COMPETITION

THE STORY SO FAR

Competition policy promotes rivalry among firms to maximize societal and economic welfare. In advanced economies, competition policy includes antitrust laws that protect consumer welfare from monopolistic behavior and other rules to prevent collusion, unfair practices that restrict competition and other abuses, and barriers to market entry and exit. As China has reached a more advanced development stage, it has ratcheted up its competition policy objectives. Beijing passed a long-awaited antitrust law in 2008, after 13 years of discussion. The 2013 Third Plenum plan declared "developing an environment for fair competition" a priority. However, long-standing instincts to favor the interests of state-owned firms over consumers – and domestic firms over foreign – are still embedded in the Chinese system with little regard for consumer welfare or fair competition.

- Since May 2013, the State Council has streamlined a wide range of administrative procedures related to business registration and taxation. As a result, new business registrations have risen steadily in recent years, and in 2018 the World Bank recognized this progress by substantially increasing its ranking of China's "ease of doing business" compared with that of other countries. The State Council has promised to similarly reduce barriers to market exit, but progress has been much more limited.

- In June 2016, the State Council launched a "fair competition review mechanism" to clean up anticompetitive policies issued by government agencies at all levels. The mechanism did not clarify whether industrial policies should be considered anticompetitive, did not establish a transparent process to identify which current policies were anticompetitive, and did not prevent new anticompetitive policies from being implemented.

- Beijing updated several competition-related laws after 2013 to reflect changing market conditions. In November 2017, China revised its 24-year-old Anti-unfair Competition Law (ACL) to cover newly emerging issues, such as commercial bribery and competition in new technologies like software and networks. In August 2018, the government also passed a new E-commerce Law to govern competition between internet companies. And it is in the process of revising patent and antitrust laws, ostensibly to strengthen legal protections for companies, though unequal enforcement between state-owned enterprises, foreign companies, and domestic firms remains a major concern.

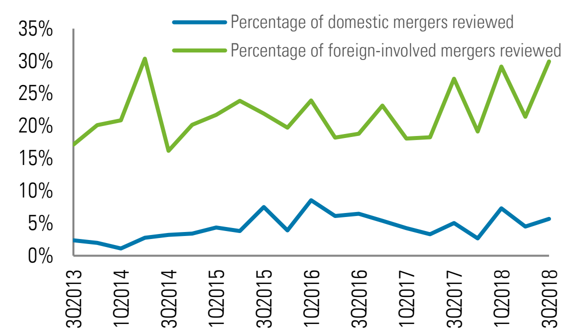
- In March 2018, China's National People's Congress approved a government restructuring plan that merged functions from various agencies responsible for enforcing competition policy. The new agency, named the State Administration for Market Regulation (SAMR), now oversees all aspects of China's competition policy regime including business registration, mergers and acquisitions (M&A) reviews, pricing policy, food security, consumer protection, and intellectual property protection. On paper, SAMR's creation reduced the influence of industrial policy regulators, but these bureaucratic changes have yet to drive any real improvement in China's competition regime as measured in our indicators.

METHODOLOGY

Competition policy is an amalgam of law, economic analysis, and politics, and gauging outcomes is challenging. Our primary indicator looks for convergence in reviews of foreign versus domestic mergers conducted by SAMR. Supplemental data look at the number of merger cases reviewed, disclosure of the results of competition-related court cases, new business starts and closures (market entries and exits), and the ability of firms to obtain viable profits in healthy markets.

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Merger Reviews
4qma, percentage



Source: Ministry of Commerce, Bloomberg, Rhodium Group

- Our assessment of competition reform remains negative this quarter: foreign firms are still targeted disproportionally in merger reviews despite bureaucratic reforms meant to level the playing field.

- All supplemental data point to continued weaknesses in China's competitive environment: judicial transparency remains inadequate and foreign investment is slowing. If the state were withdrawing from the normal marketplace, then some residual but shrinking inequalities could be tolerated and mitigated; however, with the current resurgence of state firms over private, the damage done by an uneven playing field is multiplying rapidly.

- New policy discussions center on "competitive neutrality" – the objective of treating state-owned and private firms equally – but thus far Beijing's variant of this concept places a greater emphasis on defending

Chinese state-owned enterprises' (SOEs') interests abroad rather than constraining their market power at home.

THIS QUARTER'S NUMBERS

Our primary indicator reflects a wide gap in the competitive environment between foreign and domestic companies in China. Out of 92 merger reviews undertaken by the Chinese government in 3Q2018, 59 involved foreign companies: that is, 30% of all mergers involving foreign entities were called in for review, a high percentage. Only 33 Chinese-only mergers were reviewed despite a vastly larger number of merger announcements: just 6% of announced cases were examined. In addition, two important mergers involving foreign companies were approved with restrictive conditions. Beijing has never once imposed conditions on approval of a domestic merger since the Antitrust Law took effect in 2008.

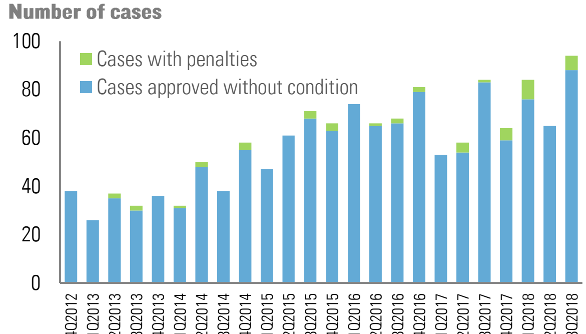
Judicial transparency around competition-related cases improved modestly this quarter but remained woefully inadequate. China's Supreme Court published 3,841 cases related to competition and intellectual property disputes (see **Judicial System Transparency**), more than the previous two quarters combined, but the volume of published cases is still tiny compared with the more than 200,000 such cases handled by the Chinese courts each year. The Supreme Court announced during the review period that it accepted 700 antitrust cases and concluded 630 of those between 2008 and 2018, but its website only published 73 cases from that 10-year period. Judicial opacity makes it difficult to know if competition laws are being fairly applied, and for foreign and domestic firms to effectively understand and navigate China's complex competition policy environment.

In our last edition, we flagged that the 18% year-on-year (yoy) increase in new business registrations in 2Q2018 was surprising and suggested that a spike in foreign-owned entity registrations was temporary. New business registrations slowed to a more reasonable level in this review period, with growth down to 9% yoy in 3Q2018 (see **Market Entry and Exit**). Total registered capital for foreign entities established in the first nine months of 2018 was only 0.1% higher than the same period last year. While streamlined administrative procedures aided the overall growth of new business registrations, other factors risk scaring foreign investment away. Both unilaterally and in talks with the United States, China is contemplating structural reforms, including more earnestly prohibiting formal and informal technology transfer requirements and freeing investors to repatriate their profits. Over the past year Beijing has also reduced or eliminated joint venture requirements and caps on equity shares in promising domestic sectors like automotive manufacturing and financial services, though other barriers to foreign investment in these industries remain prohibitive. While these moves offer an exciting prospect of a new age for foreign investment, China's politicized detention of foreign nationals as a negotiating tactic has injected a toxic element, causing foreign business professional and citizens to rethink working in, touring, and otherwise traveling to China.

The distortions in China's competition environment principally benefit the state-owned corporate sector, which has performed better even while industries are consolidated and credit growth slows to reduce financial crisis risks. Tighter credit conditions in the aggregate had the unintended effect of making capital more available to SOEs relative to private firms (see **SOE** and **Financial System** reform). This access to capital is crucial, because our data show SOE pricing power (ability to generate profit) deteriorating by 11% in the review period – to the lowest level in eight years (see **Pricing Power Index**). While private firms' pricing power increased during the review period, they still suffered from unequal access to credit relative to state firms. Cycles of thinning profitability are natural in market economies: they are the crucible in which tomorrow's dynamism and competitiveness are formed, as less-profitable firms are compelled to exit the market, creating space for more promising players to grow. But if there is not equal access to capital, these phases of the cycle will have the opposite effect: promoting survival of those most under the government's wing rather than those attuned to the marketplace.

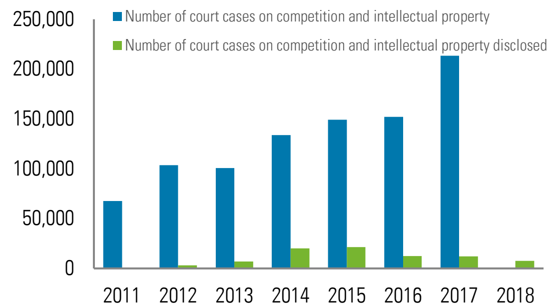
Supplemental I: Results of Merger Reviews

Number of cases



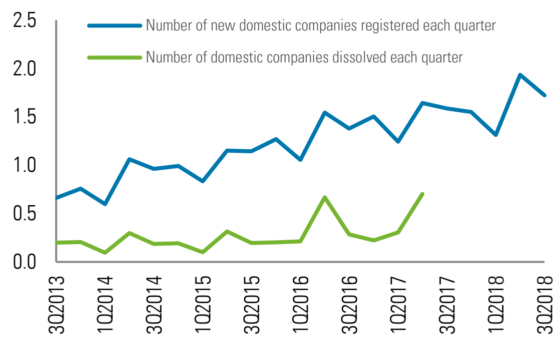
Source: Ministry of Commerce, Rhodium Group.

Supplemental 2: Judicial System Transparency
Number of court cases



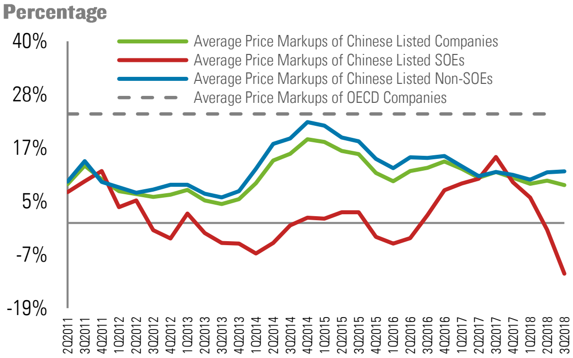
Source: Judgements Online, Supreme Court.

Supplemental 3: Market Entry and Exit
Millions



Source: State Administration for Industry & Commerce, Rhodium Group.

Supplemental 4: Pricing Power Index
Percentage



Source: Bloomberg, Rhodium Group.

POLICY ANALYSIS

The most important competition policy development in the review period was renewed discussion of competitive neutrality as an approach to managing the state in the marketplace – an objective included in the 2013 Third Plenum. On October 15, People's Bank Governor Yi Gang said at a G20 banking seminar that China will "consider treating SOEs with the principle of competitive neutrality." The term has engendered decades of debate and redefinition in OECD circles as a possible tool for managing the behavior of state enterprises operating in fundamentally market-oriented economies. Different views remain on the approach among advanced economies; how the concept would apply in an economy where market forces are far from fundamental (China) is unclear.

Governor Yi's concern with eliminating the inequalities facing private and foreign firms in China may be a positive step. However, on the same day Yi made his remarks State-owned Assets Supervision and Administration Commission (SASAC, overseer of China's nonfinancial central SOEs) spokesman Peng Huagang explained that Beijing was interested in competitive neutrality as a framework for defending SOEs' interests abroad, not for limiting their privileges at home. In his response to a G20 proposal to apply different regulatory standards to SOEs, Peng argued that "China advocates neutrality of ownership, opposes setting different rules for companies of different ownership, and opposes discriminatory treatment of SOEs in the formulation of international rules."

The Ministry of Commerce (MOFCOM) made a similar argument in December when it published a set of proposals for reforming the World Trade Organization (WTO). MOFCOM called for WTO reform to "respect members' development models," including "legitimate developmental models and policy measures, such as state owned enterprises and industrial subsidies," and stated that China opposes "special and discriminatory disciplines against state owned enterprises."

Despite the focus on competitive neutrality as a means to protect SOEs abroad, some officials see its application at home as well. On November 5, SAMR head Zhang Mao stated his agency would "adhere to the principle of competitive neutrality, that is, to apply neutrality on regulations, taxes, and lending to SOEs and private firms, and will treat all market entities equally." On November 25, a number of well-respected Chinese economists participated in a National Development and Reform Commission forum where they urged Beijing to prioritize competition and SOE reform over smaller administrative fixes. The debate over how to apply this concept to China's present challenges is just getting started.