



ISS Risk Special Report:

China's National People's Congress, 2017

April, 2017

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Key takeaways:

- The Two Sessions were an exercise in showmanship and a confirmation of President Xi's strategy that "the Party [under him] is the government."
- The work plans presented at the Two Sessions show that stability will take precedence over change/reform for 2017. Yet, the work plans also show that the need for more drastic reforms is clearly engrained in the minds of the leadership.
- The Two Sessions successfully laid the groundwork for the more important 19th Party Congress to be held this fall. It is there that Xi's reform-orientated policy directives will be laid out in public.
- Xi's consolidating grip on the CCP will make his second five-year term more intense than his first. Absent any unforeseen debilitating scandals among his key allies, Xi will be in a position to force significant changes in the coming half-decade.
- SOEs, the manufacturing sector, and industries plagued by overcapacity will be subjected to the hardest reforms. Given their size and political clout, however, the choice to prioritize stability will prevent significant reforms until after the 19th Party Congress this fall.
- Despite the apparent calm this year, China's global economic ambitions remain a top priority and will dominate much of its policymaking in the years to come.

Introduction

In early March, China held its annual "Two Sessions," meetings of the country's legislature, the National People's Congress (NPC), and its top political advisory body, the Chinese People's Political Consultative Conference (CPPCC).

During this annual gathering, political and business elites from throughout the country flock to Beijing for roughly two weeks of government work reports, press conferences, high-level meetings, and official gossip. For those watching from the outside, the well-publicised proceedings are an opportunity to gauge the Chinese government's priorities for the next year.

By most accounts, this year's Two Sessions were rather uneventful. The lofty initiatives presented in the work reports did not contain much in the way of concrete policy announcements. Rather, they mainly consisted of

re-hashed priorities from previous years and legislative developments that had been announced prior to the meetings.

For the Two Sessions to be uneventful is only expected. The NPC is essentially a rubber-stamp body whose sole purpose is to formally approve decisions already made by the Chinese Communist Party (CCP). As such, the annual assembly is more an exercise in showmanship than one in governance, with the country's top leaders seeking to present a picture to domestic and international audiences heading into the Party gathering held later in the year, in which the real agenda will be set. This was especially true this year, as the 19th Party Congress scheduled for this fall will be one of far-reaching consequences for China and the world.

Seen from this angle, last month's Two Sessions were quite significant, and the importance of the image they presented cannot be over-emphasized. Indeed, amid the



monotone readings of 30-page work reports and ceaseless rehashing of “key takeaways” by media and government relations firms, one simple message stands out from this year’s meetings – 2017 will mark a great turning point for China and, by extension, the world. Most of the concrete changes emerging from this year’s developments, however, will not begin taking shape until after the Party Congress this fall.

In the tension between reform and stability, China will choose stability during this sensitive year. This period of relative calm can be likened unto the eye of a storm. Once the Party Congress passes, we will see a more intense five years than President Xi’s first five-year term.

Domestic politics – Xi’s consolidation of power

The single greatest takeaway of this year’s NPC and CPPCC meetings was that the CCP is still, and increasingly will be, the most important governing body in China. President Xi Jinping has a firmer grip on the CCP than any leader since Deng Xiaoping. Premier Li Keqiang’s government work report presented at the opening NPC session contained more references to both Xi and the Party than similar reports have had to any other leader since Mao Zedong in the 1970s.

Other work reports presented at the Congress likewise followed these trends. Most references read like Mao-era slogans, appearing mechanically in the same rote phrase from speech to speech. This begs the question of whether the officials truly support Xi or simply view these slogans as a necessary part of their speech. Either explanation speaks volumes about just how influential Xi has become.

Xi, who was crowned with the title “core leader” just

last year¹, appears to be in a prime position to further consolidate his power during the 19th Party Congress this fall. Just how powerful he becomes will depend on how successful he is at promoting his allies to the Party’s top offices. According to CCP custom, five of the seven individuals currently in the Party’s top decision-making body, the Politburo Standing Committee (PBSC), are scheduled to retire this fall and the same is true of 11 of the Politburo’s 25 members.

Xi will seek to fill as many spots as possible with his allies. Most of the new appointees will likely be selected from the various provincial governments, which have experienced tremendous change over the past year. Since January 2016, 23 of China’s 31 provincial government heads and 18 of the 31 provincial party secretaries (the more powerful of the two groups) have been replaced. Many of the new appointees have ties with Xi. Xi has also had success bringing his protégés into top government ministries, with new heads of the all-powerful National Development and Reform Commission (NDRC), the Ministry of Justice (MOJ), and the Ministry of Commerce (MOFCOM) appointed days before the NPC. In total, personnel changes have occurred in 10 of the country’s 25 minister-level posts between January 2016 and the time of this writing.

Regarding the role of the Party, this year’s NPC put to rest any latent speculation that decision-making power was gradually shifting away from the closed-door meetings of the Communist Party and increasingly towards the government. Amid ongoing refrains about using the Party as the government’s guiding light, Xi’s top graft-buster Wang Qishan stated that “there is no separation between the Party and the government...the Party is the government.”

¹ An honorarium never given to Xi’s immediate predecessor Hu Jintao



With the Party's dominance clarified, the NPC went on to announce that a new national supervision law will be introduced in 2017 to integrate the various inspection and enforcement powers scattered between the Party and various government agencies. This new legislation will effectively codify Xi's anti-corruption campaign into law, giving full legal backing to the Party's role at the head of all anti-corruption investigations for Party and non-Party members, which critics say currently has questionable legality.

Economy – tension between stability and reform

Economic restructuring has taken the place of GDP growth as the main objective, as key policymakers make a concerted effort to avoid the middle-income trap. This year's government work report set the annual GDP growth target at "around 6.5%." This is slightly lower than last year's target of 6.5-6.7%, and use of the word "around" indicates that the government recognises the possibility that growth will fall below this target. Indeed, Chinese policymakers recognise declining growth as a by-product of development and that the country has entered a "new normal."

The first line of business in restructuring the Chinese economy is to cut overcapacity of commodities such as coal and steel. The government also hopes to continue stimulating domestic consumption, as well as growing the now-thriving service economy. Another core aspect of China's economic strategy, as outlined in the Two Sessions, is to recreate China's image as a manufacturer of high-end technology products through initiatives such as Made in China 2025 and the Internet Plus strategy.

The Two Sessions were filled with promises by some of China's top-ranking decisionmakers to reform the massive state-owned enterprise (SOE)

sector, which has been a huge productivity drain for decades. Most SOE reforms put forth during the Two Sessions relate to strengthening CCP control over SOEs and infusing the mammoth enterprises with stronger corporate governance structures. Premier Li also voiced the objective to change the government's role from that of governing the SOEs themselves to managing their assets.

The government is serious about these reforms and recognises that long-term economic health depends on affecting just the transformation these reforms and restructuring seek to bring about.

Nevertheless, **decisionmakers are not lost to the fact that restructuring of this magnitude is sure to stifle economic activity in the short-term and release a firestorm of opposition from vested interests upon which they rely much the same way U.S. politicians rely on interest groups.** Nowhere is this truer than in the case of SOEs, and governments for decades have raised the need to reform this sector but pushed the heavy lifting off onto the next generation.

With Xi set to consolidate his power to an extent unprecedented in the post-Deng Xiaoping era, he will be in a better position to enact many of these reforms than any leader before him. Nevertheless, with the 19th Party Congress coming up towards the end of the year, Xi is unlikely to pursue reforms that would potentially stifle growth in the short-run or antagonise special interests whose support he needs.

In short, reforms that are risky or require substantial investment of political capital will have to wait until next year. Stability trumps reform in the leadup to the 19th Party Congress.

Foreign exchange

The tension between reform and stability is also



evident in the currency policy voiced by officials during the Two Sessions. China has made no secret of its ambition to internationalise its currency the Renminbi (RMB) as a challenge to U.S. economic hegemony.

Faced with macroeconomic forces such as an unusually strong dollar (USD), China has resorted to selling off its foreign currency reserve stockpiles, as well as engaging in capital controls, in an effort to prop up its currency against the prevailing downward trend. China has taken these moves in opposition to its globalisation strategy both to prevent possible damage to Xi's influence in the Party (he has previously suffered criticism that he is insufficiently adept at managing the economy) and to avoid antagonizing the U.S. With the Washington seemingly convinced that China artificially deflates its currency for economic gain, Xi must tread carefully between these two potential challenges.

Premier Li raised questions in his work report by stating that the RMB would maintain a "stable position in the market," as opposed to a "stable rate," as had been the clear policy of previous years. Although, no doubt, seeking support for this policy shift aimed at stability, People's Bank of China (PBOC) Governor Zhou Xiaochuan possibly further confused matters by stating that the exchange rate will remain relatively stable despite the fact that loosened controls will subject it to the same fluctuations experienced by every major world currency. Faith in market forces' bringing exchange rates back up to appropriate levels is far from bankable at present.

Questions remain as to what role the Zhou and Li statements prescribe to the government in regulating the exchange rate. However, the duo has been guiding the other policy initiatives outlined in this report, as well as China's currency policy to this point. As such, it is highly

likely that the government will remain actively involved in seeking to preserve a steady exchange rate, at least until the 19th Party Congress late this year.

Preventing last-minute currency fluctuations in the run up to the 19th Party Congress is the government's main priority for this year. Even while it remains completely committed to RMB liberalization and internationalization in the long-run. Stability is more important than even this core goal for the time being. Any currency volatility in this period would not only reflect poorly on Xi's economic policy capabilities, but would no doubt also serve to increase U.S.-China tensions.

Improving the foreign investment environment

The Two Sessions contained multiple references to the need to revamp China's investment environment. Chinese policymakers are currently concerned that more capital leaves China in the form of outbound investment than is entering the economy via foreign investment. Further compounding this is the Trump administration's policies aimed at bringing investment back to the U.S. These flows are causing Chinese leadership to worry that their economy will get left behind if they do not significantly improve the country's investment environment.

Several announcements were made promising greater access for foreign investors in China. Perhaps the most significant of these was the announcement that foreign investors will receive equal access to benefits from Made in China 2025 and other similar initiatives. In practice, it is too early to tell what this relaxing of foreign investment controls will mean for investors. What is definitely significant, however, is what these moves tell us about Chinese authorities' concerns and priorities.



Foreign policy implications

The heavy shadow of U.S.-China relations was felt in every speech, press conference, and work report featured in the Two Sessions. We have already seen that China's currency policy is, in part, an effort to placate a U.S. administration that believes China is artificially devaluing its currency, and that efforts to improve its investment environment are partially a response to Trump's policies in the U.S. Another area where the U.S. shadow was felt was in China's military budget.

China announced just 7% growth of its military budget, its smallest increase since 2010. This figure shocked observers, as many were expecting a larger increase. While the government defended this figure as being in line with the country's economic growth, most see it as a message to the current U.S. administration, which announced a 10% increase in military spending. With tensions between the two countries high, the Chinese government wants to send a message that it does not seek to threaten the U.S. militarily, nor does it intend to embark on an arms race.

Questions about the U.S.-China relationship were featured in every major press conference, and the government took a generally positive tone. For example, when asked about Trump administration policy regarding a certain issue, Foreign Minister Wang Yi stated that U.S. policy will impact China, and that "the impact will be positive." Indeed, the impact of Trump administration policies – particularly its inward turn and rejection of free trade agreements such as the TPP – already has started to affect China positively by allowing it to take on a more pronounced role in the greater regional and international community.

China is taking advantage of the virtual vacuum the U.S. seems to be leaving by establishing itself as the preserver, leader, and reformer of the global trade regime. Premier Li, Minister Wang and other officials emphasized China's role in driving the development of bilateral and multilateral FTAs, although, doubtless in order not to attract undue attention or opposition from the U.S., China stated that it will not enter into such agreements in regions where it does not have a reasonable purpose in engaging in such a way. This seems to imply that China will not take the abandoned TPP members up on their offer to let China replace the U.S. in a new version of the deal.

The cornerstone of China's globalization strategy continues to be the Belt and Road initiative (One Belt One Road, OBOR). The Two Sessions contained multiple references to OBOR, both in the context of domestic regional development and international trade. While no concrete policy announcements were made, officials used international attention on the Two Sessions to promote the Belt and Road Forum to be held in Beijing in May, during which time more concrete policy will be announced.

Conclusion

While somewhat dull and uneventful on the surface, this year's Two Sessions laid the groundwork for a much more eventful 19th Party Congress to be held late this fall. What follows the Party Congress will bring much in the way of change and reform to a China seeking greater leadership in the regional, and even global, community. In the meantime, this year will be one of cautious calm, with emphasis being placed on stability so as to make the reforms and changes to come possible.