

19 March 2010

**China's 2010 National
People's Congress:
*It's the Economy, Again...***

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EXECUTIVE SUMMARY

- Confidence is high and delegates have a swagger in their step at this year's National People's Congress (NPC), which finished on 14 March. Leaders point out that China not only survived the economic crisis, but led the global recovery, stressing China's 8.7 percent GDP growth in 2009.
- Sustained economic growth remains the top priority of the Chinese government. In his work report, Premier Wen Jiabao made clear that economic stimulus policies would continue as needed, and he signalled an attempt to shift China's economic model away from growth based predominantly on fixed-asset investments (FAI) and exports toward allowing consumption to play a greater role, in an effort to lay a platform for ongoing future growth.
- The Chinese government has committed to further bolster its industrial policy and to pursue state-led indigenous innovation in selected strategic sectors. Health care remains a focus for government given its wide impact and potential to spur consumption.
- Foreign business in China is faced with increased risk and some opportunities as a result of the themes coming out of this year's NPC. Continued stimulus activity and efforts to boost domestic consumption will benefit some foreign business operating in the right sectors, while industrial policy tinkering and an emphasis on indigenous innovation will reduce market opportunities for others.

INTRODUCTION & BACKGROUND

With ritual regularity, the National People's Congress (NPC) convenes each March in Beijing for a two-week session, drawing together nearly 3,000 delegates from around the country. In theory, the NPC is China's highest organ of state power, and this gathering marks one of the most important events in the Chinese political calendar.

In practice, however, the NPC's yearly gathering is largely an exercise in legislative acquiescence, with delegates approving appointments, laws and ministerial work reports predetermined by the Communist Party of China (CPC) – hence the gathering's reputation as China's "rubber stamp legislature." The control exercised by the Party over NPC proceedings is owed mostly to the political allegiance of the delegates themselves - more than 70 percent of the NPC's deputies are CPC members (whereas they are only 6 percent of the total population), and all are tacitly approved by the Party.

Despite its lack of real power, this year's NPC (held March 5-14) came at a critical juncture. In the aftermath of the global recession, China's leadership is pursuing a delicate balancing act of maintaining growth and stability while moderating stimulus policies. At the same time, the leadership is setting about restructuring and addressing imbalances in the Chinese economy to provide for continuing high growth in the decades ahead. Against this backdrop, the NPC meeting served as a useful snapshot or temperature check on China's political economy and how it is being managed.

Overview of Top Issues from Wen's Work Report: 2010

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| Macro-Economy | <ul style="list-style-type: none"> ▪ China will move forward with proactive fiscal policy, which includes a smaller (but still aggressive) stimulus program. ▪ Hints that currency reform may happen in 2010, but few details given. |
| Economic & Industrial Reform | <ul style="list-style-type: none"> ▪ China will focus on industrial upgrade, technology, and indigenous innovation to power growth in a "post-economic crisis" environment. |
| Urbanization, Agricultural Development | <ul style="list-style-type: none"> ▪ China will try to speed up rural development in order to increase domestic demand. ▪ Includes agricultural reform, rural purchase subsidies, etc. |
| Cultural Development | <ul style="list-style-type: none"> ▪ The government will increase funding and support for expansion of Chinese culture abroad, including movies, music, TV, and news reporting. |
| Social Welfare & Education | <ul style="list-style-type: none"> ▪ Government made commitments to address real estate prices, post-graduate employment, and hukou reform. ▪ Experts doubt China will make real progress, as these are thorny and complex issues. |
| Reform & Transparency | <ul style="list-style-type: none"> ▪ Standard commitments to fight corruption, increase government transparency and improve the rule of law. |

ECONOMY & INDUSTRY TOP PRIORITY

“Events in 2009 again proved that no difficulties or obstacles can impede the course of the great rejuvenation of the Chinese nation.” –Wen Jiabao, 2010 NPC work report.

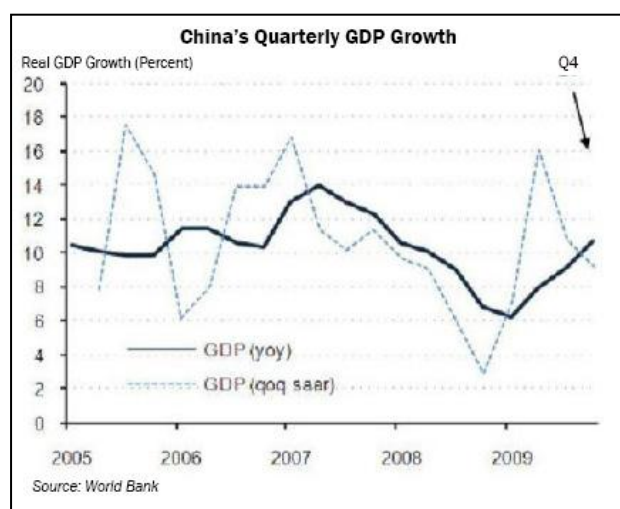
As with last year’s work report presented by Premier Wen Jiabao, sustained economic growth remains the top priority of the government. At the 2010 NPC, confidence is high and delegates have a swagger in their step; leaders point out China not only survived the economic crisis, but led global recovery, stressing China’s 8.7 percent GDP growth in 2009. Yet, Wen and NPC delegates have also been quick to sound a warning on a number of pressing issues that could derail plans for further growth. These include rising government debt, inflation, low levels of consumer spending, and an economic development model not seen as sustainable.

Fiscal Stimulus Will Continue

As expected, the government gave a clear indication that fiscal stimulus will continue to drive GDP growth well into Q4 of this year. According to Wen’s work report, the government will continue to pursue a “proactive fiscal policy” and a “moderately easy monetary policy.” This means they’ll spend as much as they feel is necessary and will use the monetary tools available (setting interest rates, tweaking reserve ratios and other administrative measures), to ensure growth remains above 8 percent. The government has budgeted for a fiscal deficit of RMB 10.5 trillion for 2010, with RMB 992 billion directed to ongoing stimulus programs in 2010. However, as with last year, the bulk of economic stimulus money will come from state-sanctioned bank loans – targeted at RMB7.5 trillion for this year.

Developments at the NPC signal that social spending on health care, insurance, employment, and education will receive a further boost in 2010. Wen stated, “...we will do everything in our power to increase employment...improve the social security system...and... reform income distribution along with health care.” Similar statements, though, were made at China’s NPC in 2009, and little of the allocated funding for social welfare projects has actually been spent, so stakes are now higher as public expectations have been lifted. Additionally, concern over local government debt and non-performing loans have prompted the central authorities to take measures to reign in discretionary spending, which includes tightening control over project approval in the provinces and increasing prudential reserve requirements.

At the NPC’s closing press conference, Premier Wen also talked about China’s exchange rate, a vexed issue that has generated ongoing tension with foreign trade partners. Wen said China’s currency was not undervalued, and that “some country’s” calls for China to devalue the Yuan were simply



another form of trade protectionism. Similar statements were made by People’s Bank of China Governor Zhou Xiaochuan, in that China should be “very cautious” when approaching currency reform. This was in marked contrast to his comments before the NPC, when he characterised China’s currency peg as “temporary;” no doubt over the course of the NPC, it was made clear to him that his comments should not stray from orthodox Chinese government thinking on this issue. Yet, with China’s exports likely to pick up in 2010, and in the face of sizzling economic growth, the government will only face increasing pressure to appreciate as an outlet for inflationary pressures. Thus gradual change may likely occur later in 2010, despite Wen’s comments at the NPC.

Focus on Structural Rebalancing and Economic Transformation

For a number of years, the Hu-Wen administration has pointed out China’s current model of economic development is not sustainable. While China has successfully engineered a post-economic crisis recovery, structural problems in its economy have only become more visible as it becomes clear China can no longer expect to see never-ending export

growth. Economic growth certainly remains the name of the game, but Wen signalled a clear shift away from growth based predominantly on fixed-asset investments (FAI) and exports toward improving its balance by allowing consumption to play a greater role. Said Wen: “We need not only to maintain sufficient policy intensity and consolidate the momentum of the economic turnaround, but we also need to accelerate economic restructuring and make substantive progress in transforming the pattern of economic development.”

Wen’s aspiration was backed up with other more specific comments about bolstering domestic demand by continuing China’s rural purchase subsidy program, which many credit as propping up the appliance and auto industry in China. Finally, there was renewed emphasis on carrying out structural reforms of the economy and industry, by making commitments to promote small and medium enterprises, service sector growth, a continued focus on industrial efficiency and an emphasis on technology and strategic industries.

Also widely discussed in the domestic media around this year’s NPC has been what is called “guojin mintui,” or the expansion of the state-owned economy and retreat of private industry. In an indirect recognition that this phenomenon exists, Wen stated in his report that “China will accelerate the reform of monopoly industries...(and) create a market environment for fair competition.” Analysts have been quick to point out the unlikelihood that reform will reduce state control.

Strategic Industries, Indigenous Innovation Receive Boost

The development of strategic emerging industries (including new energy, energy conservation and environmental protection, electric vehicles, bio-medicine, new materials, bio-breeding and IT) is a regulatory initiative that will play a critical role in reshaping China’s future development model. Widely discussed at this year’s NPC, the National Development and Reform Commission (NDRC) is taking the lead on formulating development plans for each industry, with an early focus on renewable energy and low-carbon technology. These plans are expected to be announced over the next months, and will likely include high-level guidance to industry that will be of great interest to foreign business operating in those sectors.

Indigenous innovation was again emphasized by NPC delegates and in Wen’s work report. The report, in unusually blunt language, stated that indigenous innovation is critical to “safeguard (China’s) national security,” which seems to be code for the government placing increasing importance on the substitution of foreign technology not only to foster domestic capabilities and promote growth, but also because a lack of domestic capability in some sectors is now seen as a strategic weakness. This is particularly relevant for ICT products. Indeed, in 2009 alone, Wen further revealed that the government increased science and technology funding by 30 percent for a total of 22 billion USD. This included funds for major R&D programs to build domestic replacements of strategic technology such as networking and broadcasting gear, aviation technology and bio-medicine that will continue through 2012.

SOCIAL ISSUES ELEVATED IN IMPORTANCE

Health care remains a key focus for government given its reach and impact, as well as its ability to ignite wider consumption growth if the correct policy settings are put in place. Housing and a debate about hukou registration were surprise areas of discussion this year and reflect the growing influence of civil society over debate at major political events like the NPC.

Health Care Reform

Last year, China issued a long-anticipated plan for health care reform, formally launching its effort to improve the medical system and ensure fair and affordable health services for all citizens over the next decade. In this year’s government work report, Premier Wen laid out five tasks for 2010: expand access to basic medical care, improve disease

prevention, advance public hospital reform, encourage private investment in medical institutions and promote the development of traditional Chinese medicine.

During 2010, the key focus will be public hospital reform, the core of which rests with changing the bureaucratic operating structure of government-run

hospitals from profit-driven to a public interest-orientation. This is going to be a long-term and challenging task. It also implies a reformulation of the health care value chain and reveals enormous opportunities for foreign companies in the pharmaceutical and medical devices sectors, provided they can find ways to participate in this reform process. Also, as private capital will be encouraged in the reform process, mergers and acquisitions of public hospitals by companies may become more practical.

Hukou/Internal Immigration

China's hukou system – the household registration system introduced in the 1950s that classifies citizens as urban and rural residents – surprisingly became the subject of much discussion in the lead-up to the NPC. It has long been criticized within China for widening the rural-urban wealth gap by limiting the movement of people and barring migrant workers from enjoying welfare benefits in cities. Just days before the opening of the NPC, a strongly worded editorial was published by 13 Chinese news agencies that called for the abolition of the system, describing it as “obsolete” and “unconstitutional.” The government subsequently withdrew these editorials from circulation, fired a senior editor involved and advised NPC delegates and other media outlets to restrain discussions on this issue around the NPC.

During the NPC session itself, Premier Wen did say the government will “advance the reform of household registration system and relax requirements for household registration in towns and small- and medium-sized cities.” This passing mention, combined with the wider stifling of the hukou debate, reveals the government's innate cautiousness in progressing reform. It is not hard to see why. Mishandled, hukou reform could trigger a stampede to richer urban centers. However, foreign

business will also see opportunities with the emergence of multiple second- and third-tier cities after hukou reform, as a steady stream of legitimate new urbanites become tomorrow's consumers of whitegoods, insurance and cars. Systemic reform will remain a long-term challenge – in the short term efforts will likely be limited to gradually easing restrictions. No radical changes, such as the abolition of the system or a nationwide opening of the urban hukou to rural migrants, should be expected in the near future.

Housing

Soaring real estate prices have triggering heated public complaints about a possible asset bubble, making this one of the most widely debated issues around the margins of this year's NPC. This is a prickly issue for the government as there is no silver bullet solution. How this became an issue of discussion is in itself fascinating – it was not on any leader's agenda, but the depth of feeling about rising prices on internet chat rooms and in popular TV and radio chat shows meant that leaders were pressured to ensure at least a semblance of discussion about this. In fact, no real developments occurred at the NPC on this issue as it requires careful alignment of interests between government and real estate developers. The government is also currently lukewarm about slowing growth in the real estate sector, as its primary interest is in stimulating economic development. Thus, Wen's message that the government will take action to curb the growth of real estate prices – but not suppress the price itself – was predictable, but will disappoint rural migrants and many members of the middle class who cannot afford urban housing at current high prices. However, house prices and what the government is doing about it is not the real story here – rather it is one of civil society gradually finding its voice to influence public policy discourse at increasingly higher levels.

LEGISLATION, PERSONNEL CHANGES AND U.S.-CHINA RELATIONS

Scrutinising legislation is one of the NPC's main roles. Key on this year's agenda was a revision to the State Secrets Law that became a hot topic in 2009 after Rio Tinto employees were detained under this law. The NPC is also an occasion to speculate about future leadership changes – this year saw little to gossip about as Xi Jinping and Li Keqiang remain in place to replace Hu and Wen in 2012. Wider tensions in the U.S.-China relationship were also a major topic of corridor discussion.

Major Laws Passed

State Secrets Law: The draft amendment of the State Secrets Law was read for the second time, but

not passed during this year's NPC. The revision of the State Secrets law is particularly relevant for foreign companies given the 2009 Rio Tinto case. In

2009, Stern Hu, Rio Tinto's top iron ore negotiator in China, and an Australian citizen, was detained for the theft of state secrets relating to iron ore price negotiations. There has been widespread international concern at China's decision to regard mining sector commercial information as a state secret, which is seen as stretching well beyond international norms. Since the case broke, China has retracted the state secrets claims, and charged Hu with infringement of commercial secrets and bribery, but a lack of clarity around what actually constitutes a state secret remains a vexed issue for all foreign business operating in China. The Rio Tinto trial begins on March 22.

The current law, formulated in 1989, is said to be vague and obsolete, especially in an internet era. The key controversy of the draft amendment centers on the definition of a "state secret." The new draft classifies secrets into three categories – state, work, and commercial secrets – and defines state secrets as "information that ... if leaked, would damage state security and interests in the areas of politics, economy and national defence." This definition is still viewed by many as too vague, and it may result in too much leeway for government interpretation, particularly in the case of SOE business secrets. A big focus for this revision is also making the State Secrets Law relevant in the information age. With most government agencies now online, there is concern that China's government networks are vulnerable. To counter these threats, the revision has added in specific language that forbids the transfer of state secrets over public communications networks. This has aroused concern in China, as the draft revision requires internet and telecom companies to pro-actively monitor and report to government the transmission of state secrets over the Internet.

Electoral Law: Revisions to China's electoral law mean NPC representatives will be elected from urban and rural areas based on equal proportions of the population. The current formula, established in 1953, dictates that each rural delegate represents four times as many people as an urban one.

This is particularly relevant as China's urban population is projected to exceed its rural population for the first time after 2015. However, this does not

necessarily mean the rural class will get half the seats in the NPC overnight, as the government has pencilled in a long transition period. In theory, the anticipated increase in rural deputies will lead to an increased number of policies formulated with rural interests in mind. In practice, what we are more likely to see is an increase in power among interest groups situated in China's interior, as powerful, rural provincial governments such as Inner Mongolia or Sichuan hand-pick delegates that best serve their wider provincial industrial and development (and in some cases personal entrepreneurial) interests. Over the long term, government leaders, political factions and industrial interest groups from the interior will likely have an increased ability to project influence in the capital and steer central funding and projects away from China's eastern seaboard.

Personnel Changes

Although the NPC is convened to discuss the country's legislative, social and economic agenda, many China watchers also pay close attention to the personnel changes and backroom power struggles among senior leaders and political factions at this time, in an effort to prognosticate who might emerge to replace incumbent senior leaders. This is a fascinating exercise in tea-leaf reading for parlour room discussions, but given that this NPC is still more than two years away from the 2012 18th Party Congress, when new leaders and politburo members will be chosen from the current contenders, there is little useful intelligence that can be gleaned from this year's event. Xi Jinping and Li Keqiang remain safely cemented as leaders-in-waiting, and it would presumably take a major political event to alter this succession now. Seven slots out of nine in the standing committee of the Politburo are also up for grabs in 2012. While some of these slots are practically allocated already (e.g. for current vice premiers Wang Qishan and Zhang Dejiang), others are yet to be filled. Candidates to watch include Bo Xilai, the charismatic but controversial Party Secretary of Chongqing and Wang Yang, the reformist Guangdong Party Secretary. Bo in particular will be an interesting case to watch, as he tries to "perform" his way back into the inner circle of political power via an eye-catching crackdown on organised crime in Chongqing.

Politburo Standing Committee of the CPC Central Committee



Notes

- Listed in order of seniority (left to right top row; left to right bottom row)
- Yellow shading indicates newly appointed to the Standing Committee during the 17th Party Congress

On the eve of the NPC, provincial governments saw a flurry of personnel changes, partly to replace disgraced officials and also to clear the decks for the 18th Party Congress. This included appointments of four governors, one deputy governor and six provincial People's Congress chiefs. Among them are several prominent figures who could be potential leaders of the generation after Hu-Wen's presumptive successors. This so-called sixth generation includes those born in the 1960s, normally with economic, legal or even foreign-educated backgrounds (as opposed to the current crop who remain predominantly engineers). This reflects a general trend toward selecting more business-focused and "international" individuals in China's emerging leadership ranks. Hu Chunhua, with a Chinese Communist Youth League (CCYL) and Tibetan provincial government background, and current Party Secretary for Inner-Mongolia, and Sun Zhengcai, with a princeling and agricultural background, and current Party Secretary for Jilin, are two rising stars who should be watched closely, as they are widely expected to be core members of China's sixth-generation leadership, which will take the reins of power in 2022.

U.S.-China Relations

The Obama administration's recent decisions to meet the Dalai Lama and sell arms to Taiwan,

jawboning over the RMB and wider trade niggles that have emerged in the aftermath of the financial crisis have brought a chill over arguably the world's most important bilateral relationship. At the NPC, U.S.-China relations did not sound a positive note, with both Premier Wen and Minister of Foreign Affairs Yang Jiechi publicly chastising the United States, and asserting that it is up to the United States to improve relations. Premier Wen made equally robust comments about the relationship during his annual post-NPC press conference. According to one CPPCC delegate, U.S.-China tensions were a major topic of corridor discussions. To express its displeasure, China has postponed some military exchanges and threatened sanctions against U.S. companies that sell arms to Taiwan. (Interestingly, one of the surprises of this year's session was the small increase in China's defense budget - only 7.5 percent, the slowest pace of expansion in a decade.)

Despite these negative developments, in the long run it is likely both sides will move on. In a sign that things may be already beginning to thaw, China still allowed a port call by a U.S. Navy aircraft carrier into Hong Kong earlier this month. Additionally, on the eve of the NPC opening, senior Obama Administration officials arrived in Beijing for a series of talks designed to assuage relations and make progress on issues such as Iran and North Korea.

WHAT IT MEANS FOR FOREIGN BUSINESS

Economic stimulus remains an opportunity:

Positive messaging about continued economic stimulus means good news for companies involved in clean energy and infrastructure, particularly transportation. Rail will continue to be a focus, but increased scrutiny will be placed on intelligent track planning, rising rail sector debt, and overall efficiency. Health care and education will be other strong focus areas for 2010 as the government has lagged in its investment commitments in these sectors.

Industrial planning presents challenges:

Wen again called for industrial reform and increased indigenous innovation. This is not new, but a stronger emphasis than in past years will mean an uptick in industrial policy planning, which may present new market access challenges for foreign business based on standards, procurement and other preferential policies. Foreign business should carefully scrutinize plans being drawn up for the six “strategic industries,” as well as the next national five-year plan (China’s 12th, from 2011-15) and how that will impact their business and sector. There are opportunities for participation in government projects, especially in favoured sectors, but also major risks to IPR and core-competitiveness.

A more responsive and complex government:

While the NPC remains an orchestrated event, events this year demonstrate that China’s decision-making process is increasingly prone to civil society creating “hot” issues in the media. Examples include real estate and the growth in SOEs – the

government did not want these to be topics of discussion, but they were forced to talk about them because of public pressure. Foreign business must realize it is dealing with an increasingly complex government stakeholder environment, and should carefully map and understand each of their stakeholder’s priorities as it relates to business.

A changed business environment:

China’s air of confidence on a multitude of issues such as climate change, U.S.-China relations, internet censorship, domestic innovation and the prosecution of Rio Tinto employees leaves some in China’s foreign business community doubting whether their investment and contribution to China is fully understood and welcomed. Growing industrial policy tinkering that encourages “indigenous innovation” by giving preferential treatment to Chinese firms via policy incentives have only added to concerns. It should be stressed that Chinese leaders are not shutting the door to foreign investment, and no major company (bar Google) is considering leaving the market, but more such tensions should be expected in the future, in large part because they reflect a maturing and rapidly transforming market. Foreign business will need to adapt to a changing and increasingly complex government, regulatory and market environment, where multiple and complex stakeholders may have a voice on issues that matter to their business, by developing more effective channels into those stakeholders and ensuring their communication strategies reflect the priorities of those stakeholders.

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