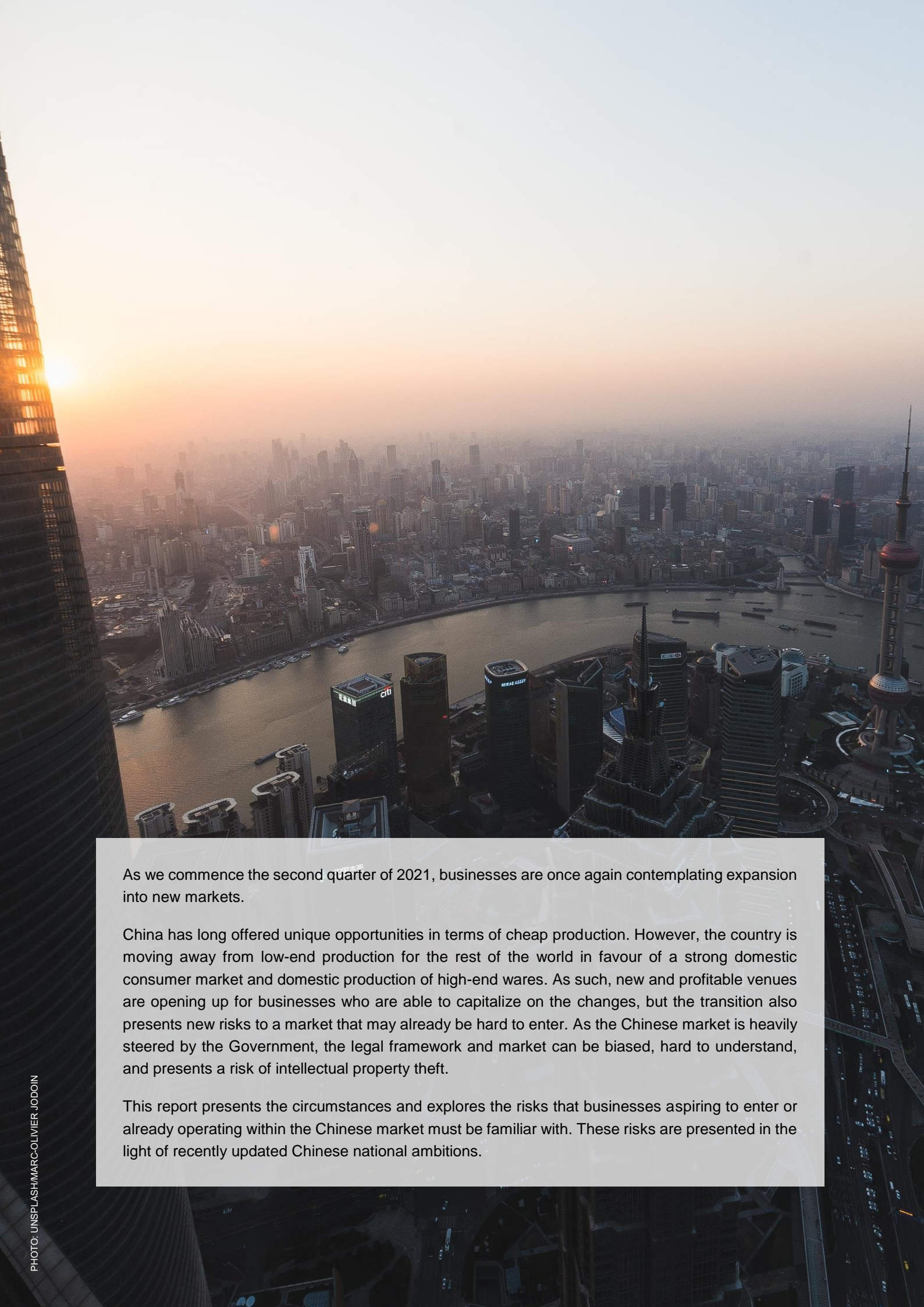


CONDUCTING BUSINESS IN CHINA



As we commence the second quarter of 2021, businesses are once again contemplating expansion into new markets.

China has long offered unique opportunities in terms of cheap production. However, the country is moving away from low-end production for the rest of the world in favour of a strong domestic consumer market and domestic production of high-end wares. As such, new and profitable venues are opening up for businesses who are able to capitalize on the changes, but the transition also presents new risks to a market that may already be hard to enter. As the Chinese market is heavily steered by the Government, the legal framework and market can be biased, hard to understand, and presents a risk of intellectual property theft.

This report presents the circumstances and explores the risks that businesses aspiring to enter or already operating within the Chinese market must be familiar with. These risks are presented in the light of recently updated Chinese national ambitions.

THE CHINESE MARKET

Population

1.39 billion

GDP Per Capita

\$10 261

Growing consumer spending

\$5.6 trillion (2019)

\$12.7 trillion (2029 EST)

Market

Socialist market economy

Companies in 2018

34.7 million

Chinese E-commerce

\$2.09 trillion

50% of online retail sales

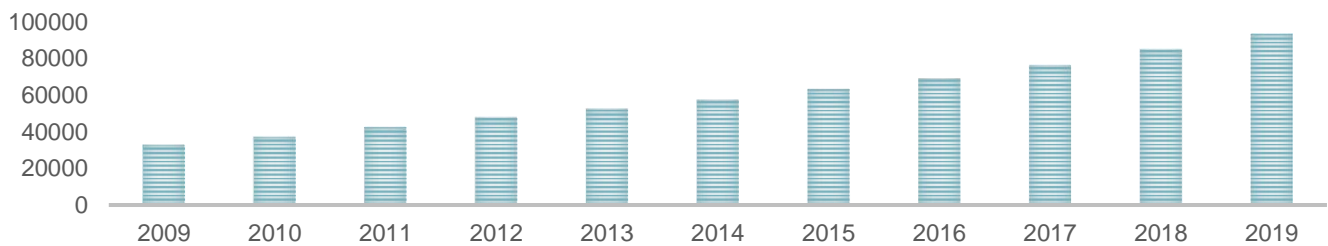
GDP 2019

\$14.3 trillion

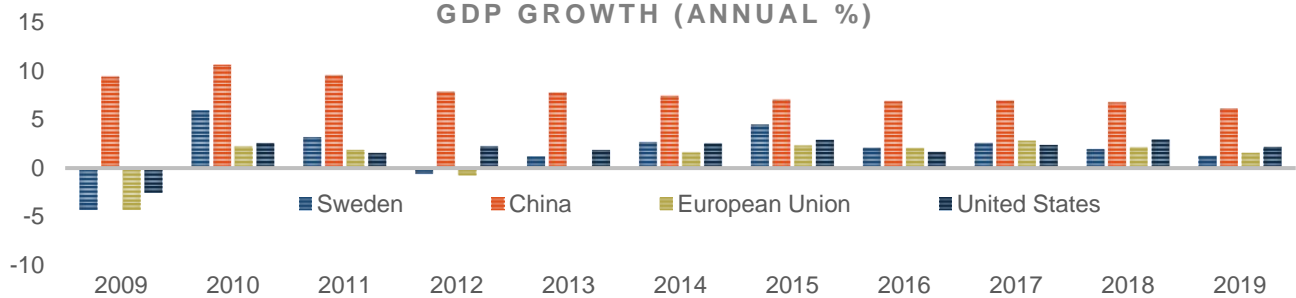
China/EU trade per day

€1 billion

AVERAGE YEARLY WAGE IN CNY



GDP GROWTH (ANNUAL %)



OPPORTUNITIES

The Chinese market is very attractive with a high involvement from western companies. During the ongoing pandemic, China was one of the few countries able to respond effectively enough to come out of 2020 with positive economic growth – a 2.3 percent year-over-year growth. In the last 40 years, China has shed its Maoist economic strategies and developed into a booming economy. In 1979, Chinese trade accounted for less than one percent of world trade. Today, Chinese trade in goods account for 12.4 percent of global trade and China has the world's second largest economy.

The country's GDP was estimated at \$14.3 trillion in 2019 and since 2017, China has overtaken the United States (US) as the country with the highest PPP-based GDP. International trade has become integral

to the Chinese economy with the EU and US being two of the biggest trade partners. Today, China is the biggest trade partner of the EU and the third biggest of the US. China's success spreads, with demand from China helping to support global manufacturing and trade throughout 2020. In February, Eurostat reported that China was the leading trade partner for Europe in goods in 2020, exceeding the USA for the first time. China's global trade expanded by nearly 13 percent on an annual basis, and domestically Chinese retail sales grew by 4.6 percent.

With rising salaries, China's domestic consumer market has grown indicating a bright future for businesses who manage to establish themselves on the market. This development goes hand in hand with China's ambition to leave the investment-led growth

behind in favor of domestic high-end production and higher domestic consumption.

Although the Chinese market is very attractive, it presents a unique blend of challenges and risks, not present in most western markets. Theft of intellectual

LEGAL RISKS

Before engaging in any market, businesses need to understand the legal framework they will be operating within. This perhaps truer in China than anywhere else. Besides understanding regular trade laws, foreign actors must understand that China's national security laws and efforts to control the information flows directly affect foreign businesses in China. Non-compliance is a grave risk due to severe legal consequences however; compliance often exposes sensitive business information.

POTENTIAL ANTAGONISTIC ACTORS

- Commercial rivals
 - Both domestic and foreign
- Intelligence agencies
- Employees
 - Disgruntled employees
 - For financial gain
 - Pressured by intelligence agencies, enabled by national intelligence laws.
- Criminal elements

The Chinese National Intelligence Law

The law was introduced in 2017 and, as the name implies, deals with national security and intelligence. The law has come under western scrutiny since it obliges Chinese subjects, both businesses and citizens, to aid Chinese intelligence efforts if requested. In light of the history of Chinese espionage - both national and corporate, critics fear that the law can and will be used to gain access to sensitive information through the use of technical "backdoors" and Government pressure. China has pushed back

property is common and the market is heavily regulated, argued by some to be rigged in favor of Chinese businesses and to specifically extract foreign know-how and technologies. European businesses engaging in the Chinese market must be aware of these risks as to be able to avoid them.

against the critique stating this is not in line with how China conducts business. To this date, there are no substantial evidence that the law has been used in such a manner. However, as the legal frameworks allows for it, the risk has been deemed high enough for several Governments to prohibit involvement from Chinese companies in the expansion of 5G networks. Companies doing business with Chinese entities should be aware that even though intent may or may not exist, the Chinese Government, through the legal framework, possess both capabilities and opportunity to demand access to these Chinese businesses in the name of national security.

CASE: AMERICAN SUPERCONDUCTOR

Chinese company Sinovel was American Superconductor's biggest customer. One day in 2011, Sinovel refused to pay the millions of dollars they owed for the purchase of electrical components. It was discovered that an employee at American Superconductor in Austria had received payment for leaking source code to the Chinese company. Source code that was then used to install pirated versions of the electrical components, enabling Sinovel to produce wind turbines at a much lower price. In 2018, Sinovel was convicted of stealing trade secrets from American Superconductor, but not without the American company almost going bankrupt.

The Chinese Cybersecurity Law (CSL)

Introduced in 2017, the law combines and builds upon previous more fragmented legislation. The law is not geared towards personal data protection. Instead, it is part of a greater effort to bring government order to the Chinese information space. In an effort to stamp out fraudulent and malicious behavior, this law primarily targets domestic businesses.

The law applies to Network operators and operators of Critical Information Infrastructure. Determining if the business is subject to and compliant with the CSL is essential when operating in China, be it domestically or internationally. Failure to comply with the law is penalized.

The law may also pose a risk to businesses' intellectual property. To enforce the law, the Government is mandated to conduct investigations. What data is to be collected through such an investigation is regulated but with malicious intent, the law could be used to gain access to sensitive data and valuable intellectual property. Though the law could be used to gain access to sensitive data, businesses should adhere to security reviews as failure to comply may have negative business implications. Businesses must weigh the risks of exposing sensitive information against the gains of operating within the Chinese borders.

The Great Firewall of China

The Great Firewall of China (GFC) is the nickname given to the mixture of technical and legal measures that act as a filter for the Government to moderate online information flows in and out of China. The technical aspects include several measures for blocking and monitoring internet traffic and users may face legal punishment if they spread what is deemed as undesirable information.

As the Government owns all internet service providers, all regular internet traffic can be monitored and as such, should not be considered a safe way of communicating. VPN:s offer the ability to circumvent blocked webpages and communicate without the government monitoring and should therefore be considered a requirement when operating in China. Chinese operated VPN-services are approved by the Government and affiliated with Chinese telecom businesses, and as such, the Government may

CASE: AGRICULTURAL ECONOMIC ESPIONAGE

In 2019, Haitao Xiang a previous Monsanto employee from Missouri was charged with economic espionage. Xiang worked as an imaging scientist and was involved in the development of digital online farming software. Xiang was allegedly recruited through "Talent Plans" and within a year he had quit the job at Monsanto and was travelling to China. However, Xiang was caught at the airport with proprietary data belonging to Monsanto.

TRADE LAWS THAT WARRANTS A COMPREHENSIVE UNDERSTANDING:

- Foreign NGO Management Law
- E-Commerce Law
- Foreign Investment Law

Furthermore, businesses must ensure their operations are not prohibited in the following lists:

- The Foreign Investment Negative List
- The Markets Access Negative List

CASE: SOLARWORLD

In 2014, a US grand jury filed charges against five People Liberation Army (PLA) officers for hacking into the US branch of SolarWorld, stealing thousands of files. The intent was allegedly for the PLA to give businesses in the Chinese production market an edge over its western competitors. The SolarWorld USA Chief Executive Juergen Stein has later testified that two Chinese companies "leaped overnight" into the technology they had been developing, forcing SolarWorld to compete against its own proprietary technology produced in China.



PHOTO: UNSPLASH/RYAN TANG

request access to users. Businesses should therefore rely on foreign VPN services. However, many websites of foreign VPN providers are blocked within China and may require registration outside of the country.

VPN services are not likely to be outlawed as many foreign businesses rely on them to operate within China. Though the Government will most likely continue to making the use of non-state sanctioned VPN:s cumbersome.

2020 – A YEAR OF TURBULENCE

In the early months of the pandemic, the Chinese economy was greatly affected by the lockdowns. The forceful restrictions imposed by the Government to stop the spread of the virus had negative effects on production and trade. Several businesses had to close down and much of the workforce was indisposed due to the restrictions on movement. Furthermore, the adverse effects of the Covid-19 pandemic on Chinese production and export highlighted the benefits of diversifying foreign operations. As such, some companies have left China to the benefit of countries that can fulfill cheap production needs. Coupled with the ongoing trade war with the US, 2020 looked to be a tough year for the Chinese economy.

Even though Covid-19 caused a blow to the Chinese economy in the early days, the extreme restrictions implemented by the Government showed effective and the market recovered faster than most. As many western countries started fighting the pandemic, China had already almost recovered. Furthermore, the US trade war has caused US/China trade to decrease but trade with other regions, such as the EU, has instead increased. As a result, China overtook the US and became the biggest trade partner of the EU in 2020.

Though China saw its lowest economic growth in decades, at only 2.3 percent, during 2020, they still showed a stronger growth than most western economies. Three months into 2021, the Chinese

economy has almost normalized, and the IMF has estimated that it will grow by 8,1 percent in 2021. Furthermore, US efforts to hamper Chinese trade as to force them to change practices has limitations. China has grown to become the primary trading goods partner of 64 countries while the

corresponding number for the US is only 38. Severe pressure from the US could lead to the country isolating themselves by forcing others into the hands of China. As such, it is unlikely that the US will be able hamper Chinese development through trade war practices.

PRIORITIZED SECTORS

In 2015, China announced its new strategic plan to develop manufacturing sector, commonly known as Made in China 2025 (MIC2025). China's impressive economic development has rested heavily on cheap production of low-tech wares for markets all over world, leading to China earning the epithet "the world's factory". MIC2025 marks a departure from this. By introducing this strategic plan and investing heavily in the ten listed sectors, the Government intends to reshape China into a self-reliant and world-leading producer of high-end goods. One of the main goals is to produce 70 percent of core components and materials in by 2025.

Following international criticism, the Chinese Government has de-emphasized the term but continued to invest in the sectors outlined. In March 2021, the 14th Five Year Plan was approved. In the

spirit of MIC2025, the plan emphasizes the improvement of domestic manufacturing and technological prowess.

Although China has de-emphasized the MIC2025 plan, the funding going into these goals indicate that these ten sectors will be of national interest for the coming years. Furthermore, they indicate which foreign sectors might be of particular risk of IP-theft when conducting business in China. Businesses within these sectors should take special precaution when engaging on the Chinese market, especially if the business is set up as a Joint Venture. Furthermore, the aspiration to improve domestic sectors means that foreign businesses engaged in China may face disadvantages compared to the Chinese competition.





PHOTO: SHUTTERSTOCK/RUSLAN BARBASH

IP-THEFT THROUGH JOINT VENTURES	ATTEMPTED BIOTECH THEFT	CORRUPTION AND BRIBERY
<p>When incorporating the entity into the Chinese market, a business may choose between a registering as a Joint Venture (JV), Wholly Foreign-Owned Entity (WFOE) or Representative Office. Unlike a WFOE, where the foreign business has full autonomy, a JV is set up with a local Chinese partner. For some markets a JV is the only option and while JV's sometimes offer unique benefits through the local partner, they come with a heightened risks of IP theft by the local partner. Several European businesses have reported setting up JV's and later competing against their own product. Some argue that the Chinese Government facilitate this practice and that it therefore should be considered forced technology transfer. Swedish businesses seeking to establish themselves in China must evaluate how to structure their business venture.</p>	<p>In 2017, Chinese national Weiqiang Zhang was convicted on one count of conspiracy to steal trade secrets. Zhang had worked as a rice breeder for Ventria Bioscience. During his time at the company, Zhang had stolen hundreds of genetically programmed rice seeds intended for use in the production of therapeutic and medical fields. Several years and millions of dollars had been spent developing the seeds. The theft was detected as a Chinese visitor of Zhang was caught at the airport with several Ventria seeds in his luggage.</p> <p>The value of the Chinese biotech market has skyrocketed causing a potential market bubble. As the sector is booming, Swedish businesses should be cautious of potential Chinese actors seeking an edge through illegitimate means.</p>	<p>Understanding the laws surrounding corruption and bribery is essential in China. The current administration has stamped down hard on bribery and corruption. These offences now carry the possibility of life in prison if considered severe. In 2021, China sentenced the former chairperson of one of China's biggest state-asset management firms to death on the charges of corruption and bribery.</p> <p>As interpersonal relationships are integral to the Chinese business environment, foreign businesses unfamiliar with the culture are susceptible to, accidentally, engage in corrupt practices. Swedish businesses seeking to establish themselves within China, need to be knowledgeable about the culture, laws and always conduct proper due diligence.</p>

WHAT ABOUT HONG KONG?

Since 1997, when the region was handed over from the English to China, Hong Kong has operated as a special administrative region. Under the banner of “one country, two systems”, Hong Kong has been allowed a certain degree of autonomy and the continuation of their capitalist system. During the last decade, production has largely moved to mainland China as Hong Kong has transitioned into a service economy. Today, Hong Kong is a financial hub and holds over USD 10 trillion in cross border investments. Because of Hong Kong’s autonomy, Government involvement in the market has been low and for 25 years, it was ranked the freest economy in the world, a position recently overtaken by Singapore.

Due to the Chinese attempt to expand their extradition law into the region, and because of the subsequent 2019-2020 Hong Kong protests, China – Hong Kong relations have been strained. In 2020, China introduced a new National Security Law for Hong Kong, targeting secession, subversion, terrorism and collusion. The law has been accused of killing the one country, two systems agreement. In the recent National People’s Congress 2021 session, the

Congress deliberated a draft amendment on “improving” the electoral system of Hong Kong. The Congress expressed a need to “plug loopholes” that has been exploited by so-called anti-Chinese actors. Central to this improvement was the importance of having “patriots administering Hong Kong”, tightening Chinese control over the region.

The events of 2019 and 2020 caused many to worry about the future of “one country, two systems” and the potential death of liberalism in Hong Kong. Many feared that China clamping down on Hong Kong would lead to panic and mass exodus amongst foreign entities. By interfering in Hong Kong, China showed that they would not accept perceived political dissidence amongst the special administrative region. As such, they have strengthened the “one country”. However, China has shown financial regulatory restraint by not interfering with Hong Kong’s business landscape which have preserved the markets aspects of “two systems”. Against western fears, Hong Kong as a financial hub is booming with both foreign and Chinese top firms maintaining presence.

CASE: AGRICULTURAL ECONOMIC ESPIONAGE

In 2019, Haitao Xiang a previous Monsanto employee from Missouri was charged with economic espionage. Xiang worked as an imaging scientist and was involved in the development of digital online farming software. The Chinese government through “Talent Plans” allegedly recruited Xiang who had promoted himself based on his experience from Monsanto. Within a year, he had quit the job at Monsanto and was travelling to China. Xiang was caught at the airport with proprietary data belonging to Monsanto. The Haitao Xiang case is just one of several where Chinese actors have used employees at foreign companies to gain access to trade secrets from the agricultural industry. With explicit intent from the Chinese Government to upgrade agricultural production, Swedish businesses within this sector should be wary of heightened Chinese interest in trade secrets.



PHOTO: UNSPLASH/RUSLAN BARDASH

ADDITIONAL RISKS TO TAKE INTO CONSIDERATION

TRAVEL RISK	CRIME	INTERSTATE TENSIONS	ENVIROMENTAL RISK
<p>Tensions are currently high in Tibet, Hong Kong or Xinjiang. Security and travel conditions in these regions can deteriorated quickly. Since 2017, travelers between the ages 14 and 70 entering China, can be subject to fingerprinting upon arrival. Furthermore, the coronavirus outbreak has brought additional complexity and it is crucial to be continually informed about travel restrictions and preventive measures adopted by the Chinese authorities before commencing your travel.</p>	<p>Petty crime is common, especially in crowded urban areas. This includes personal property theft. Kidnapping, extortion and murder constitute a low risk for foreign nationals in major cities. Meanwhile, the risk of cyber-crime and industrial espionage is increasing common in high-tech companies and industries related with China's long-term industrial transformation. As one of the main producer of goods globally, China has a well-established counterfeit market.</p>	<p>Naval harassment and the risk of unintended escalation of military confrontation is expected to grow between China, Taiwan, the USA, and South China Sea claimant countries. After the re-election of the Democratic Progressive Party in Taiwan, the relations with China will probably continue to deteriorate and recently we have observed an increase in overt and aggressive actions by China towards Taiwan. China is involved in a decade's old territorial dispute over the South China Sea with several of its neighboring countries. During recent years, tensions have been increasing.</p>	<p>Environmental hazards pose a moderate risk in China. The risk is elevated in some urban areas, mainly due to air pollution. Estimations state that more than one million people die each year in China due to air pollution. In the northeast of China, the climate is continental and it is important to note that sandstorms can strike Beijing in April. China has suffered nine earthquakes with magnitudes at or higher than 7.6 on the Richter scale in the last ten years. Due to the earthquakes, tsunamis can affect areas along the coast.</p>

GENDER EQUALITY

Gender equality is an important indicator of whether or not economies and societies prosper. Achieving gender equality has an important impact on the growth, competitiveness and future-readiness of economies and businesses. According to the World Economic Forum, China ranks 106th on the Global Gender Gap Index 2020, while Sweden ranks fourth. The Chinese political landscape remains dominated by men, with women holding only two ministerial positions and representing one-quarter of the

National People's Congress membership in 2018. Leadership positions in the private sector remain dominated by men, with one woman for every five men in leadership roles. However, China has virtually closed the educational gender gap, with both sexes achieving universal literacy. Available statistics from China indicate that the portion of women attending tertiary education is larger than the percentage of men.

TIPS TO BE SUCCESSFUL IN THE CHINESE MARKET

1. Strengthen your business relationships

In Chinese business culture, building interpersonal relationships is very important. Local businesses may only do business with you if you have established a reliable and trustworthy relationship

2. Study your competitors

Most Swedish companies will find several well-established competitors already trading in China, so it is important to know what they offer, their strengths and weaknesses, and how they are perceived by consumers

3. Adapt your products and services to the Chinese market

Understand Chinese client needs before entering into the market and be aware and flexible to the needs of consumers

4. Employ a local expert to communicate in Chinese

It is important to have the advice and suggestions of a Chinese expert to translate products and service information or to develop trademarks, slogans, illustrations and a website

CONCLUSION – THE FUTURE OF BUSINESS IN CHINA

At the start of 2020, Covid-19 and hostile trade relations with US made it look like China had a tough year ahead of them. Three months into 2021 with a pandemic still crippling many western markets, and China is back on track with GDP growth projections far stronger than most western countries. As the Chinas economy grows, so does national wages in turn the consumer class. The future of foreign engagements in China is the domestic market, a market that is sure to grow. By 2028, China is projected to overtake the US as the world's largest economy. As the Chinese consumer market grows, great opportunities present themselves to Swedish companies interested in expanding their operations in China. However, businesses should also be wary when engaging with the market.

Under the current president, Xi Jinping, the country has continued its economic boom. This has been enabled by technology transfer from the West to China that many argue often happens forcefully. This is supported by the recurrent reports of IP-theft from Western companies. One must be aware that even though the current administration has created a more attractive business landscape by stamping out corruption and, through the latest Five Year Plan, introduced a “dual circulation” system where global and domestic markets are intended to boost each other, the current administration is not a liberal one. Any Chinese attention given to the “external circulation” – the export to foreign markets, must be understood as a way to bolster the domestic market and furthering Chinese global influence not the other way around. The Chinese market goes where the current administration wants it to go. In other words, to understand the intent of the Chinese Government is to understand the direction of the Chinese market. Swedish businesses engaged in China must not only monitor and understand market regulations, but also the Government that closely regulate the market.

The Government has shown that it wants China to become the world's economic and influential leader, headed by the Communist party. This is to be achieved in part by breaking away from current global

trade dynamics where China is seen as the world's factory to instead become a self-reliant producer of high-end goods. This is described through the “dual circulation” concept, where the “internal circulation” - the domestic cycle of production, distribution and consumption stands at the center. Made in China 2025 and, more recently, the 14th Five Year Plan show which areas will be prioritized in the coming years. Swedish businesses within these sectors may see incentives to engage with the market but must also be attentive to threats to their intellectual property and future market structures that may give further advantages to domestic actors. Businesses expanding their operations to China must embrace a unique security culture as potential vulnerabilities are much more exposed to antagonistic actors.

China will continue to try to attract more foreign investors, bolstering production development, technology transfer and self-sufficiency with the intent to bring foreign engagement on their own terms to support Chinas rise to the top. The history of IP-theft from Chinese actors and the Governments current wishes to improve its own sectors of production means that the protection of intellectual property will continue to be a high priority when operating in China. Furthermore, the current reach of the Chinese NIL is so vast that businesses operating from their home countries run the risk of being targeted if business operations can be considered a threat to Chinese national security.

With the current administration, China is likely to further develop national security laws, akin to NIL and CSL. As China becomes less reliant on foreign markets and resources, the ability to affect the behavior of the government through market mechanism diminishes, enabling the Chinese Government to act on their own terms due to the lack of consequences. As a great number of countries rely on China as a trade partner, it is unlikely that any antagonistic trade measures from the US will have noteworthy effect. Instead, it must be concluded that the future of global trade will be heavily reliant on China.

Businesses expanding their operations to China must embrace a unique security culture

2SECURE

RECOMMENDS



PHOTO: UNSPLASH/RYOJI IWATA

2Secure




1. Reviewing interests the Chinese Government may have in your business
If your business is engaged in operations that may fall under the purview of Chinese national security, the legal framework authorizes far-reaching measures from the Chinese intelligence services including mandatory participation from Chinese businesses.

2. Identifying and monitoring developing threats to your sector from Chinese actors
As China is going through a process of upgrading domestic industries, businesses engaged within any of the ten sectors listed in MIC2025 should take extra precaution, as there may be particular interest in your intellectual property.

3. Consider Wholly Foreign-Owned Enterprises rather than Joint Ventures when engaging on the Chinese market
By setting up your business in China as a Wholly Foreign-Owned Enterprise, you minimize the risk of IP-theft from the local partner as a Joint Venture may make them privy to valuable information.

4. Conduct due diligence
Research Chinese actors before entering into business with them; ensure you know who they are and what their history with previous partners looks like.

5. Ensure you fully understand Chinese laws and the implications before engaging with the market
Always seek legal counsel before engaging with the Chinese market. Identify which laws are applicable in your sector what risks they pose to your operations.



+46 101 740 310

Visit our [website](#) for more information on how 2Secure can support you with your international security and risk management needs.

We provide bespoke and tailored analysis, trend monitoring, and risk assessments on a variety of issues and locations around the world.

[Email](#) or call our experts for an obligation free discussion today.

2Secure

Box 34037 • 10026 Stockholm • www.2secure.se