Global Counsel

China's two sessions, three battles, and external tensions

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Summary

China's "two sessions" were revealing about the tensions between the leadership's internal and external policy objectives. The authorities are attempting to strike a balance between controlling slower growth and increasing urban employment, while reducing rural poverty, combatting pollution and reducing financial risk. The most important development was the passing of a new foreign investment law which seeks to address long-standing complaints of foreign businesses. But in this and other areas that matter for China's external relationships, there are questions about implementation and enforcement. China's apparent embrace of the concept of "competitive neutrality", both domestically and in foreign markets, is also potentially significant. But that depends on how it is deployed in practice. Further steps to increase trust and transparency are needed if western countries are to become more receptive to Chinese acquisitions and more are to embrace the Belt and Road Initiative.

March saw the annual concurrent sessions of the National People's Congress (NPC) and the Chinese People's Political Consultative Conference take place in Beijing. These are the biggest events in the Chinese political calendar and a moment to take stock of the country's policy direction. This GC Insight considers the main points to take and the implications for China's increasingly fraught economic and political relationships with other countries. While we saw significant steps in areas like the new foreign investment law, the policy discussions and policy inactions probably did more to highlight the structural problems in these relationships, which are unlikely to be resolved soon and some of which may not be resolvable at all.

Domestic policy tensions, foreign consequences

Last year, the "two sessions" were a moment of triumph for President Xi Jinping, as he consolidated his grip on power, removed the two-term limit that constrained his predecessors, and saw "Xi Jinping thought" enshrined in the constitution. This year, in the face of a slowing economy and a deteriorating relationship with the US, the challenge was to demonstrate the leadership has a grip on problems at home and answers to critics abroad, while not compromising on core political ideology.

In his government work report, Premier Li Keqiang confirmed that the growth target would be lowered to 6-6.5% and acknowledged the headwinds facing the economy and the "complex and severe situation" in China and externally. Last year, GDP growth was measured at just 6.6%, impressive by western standards, but the lowest in China since 1990, and with a suspicion that the figures are being massaged to disguise the full extent of the slowdown. A minimum growth rate of 6.2% is required for the Chinese Communist Party (CCP) to meet the goal of doubling GDP between 2010 and 2020.

Li's work report emphasised the importance of stabilising the labour market, suggesting the government fears the consequences for jobs as the economy slows. He committed to creating 11m additional jobs in urban China and to capping the urban unemployment rate at 5.5%, with a promise of additional financial support for workers to retrain.

At the two sessions last year, a bullish President Xi and his premier identified three battles that they would wage for the Chinese people – against poverty, pollution and financial risk. Those battles are still being waged, but the tension between them and the challenge of avoiding a sharp economic slowdown is now becoming more apparent and impacting on the room for the government to manoeuvre in dealing with its external problems.

Ending poverty means developing rural China and the west of the country, the latter being one rationale for the Belt and Road Initiative, which is dividing European countries and is the subject of growing hostility in the US.

Addressing pollution means restricting the activities of a vast part of China's industry, which is contaminating the air, water and soil. It also often involves the use of fiscal incentives and an active industrial policy to support cleaner technologies, such as electric vehicles. This creates not only a tension between cleaner and faster growth, but also between legitimate support for environmental policy objectives and what many western governments view as excessive support for new technologies that gives Chinese firms unfair advantages.

Managing financial risk means sticking with changes to how demand is managed, just as the economy slowing and the need for active demand management is more acute. Over the past few months, the authorities have sought to strike a fine line between pushing out credit and green-lighting large infrastructure projects – the usual means to boost growth – and alternatives such as tax cuts and increasing credit to smaller private enterprises, prioritising the services sector over industry.

The two sessions saw the government commit to lower corporate taxes and a cut in VAT (up to 3pp for the highest bracket) which was at the higher end of market expectations, amounting to a fiscal boost of around 0.6% of GDP. The government also promised to boost bank lending to smaller private enterprises by 30%, with Li saying the government will adopt a policy of "competitive neutrality" between state-owned enterprise and private firms in future. This builds on Xi's affirmation of the CCP's "unwavering" support for private enterprise in late 2018 and looks like a significant firming up of a previous commitment to ensure the private sector plays a "bigger role" in driving growth, which has not previously been fully reflected in policy.

New legislation

The NPC's work report promised two new pieces of legislation and revisions to six existing laws that are relevant to business, including changes to export controls, property taxation and the legal framework for healthcare.

The single most important policy outcome of the two sessions, at least from an international perspective, was the passing of the foreign investment law, which replaces three existing laws governing foreign enterprises. This will come into effect on January 1st next year and attempts to address some long-standing complaints of foreign businesses, many of which have been the subject of negotiation between the US and China as the two countries seek to de-escalate their trade war. Measures include committing to national treatment for foreign investors, providing equal treatment in procurement, strengthening intellectual property protection, consulting on future rule changes governing foreign investment, providing a new process for foreign companies to appeal against administrative decisions, and (in principle at least) banning forced technology transfers by administrative measures.

The new law will incorporate the existing negative list of sectors where foreign investment is restricted. And the government is expected to announce soon a list of sectors where foreign investment will be encouraged, in some cases specifically in the under-developed central and western regions.

Premier Li said the concept of "competitive neutrality" would apply to all forms of private and state-owned enterprise, regardless of whether they are domestic or foreign owned. This is a political statement, so it remains to be seen what practical consequences it has. Even so, it may seem too good to be true for businesses in other countries who regard the Chinese state as the single biggest source of distortion to a competitive level-playing field globally.

The work report had little to say about state subsidies for business. It was also notable that the Made in China 2025 programme – which seeks to use all the levers of the state to ensure that Chinese firms establish leading positions in high-tech and innovative sectors by that year – was not directly mentioned in the work programme at all.

The passing of the new foreign investment law is clearly important, and it has been broadly welcomed by foreign investors, including the US and European chambers of commerce in China. While there have been concerns that the compressed process has not allowed enough consultation, the same critics usually complain that Chinese policymakers move too slowly. Perhaps a more valid concern is that some of the legislation is vague, leaving important details to be filled in through implementing regulations.

Trouble abroad

The US relationship has been the focus of attention, because of the hostile stance taken by the Trump administration and its introduction of additional duties on roughly half of China's imports. But strains in Beijing's external relations don't begin and end there. European countries and the EU institutions share many of the US concerns and like the US have been tightening their frameworks governing inward investment, with Chinese investment the main reason for the additional scrutiny. China's external policy, which across Asia and beyond is increasingly channelled through the Belt and Road Initiative, is also a source of tension for some while being an opportunity for others.

The two sessions tell us much about the prospects for these relationships. There are several implications that can be drawn – and quite a few questions left unanswered – under three headings: questions about implementation and enforcement; the potential significance of China embracing competitive neutrality; and the need to build trust and improve transparency on all sides.

Implementation and enforcement

The passing of the foreign investment law is significant. It has been a long time coming, with the legislation first proposed in 2015, but in the end passed through the three reading stages of the legislative process at remarkable speed. The substance of the law, including the ban on forcing technology transfers through administrative measures and the rights given to foreign firms to appeal against administrative decisions, appears directly to address foreign investor concerns about administrative coercion. It is no surprise that this is also one of the most sensitive issues in the negotiations between the US and China.

These issues are not particular to China or the US-China relationship. Many foreign investors face the problem of enforcing their rights (including property rights) when investing around the world, which is why agreeing investor-state dispute settlement processes has become part of trade negotiations. But it has also become controversial, because of concerns about the impact on the sovereignty of the host state when, for example, an investor may object to what might be regarded as valid policy choices of a national government.

That tension between sovereignty and recourse is also prominent in the US-China negotiation at the state-to-state level. The US appears to want the unilateral right to punish China if the US concludes that the Chinese authorities are not standing by the terms of the agreement, at least during a transition as the existing additional duties are progressively removed and a permanent deal enters into force. As far as China is concerned, however, the ministry of commerce has noted the importance of enforcement being two-way, fair and equal, and not infringing on Chinese sovereignty.

The relevant provisions of the new investment law – which concerns the investor-state relationship under Chinese law – can be seen as an attempt to shift the balance in that negotiation. They allow the Chinese to point to a new legal mechanism by which US companies (and other foreign investors) will be able to protect their interests directly through the Chinese legal system.

Will it work? It may help. But it leaves the question of enforcing the enforcement mechanism, given doubts about the impartiality of the Chinese legal system. It will also take time to demonstrate that it works, even once the law enters into force several months from now. Many foreign businesses will remain sceptical until they begin to see successful actions taken against local authorities and government agencies that are often the instruments of unfair practices in China.

Competitive neutrality in practice

What exactly does Premier Li mean by “competitive neutrality” and what practical impact will it have on Chinese economic policy? The concept has been used by the OECD, but that does not mean the Chinese will accept its definition. US negotiators and their counterparts in Europe will want to understand how this will work in China. There are several unknowns, such as whether it will apply to future policy only, or also to the existing legislative and regulatory stock. Does it, for example, mean that Chinese state-owned enterprises will now also be covered by the anti-monopoly law of 2008, from which they are currently exempted? Even if the answer to these questions is yes – which is far from certain – it would again presumably still take several years before this is reflected fully in the statute book.

US trade negotiators will be asking their Chinese negotiators what competitive neutrality means for their firms, not only in China, but in the US market and other countries. For the US, genuine competitive neutrality almost certainly means the elimination of direct subsidies and indirect support for Chinese companies, for example through cheap finance. It is inconceivable that the Chinese will be willing to do that.

A more realistic objective might be for China to give it an operational definition against which its actual behaviour can be assessed. In form, this might be something like the Chinese equivalent to EU state aid rules, even though the former is never likely to be as restrictive as the latter. That would have many advantages, including bringing clarity to the compatibility or otherwise of Chinese policy with the terms of its membership of the WTO, which is another source of tension. This will therefore be the focus of scrutiny at the multilateral level, as the WTO membership thrash out stricter anti-subsidy disciplines as part of wider institutional reforms that are currently being negotiated.

Trust and transparency

In the past couple of months, the Chinese media have reported increasing concerns that the EU's new investment screening framework may be targeting China. Beijing restrained outbound FDI in late 2016 to curb the drag on the renminbi and forex reserves, but another reason for the fall in Chinese investment in Europe may be the changing attitude of European industry and policymakers.

European politicians are concerned that unfair competition is allowing Chinese firms to buy up advanced European technologies, which is damaging European competitiveness. They are also concerned about the national security implications of some Chinese investments. Both concerns are among the main motives for the recent moves to tighten investment screening regimes in the UK, France and Germany, plus the new role the EU is seeking to coordinate approaches and share information across member states. And they are also the impetus for a recent German proposal to create a new state fund to allow the government to take temporary stakes in companies in order to guard against unwelcome acquisitions.

The low profile for Made in China 2025 and a commitment to competitive neutrality, which echoes European calls for reciprocity in the relationship, may ease some European concerns. But the much more important missing piece is trust and transparency. Trust is hard to build and may require something else that was also missing from the two sessions, which is a commitment to open up Chinese retail portfolio investment outflows.

Portfolio investment does not provide control over assets, which is what many European policymakers fear. The Chinese authorities have long been worried about capital flight, but allowing Chinese savers to invest abroad could be done gradually. It would push down the cost of finance for businesses in Europe – and bring this closer to the cost of finance for Chinese companies – and as such would be welcomed by European businesses and politicians alike. It may also assuage some of the concerns about the motives behind Chinese investment. And that in turn could help restore trust, which is a necessary condition for Chinese firms to be allowed to take larger strategic or controlling stakes in European businesses in sensitive sectors.

The investment relationship could get more complicated before it improves, however. As part of China's new system to protect foreign investors under the new investment law, China has said that it reserves the right to retaliate against countries that discriminate against Chinese investment. China may regard investment screening frameworks as doing just that, so the two sessions may signal increasing tension instead of a step towards improving this part of the relationship. Even so, Europe is expected to remain a relatively attractive destination for Chinese investments, especially given the problems between the US and China and the even more restrictive approach to Chinese investment being taken there.

A second area where building trust and transparency is important is in the Belt and Road. The two sessions left little doubt that China remains committed to the initiative. But little emerged that will help to address the concerns of western governments that the primary motives are exporting excess industrial capacity and widening China's political influence over other countries. Indeed, there are some in the Chinese commentariat who regard the hostility of western countries to the Belt and Road as an indication of its success.

Lack of transparency in the governance of Belt and Road projects, as well the preferential treatment granted to Chinese companies in tender processes, remain among the key commercial reasons why other large European states will hesitate before following Italy's recent embrace of the Belt and Road, and why the US position will remain hostile towards it. This is almost certainly an area of policy where the trust deficit is widening. So perhaps the single most important announcement concerning the Belt and Road was found in the work report, with Premier Li noting the need for China to follow internationally-recognised market rules in the Belt and Road Initiative. If the trust deficit is to be reduced and more countries are to take Italy's approach, then following internationally-recognised market rules could prove to be an effective way to start.

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