

Fifth Session of the 12th National People's Congress



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Seeking Growth, Reform and Stability

The just concluded National People's Congress (NPC) and Chinese People's Political Consultative Congress (CPPCC) gave a fresh view on the priorities of the administration and the implications for those operating in this ever complex market. The Two Sessions, held in March and commonly known in China as the *lianghui*, are among the most important events in the Chinese political calendar.

This year the Two Sessions are the warm up act to the much more important 19th Party Congress at the end of this year when Xi Jinping will end his first five-year term as head of the Communist Party of China and when a number of the most senior members of the Party are expected to retire. The question is not if Xi Jinping stays for a second term (that's a certainty), it is who will join him in the Politburo and the Standing Committee as this will influence the next five years and give early indication whether he may break with recent precedent and stay for a third term (2022-2027).

Key topics at this year's sessions included ensuring reform, continued growth, job creation, and poverty alleviation.

There were few surprises. Instead discussions focused on moving forward directives already agreed. Key observations from this year's gathering are below. A fuller analysis follows.

Still growing

Growth has slowed. But, a target of 6.5% for an economy of more than USD 11 trillion represents adding more than Switzerland to the world this year or more than Germany over the next five years (assuming the country continues at this rate).

China is open

The Chinese authorities would have it that China is one of the world's most

open economies and the bastion of globalization. Yet, stories abound of unfair competition, protectionism and operational challenges in-market. The truth remains somewhere in between.

The door is not closing to foreign investment. China will continue to open up and the latest Two Sessions talks about new areas of liberalization. The catalogue of industries open to foreign investment will be revised and trials granting market access based on a negative list will be accelerated. The reality, however, is that some sectors are more welcoming than others. It remains important to understand how foreign investors align with national development goals and can tackle challenges. Communicating the value one brings to China is paramount.

China Going Global

Chinese businesses will continue to seek expansion overseas. However, tightening capital controls and greater scrutiny of investment outside investors' core business will impact the pace of investment in the near term.

Supply-side reform

Supply-side reform will be a focus in the year ahead, most notably in the shape of simplified and streamlined administration, tax cuts, expanded market access, and innovation. On the face of it, these should be positives for investors. But while reforms should help growth, they do not represent a serious challenge to the overcapacity and inefficiencies that have plagued many old pillars of the economy—from petrochemicals to steel and coal.

Geopolitics

A meeting between the presidents of China and the U.S. may happen as early as April. Yet relations remain strained and will likely remain that way even after a meeting of the presidents. Both sides have stated that they do not want

a trade war. While stressing this, Li Keqiang issued a veiled warning that if a trade war erupts that "*the first to incur losses would be the foreign investment companies, in particular the US-funded enterprises.*" Potentially more pressing is managing issues in the Korean peninsula.

The Belt and Road

The Belt and Road Initiative has so far been long on rhetoric and short on tangible achievements, but these are early days in a long-term initiative. The initiative was unveiled in 2013 and aims to connect China with Europe, the Middle East and Africa along the ancient Silk Road land and sea routes.

A significant government endorsed forum focused on the Belt and Road will be held in mid-May and is being positioned as a new chapter. The long-term impact of this initiative should not be ignored.

Higher Quality Products

Companies selling in China should pay attention to Premier Li's call for more products sold in China to be produced on the same production lines, meet the same standards, and be of the same quality as those for export. Disparities in product quality have historically been called out by consumers in China.



Stability

Achieving the Holy Trinity of growth, reform, and stability remains extremely challenging.

In the run up to the 19th Party Congress at the end of this year the authorities will balance reform and growth with ensuring stability.



The Two Sessions in Review

Increasing power of Xi

Since Xi Jinping became head of the Communist Party of China in 2012 much has been written about his systematic increase in power. In October last year he was anointed “core” leader of the Party, cementing his position at the top of the Party and effectively confirming his consolidation of power. The term was originally coined by Deng Xiaoping in 1989 when he stated that every leadership team must have a core and that if this is undefined the team will be weakened.

While the latest title is largely symbolic, the designation is an important signal that Xi Jinping stands above his peers. Speeches and documents from this year’s Two Sessions paid increased tribute and reference to Xi Jinping, reaffirming this elevated status.

Premier Li Keqiang started his opening

remarks this year noting that Xi Jinping was at the core of the Party and that this “*reflects the fundamental interests of the Party and the Chinese people.*”

The timing of the designation as core leader, one year before the end of Xi Jinping’s first five-year term as head of the Party, is important as it increases Xi Jinping’s ability to influence personnel appointments. The past few months have already seen personnel changes in government and Party posts. This includes the heads of the National Development and Reform Commission and the Ministry of Commerce who are now led by close associates of Xi Jinping—He Lifeng and Zhong Shan, respectively.

Over the coming months expect continued political jockeying as rising stars and protégés are positioned ahead of the 19th Party Congress.

Xi Jinping and the administration have been criticized by some for a lack of substantive progress on the reform agenda. To be clear, western style political reform was never on the agenda. But, even the degree of economic and social reform has been slower than many had hoped. The optimists hope that after a first term consolidating power and addressing vested interests who stand to lose out from a more ‘market-driven’ economic approach, that a second term will see more substantive actions. Time will tell.



Balancing the Holy Trinity – stability is paramount

If Chinese politics is a story of balancing contradictory priorities, then there is perhaps no better example than the attempt to achieve the Holy Trinity of growth, economic reform, and stability. At last year's Two Sessions, the authorities spelled out a desire to achieve growth and reform—including drastically reducing overcapacity—while ensuring stability and enduring minimal pain. Achieving this Holy Trinity simultaneously remains extremely challenging. This year's meeting talked extensively about the reform agenda and its role in ensuring long-term growth, yet the importance of stability leading into the 19th Party Congress later this year is potentially even more important. Li Keqiang stressed that “*stability is of overriding importance*” and referenced stability close to 30 times in his opening address.

Economic Growth

Premier Li struck a cautiously positive tone on the economy, looking back on last year in which China “*registered a slower but stable performance with good momentum for growth.*” Having expanded 6.7% in 2016, this year the authorities target growth of “*around 6.5%, or higher if possible in practice.*” This is the lowest growth target in more than 20 years.

During the closing press conference, Li Keqiang noted that he'd read international reports commenting on the decreasing growth in China. The premier observed that growth of 6.5% is not low nor is it easy to achieve. He went on to compare the state of today's economy to an adult Shaolin monk who could perform fewer somersaults compared to a younger monk, yet

remained impressive. He continued by noting that if the country achieves this year's economic growth target the volume of growth will be larger than last year and that it remains critical to focus on quality growth over quantity.

Changing the economic growth drivers away from infrastructure investment and manufacturing to consumption and innovation-driven sectors has been a priority since the mid-2000s. Last year consumption became the main driver of economic growth with the value of the service sector representing 51.6% of GDP.

Yet more work remains on reforming the old pillars that drove the economy for the first 30-years of the opening up era. Premier Li stated that the country can “*now advance only through reform and innovation.*”

Jobs, Entrepreneurship and Stability

Continued steady economic growth is critical to ensuring employment. Creating jobs for graduates and those impacted by industrial restructuring is a priority. If growth slips, stability will be undermined. Premier Li noted at the close of the Two Sessions that over the last four years more than 50 million new urban jobs had been created and this year they aimed to create 11 million new urban jobs—one million more than last year.

The pressure to create jobs this year is even higher with the number of graduates the highest in history with 7.95m students graduating from college and more than five million graduating from vocational schools. This is on top of the thousands

impacted by industrial restructuring.

This year Li Keqiang re-stressed the importance of creating an environment that enables graduates and laid off workers to create their own businesses and create their own employment opportunities as opposed to expecting the government to provide secure employment. The premier noted that while more needs to be done to support entrepreneurship and innovation, the environment is working with “*on average more than 40,000 market entities registered on a daily basis, which amounted to an annual increase of more than 10 million entities.*” Premier Li called on foreign journalists at the closing press conference “*to provide more coverage of the fact that employment in China is created by China itself.*”

Poverty alleviation

A year ago Li Keqiang pledged to move the remaining 60 million citizens in poverty to above the official poverty line by 2020.

During last year the number of people living in poverty in rural areas was reduced by roughly 12.4 million leaving 43.35 million in poverty at the end of last year.

Tackling these vast discrepancies remains a priority. This year the government aims to reduce those in poverty by more than 10 million. To achieve this the government has increased poverty alleviation funding by more than 30% and earmarked RMB 100 billion.

Xi Jinping noted that the closer to the deadline, “*the more difficult the campaign to eradicate poverty will be*”



and Li Keqiang stated that poverty cannot be eradicated only by the actions of the government and they will *“support non-governmental participation in combating poverty.”*

Inter-governmental organizations, non-profits, and corporates should consider if and how they can support this mission in the years ahead.

Deepening Reform

At the start of the Two Sessions Li Keqiang laid out five major reform priorities for the year ahead that will support supply side reform: cut overcapacity; cut excess urban real estate inventory; deleverage debt; cut corporate costs; and strengthen areas of weakness (focused on poverty alleviation and developmental disparities).

In his Work Report, Li noted that the authorities had *“pushed ahead with reforms to restructure and reorganize state-owned enterprises and introduced into them mixed ownership structures”* and he announced that the government *“will encourage non-public enterprises to participate in SOE reforms.”*

There is limited detail on additional measures related to SOE reform and the attention given to SOE reform in the premier’s remarks this year was notably less than in previous years. However, the drop in attention is not for a change in commitment, but because last year the authorities reached agreement on actions.

They promulgated 38 regulations and programs to guide SOE reform, pilot projects in ten reform areas were carried out at the corporate level of central SOEs, and more than 760 measures were taken by provincial authorities in the last year alone.

Encouraging Good Constructive Behavior

The authorities’ efforts to tackle corruption will continue. This stopped being a campaign long ago and is now part of the broader ‘new normal’ environment. Past behavior that was regarded as acceptable is no longer tolerated, regardless of position or background.

The establishment of a new state supervisory commission is the next step in the arsenal to change behavior.

The new commission will coordinate with the Central Commission for Discipline Inspection and integrate government supervision departments and corruption prevention bureaus. The new commission will supervise Party, government and judicial bodies.

At his meeting with the press, Li Keqiang noted that as the country has increased access to the market it must create an environment of fair competition while investigating and punishing cases of wrongdoing. He summed up by stating that *“we want to send the signal of “go ahead, go ahead, and go ahead” to market entities abiding by the laws and regulations; show the green light of “can do, can do, and can do” to start-ups and innovators relying on labor; and promptly flash the yellow card to illegal and undesirable activities, sending them off with a red card if necessary.”*

Foreign Investment

Li Keqiang reiterated that China will remain open to foreign investment and noted that last year China utilized more than USD 130 billion of overseas investment, which ranked the highest among developing countries. The premier noted that the catalogue of industries open to foreign investment

will be revised and that they will make service industries, manufacturing, and mining more open to foreign investment.

He also stated that the government will expand a pilot program that grants market access on the basis of a negative list.

China has historically restricted foreign investment in any sector it doesn’t explicitly approve. A negative list approach would allow all investment not explicitly forbidden and detailed in a negative list.

Following the establishment of pilot free trade zones in Shanghai in 2013 and zones in Guangdong, Tianjin and Fujian, the authorities have further expanded the initiative. Last year seven new pilot free trade zones and 12 new experimental zones for cross-border e-commerce were created. This year *“11 high-standard pilot free trade zones”* will be launched drawing on *“practices developed in these zones that are proven to work.”*

Yet, this month, EU and U.S. trade groups published reports criticizing the Made in China 2025 strategy due to preferential treatment given to Chinese companies. The U.S. Chamber of Commerce cited central government-directed initiatives and the European Chamber of Commerce in China accused China of setting aggressive market-share targets for the Chinese and international markets and “self-reliance” for key components.

Addressing these concerns, Premier Li stated that *“foreign firms will be treated the same as domestic firms”* and *“will enjoy the same preferential policies under the Made in China 2025 initiative.”* Statements are simple. Proof is in action.



Powering the Nation

Adjusting China's energy mix has been a major priority over the past four years. Beyond the obvious environmental imperative, the government has the added incentive of needing to tackle overcapacity in the nation's vast network of coalmines. Wind, solar, hydro and nuclear are all destined to play a part in the solution.

A new energy mix will require China to address 'zombie enterprises' that litter the state-owned power-generation, petroleum and natural gas sectors, something Premier Li pledged to do in his work report. If the government is successful, genuine competition from the private sector should emerge. Upstream oil and gas, where the state-owned sector has traditionally lacked expertise, should be further opened to private Chinese and foreign players, but details on such reform are yet to be announced.

Underpinning everything, of course, is the need to "make the skies blue again," an aim Premier Li stated multiple times in his report. In addition to rolling back coal power generation, the government will continue to look at the roles and responsibilities of regulators and enterprises in protecting the environment.

The Health of the Nation

The authorities continue to grapple with healthcare reform and balancing access and affordability.

Last year Li Keqiang noted that "health is at the root of happiness" and spoke about creating a healthy China and ensuring access to medical care. During 2015 the authorities achieved complete basic medical insurance coverage. In the year ahead subsidies for basic health insurance for rural and non-working urban residents will be increased while also adding more medicines to the inclusion list.

An additional access challenge has been using medical insurance when having treatment beyond one's registered home location. On-the-spot settlement of medical expenses incurred anywhere in the provincial-level administrative area where one's insurance is registered is now possible. In the year ahead the authorities will accelerate building a nationwide IT network for basic health insurance so that healthcare costs can be settled directly where incurred.

On the broader health of the nation, Li spoke about the priority to further enhance the safety of food and drugs. The head of the China Food and Drug Administration complained that food safety and supervision "still falls short of expectations." He stressed that irregularities will be punished

severely. Expect new regulations and increased enforcement.

Product Quality in China

When discussing how to increase consumer spending, the premier noted it was important to focus on how to boost consumption of quality products. In a measure that will make those living in China happy, Premier Li called for more products sold domestically to be produced on the same production lines, meet the same standards, and be of the same quality as products for export as a root to "upgrading consumption."

He also promised to "be strict about investigating and punishing the production and sale of counterfeit and substandard goods, false advertising, and price fraud" and strengthening the protection of consumer rights in order to make spending "an enjoyable rather than a disappointing experience."

Disparities in product quality and service standards offered by companies in China and overseas have historically been called out by consumers in China. Companies should be mindful of this new focus, however differences in technical standards country-to-country make achieving the need to "meet the same standards" unclear.

China and the World

Sino-US Relations

Relations with the U.S. have been strained since the end of last year when President Trump broke with the long standing one-China policy and spoke with Taiwan's leader. China was fairly restrained in its response and stressed that the conversation *"can't change Taiwan's status as a part of China"*. Trump doubled down during a Fox News interview on December 11th when he stated that the U.S. did not have to stick to its long-standing position on Taiwan and suggested this could be a bargaining chip. In the same interview he criticized China's currency policies, its activities in the South China Sea and its stance toward North Korea.

China responded swiftly. They urged Trump to *"listen clearly, the one-China policy cannot be traded"*. Trump had focused on an issue fundamentally non-negotiable from China's point of view. Officials in China stated that bilateral relations will be badly affected and that cooperation was out of the question if Washington couldn't recognize China's point of view regarding the one-China policy.

In his Work Report, Li Keqiang had pointed comments regarding the policy. He noted that China *"will resolutely oppose and contain separatist activities for Taiwan independence"* and *"will never tolerate any activity, in any form or name, which attempts to separate Taiwan from the motherland."* The tone is far stronger than in recent years.

At the close of the Two Sessions Li also issued a veiled warning that if a trade war erupts between the U.S. and China that *"the first to incur losses would be the foreign investment companies, in particular the U.S.-funded enterprises."* He stressed, however, that China does not want a trade war as it would bring losses to both sides and wouldn't lead to fairer trade. He also noted that *"trade and mutual investment between China and the U.S. have created close to one million jobs in the United States."*

Both sides are working to stabilize relations. The presidents have spoken on the phone and the groundwork is being put in place for face-to-face meetings in the US as early as April and

later in the year in China. Yet the relationship remains strained.

An upcoming date to pay attention to, potentially after the rumored meeting in the U.S., will be the Department of the Treasury's report to Congress in April to see if they conclude that China has been manipulating its currency as Trump has previously claimed.

One Country, Two Systems

In relation to Hong Kong, Li Keqiang included standard language in his Work Report about the commitment to one country, two systems—but went further than in previous years when he stated that *"the notion of Hong Kong independence will lead nowhere."*

Again—far stronger than in previous years. During the closing press conference, he elaborated that the principal of one country, two systems must be implemented in its entirety and cannot be bent or distorted. Premier Li also stated that the central government plans to pilot the "bonds connect" between the mainland and Hong Kong during this year allowing overseas capital to access the mainland bond market.

China and Globalization

During Li Keqiang's opening remarks he did not mention the new Trump administration, but it likely inspired some comments. He emphasized that China will remain committed to global economic cooperation and engaged in

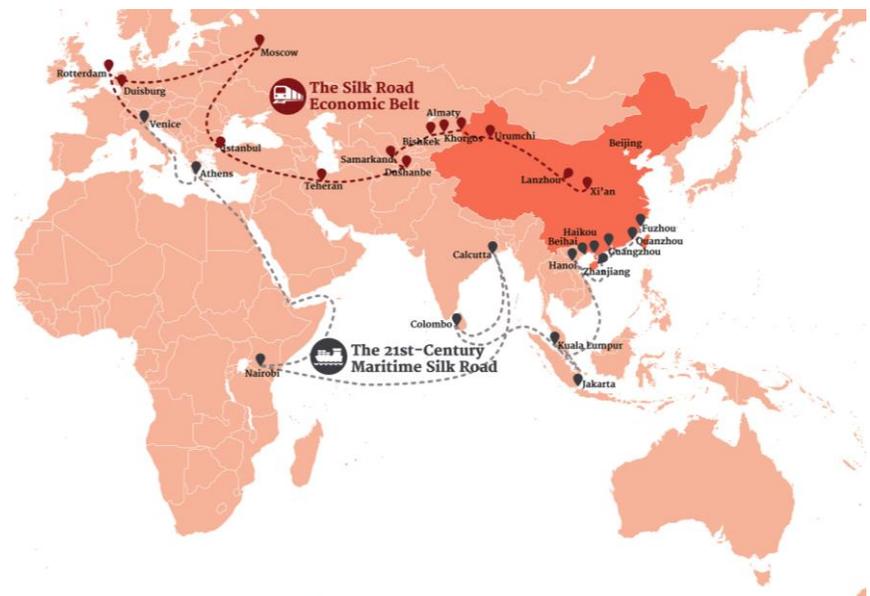
multilateral trading regimes. At the 2017 World Economic Forum Xi Jinping argued for globalization and trade and against protectionism and isolationism.

While it is positive to see China stepping forward as an advocate for globalization and against rising protectionism, many observers are concerned with increasing access challenges domestically. The gulf between international engagement and the domestic environment highlight continuing contradictions in China. Yet ultimately, international engagement will play a part in driving domestic reform.

The Belt and Road

The Belt and Road Initiative was also frequently referenced during the Two Sessions as a critical part of China's engagement. He Lifeng, head of the National Development and Reform Commission, noted that China had invested more than USD 50 billion in countries along the Belt and Road since the initiative launched in 2013 and that the initiative had won support from more than 100 countries and international organizations, with nearly 50 cooperation agreements signed between governments.

Expect continued priority and attention to given to the Belt and Road Initiative. Premier Li also called out the upcoming Belt and Road Forum for International Cooperation which will be held in May in Beijing.



What's Next – the 19th Party Congress

The annual Two Sessions are an important milestone in the political calendar. But, the real focus this year is on the 19th Party Congress which is set to take place in the fourth quarter of this year (most likely in October).

The 19th Party Congress will mark the start of Xi Jinping's second five-year term as head of the Party. The emphasis on stability during this year's Two Sessions should not be taken as an indication that Beijing is stepping back from longer-term reform, rather their focus on a smooth road to the Party Congress.

One of the biggest questions is who will be in the Politburo and even more importantly in the Politburo Standing Committee for the next five years. Based on recent precedent, a significant number of current Politburo members are expected to retire based on their age.

In recent years the Party has operated an informal rule that senior leaders can be appointed into the Politburo if they are younger than 68 at the time of a new Party Congress. If they are older they must retire. Based on age and recent precedent five members of the seven person Politburo Standing Committee will retire this year, along

with at least six additional members of the broader 25-person Politburo.

The emphasis on 'precedent' is because there is significant debate whether Xi Jinping will break with recent precedent and keep Wang Qishan in the Standing Committee. Wang, who has been instrumental in driving the anti-corruption campaign as head of the Central Commission for Discipline Inspection, will turn 69 in July this year. There has been speculation that he could continue in his current role leading the anti-corruption drive or even replace Li Keqiang as premier. If Wang remains, it will add credibility to speculation that Xi Jinping may remain in office for a third term (2022-2027).

Also based on recent precedent, the Congress prior to the retirement of the head of the Party (and the premier) will include the heir apparent in the Politburo Standing Committee to provide five-years of on the job training. The heir apparent will, based on recent precedent, serve for three terms in the Standing Committee (at least one as heir and two as leader). These practices date back to the 1990s. In 2007 Xi Jinping and Li Keqiang were appointed straight into the Standing Committee before being appointed

head of the Party and premier, respectively in 2012 and 2013.

Later this year all eyes will be on who walks out on stage to spot a potential successor. Based on recent precedent, only two members of the current Politburo are eligible based on age to succeed Xi Jinping and Li Keqiang—these are Hu Chunhua and Sun Zhengcai. Yet, just like Xi Jinping's own ascension—it is possible for the future leader to rise directly into the Standing Committee having never previously been in the Politburo. Other candidates to watch in the months ahead, who may rise from the Politburo into the more exclusive Standing Committee include: Wang Huning; Wang Yang; Han Zheng; and Zhang Chunxian. And, the question remains who could be selected from beyond the current Politburo.

What is clear is that the Politburo and the Standing Committee will be filled with a significant number of Xi Jinping's allies and protégés. With a consolidation of power during the first five-year term there is hope that the second term will see greater reform.



Expected vacant seats in the Politburo and Standing Committee based on recent precedent going into the 19th Party Congress later this year are denoted with an asterisk. The top row are Standing Committee members.



Political Backgrounder

What are the Two Sessions?

The Two Sessions, or *lianghui* (两会) as the sessions are commonly known in China, are the annual gathering of the National People's Congress (全国人民代表大会全国人民代表大会) and the Chinese People's Political Consultative Conference (中国人民政治协商会议中国人民政治协商会议). The Two Sessions are typically held during the first two weeks in March.

What is the NPC?

The National People's Congress (NPC) is the highest legislative body in China and has sole responsibility for enacting legislation in the country. The NPC meets once a year in March and enacts and amends basic laws relating to the Constitution, criminal offences, civil affairs, state organs and other relevant

matters. When the NPC is not in session each March, the Standing Committee of the NPC is tasked with enacting and amending laws, with the exception of basic laws that must be enacted by the NPC.

The NPC is also responsible for electing and appointing members to central state organs—including the Standing Committee of the NPC, the President of the People's Republic of China (currently Xi Jinping) and the Premier of the State Council (currently Li Keqiang). Based on nominations by the Premier, the NPC is also responsible for appointing China's Vice Premiers, State Councilors, and Ministers.

This is the fifth and final session of the 12th NPC. The 12th NPC was formed in March 2013 and will serve a five year term. This year's session was held from March 5th to 15th.

What is the CPPCC?

The Chinese People's Political Consultative Conference (CPPCC) is a political advisory body that consists of representatives from a range of political organization, academia, business leaders, celebrities, and other experts. The National Committee of the Chinese People's Political Consultative Conference (中国人民政治协商会议全国委员会) meets on an annual basis at the same time as the NPC.

This is the fifth and final session of the 12th CPPCC. This year's session was held from March 3rd to 13th.

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