



The Waiting Game:
China's National People's Congress,
the Stimulus Package and Its Impact
on Foreign Business

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INTRODUCTION TO APCO

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EXECUTIVE SUMMARY

- This year's National People's Congress (NPC) was as interesting for what was not said as for what was. Despite mounting speculation in the run-up to the meeting, no second stimulus plan was announced, and key questions regarding the first package remain unanswered. Instead, the Chinese government has adopted a 'wait and see' approach before undertaking further stimulus measures.
- This has led to accusations of policy complacency and concerns over a "W" shaped recovery. However, the Chinese government does appear well-positioned to implement further substantial responses, if necessary, due to the strength of its reserves, its low fiscal deficit and control over the banking system.
- Developments surrounding a shift in the spending priorities of the first stimulus plan (more welfare and consumption, less infrastructure) and moves to give provinces greater capacity to raise funds for stimulus projects further underline the need for foreign invested enterprises (FIEs) wishing to access the stimulus to have a well-crafted government engagement strategy - at both the national and provincial levels - and a detailed understanding of and proactive participation in national- and provincial-level procurement processes.
- Other key pieces of legislation such as the Food Safety Law, which has the potential to radically change the operating environment for Food and Beverage (F&B) players in China, and developments concerning China's increasingly serious efforts to build a social welfare infrastructure must also be carefully monitored by FIEs wishing to enhance and expand their China operations.

THE SECOND SESSION OF CHINA'S 11TH NPC: A CONTEXT

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

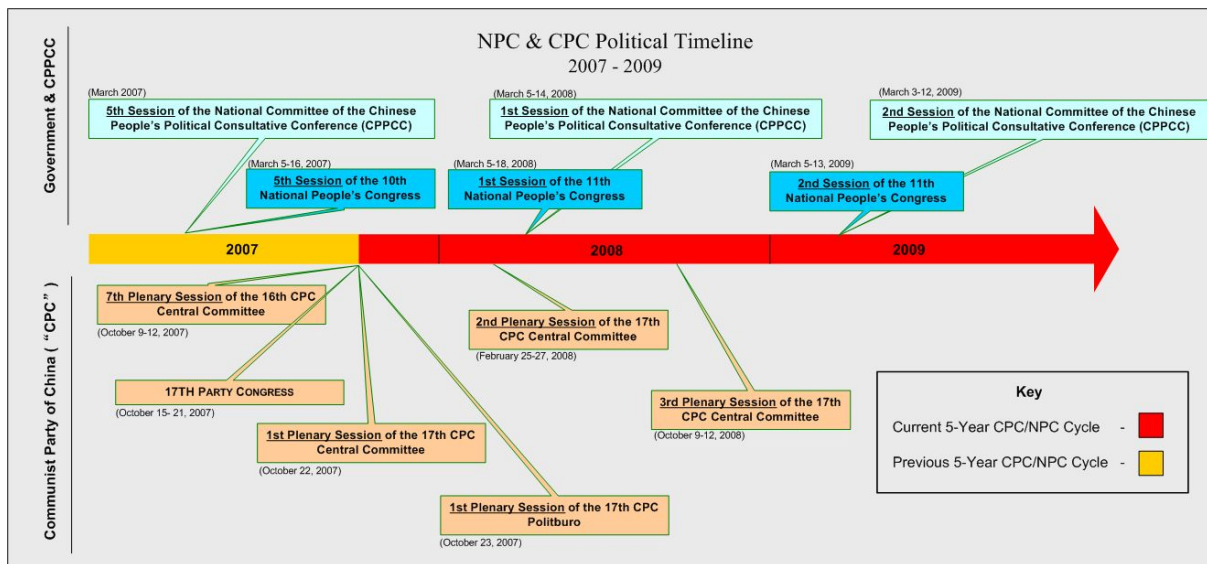
delegates approving appointments, laws and ministerial work reports predetermined by the Communist Party of China (CPC) – hence the gathering's reputation as the "rubber stamp legislature." The control exercised by the Party over NPC proceedings is owed mostly to the political allegiance of the delegates themselves - more than two-thirds of the NPC's deputies are CPC members, and all are tacitly approved by the Party.

Despite its lack of real power, this year's NPC (held March 5-13) came at a time of great economic upheaval. Accordingly, key speeches such as Premier Wen Jiabao's work report on the Chinese government, the Ministry of Finance's 2009 national budget and other announcements by central ministries have shed further light on the government's response to the economic crisis and its efforts to achieve its central goal of 8 percent GDP growth this year. Other important developments concerning food safety and social welfare legislation were featured and will have important implications for the investment environment in China. This year's NPC session was shorter than usual, despite the

imposing agenda, in what was described as an effort by the NPC to reduce costs in light of China's other more pressing needs.

This year's NPC also provides an opportunity to further assess some of the highly significant leadership and administrative decisions confirmed at last year's session, which followed the October 2007 17th Congress of the Communist Party, the key event in the Chinese political calendar that sets overall policy and the appointment of China's top leaders for the following five-year period.

Chart 1: NPC/CPC Political Timeline 2007 - 2009



KEY FEATURES OF THE NPC

During the NPC, Premier Wen and other senior leaders presented their work reports discussing the main policy issues and challenges facing China in 2009.

Work reports are a central feature of each NPC. Heads of all of the key government agencies nominally supervised by the NPC are brought before the assembly to summarize their organization's accomplishments from the previous year and detail their work plan for the year ahead. The reports are presented as an annual evaluation tool for NPC members to assess and comment on the performance of the government offices that they constitutionally oversee. NPC members vote to approve the report at the conclusion of each presentation.

No work report has ever been rejected, and it is not clear what would happen if one were.

The highlight of each work report session is the opening remarks delivered by the State Council premier and China's top economic planner, Wen Jiabao. Often compared to a "state of the union" address, the Premier's speech is one of the few times each year that a top leader provides an overview of the government's political, social and economic priorities, and it is analyzed carefully as a rare window into Party thinking. At the end of each NPC, the premier holds a press conference. This is usually the premier's only such press conference each year, and his remarks are also subject to close scrutiny.

NPC – POLICY COMPLACENCY IN THE FACE OF ECONOMIC CRISIS?

No Stimulus II, Key Questions Unanswered

This year, Premier Wen's work report was particularly anticipated with speculation that further major stimulus measures, following November's RMB 4 trillion stimulus plan, would be announced. However, there was no stimulus mark two and many details regarding the original plan – in particular how much genuinely new investment will be forthcoming – were left unanswered. Instead, Premier Wen focused his attention on restating the Chinese government's commitment to deliver 8 percent GDP growth in 2009 and unveiled a series of longer-term measures designed to aid China's transition to a more consumption-driven economy.

Yet at his annual post NPC press conference (to both Chinese and international press), Premier Wen did confirm the government would announce further fiscal pump priming if deemed necessary. Therefore, it appears likely Chinese leaders will wait for further economic data to emerge following the release of the first two batches of central government stimulus funds in Q4 2008 and Q1 2009 to judge progress in achieving their 8 percent GDP growth target before deciding on further measures.

Policy Complacency?

This "wait and see" approach and the lack of greater detail concerning the first stimulus package has led to media accusations of policy complacency. Such accusations were seemingly underlined by the NPC's approval of China's 2009 national budget, which on the face of it did little to answer how the Chinese government would fund its original stimulus plans.

The budget predicts that China will accrue a budget deficit of RMB 950 billion this year and government expenditure will increase by 21 percent in the period. Although Chinese policy-makers have argued that both of these figures represent record highs, critics point out that the deficit is only 3 percent of GDP (as opposed to 0.6 percent in 2008), and the increase in expenditure is less than last year's increase of 25.4 percent. The modest nature of these numbers has worried critics who argue that the Chinese government could and should take far more substantive action in reaction to what increasingly appears to be the most challenging economic conditions in a generation.

The strategy, which has variously been ascribed as a result of overconfidence by some commentators and excessive caution by others, has raised fears that China could be heading towards a "W" shaped recovery. Under such a scenario, the initial stimu-

lus investment would result in a short-term recovery of key indicators but one that quickly tapers off as the lack of additional funds means the pickup in demand is temporary –resulting in a second, possibly sharper, slump.

However, while it is too early to make such a judgment as to the effectiveness of the government's response, or the shape of the recovery, it should also be remembered that the strong fiscal position of the government, with a relatively low debt to GDP ratio; strong reserves, relatively low level of leverage in both the banking and wider corporate sector; and the ability of the Chinese government to force the state-owned banks to lend aggressively throughout the slowdown, means that the Chinese government should be well-placed to take further, substantial action if necessary.

Financing – Where is the Money?

The small projected budget deficit has raised concerns that China's government is seeking to rely too heavily on lending from China's banks to fund the stimulus and that the pressure placed on banks could risk the progress they have made in addressing the quality of their lending portfolios in recent years. This is because, although it was clear from the original plan that the central government would only provide one quarter – RMB 1.18 trillion – of the RMB 4 trillion, little has been said in the intervening months, or at the NPC, to clarify how further funds will be raised to make up the remainder of the projected total.

This concern has been compounded by the fact that the measures announced at the NPC to help provinces and SOEs raise funds to meet the one third or more of total project costs that they will be required to contribute, will only raise a small proportion of the targeted RMB 4 trillion, leaving banks as the last viable source.

Special Transfers – As part of the budget, MoF said "special transfers" to provinces to help stimulate consumption would increase this year by RMB 261 billion, an increase of 26 percent on 2008.

Provincial Bond Sales – Premier Wen announced that provincial governments will be allowed to sell bonds to raise capital for stimulus projects. The value of bonds the provinces will be allowed to sell will be strictly controlled by the Ministry of Finance (MoF). The measure is being described as a "special arrangement" indicating that this move does not mark greater decentralization but rather is a

temporary innovation born of necessity as falling tax revenues and the need to raise funds place provincial budgets under severe pressure. It is also clear that the central government is effectively underwriting the bonds, as it will not allow one of the provinces to default on its debt. MoF approved a total quota of RMB 200 billion which will be divided amongst the provinces. However, as critics point out, this additional funding for the provinces will barely be enough to cover their losses from falling tax revenues as a result of the slowdown, let alone fund a massive expansion of spending.

Enterprise Bonds – Zhang Ping, minister in charge of the National Development and Reform Commission (NDRC), announced China would expand the issuance of enterprise bonds by state-owned enterprises to fund stimulus projects. The issuance will be extended to another 50 companies with a total value of RMB 100 billion to go with the enterprise bonds, worth more than RMB 130 billion, that have been issued since Q4 2008.

EVOLVING STIMULUS PRIORITIES

Despite the lack of desired clarity regarding stimulus financing, NDRC did announce a measured shift in the spending priorities of the stimulus, with some of the funds previously allocated for infrastructure development reallocated to social welfare programs.

Chart 2: Revised Stimulus Funds (RMB Billion)

Prioritized Sector	Original Total	Revised Total	Change
Infrastructure	1,800	1,500	-300
Sichuan reconstruction	1000	1000	0
Housing	280	400	+120
Rural livelihood and infrastructure	370	370	0
Indigenous innovation	160	370	+210
Environmental projects	350	210	-140
Health and education	40	150	+110

The key drivers behind this re-allocation include:

Concern over social stability – With anecdotal evidence suggesting a sharp upswing in the number of organized protests throughout China in recent months, the Chinese government has become increasingly concerned over the impact of the slowdown on social and political stability. The change in emphasis of spending can therefore be seen as a move by the government to mitigate some of the pain caused by the slowdown and to appear responsive to popular concerns, hence the new focus on housing, health care and education.

Investment/consumption balance – The Chinese government has also been receptive to criticism that the original investment prioritization leaned too heavily toward fixed-asset investment (FAI). Critics argued such a balance risked holding back the targeted transition of China’s economy from one driven by investment to one more reliant on consumption, and that it also overly advantaged SOEs to the detriment of China’s private sector. Therefore, cuts to funds available for FAI and reallocation to social welfare programs such as health and education are designed to aid this transition to a more domestically-driven economy and also to make the recovery, when it comes, self-sustainable rather than reliant on continuing high levels of FAI.

However, despite this reallocation, stimulus funding will still remain heavily focused toward infrastructure development, as such projects remain the best available method of providing the immediate momentum needed to meet the government’s two overarching and prioritized goals – 8 percent GDP growth in 2009 and tackling the rising trend of unemployment and thereby maintain social and political stability.

STILL NO GREATER CLARITY ON PROJECT APPROVALS

Anecdotal evidence suggests that March and April will see the establishment of provincial “project offices” for projects that will commence on the basis of the first rounds of central government funding, released in Q4 2008 and Q1 2009. FIEs will need to monitor closely the establishment of these project offices as they will likely be used to tender for sub-contracted services under the main project (typically owned by a SOE or special provincial investment vehicle).

In recent weeks, further details have also emerged as to the approval process for stimulus projects. These details include further requirements for projects of a scale that need provincial or national NDRC approval. For example, those valued under US\$100 million have now been devolved to provincial-level authorities for approval, while further clarity has been provided around the process required prior to receiving approval - projects must pass an environmental impact assessment, obtain a provisional land use certificate and gain provisional planning permission. Overall, the project procurement and approval process remains extremely opaque, and we expect further details to slowly emerge over the next several weeks. FIEs wishing to participate in this process will likely need to expend considerable resources understanding this process should they hope to tender successfully.

OTHER ECONOMIC MEASURES AT THE NPC

Outside the RMB 4 trillion stimulus plan, Premier Wen and other ministers have outlined other measures to support economic growth:

Exports – Commerce Minister Chen Deming announced China will steadily cut export-related taxes to “zero” and raise financial support for exporters to avert another sharp drop in external demand.

Currency – Premier Wen stated that the RMB/USD exchange rate would remain “relatively stable” throughout 2009 as a further move to bolster China’s exports.

Employment – The government announced it will allocate RMB 42 billion to create 9 million urban jobs.

Innovation and R&D – RMB 20 billion will be provided to support technological transformation of enterprises and government expenditure on Research and Development will be increased to 1.6 percent of GDP.

Rural Consumption - RMB 103 billion will subsidize rural residents' purchases of home appliances and vehicles and to increase grain, petroleum, non-ferrous metals and specialty steel products reserves.

OTHER KEY NPC DEVELOPMENTS

FOOD SAFETY

This year’s NPC has seen the introduction of the highly anticipated Food Safety Law. The law, which has undergone a five-year legislative process, will replace the ineffective Food Hygiene Law. The law will significantly alter the structure of China’s food regulatory and monitoring system. A number of recent high-profile scandals, particularly the latest melamine scandal in autumn 2008, have added extra urgency to such a change. The law is set to become effective on June 1, 2009.

The new law will provide the basis for stronger food product supervision, safety standards, and legal action against violators. It prohibits all additives, other than those officially approved for use in the food product, and notes that additives may be used only for the specific purposes for which they were originally approved.

National Food Safety Commission – A key aim of the food safety law is to streamline and consolidate the number of bodies involved in the regulation of the food industry. The law also mandates creation of a new National Food Safety Commission that will oversee the newly rationalized set of industry regulatory organizations. Although details are yet to be confirmed, it is likely that elements of China’s Ministry of Health; Ministry of Agriculture; State Administration for Industry and Commerce (SAIC); Administration for Quality Supervision, Inspection and Quarantine (AQSIQ); and State Food and Drug Administration (SFDA), will report directly into the new commission.

SOCIAL WELFARE

One of the most important issues arising from this year’s NPC for foreign investors and the investment environment in China was that of social security, with the recently introduced draft Social Security Law, a topic of hot debate.

The focus of attention is due to the fact that developing a social welfare infrastructure is increasingly seen to be one of the most important policy solutions to address two of China’s most serious problems – the widening gap between rich and poor and the rebalancing of China’s economic growth model to one that is principally driven by domestic consumption rather than overly reliant, as present, on trade and fixed asset investment.

Currently the Chinese government spends only 5 percent of GDP on health care, pensions, unemployment benefits and other social services. (U.S. social-welfare spending as a percentage of GDP is about 20 percent and is considerably higher still in many European countries). Therefore, the need for this emerging policy drive to develop China’s social welfare infrastructure is clearly in place but the scale of the challenge of developing such an infrastructure is daunting given the size of the Chinese population and the relatively low starting point. As such, this will be a multi-decade challenge.

However, with growing unemployment and increasing strains emerging from the economic slowdown and the resulting need to make China’s economy more self-sustaining in the long-term, the current crisis appears to be providing further impetus to China’s push for social welfare development. This push will have clear long-term indirect and direct benefits for foreign investors in China. The indirect benefits will be the entrance into multiple market segments of potentially hundreds of millions of new Chinese consumers. The direct benefits will be the enormous range of project opportunities that will arise in building China’s social welfare systems, particularly in the early years when international companies are likely to enjoy a large technology and capability gap over their Chinese counterparts.

Key NPC social welfare measures:

Social Security – A draft law on social insurance that was first published in December 2008 was a topic of heated debate at the NPC. The draft law specifies a common right for citizens, urban and rural alike, to pay premiums to receive social insurance for medical care, work injuries, unemployment and childbirth. The draft law was formulated to strengthen and standardize the basic principles for collection, disbursement and management of social insurance premiums in China. Under the new system, mobile workers will benefit by being entitled to contribute to and receive social pension funds in different locations and freed from current “hukou” restrictions. Following the NPC the draft law will undergo further revision before being published in a final version later in 2009.

Health care – In his work report Premier Wen re-emphasized the importance of China’s recently passed health care reform plan. The plan calls for RMB 850 billion of investment in China’s health care system over the next three years. The reform will focus on several key aspects – the establishment of a basic medical security system, establishment of a basic drug system, improvement of a

grassroots health care system and improvement of the public health service. Premier Wen revealed the central government would finance 39 percent of the RMB 850 billion.

Education – Premier Wen said a key goal of 2009 will be the formulation of China’s Medium and Long Term Education Development Plan. This plan will be one of the key strategy documents relating to education and will set out goals and targets for the next 10-15 years.

CHINA/TAIWAN RELATIONS

The NPC also saw a further warming of relations between China and Taiwan, which have increasingly gained momentum since the election of KMT President Ma Ying-jeou in March 2008. Speaking at the NPC, Premier Wen said the mainland would actively promote financial cooperation across the Taiwan Straits and support the development of Taiwan-funded enterprises on the mainland. Premier Wen also said that in 2009 the Chinese government would accelerate normalization of cross-Straits economic relations and facilitate the signing of a comprehensive agreement on economic cooperation.

POLITICS AND THE NPC

A TEAM OF RIVALS?

While the NPC is supposed to be a key state pillar under China’s “party and state” system (this system seeks to formalize the notional split between the Communist Party and the government bureaucracy), the highly interwoven nature of the Communist Party and all aspects of the government means the politics and rivalries of the Party are never far away from the surface of NPC meetings. In a year during which China faces perhaps its toughest economic challenges in a generation, this could not be more true.

Although in recent years the Communist Party has moved away from dependence on a paramount leader and now relies on the nine-man standing committee of the Politburo, this apex of power is also the center of informal coalitions within the Party that compete against each other in terms of policy emphasis. While this competition rarely spills out onto the public stage, it is fierce and the current economic crisis could have important implications for the dynamics of this competition and ultimately how China is governed. Broadly, there are two groups within the Party – the “Tuanpai” faction and a loose coalition of “Princelings,” and a

“Shanghai faction” that are sometimes described as “elitists.”

The Tuanpai group is currently led by China’s President Hu Jintao and – less formally – Premier Wen Jiabao. Members of their core group include Vice Premier Li Keqiang and Director of Party Organization Li Yuanchao, who formed bonds during their time at the Chinese Communist Youth League, through which they advanced their careers. The elitist coalition features Wu Bangguo, chairman of the NPC and Jia Qinglin, head of the Chinese People’s Political Consultative Congress, both closely associated with previous Party Secretary Jiang Zemin and his so-called “Shanghai faction.” Other members of this elitist group include Xi Jinping, and are known as princelings because they are the children of former high-ranking officials.

The two broad groups, although absolutely united on certain issues, including the primacy of the Party, do take different views on socio-economic development. The Tuanpai grouping tends to take a more equitable view of China’s development. Under the aim of what has been termed creating a “harmonious society,” Tuanpai members believe that ensuring all sections of China’s population

share the benefits of growth is of equal importance as rapid growth and development. The elitists, on the other hand, are much more focused on rapid growth to solve China's development issues and boost China's power and prestige, and are more willing to accept the growing disparities in wealth evident in China as an unfortunate but necessary consequence of this.

APPRAISING XI AND LI, ONE YEAR ON

At last year's NPC following the 17th Party Congress, this factional split was institutionalized for what could be as long as five years until the 18th Party Congress, with the elevation of Xi Jinping and Li Keqiang, representing the elitist and populist factions respectively, as the heirs apparent to Hu Jintao and Wen Jiabao in 2012-2013.

This year's NPC provides a good opportunity to assess the two leaders one year on. Although both Xi and Li had productive, if uninspired, years in 2008, the year ended with Xi clearly in pole position to take the top jobs of party secretary and president. This was confirmed with his high profile appointment to manage the Beijing Olympics. This year it is likely that both Xi and Li and will emerge further onto the public stage as the Party seeks to manage their image in the eyes of the Chinese people in preparation for their succession.

ADMINISTRATIVE RESTRUCTURING ONE YEAR ON

This year's NPC also provides the opportunity to look at the progress of China's administrative restructuring one year after it was confirmed. As with the performance of Xi and Li set in the previous section of this document, the restructuring process has done little in the way of raising controversy. The central level consolidation and streamlining of ministries was completed and the process is now underway across China's provinces.

Of greatest interest to foreign investors is the increasingly important role of Ministry of Industry and Information Technology (MIIT), created from the restructuring process, and the space it has staked out in what was traditionally the reserve of NDRC. Indeed, the central role in economic and industrial planning that MIIT established is reflected in its key position alongside NDRC in approving projects under China's stimulus plans. Yet the exact division of responsibilities held by the two crucial ministries is yet to be determined and must be carefully monitored by FIEs as there is the potential for regulatory conflict and bureaucratic inefficiency as both ministries fight to protect and enhance their power.

It is now likely the broad shape of China's government structure will remain in place until at least 2012-2013 and the elevation of the fifth generation of leaders.

IMPLICATIONS FOR FOREIGN INVESTORS

STIMULUS

This year's NPC was interesting more for what was not said than for what was. Whilst speculation had been rife that China's Premier Wen Jiabao would announce a second stimulus package, it now appears that China's leaders have adopted a "wait and see" approach, seeking to monitor the results of the first round of stimulus spending through future economic indicators before announcing any further measures.

A more pressing concern for foreign investors is the ongoing lack of clarity regarding the financing and specific project details of the first stimulus plan. The absence of greater detail around these key issues underlines the need for FIEs seeking to access stimulus funding to continue to monitor carefully the evolving priorities and intentions of the Chinese government and how they will affect potential opportunities. A good example of these changing priorities was seen at the NPC through the shift in the broad prioritized targets for the first rounds of stimulus spending, designed to redirect

additional funding to social welfare (while maintaining infrastructure as a focus). If economic indicators do not show fairly rapid signs of tangible recovery, further changes and possibly new and substantial stimulus packages are very likely in the coming months.

The limited move to allow provincial governments to issue bonds to fund stimulus projects and the devolution of approvals under US\$100 million to provincial governments further underlines the need for FIEs to have well crafted provincial strategies as projects will be executed, and increasingly financed, at the provincial rather than national level.

SOCIAL WELFARE

This year's NPC saw an important further confirmation of the Chinese government's seriousness in developing a social welfare infrastructure. Although this will likely be a multi-decade challenge, the potential direct and indirect benefits for FIEs are clear. Once again, understanding which

projects will be approved and how they will be financed will be key for FIEs seeking to capture new business opportunities. Already potential projects such as the development of a national medical IT system are raising potential opportunities for foreign investors, and crucially doing so in areas where there is a considerable capability gap with Chinese companies – hence a lowered risk from the government’s unofficial policy of economic nationalism, one of the key barriers in recent times.

FOOD SAFETY LAW

The Food Safety Law is likely to change radically the regulatory environment for F&B companies in China. This year will see further key milestones in the development of this law, in particular the crucial implementing guidelines that the State Council

is expected to issue this summer. FIEs operating in this sector will therefore need to remain in close contact with key government stakeholders throughout this critical time as decisions taken now will shape the sector for many years to come.

POLITICS

The political implications of this year’s NPC, particularly in comparison to last year’s, have been limited. However, with the Communist Party facing perhaps its biggest economic challenge in a generation, the potential political implications of a sustained and sharp economic slowdown could be far reaching. FIEs will therefore need to be prepared for what could be increasingly turbulent operating conditions in China in the coming months and years.

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