SPECIAL REPORT

CHINA'S 2019 TWO SESSIONS

What It Means for Your Business

MARCH 2019

APCO worldwide®

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KEY TAKEAWAYS

1.

This year's Two Sessions was **decidedly low-key amid turbulent trade and diplomatic ties with the rest of the world**. Nevertheless, it remains the most comprehensive annual review of priorities set by China's leadership, which include measures to address economic and social challenges.

2.

Stability is the government's top priority amid the continuation of China's economic slowdown. 2019 will see the implementation of major tax cuts, job creation measures and expanded financial support for private enterprise.

3.

Beijing made a concerted effort to **reassure foreign investors of a level playing field in response to widespread international pushback** against market restrictions. The passing of the *Foreign Investment Law* is a positive step, but its success hinges on the government's ability and willingness to enact the law through concrete measures.

4.

Despite the end of Made in China 2025 as a policy term, **China is still pushing forward its industrial upgrading agenda under a different guise**. High-end technological development remains at the heart of China's development strategy and will likely continue to cause disputes with the foreign business community and major trading partners.

5.

One year on, **the dust has settled on China's government restructuring**. Foreign multinationals can expect more clarity in their regulatory landscape this year and should grasp every opportunity to engage their government stakeholders.

OVERALL ANALYSIS

Every March some 5,000 delegates from around China travel to Beijing to attend the Two Sessions—approximately 10 days of meetings that gather China's top legislative body, the National People's Congress (NPC), and its top advisory committee, the Chinese People's Political Consultative Conference (CPPCC).

The 2019 edition of the annual meetings concluded with relatively little fanfare. It took a markedly different tone from last year, when China boldly projected Xi Jinping's vision for a "New Era" to the world, formalizing major constitutional amendments and announcing the most far-reaching government restructuring in decades. This year, China's top leadership found itself needing to reassure audiences at home and abroad that it can tackle pressing economic challenges amid turbulent trade and diplomatic relations around the world.

Central to these challenges is a concern over the pace of the economic slowdown. In 2018, China's economy grew by 6.6%, the slowest pace since 1990. As China continues to transition from a low wage, export-orientated economy to a high-end manufacturing and consumption power, policymakers need to find ways to both stabilize and stimulate the economy. Meanwhile, discontent towards China's industrial upgrading goals and assertive foreign policy has intensified abroad.

Amid continuing U.S.-China trade tensions and a sharpened pushback from Europe on China's foreign policy efforts, the legislative decisions pronounced during this year's Two Sessions are important indicators of how last year's "New Era" pronouncements will translate into policy action. To the international community, the legislative consolidation will signal to what extent China is willing to recalibrate its policies in response to international pushback.

Key Reform Priorities for 2019

The government work report, presented by Premier Li Keqiang at the opening of the NPC, provides a window into the government's high-level goals for the year. Based on this report and various press conferences given by central ministries, the following key reform priorities have crystalized for 2019:

Economic Stability

Economic stability remains as the most important priority for the Chinese government in 2019. The report featured a frank recognition that China is facing a "graver and more complicated" environment than ever before. In preparation for the "difficult struggles" ahead, Premier Li Keqiang set the country's GDP growth target at a more moderate 6 to 6.5%, down from 6.6% growth in 2018. It is worth noting the broadened scope from last year's target of "around 6.5%" to "6–6.5%." This illustrates that the Chinese government is giving itself more leeway to relieve upcoming economic pressures amid trade uncertainties and a generally less stable external environment.

As financial risk remains one of China's "three critical battles," controlling all forms of it is an important task as the government pursues economic stability. However, there were also measures to stimulate growth. Premier Li unveiled plans to provide over 11 million new urban jobs under a new Employment First Policy, while announcing cuts to China's required reserve ratios to allow banks to lend to private enterprises in need. Other stimulus measures included a series of tax cuts, such as the lowering of the value-added tax (VAT) for manufacturing from 16% to 13%.

China's leadership also continues to push for greater domestic consumption, notably through the implementation of the *Individual Income Tax Law* and the further development of the services industry.

High-Quality Development

China is continuing, if not solidifying, its emphasis on high-quality development, central to which is the transformation and upgrading of traditional industries such as manufacturing. Despite not explicitly mentioning the controversial Made in China 2025 initiative in the work report, domestic technological innovation features prominently in the agenda, with the specific goal of boosting the integrated development of advanced manufacturing.

Beijing is also pledging increased support for research and development (R&D) in cutting edge technologies such as big data and artificial intelligence. Meanwhile, preferential tax policies for small businesses and a new Science and Technology Innovation Board recently piloted to help with IPO registration are part of increased measures to support emerging startups.

Opening to Foreign Investment

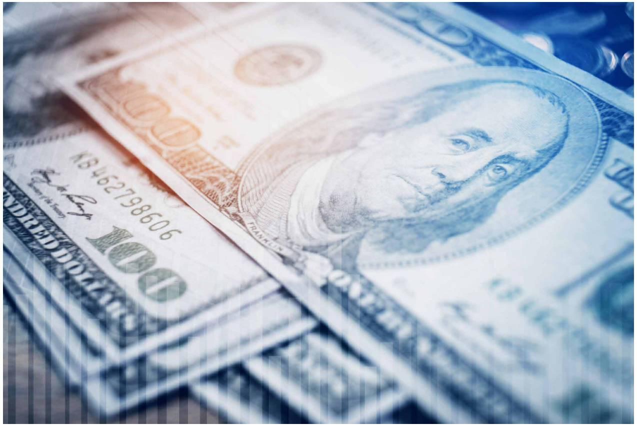
Amid growing international pushback over China's market restrictions, voiced particularly by U.S. trade negotiators, China's top leadership prioritized maintaining its commitment to further open up the country's market to foreign players. Particular emphasis was placed on China's large-scale development programs, including the Greater Bay Area, the Hainan Free Trade Zone and the Xiong'an New Area, which the government promises will offer major opportunities for foreign investors. While these ambitious programs offer potential long-term opportunities for foreign companies, they currently still lack specificity, especially on implementation measures. Initial sideline Ministry of Finance announcements on preferential tax policies for talent in the Greater Bay Area signal that additional measures could follow soon.

Beijing hailed the protection of intellectual property (IP) for both domestic and foreign firms as a key priority at the Two Sessions. The *Foreign Investment Law*, submitted to the NPC during the Two Sessions, represents the government's largest commitment to improving the investment environment, while simultaneously seeking to address dissatisfaction from the foreign business community.

Social Stability

Social stability remains a key goal for the Chinese Communist Party as it fights the "critical battles" that, if unaddressed, threaten to cause social unrest. This year will be the home stretch for President Xi Jinping's five-year commitment to create a "moderately prosperous society" and eliminate absolute poverty by 2020. Rural development was still a major focus as Premier Li pledged to raise another 10 million citizens out of poverty in 2019. Efforts to reduce pollution also continue among industry, coal plants and motor vehicles, with increased emission standards and environmental inspections.

Measures to improve quality of life were also announced, including more care services for the elderly, better access to public health and stringent pharmaceutical controls to address concerns over China's domestic vaccine industry.



Spotlight on the Foreign Investment Law

One of the most highly anticipated agenda points of this year's NPC meeting was the formal passing of the *Foreign Investment Law*, which will come into effect on January 1, 2020.

First drafted and released in January 2015, the law resurfaced in a new draft in December 2018. The resurfacing was widely seen as an obvious effort by Beijing to address major U.S. grievances over market access in a bid to solve the ongoing trade dispute. Sped through the legislative process in under three months, the law was officially approved by NPC lawmakers on March 15, 2019.

The new *Foreign Investment Law* represents a positive step in consolidating China's governance regime for foreign investment, previously fragmented under three separate foreign capital laws. On paper, it promises "equal treatment" to foreign and domestic companies, applies the country's so-called "negative list" nationwide, and gives foreign companies equal access to government procurement and standard-making. Most importantly, the law pledges better protection of IP rights by prohibiting forced technology transfers by administrative measures. Last-minute additions of language that imposes criminal penalties for IP theft offer hope that China will act on its promises of improving IP protection, especially when read alongside the IP rights tribunal launched within the Supreme People's Court in January.

Despite being widely hailed by Chinese leadership and state media as a milestone in guaranteeing multinationals equal investment opportunities in China, the law has received criticism for its lack of detail. With only 42 articles, it is significantly shorter than the 170 articles proposed in the 2015 draft. Key implementation details are still lacking and vague provisions that, for example, allow the government to expropriate or requisition investments "under special circumstances" and when in the "public interest" have created potential loopholes.

The extent to which foreign multinationals can expect a significantly improved investment environment hinges on the central government's ability and willingness to implement and enforce the law. Speaking at the closing press conference of the Two Sessions, Premier Li Keqiang vowed that the government would issue follow-up regulations and even set up a complaints system in the months leading up to the law's implementation. The government's willingness to accept foreign input during this period will be a crucial indicator of Beijing's resolve to truly level the playing field for multinational companies.

One Year On:
China's Government Restructuring

In March 2018, the Two Sessions featured the most significant and comprehensive reorganization of China's government ministries and agencies in decades. As the dust settles on these reforms, how impactful have they been?

The restructuring aimed to streamline the country's regulatory environment. This overhaul of central level government ministries has already been completed, with newly formed or merged entities settling into their new responsibilities.

The effects of these new ministries are already being felt. The new State Administration for Market Regulation (SAMR) is steeped in activities that strengthen government oversight of the consumer market environment, including areas such as food safety. Similarly, the pharmaceutical industry is encountering renewed action on drug price cuts, now that a dedicated National Healthcare Security Administration (NHSA) has been formed.

At the provincial and municipal levels, government bodies are in the last stages of finalizing their organizational details throughout March, in line with plans published at the end of 2018. Localities have already successfully merged and consolidated a variety of functions and responsibilities. In Beijing, for example, the municipal government has already introduced eight new agencies.

Progress has also been made on the division of responsibilities between central and provincial bureaus. For example, the anti-monopoly functions of the SAMR have been allocated between the agency's national and provincial entities. With only some final outstanding details on the relationship between municipal and

district level agencies, as well as the assignment of leadership positions, the restructuring process will likely be completed within months.

Over the past year, the vast scale and ambition of China's restructuring created an abundance of practical hurdles, as government departments and agencies at various levels scrambled to determine the structure, function and personnel of new entities. As expected, the government restructuring caused significant delays and disruptions to the stakeholder engagement activities of foreign companies.

However, as regulators settled into their new roles, there have been positive signs of streamlined decision-making and, in some cases, greater openness to foreign input. The current landscape is an opportunity for MNCs to engage with these new central and local government stakeholders to maximize chances to impact policy agendas at the formulation stage. In the meantime, they should also expect swifter government action on central policy initiatives pronounced at the Two Sessions.

BUSINESS IMPLICATIONS:
Macro Implications

Leveling the Playing Field

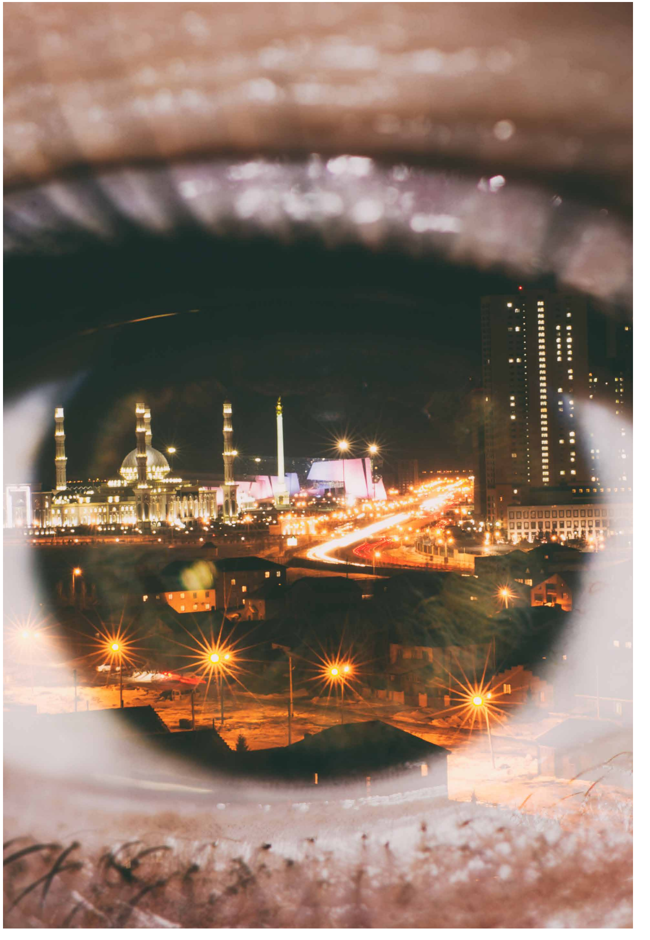
While the *Foreign Investment Law* promises equal treatment for foreign companies and pledges better IP protection, foreign MNCs should pay close attention to the follow-up measures that will be issued in the months leading up to the law's introduction on January 1, 2020. Realistically, favoritism of domestic companies and discrimination against foreign players will continue, especially in sectors crucial to China's industrial upgrading efforts.

Impressing with High Quality

Amid fierce competition from Chinese companies, foreign companies can still leverage the government's focus on improving the quality of products and services for its citizens, in areas ranging from food and pharmaceuticals to financial technology. Foreign MNCs can seek out opportunities to capitalize on their expertise to provide valuable input to regulators as they strive to meet ever increasing quality standards.

Solidifying Stakeholder Relationships

With the government restructuring complete, 2019 is shaping up to be a year of major policy implementation. Foreign companies should expect swift government action on central government initiatives, especially if a trade agreement is signed with the U.S. MNCs should be prepared for the passage of controversial measures previously shelved due to international tensions, such as China's cross-border data flow measures.



IMPACT BY SECTORS

ICT

HEALTH CARE

FOOD & RETAIL

FINANCE

MANUFACTURING

EDUCATION & NGOs

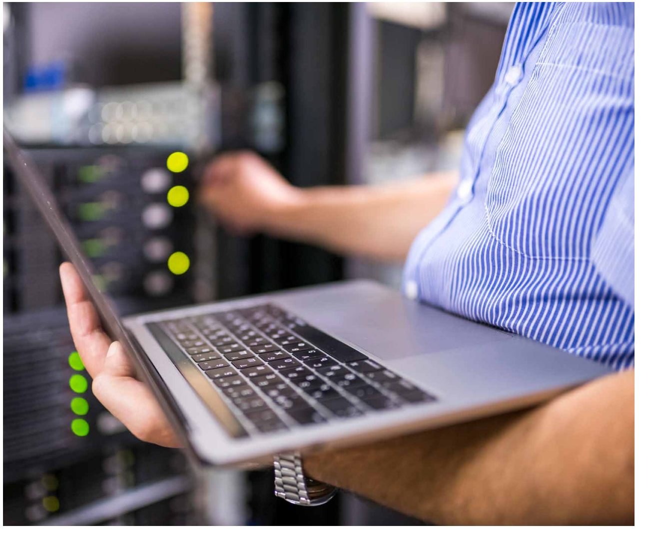
Information & Communications Technology (ICT)

Unlike in previous years, Premier Li Keqiang made no explicit reference to Beijing's industrial master plan Made in China 2025, in his government work report. The Ministry of Industry and Information Technology also made a public pledge to ensure "competitive neutrality," which refers to state-owned and private businesses competing on a level playing field. The official adoption of a revised *Foreign Investment Law* further cemented Beijing's commitment to protecting intellectual property (IP) by prohibiting forced technology transfer.

Despite this posturing, China will not give up its technological ambitions. Just one week prior to the Two Sessions, Chinese state media propagated President Xi Jinping's "new national state-sponsored system," which emphasizes achieving technological development goals by mixing top-down legislative guidance with the dynamism of the private sector. Premier Li also urged the acceleration of big data and artificial intelligence technologies alongside advances in smart cities and the digital economy. Instead of quoting Made in China 2025, the government is continuing to drive its agenda under alternative umbrella terms such as the "development of high-quality manufacturing."

Cybersecurity also remains a core priority for China and will continue to be a contentious issue for foreign ICT companies. The protection of data received much attention at the Two Sessions, while controversial cross-border data flow regulations have been temporarily shelved amid U.S.-China tensions. The NPC is speeding up the drafting of a national security-focused *Data Security Law* and a more consumer-focused *Personal Information Protection Law*, which will likely be the focus of regulations and standards in the coming year.

Foreign ICT companies stand to benefit from the growing international pushback against China's discriminatory policies in the technology sector and the resulting implementation of the *Foreign Investment Law*. MNCs should closely monitor the government's progress on related implementation measures and seek opportunities to provide input, as the success of market opening pledges will depend on concrete enforcement measures. Meanwhile, domestic ICT companies will continue to enjoy preferential treatment through less obvious subsidies and supportive measures.



Health Care

Following a year marred by a series of vaccine related scandals, China's leadership pronounced restoring confidence in China's domestic vaccine industry as a key health care priority for 2019. Health care regulators made strong statements vouching for the quality of domestically produced vaccines and called on manufacturers and local governments to strengthen quality control and regulatory oversight. Beyond the already publicized draft *Vaccine Management Law*, however, no additional regulatory measures were announced during the Two Sessions.

This year's government work report also emphasized the need to address China's unmet health care needs through a broader range of medical services, highlighting especially the treatment of cancer, rare diseases, and the development of medication for children. Existing policy initiatives that build out China's treatment capabilities and provide green channels for the introduction of new treatments will continue to play an important role.

The creation of a tiered medical system is still seen as an essential step to ensure an equitable supply of medical resources. Existing policy initiatives that aim to diversify the supply of medical expertise both geographically and by the level of medical institutions will continue to receive government attention. The reduction of health care costs also remains a government focus, with centralized procurement of pharmaceuticals mentioned in the government work report.

Foreign health care companies will face continued pressure to reduce prices over the coming year as competition from domestic competitors intensifies, especially in the low- to medium-end segments. However, MNCs will benefit from the government's focus on improving the quality of medical services and using emerging technology to improve the efficiency of treatment methods. Foreign businesses should closely monitor policy developments to identify how they can best capitalize on their expertise to support regulators as they evaluate new medical products and localize China's R&D capabilities.

Food & Retail

Boosting domestic consumption has become a crucial government method to rebalance the Chinese economy. To stimulate demand, China's top leadership announced measures to increase urban and rural personal incomes at the Two Sessions. These include implementing revisions to the *Individual Income Tax Law* to ensure that 80 million citizens benefit from tax reductions. Simultaneously, the government announced its goal of fostering new growth areas for both online and offline consumption through, for example, developing pedestrian shopping streets and improving access to rural areas through e-commerce.

Embedded within the government's focus on consumer spending as a key driver of economic growth is its belief that demand can only be stimulated within a trustworthy retail environment. Online shopping platforms continue to be scrutinized by Chinese consumers for counterfeit and substandard products. Likewise, doubts over the quality and safety of domestic food products continue to hang over the industry amid incidents such as the recent recall of pork products contaminated with African swine fever.

Consequently, regulatory oversight of the consumer market environment will increase, with a focus on improving consumer rights protections, cracking down on counterfeit products and improving traceability. In the food industry, the SAMR will strictly oversee the compliance and punishment of food safety violators, especially on drug residues, additives and environmental pollution. Retailers and producers of consumer goods should expect more rigorous quality supervision across the whole supply chain. The SAMR is also likely to ramp up its inspections of online activities now that the *E-Commerce Law* is in effect.

While comprehensive inspections may create challenges for MNCs, the government's intention to upgrade consumption also presents a favorable environment for innovative retail business models. Higher end food and retail businesses that emphasize quality products may benefit from an environment marked by greater government scrutiny, and may even find new opportunities to engage with local stakeholders who are increasingly held accountable for product safety violations.

Manufacturing

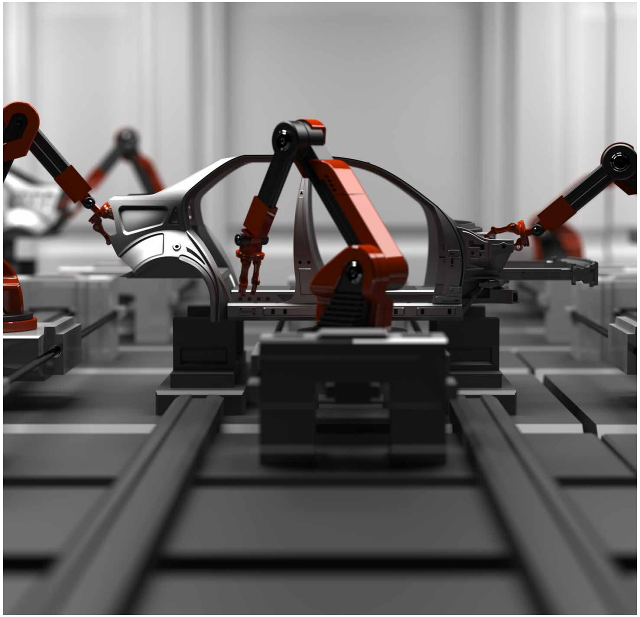
The goal of transforming and upgrading China's manufacturing industry featured heavily during the Two Sessions amid a shift in rhetoric from promoting Made in China 2025 to the more general "development of high-quality manufacturing."

To this end, the government work report announced that the current top rate of the value-added tax (VAT) of 16% would be reduced to 13% for the manufacturing sector. Commercial banks will be encouraged to increase their medium- and long-term loans to the manufacturing sector. Beijing also pledged to deepen market-oriented reforms in the electric power sector, overhaul surcharges on electricity prices, lower electricity costs in manufacturing, and cut the average electricity price for general industrial and commercial businesses by another 10%.

The newly passed *Foreign Investment Law* provides some cause for optimism as it pledges "equal treatment" of domestic and foreign companies in government procurement. Yet, as previously mentioned, its vague wording leaves much doubt regarding its enforcement on the ground.

The overarching objective of industrial upgrading plans is still to assist Chinese companies at the expense of foreign competitors, even if there is some scope for products manufactured in China by foreign companies to qualify as "domestic" amid confusion over the definition of "domestic products."

Foreign manufacturing companies will benefit from the government's broad tax cuts, especially the reduction of the VAT, which applies equally to foreign and domestic manufacturers. Yet, foreign MNCs should remain wary of policies that support the manufacturing sector, especially high-quality manufacturing, as Made in China 2025 moves forward under a different guise.



Finance

A top priority for Beijing is to build a healthy financial sector that can support China's real economy. Policy actions include structural reform to the domestic financial system, the development of a multi-tiered capital market, and allocating China's central bank with more policy-making responsibilities by merging the banking and insurance commissions into the China Banking and Insurance Regulatory Commission (CBIRC).

At a press conference during the Two Sessions, central bank governor Yi Gang announced that the government will adopt a "prudent monetary policy" to support the financing of small- and micro-sized enterprises and private businesses. He also encouraged the use oftechnology to alleviate financial difficulties in the private sector and renewed Beijing's pledge to open up China's financial market by easing the domestic bond market to encourage inflows of foreign capital.

The financial priorities set at this year's Two Sessions also reflect Beijing's ongoing commitment to eliminate risky financial activities and prevent "abnormal financial fluctuations." The past year saw China's domestic financial market go through drastic ups and downs, with the unfolding of a peer-to-peer (P2P) lending crisis, a stock market crash, and ongoing trade tensions with the U.S. While the government is still focused on deleveraging in principal, financial regulators are now prioritizing more immediate risks found in shadow banking, internet finance, and financial holding companies.

The outlook for foreign financial firms seems positive as China continues to ease market access to its financial sector and enhances foreign investment protections through the new *Foreign Investment Law*. Foreign MNCs could also benefit from looser foreign ownership restrictions for securities ventures and insurers as well as increased client potential in the financial services space. Other measures, such as income tax cuts, could also put more money in the pockets of China's rising middle class.

At the heart of the opening of China's financial sector is Beijing's recognition that foreign participation reduces overall risk, by providing greater transparency, efficiency and competition. However, there are limits to participation and questions about the attractiveness of a market which still gives preference to state-run financial institutions. Innovative services and niche offerings may prove lucrative for select outside players, especially those aimed at mitigating risk and smoothing overseas transactions.

Education & NGOs

Amid reports that China may have 23 million fewer high-skilled workers than needed by 2020, education received much attention in the government work report. The government sees vocational education as a particularly promising vehicle to tackle urban unemployment and close the talent gap for highly skilled workers. Beijing has pledged to recruit an additional one million vocational education students in 2019 and continues to promote funding for vocational education in the medium- to long-term.

Beijing wants more attention and funding across the entire education system. The government is keen to expand access to primary and secondary education, especially in rural areas. It also issued the Double First Class University Initiative to cultivate multiple world-class universities and disciplines over the next decades. Meanwhile, overseas student returnees and foreign talents are to receive more government attention, as they are considered crucial for China's innovation-based development.

Foreign education businesses and institutes can expect to see new market opportunities emerge in sectors such as vocational education, pre-school education and continued education.

In the non-governmental space, NGOs are encouraged to take on more roles in providing supplementary public services and poverty alleviation support. More government guidance and support will likely be given to areas including the development of social organizations, humanitarian aid, voluntary services, and philanthropy development. China based NGOs and philanthropic organizations will see more regulatory clarity now that the Ministry of Civil Affairs has finalized the responsibilities of its internal bureaus and set up new entities, such as the Philanthropy Promotion and Social Work Bureau.

The Chinese government is increasingly explicit in delineating the role of domestic social organizations. They are mainly seen as supplementary suppliers of social services and as a function of community-based social governance. Under the management of the *Foreign NGO Law*, foreign NGOs will likely only be able to play a supportive role to domestic NGOs in activities in line with the officially endorsed functions of domestic organizations. However, foreign NGOs may be able to play a larger role in providing support to Chinese NGO's "going-out" efforts, such as in international humanitarian aid efforts.

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