

# China Matters

Your China Public Affairs Newsletter from Weber Shandwick Worldwide

March-April, 2006

POWELL  
TATE | WEBER  
SHANDWICK

## In this issue

- PAGE1** *Executive Summary.*
- PAGE2** *The 2006 National People's Congress.*
- PAGE2** *Lower Growth Rates.*
- PAGE2** *Hu and Wen's Roadmap.*
- PAGE2** *Rise of the 'Orderly' Interest Groups.*
- PAGE3** *Highlights.*
- *State Enterprises*
  - *Financial Services*
  - *Environment*
  - *Energy*
  - *High Technology*
  - *Autos and Pharma*
- PAGE4** *Changing Rules of the Game.*

## CONTACTS

### John Russell

Executive Vice President, Asia Pacific  
Tel: 8610-8580 2022 ext 212  
Fax: 8610-8580 4834  
Email: jrussell@webershandwick.com

### Ning Shao

Managing Director  
Powell Tate, China  
Tel: 8621-6279 8818  
Fax: 8621-6279 7887  
Email: nshao@webershandwick.com



# China Changes Course !

## Executive Summary.

### Overview.

The 11th Five Year Program (FYP) endorsed by the National People's Congress (NPC) represents a change of course for the Chinese economy. The previous emphasis on high economic growth based on the two pillars of cheap labor and low energy costs is to be tempered. GDP growth is expected to drop to 7.5 percent and there will be more emphasis on promoting domestic consumption.

The plan proposes some modest income redistribution to the rural areas and the underdeveloped western provinces. This will take the form of tax breaks, increased welfare, especially with healthcare and education spending. An embryonic regional policy based on fiscal transfers, somewhat similar to that of the EU, is taking shape to maintain the "harmonious society". Expect more taxes on luxury goods.

The controversial property rights law remains unresolved, though a compromise is expected in the course of 2006.

Greater use of, and efficiency via technology and environmental protection are to be promoted. Conversely, price caps will be eased.

### Politics and Process.

This NPC session marks a milestone in the consolidation of the Hu Jintao and Wen Jiabao's administration. While control at the strategic level ("macro-control") remains with the Communist Party, at the operational level of developing specific programs and legislation, the State Council increasingly makes use of consultative processes.

The government is delicately balancing the interests of State Owned Enterprises (SOE), foreign direct investment (FDI) and the domestic private sectors, within a climate of increasing economic nationalism. New regulations and review procedures for foreign takeovers are expected. SOEs are gaining confidence and becoming more active in markets. Many Joint Ventures (JV) will come under pressure and foreign investors need even more prudence and flexibility in managing these relationships.

Companies, interest groups and NGOs are

engaging in activities to influence public policy and legislation.

### Heavy Legislative Agenda.

Legislation can be expected to mushroom and become more detailed as the economy matures. This re-regulating of the economy is necessary for structural adjustment, to accelerate trends towards use of higher



technologies, enhanced service sectors and consolidation of manufacturing sectors.

Expect heavy activity in the following areas during the 11 FYP:

- Financial services
- Energy and transportation sectors
- Environmental protection, health and safety standards
- Technology, innovation and R&D
- Healthcare

### Growth of CSR.

The benchmark will rise significantly for foreign investors to demonstrate their commitment to the Chinese market. Key areas are for technology transfers and corporate social responsibility (CSR).

### More Technology.

R&D centers will proliferate. Under domestic rather than foreign pressures, IPR protection will improve gradually. Research based industries, such as pharmaceuticals will then accelerate their investments.

### Conclusion.

Overall, this FYP is the product of a politically and socially cautious administration. Its strategic objective is to accelerate the transition to a more mature, efficient economy, taking the first steps towards sustainable development. The government's aim is maintenance of stability while promoting the emergence of Chinese brands and companies capable of investing and competing internationally.

# The 2006 National People's Congress

On March 14, China's National People's Congress (NPC), the supreme legislative body closed its annual session in Beijing. This year the short two weeks agenda was notable for its launch of the 11th Five Year Program (FYP), indicating the priorities of economic development and public policy in the next five years. Also, pertinent was its expose of a political system in transition. For China, political changes are less hurried, than the skylines of the east-coast cities, but it is useful to ascertain the trends in a timely manner. They impact international companies operating in the China market.

The 11th FYP calls for a tempering of the break neck economic development that has been the focus of previous plans. GDP growth is expected to fall to 7.5 percent from 9 to 10 percent. High growth has exposed cracks and imbalances in the economy between cities and rural areas, between the eastern seaboard and the underdeveloped western provinces. Income disparities have widened, environmental degradation worsened, and poor performances persist in services sectors such as healthcare and education. Land seizures and property rights have grown as volatile issues.

## Lower Growth Rates.

In the new plan, fixed asset investment in infrastructure will be curtailed and fiscal transfers are slated for rural areas. The aim is to offer relief to mounting social pressures. With the export sector now constituting 50 percent of the GDP growth, the government seeks to promote domestic consumption and income redistribution, albeit modestly.

## Hu and Wen's Roadmap.

While different times call for different policies, one motivation for this change of direction can be found in the backgrounds of the political leadership.

The FYP is a milestone in the consolidation of Hu Jintao's administration. His predecessor Jiang Zemin had his power base in Shanghai and the east. It relied on "trickle down" economics. President Hu and Premier Wen Jiabao both spent much of their early careers in the less developed western region. Coupled with Hu's academic and professional background in water conservancy, these are pointers to the new sensitivities and the goal of improving China's environmental performance.

While many international media commentators dismissed the NPC as a mere rubber stamp, this description overlooks the subtle evolution of the political processes. The true situation is more nuanced.



## Consultation Increases.

The Party controls all levels of government and strategic objectives via "macro control" are dictated from above. Yet there are increasing signals of tolerance and even promotion of involvement by a broader range of interest groups and civil society at the operational level of public policy formulation. Whereas there was previously a "black box", now there is increased evidence of negotiations between ministries, akin to the inter-agency process of Washington and the inter-service and inter-institutional debates that characterize Brussels.

Greater prominence in the state media is given to the views and pressures of NGOs and "civil society." The SOE are becoming more vocal. The various ministries are making greater use of interagency and external consultations in drafting legislation. A controversial draft law, defining the rights of property ownership, elicited 11,500 submissions during its consultation. For much legislation impacting business the NPC and its standing committee are less a rubber stamp, but becoming the culmination of a long distillation process.

This is similar to what we see with the preparatory process for the conduct of decision-making at international summits.

And as occasionally happens, the precook does not produce the preordained result. The draft property law was delayed from this NPC due to the ferment of debate and the inability to find consensus. Many leaders in Europe would understand this situation well, by their experiences with the EU summits.

## Rise of the 'Orderly' Interest Groups.

Why is this debate and increased transparency now allowed?

The answer lies with the simple pragmatism that has been the hall-mark of Chinese attitudes for the past twenty years. A mature, complex economy requires more detailed legislative and regulatory regimes, especially for the services sectors. Accordingly, more complex public policy process are needed to procure the optimum results. Since Deng Xiao Ping, Chinese governments have long embraced the economic marketplace, as long as it operated within a defined framework. Now they are beginning to tolerate the market place of public policy options and interest groups that typify the advanced economies.

As the flurry of legislation re-regulating the Chinese economy moves forward in the coming years, opportunities and threats will arise. SOEs will exploit their power as insiders. Expect the Chinese domestic private sector to become more adept at pushing their interests. Knowing the "modus operandi" and good intelligence of this public policy market offers opportunities to companies and NGOs to impact government legislation and the markets in which they operate.

### **NPC: The National People's Congress**

The National People's Congress (NPC) is the highest legislature body for state power in China with about 3,000 members. It only meets once a year. Major legislation and policy initiatives constitute its agenda. A subset of 150 members known as the Standing Committee meet bi-monthly to address implementation and operational level legislation. The work of the NPC and the Standing Committee is assisted by nine committees covering specific areas. Party control is maintained. The NPC members are elected from provincial people's congresses which in turn are elected from local congresses.

# Future Highlights.

The FYP includes a complex tapestry of sector specific plans, but it is worth picking out a few highlights that will act as bell- weathers for coming years.

## **Economic Nationalism: Watch the State Owned Enterprises!**

The future role of SOE will have a large influence on the economy and public policy and could upset the delicate balance presently existing between SOE, foreign investors and local private sectors. In the NPC, there was harsh criticism of the promotion of FDI. SOE representatives advocated policies preventing key sectors such as steel from being "dismembered" by foreign investment.

This economic nationalism was echoed in the CPPCC by Chinese private sector representatives calling for "level playing fields", arguing for equal treatment with foreign enterprises in taxation, land supply,



and bank credit. This, accompanied by an ongoing trend in the media to criticize foreign firms and products, has led many companies to strengthen their CSR and internal communications programs for employees.

With the avenue of management buy outs (MBO) now closed to them, key SOE executives have confidence that they can evolve to produce Chinese versions of Gazprom, Electricité de France, or Airbus ready to compete internationally as national champions.

Since its establishment in 2003, State Assets Supervising and Administrative Commission (SASAC), has become a powerful advocate for SOE consolidation and ambition. Under SASAC's chairman Li Rongrong, this trend will continue.

## **Financial Services.**

With the opening up this sector under WTO mandate at the end of 2006 there has been a flurry of FDI in the past few years. The minority shareholding and JVs

are a rights of passage for foreign banks to enter into the Chinese market.

This is analogous to what happened in the manufacturing sectors some five to 15 years ago. What is new are the rising calls for economic nationalism.

As occurred in the manufacturing sectors, one can expect that many JVs will prosper, while other deals will become loveless marriages and there will be "tears before bedtime".

Notably, with the opening of financial markets one can anticipate in the coming years a raft of legislation, for regulating all aspects of the financial services sector, from retail, investment banking, insurance, securities, derivatives, payment systems to funds and trusts. The scope will be similar to what happened in the US markets in the late eighties, early nineties and in Europe during the last few years of the Lamfalussy Process with over forty pieces of legislation.

Powell Tate | Weber Shandwick in China is already following closely such changes and produces legislative issue tracking for its clients.

## **Environmental Protection and Standards.**

Chastened by recent high profile environmental accidents, China has embarked on a program to raise standards. Water quality and management are priorities. According to State Council officials, EU legislation provides the benchmark and model.

Draft legislation is already proposed for the IT sectors based on Europe's Waste from Electrical and Electronic Equipment (WEEE) and Restrictions of Hazardous Substance (RoHS). Regulations covering other waste streams, updates on packaging, chemicals, Integrated Product Policy (IPP), energy conservation to name a few can be anticipated.

Implementation and enforcement remain a challenge. Administrative structural issues persist. Provincial and local authorities have been fixated by GDP growth, even at the expense of the environment. Such attitudes will not be turned around overnight. Also, provincial and local environmental protection agencies are still answerable to local officials, rather than central government, making them susceptible to manipulation. Central government officials admit that environmental regulation will be selectively enforced in the underdeveloped western provinces.

Yet, evidence exists that there is a head of steam behind the push for higher environmental standards. In addition to the burdens on the countryside and raising the

quality of life in the cities, environmental standards, particularly the drive for energy efficiency, are being used as instruments of industrial policy to take the economy, especially manufacturing, to the next level of development.

In briefings, ministry officials are quite explicit on the impact of raising the bar of environmental standards: 30-40 percent of the companies will meet new standards without investment; another 30 to 40 percent will require investment and 20 to 30 percent of companies will never meet the standards and will be taken out of the market. Such candor is seldom heard in Washington, Brussels and Tokyo !

If Chinese indigenous brands are to emerge and compete internationally as part of the "go-out" policy, many sectors need to undergo consolidation. Imposing higher environmental standards is part of the policy mix that will drive this consolidation.

## **Energy.**

The push for higher energy efficiency will impact most sectors. A target of reducing energy consumption 20 percent per unit of GDP is ambitious. This will translate into a series of regulations, ranging from tighter product standards, building design and so on.

New energy products are to enter the market. Natural gas at 3 percent of the total energy mix is low compared to the global average of 25 percent. LNG is due to be introduced to the market in economic quantities in 2006 and will grow. Government policy can be expected progressively loosen price caps to allow energy prices to rise. Introduction of a tax on motor fuel is under discussion.

Health and safety standards will be used for driving reorganization of extractive and manufacturing sectors.

Confronted by a woeful safety record in the mining sector, the government intends to close over 10,000 small coal mines. Yet, China's dependence on coal is set to continue with coal rising from 75 percent to

### **CPPCC: The Chinese People's Political Consultative Conference**

CPPCC is a political advisory body established in 1949. The organization is a forum for non-party interests to be involved in the legislative process. Members are drawn from various official cultural and professional interest groups. The CPPCC typically holds annually at the same time as plenary sessions of the NPC. The present CPPCC has about 2,200 members, with 290 members of the Standing Committee, supported by nine specialty committees.

80 of the energy mix. The increased production of 16% will be produced by the inauguration of 13 large scale mines.

### **More Foreign Capital, but with More Technology**

The IT industry is a useful indicator of public policy trends.

In the next 15 years, the government intends to reduce the economy's reliance on foreign technology from over 50 percent to approximately 30 percent. To achieve this top line goal expect increased R&D expenditures, tax deductions and industrial policies for "innovation oriented" companies, including VAT holidays and favorable contracts in development zones.

In 2006 two issues are worth following as precursors of the future. The allocation of 3G licenses in the autumn and Ministry of Railway's US\$ 250 bn ambitious investment program

3G, with the TD-SCDMA standard gives a road map as to how activist the government intends to be promoting Chinese standards, domestically and internationally. The wireless internet protocol WAPI and digital TV IPTV are other high profile ongoing standards issues in the IT sector. Expect this policy of promoting indigenous standards to continue.

The railway construction plan, particularly the Beijing-Shanghai high speed link, is an example of the flexible attitudes to the definition of "Chinese technology", even if it has antecedents from foreign technologies. Expect the benchmarks to rise for multinational corporations to show good citizenship with respect to technology. There will be increasing pressure for transfers and the establishment of R&D centers in country.

### **Cars and Pills.**

Two sectors, automobiles and pharmaceuticals, are bell weathers for the trends to higher technology and consolidation.

The automotive sector with its proliferation of brands and over capacity is expected to consolidate. The political objective for a Chinese Honda or Hyundai to emerge, coupled with the ambitions of SOE entrepreneurs, ensures that the sector will have a turbulent future. The results will be high profile and undoubtedly affect trade relations internationally in the coming decade.

Concurrently, the ongoing trend of the past years for improved IPR protection will continue. There is still a long road to travel in this area, but enforcement will strengthen.

Frankly, this improvement will not result from external coercion, but from increasing domestic pressure. The government objective to move away from a China labeled simply as the world's low cost manufacturer, up the technology value chain simply demands effective IPR.

With this evolution expect more announcements of investments into the market by "big pharma", the research based pharmaceutical companies. Healthcare R&D centers will multiply.

## **Conclusion: Changing Rules of the Game.**

Overall, this FYP will constitute a step change in the maturity and development of the Chinese economy. Responding to the emerging social pressures, growth will be reined back and social welfare increased. There is a modest program of income redistribution and fiscal transfers to the rural areas and western provinces. Increased consumption is expected to result.



For the economy, there is a shift away from reliance on cheap labor and low energy prices towards use of higher technologies and the services sectors. This will accelerate the transition to a more mature, efficient economy. With focus on the environment we are seeing the tentative adoption of "sustainable development".

A busy legislative agenda is expected in the coming years in order to reshape corporate China and the economy. Gradually, consultative processes will become more prevalent and interest group engagement more pronounced. Economic nationalism will grow and government policy will be a trade off between the interests of SOE, the domestic private sector and foreign investors.

FDI will continue to be welcomed, but there will be increasing caveats for higher technology.

The government's aim is maintenance of stability while promoting the emergence of Chinese brands and companies capable of investing and competing internationally.

If you thought the 10th FYP was an exciting time in China, then the next five years will be just as exciting, but somewhat different.

Changing times and changing conditions require changing rules of the game.

## **About US...**

**POWELL  
TATE** | **WEBER  
SHANDWICK**

China Matters is produced by Powell Tate | Weber Shandwick, the public affairs arm of Weber Shandwick in China. Powell Tate provides government relations, public policy, issues management, strategic communications campaigns and business development consulting services in China. With extensive experience, Powell Tate's research-based counsel helps organizations successfully navigate complex public policy issues in China, both at national and provincial levels.

Powell Tate | Weber Shandwick is part of the world's leading public affairs consultancy network with leadership positions in the main political centers, including Washington DC, Brussels, London, and Tokyo.

To learn more about Weber Shandwick in China visit [www.webershandwick.cn](http://www.webershandwick.cn). You can also download our newsletter from this website.