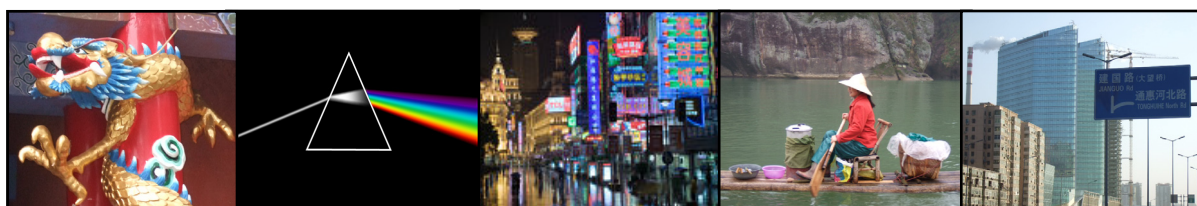


Multinational Companies and the Prism of Chinese Development – Market for Technology and Know How

Part Two - October 2007



There is much talk today in the West of reevaluating China's role in the world – as trade and manufacturing powerhouse, economic miracle, resource mega-user, Olympics host, complex political power. Western audiences may be less aware than they need to be, however, that a parallel reevaluation is taking place in China - of the role of multinational companies (MNCs) and other global stakeholders in China's development and growth.

In Part One of this article, in June, we discussed a surge of Chinese policy initiatives designed to “balance” China's uneven development by utilizing foreign direct investment (FDI) more selectively than in the past, and curtailing perceived MNC “dominance.” Since June, 2007, China's National Development and Reform Commission (NDRC) has finalized its 5-Year Plan to accelerate “domestic high-tech development” and “autonomous innovation.” Influential domestic voices have clamored so loudly against mergers and acquisitions (M&A) of Chinese firms by MNCs that China's Ministry of Commerce (MOFCOM) felt a need to announce that MNC's M&A was still permitted (since such M&A helps “revitalize” local companies!). MOFCOM plans to soon launch a revised policy guiding foreign direct investment (FDI), as part of efforts to protect “national economic security”. And China's National People's Congress (NPC) passed long-anticipated new anti-monopoly law, clarifying that all investments by foreign players seen as “market dominant” in China will be reviewed for possible national and/or economic security violations. Clearly, China continues to reevaluate MNCs in light of national development priorities, and in many cases finds MNCs wanting.

These concerns will also inform and influence discussions at the 17th National Congress of the Communist Party of China - a major event in China's system of governance and politics held every five years – taking place from the middle of this month in Beijing.

Central to arguments against FDI are charges that MNCs have failed to fulfill commitments they are perceived to have made as part of a “market for technology and know-how” bargain, a bargain China felt it struck back in the 1970s. In our view, frustration over the perceived failure of this “strategic bargain” is driving much of today's thinking – and policy-making – related to FDI. By examining this area more closely, using the prism of Chinese development, MNCs can help illuminate crucial business risks and opportunities in China.



Back to the Future: some history on WHO introduced market-for-technology, and its importance

As China dominates global FDI flows and trade today, it is easily forgotten how recent China's reentry to world trade was. Deng Xiao-ping launched China's "openness and reform" policy and "Four Modernizations" in the late 1970s. His goal was to reignite and accelerate China's economic development after decades of self-imposed isolation based on Maoist ideological hostility to foreign "capitalist imperialism" (an ideology informed by historical humiliations dating back to the Opium Wars which had led China to focus on independent self-reliance). Crucially, within China, the Dengist reforms were explained – and widely understood – as hinging on an implicit "market for technology and know-how bargain" with foreign capital that would enable China to develop quickly. Whether or not MNCs ever consciously agreed to these terms, it remains true that many if not most Chinese saw – and see – this bargain as the paramount and only logical reason for accepting opening Chinese markets wide (many other nations have been far less open at comparable stage of development) . And if the market-for-technology "bargain" is seen as having failed, then market opening is seen as largely unjustified.

Under "market for technology," MNCs are seen as having a right to operate in China only to the extent that they broadly and extensively share technology and expertise that helps Chinese companies and industry grow, and enables China to address other development challenges.

Best intentions: culture helps explain WHAT was expected from market-for-technology

Cultural differences between China and the West have deepened misunderstandings around market-for-technology. Western business culture's tendency toward fine legal readings of contractual obligations clashes easily with the more personal, give-and-take nature of Chinese business culture, and with the value China places on "sincerity." Market-for-technology is based on the expectation that MNCs allowed to operate in China would display an open-handed commitment to helping China grow, in a range of ways. As many have observed, protection of IP has not historically been as central for China as for the West (at least in recent decades); many great Chinese inventions were shared with the world well before global patent systems were established. But today's Chinese firms seeking (in many cases in good faith) to develop products inspired by MNC inventions met in many cases with hostile MNCs, armies of lawyers trained to "gun for pirates," and quick-trigger lawsuits. Of course, much Chinese IP infringement happens in bad faith, and MNCs can and should defend their IP. It is, however, worth recognizing that cultural disconnects have likely contributed to China's sour feelings toward MNCs today.

None of this is to say that MNCs are perceived as having contributed nothing. Undoubtedly foreign technology and know-how has played a key role in China's development, and Chinese decision-makers recognize that fact. As one Chinese official said to us : "Whether or not MNCs can fully play a role will have a direct impact on the level of development our...industry reaches, and how long it takes." Nevertheless, there is a strong, and we believe growing, sense that what China has gotten from MNCs is not enough - especially considering the massive share of the Chinese market captured by foreign players and the obstacles this presents to local aspirants.

Titan projects: development economics helps explain WHY market-for-technology is hot today

The "market-for-technology" ideal dates back to the 1970s, but was relatively low-profile as a demand for MNCs through the 1980s and 1990s. Despite debates about competing developmental priorities, most Chinese leaders argued successfully in those years that it made sense for China to pay for foreign technology while focusing on developing its own manufacturing base, rather than pouring China's then-scarce capital into R&D mega-projects with uncertain outcomes. The relatively few large-scale government-funded projects which came together in that period (under such rubrics as "863," the "Golden Projects," and the "Torch projects") often resulted in misallocations of resources and meager results, bolstering arguments for imported technology. So why has market-for-technology regained such force now? We believe several factors have come together, including: an administration in Beijing more focused than its predecessors on "balanced development" and creating opportunities for the poorest Chinese (including, for instance, access to low-cost drugs, whether or not the IP behind them is protected), a Chinese legal and business community growing in sophistication about IP rights, a growing sense of security in Chinese engineering and innovative skills, and underlying all of these, \$2 trillion in foreign reserves (by next year), allowing both room for some mistakes, and the resources to support success.

And of course the larger context of this debate is China's ongoing rapid development curve. China seeks to move up the industrial value chain, overcome major resource dependencies and shortages, compete with emerging markets, radically curtail environmental damage and maintain social stability, all via continuing economic prosperity and growth. As a result of all these factors and trends, in industry after industry, MNCs are today meeting greater demands and higher expectations than perhaps ever before. Indeed, in China's current phase of development "technology and know-how" are more vital than ever in ensuring a corporation's goals are aligned with China's.



The rubber meets the tarmac: market-for-technology in the aviation industry

One industry frequently cited by PRC decision-makers in recent years as an example of failure in the market-for-technology bargain is aviation. Decades ago, China aimed to develop its own large-scale passenger planes, starting with the Y-10, a pet project in 1970 of Chairman Mao. But Dengist market reforms meant opening China to sales by McDonnell Douglas, and then Boeing, and Airbus, who have collectively sold many hundreds of planes into China. For years China seemed more or less satisfied with buying full aircraft, receiving training in maintenance, and gradually taking on component work. In recent years, however, calls are once again arising for China to have its own capacity to independently produce full aircraft. Already China is manufacturing two mid-sized regional planes, the Xinzhou 60 and the ARJ-21, which China states are based wholly on local technology. Premier Wen Jiabao has declared that China will have its own jumbo jet by 2010. Starting in 2006, Airbus began training Chinese engineers to jointly build a complete aircraft; " Laurence Barron, president of Airbus China, was quoted in the *Financial Times* recently as saying: "China cannot just be a sales operation. You cannot expect the Chinese to buy hundreds of planes and there be no spin-off for China." Time will tell how this plays out for Airbus and other international players.

Despite positive awareness of MNC investments, powerful negative perceptions (fair or not) regarding MNC control over technology hold sway in China today. MNCs are seen as not having shared technology in the open-handed fashion expected, so much as sold it piecemeal and at high prices, leaving China shackled to the whims of foreign players and their China-based joint ventures (JVs). Local firms are seen as being left to pick up crumbs, struggling to compete as they battle to develop intellectual property (IP) in a world where MNCs own tens of thousands of patents and use (or warehouse) them to prevent new competition.

Network failure: In WHICH ways is "market for technology" seen by many as having failed?

- Foreign automakers control 75% of car sales in China
- Though China makes 90% of the world's DVD's, China owes an estimated RMB Y10 billion/year in royalties for MPEG-4 compression technology, leaving razor-thin profits
- Chinese media estimate 80% of the value-added in China's \$60 billion annual computer exports goes to licensing fees to chip and software MNCs
- Few Chinese brands have developed even strong Asia regional, let alone global, reach (though this is changing, as firms like Haier, Lenovo, Huawei and ZTE make global gains)
- One recent study showed over 60% of new patents issued IN CHINA go to MNC JVs; even when Chinese firms patent inventions, most are for design or package, NOT original inventions
- Studies suggest some 85% of China's vaunted high-tech exports come in fact from foreign-owned firms using China as a base for low-cost manufacturing
- Key technologies needed to address China's environmental challenges are owned by MNCs who many believe created the problems at hand via "dirty" manufacturing in China

In other words: the proof (non-proof) is seen as being in the pudding; China has not gotten the degree of technology/ industry development it hoped for, and many blame MNCs for not sharing fairly.

NOTE: These statistics are drawn from sources including: reports from the World Bank, Asian Development Bank, China Academy of Social Sciences, and a report on PRC technology standards by the National Bureau of Asian research.

MNCs may object that they have invested widely in China innovation and sharing technology, and there is much truth to those claims. Still, the reality remains that most value-added IP in many if not most key industries in China remains controlled, all these years later, by foreigners. Many arguments can be and have been made as to why that is the case, how much has to do with MNC IP monopolies and brain drain, and how much to do with inadequacies in China's creative education, compensation structures for inventors, protection of IP rights, and so on. Those discussions are important, but are beyond the scope of this article. For our purposes, the crucial point is that, fairly or not, many if not most Chinese PERCEIVE the greater fault as lying with manipulative abuse of IP right mumbo-jumbo by ill-intentioned MNCs. And therein lies the rub, for like it or not, agree with them or not, the perceptions of key Chinese decision-makers directly affects the investment realities MNCs face in China every day.

Understanding these perceptions is the first step toward operating successfully in the environment they have helped create. To that end, we can examine several areas of MNC investment in technology innovation in China using the prism of development, in order to illuminate reasons why so many of these investments, from Chinese perspectives, are seen as inadequate. Once again, we see that FDI is very much perceived as a double-edged sword for China, both an instrument for and an impediment to China's development.



Foreign MNC R&D and VC in China

By some estimates China boasts 750 MNC R&D centers, and counting. These are touted as aligned with China's innovation strategy, and as benefiting China via "spillover effect" and the development of local talent. Such benefits have indeed been recognized for the best R&D centers. Leaders like Intel and IBM, for instance, have moved core global research to China, and Microsoft has cited the creation of a major global R&D center in Beijing as a crucial turning point in improving its standing in China. These select companies have raised the bar. Companies that list IP protection concerns as a reason to hold back on core R&D in China now have to contend with the fact that a number of major global companies are doing it with apparent success.

Indeed, many MNCs stand accused of duplicity in establishing what local wags call 'PR&D' centers – technology localization shops created to seek beneficial treatment, while keeping core R&D and innovation out of China and Chinese employees out of core research. Even the best MNC R&D generate concerns around internal "brain drain," siphoning the brightest Chinese minds into MNCs, instead of local players. Thus, viewed across the spectrum of Chinese concerns, MNC R&D centers, while still an encouraged investment, offer a mixed bag of results.

Similarly, MNC venture capital investments are also regarded as a double-edged sword. Many key Chinese technology firms began with MNC VC but in many cases there is concern that VC arrangements can be used to sustain relationships of dependency with the IT or other MNCs providing the capital, allowing foreign players once again to profit most from Chinese innovation and also to push the development of companies that rely on core foreign technologies.

Foreign MNC M&A

As demonstrated by the far-reaching new anti-monopoly law, M&A is a heated area of recent debate. Parts of China's government still reach out to MNCs for capital to revitalize ailing local firms, but increasingly, China's media and leadership are sounding alarms about alleged attempts by foreign players to "capture famous Chinese brands". Many in China believe MNCs seek to buy up Chinese brands only to shut them down, and dominate the market with their own brands. Other M&A bids are seen as attempts to capture valuable local technologies. Many acquisition bids have been rejected, especially where foreign players are said to be contributing "no value" beyond money. In other cases assets have been reclassified after initial investments have been completed. Several of these moves have been openly justified as "retaliation" for Western treatment of China-based investors, such as the high-profile US rejection of the China National Offshore Oil Corporation's bid to purchase UNOCAL. Strategic "pillar" industries such as banking, finance, telecoms, and petrochemicals are particular targets for protection (the new anti-monopoly law declares that these pillar industries must remain under Chinese control). Some global companies are now pursuing much smaller acquisition targets in China in the hope that these will not set off the "national economic security" alarm bells.

Foreign MNC IP in China

Foreign technologies are recognized for having contributed to leap-frog advances by China in a host of areas. Yet insistence on proprietary technology standards and IP rights enforcement, as well as lawsuits in this area by MNCs, have met intense criticism from audiences that see these as tools to perpetuate China's technological dependency on (and royalty payments to) foreigners, and to stifle Chinese innovation and success. As a result, Beijing has formulated a comprehensive strategy to foster "autonomous innovation" and has issued policies supporting "home-grown" standards and other technology: not so much made in China as "created by China". WAPI (home-grown wireless encryption) and TD-SCDMA (home-grown 3G wireless) are two controversial technology standards that can only be fully understood in this context, and in light of China's broader innovation strategy. Efforts by foreign MNCs to partner and collaborate with local players on these technologies can be understood as efforts to mitigate concerns about MNC dominance, which also illuminate the hostility met by firms perceived as trying to block or contain China's efforts in this area. All of this raises fundamental questions such as: what is the role of foreign companies in a strategy to develop "independent" or "autonomous" innovation? When does "cooperation" play into fears about "dominance" by foreign companies? When can foreign companies differentiate by facilitating or enabling local innovation? It depends on who you talk to. We believe there are still abundant opportunities to participate, contribute and benefit - even if the bar has been raised and a far more nuanced understanding is required.

The politics are getting hotter, the expectations more complicated

Any hope that the re-emergence of “market-for-technology and know-how” type demands is a passing trend – or that increasing “Chinese self-reliance” means less is required of MNCs - should be dispelled by the many uses of related language and concepts by the current leadership (even when they don’t refer specifically to “market for technology,” or have a slightly different emphasis). For instance, MOFCOM’s 2007 *China Foreign Investment Report* states: “it is very difficult for MNCs to compete in this market without bringing high technology in.” Definitions of “market for technology” are being expanded to include “enabling” China to develop its own IP via sharing expertise and collaboration with Chinese firms. In other words, the “know-how” part of the original equation is now much more important (some Chinese have given up on the idea of wholesale “technology transfer”), as part of an increasingly “qualitative” and selective focus on MNC contributions. Now China might offer “market for helping promote a Chinese standard globally”, “market for supporting China’s efforts to secure natural resources”, “market for supporting China’s interests in global debate”, “market for helping local companies access global markets”, “market for bringing high-end production to China”. The fundamental assumption that foreigners need to give something in return for market access has not changed, even if the types of contributions sought are more complex, reflecting China’s ever more complex development agenda, faster changing needs and more complicated expectations.

Foreign MNCs and China’s Environment

China’s environmental issues are widely understood, both within and without China, to have reached crisis proportions, and “greener” and more sustainable development is one of the core platforms of the current Chinese administration. Yet as recent media coverage has suggested, even strong attention from the top-most leaders has made relatively few dents in the Juggernaut of China’s rapid, resource-hungry economic growth, much of it in the heaviest – and dirtiest – industries. Targets for water and energy use, resource efficiency, and emissions reductions are falling by the wayside daily. The complexities are enormous, ranging from coordination problems between the central and local governments, to shortages of cash and technology that tend to promote shortcuts for polluters, to inadequate enforcement and corruption. These problems are entrenched and systemic and will likely take many years to resolve; meantime, as China’s pollution-related death tolls mount, MNCs (rightly or wrongly) are easy targets.

To be sure, some MNCs are perceived as having benefited China by upholding high standards of environmental performance. Others have earned kudos by bringing vital technology and know-how to help China address sustainability challenges (even if hasn’t been completely transferred) in areas ranging from water treatment to energy efficiency to “cleaner” utilization of China’s vast coal reserves. Continuing tax breaks for MNCs and FDI in these areas, when tax breaks have been rolled back in so many other fields, demonstrates the degree to which sustainability remains a priority.

That said, most current Chinese debate about the role of MNCs in China’s environment centers not on the potential of foreign abatement technology, but on the perceived reality of MNCs pouring pollution into China. MNCs stand accused of “exporting pollution,” via “sunset industries” that are being phased out in developed nations, and by failing to transfer sufficiently advanced abatement technologies. Certainly Chinese decision-makers also recognize that internal Chinese issues and standards have also worsened China’s environment, but part of the perceptual reality of China is that foreign companies will always be held to higher standards.

Foreign MNCs and Enabling Chinese firms

Perhaps the most desirable contribution an MNC can make to China is to help or enable the development of a local company or industry. This was the main justification for the joint venture (JV) arrangements MNCs were compelled to enter in the early years of China’s market reform. Of course, from the MNC perspective many JVs failed, too many becoming channels for IP theft and the creation of new competition; but from some local perspectives there were benefits to those trends. Today, with most new FDI coming in the form of wholly-foreign-owned enterprises (WFOEs), Chinese leaders have recognized and praised MNCs seen as aiding local industry growth. The assistance large tech players gave to Lenovo at early phases of its development, for instance, the role leading foreign auto companies have played with Shanghai Auto Works, and an energy major’s support for petrochemical firms in Chengdu have all been widely recognized. Partnerships that help Chinese firms access international markets, transfer expertise, or do collaborative R&D come in for particular praise – as do, in the wake of recent scandals, firms that help strengthen China’s capacity for quality and process controls to help improve food and product safety. Finding credible way to help Chinese firms ‘go global’ without giving up the store in terms of an MNC’s own global markets is becoming the sine qua non of what Chinese perceive as good-faith market access bargains today.

What can foreign MNCs do?

So, in this ever-more-complex and demanding environment, what can MNCs do to be and be seen as having struck a fair bargain? Each company's solutions will of course be idiosyncratic to its own specific needs, but some basic principles and practices will be helpful for nearly all firms. Companies should, for instance:

- Recognize that China's demands regarding technology and expertise transfer are rising as part of a larger reassessment of the value of MNCs and FDI to China, and develop plans to deal with these changing market realities
- Understand that, even as companies shift from being "international" to "multinational" to what IBM calls "globally integrated," in China MNCs are still seen as being French, German, Japanese, or American - and assumed to have their home nation's interests at heart
- Recognize that being a "thought leader" requires in China leadership in thinking about China's own technological development curve
- Expand routine due diligence assessments for new projects, facilities, acquisitions, etc. to factor in potential exposure to Chinese sensitivities, and/or support for Chinese priorities
- Avoid overstating technology and knowledge transfer contributions - but know how to articulate real contributions made in the context of China's broader development goals
- Seek opportunities to collaborate and partner with local stakeholders that the MNC can benefit - for instance via education in R&D methodologies - while protecting MNC IP
- Understand and articulate the core values the company offers, and how those values are aligned with China's various developmental goals
- Consider China as a location for core R&D wherever that fits with your global strategy, and be ready to articulate benefits while managing concerns
- Focus on ways to support the growth of Chinese firms and industries without sacrificing core markets abroad, for instance by helping to build networks of expertise ("industrial ecosystems") and strong awareness of quality and safety issues to support the growth of value chains for Chinese firms.

Of course, all China-related plans must also be reviewed from the perspective of key constituents in the MNC's home country and other key markets. Major R&D investments cannot be made to please the Chinese while ignoring global concerns, any more than such investments can be made where they do not align with the company's own long-term global strategy. The key is balancing Chinese and global perspectives - an increasing complex task in an ever-more inter-connected world, but also a crucial demand for today's business leaders.

There is much discussion in today's China of the many dimensions of these issues, and a plurality of views on how to calibrate and balance China development strategies. Perhaps the one point on which virtually all Chinese decision-makers have reached consensus is their sense that foreign companies benefited too much from China's market in the past. To cope with this environment, MNCs need to have a nuanced understanding of the demands, needs, and perspectives of Chinese decision-makers. Insights derived from applying the prism of Chinese development to questions of technology-related investment can help. Whether a company is evaluating whether and how to do R&D in China, and/or where to locate a facility, or whether to acquire a Chinese firm and how to restructure its operations, proper positioning for the MNC along the spectrum of technology and other development-related Chinese concerns will be crucial to success. The goal is not to abandon approaches that have worked for the MNC in other markets, or approaches the MNC treasures worldwide, but to find ways to tailor those competitive strategies to China in order to maximize their chance of success in achieving both China's and the MNC's goals. As the global importance of the China market continues to grow, finding that balance will be crucial to the continued growth of more and more companies worldwide.

**– Douglas Dew, Managing Director and Practice Leader,
Public Affairs Practice, Burson-Marsteller China with Rebecca Weiner, Senior Consultant**

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For more information on how to conduct business and build and protect a successful reputation in China, contact Cindy Tian, Managing Director of Burson-Marsteller China at Cindy.Tian@bm.com or Douglas at Douglas.Dew@bm.com. Either can be reached by phone at 8610 5816-2525.

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