textile industry
CSR	Corporate social responsibility
DFID	Department for International Development of the United Kingdom Government
GEI	Global Environment Institute
ILO	International Labour Organisation
ISO	International Organisation for Standardisation
MOFCOM	Ministry of Commerce of the People's Republic of China
OECD Watch	NGO advisory body to the OECD
RBC	Responsible business conduct
SA8000	Social Accountability
SASAC	State-owned Assets Supervision and Administration Council of the State Council
SAWS	State Administration of Work Safety
SFDA	State Food and Drugs Administration
SME	Small- and medium-sized enterprises
SOE	State-owned enterprise
TUAC	Trade Union Advisory Committee to the OECD

Chinese Glossary

ACFTU	中华全国总工会
BIAC	经合与发展组织工商咨询委员会
CNTAC	中国纺织工业协会
CSC9000T	中国纺织企业社会责任管理体系总则及细则
CSR	公司社会责任，企业社会责任
DFID	英国国际发展部
GEI	全球环境研究所
ILO	国际劳工组织
ISO	国际标准化组织
MOFCOM	商务部
OECD Watch	经合与发展组织民办组织咨询委员会
RBC	有责任的社會行为
SA8000	社会责任国际 8000（社会责任标准）
SASAC	国务院国有资产监督管理委员会
SAWS	国家安全生产监督管理总局
SFDA	国家食品药品监督管理局
SME	中小企业
SOE	国有企业
TUAC	经合与发展组织工会咨询委员会

OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(20 2008 07 1 P) ISBN 978-92-64-05366-3 – No. 56403 2008

CHINA

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