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Research China

NPC vows more support to private sector and SOE reform

- **The lack of a growth target, fiscal stimulus and the upcoming Hong Kong National Security Law stole the headlines at the National People's Congress (NPC). However, as usual, the NPC provided a lot of interesting information that didn't make it into the headlines. Below, we give a bit of colour on some of the issues that didn't get so much attention.**
- **Further support to the private sector, a three-year plan to speed up reform of State Owned Enterprises (SOEs) and a 'significant shortening' of the negative list for foreign investment were key features in the Government Work Report.**
- **Chinese leaders also again emphasised a boost to investments in technology and a strong focus on domestic demand.**

The annual NPC ended in Beijing last week following a week of new laws passed and goals set for the coming year. The highlight of the NPC is the *Government Work Report* presented at the opening by the Premier, Li Keqiang, which looks back at what was implemented in the past year and outlines plans and goals for the coming year. The worsening relationship with the US did not take up much space in official documents but was nevertheless hinted at in one key statement in the Work Report: **'*At present and for some time to come, China will face challenges like never before*'**. On top of the tensions with the US, the statement likely referred to the challenges posed by the COVID-19 crisis.

The three things that grabbed the headlines

While I will focus on some of the less reported issues, first a comment on the main headline-grabbing points:

1. **No GDP growth target.** For the first time since the 1990s, China refrained from setting a growth target. It was not a big surprise, as it has been signalled for a while. According to Li Keqiang, the reason is that China will face factors that are difficult to predict and he mentioned the COVID-19 development uncertainty for the world economic and trade environment. China instead outlined a focus on security in six areas (employment, finance, foreign trade, foreign investment, domestic investment and expectations) to ensure stability on six fronts (jobs, living needs, operations of private sector, food and energy security, supply chains and primary-level governments). Employment is mentioned 34 times in the 24-page document, which clearly highlights the focus China puts on this. A target of 9m new jobs was put forward.

   Comment: Scrapping the growth target makes a lot of sense, as the uncertainty *is* unprecedented and a target would risk local governments pursuing wasteful investments to achieve a specific target.

2. **Stimulus.** The Work Report outlined plans for both monetary and fiscal policy. When it comes to monetary policy, China intends to cut reserve requirement ratios and interest rates, and enable M2 growth and aggregate financing to grow at 'notably higher rates' than last year. On fiscal policy, plans for further easing were outlined, bringing the total stimulus for 2020 to around 4½-5% of GDP.

Key points from NPC Work Report

1. Growth target skipped this year. Focus instead on employment (target of 9m jobs)
2. More stimulus coming
3. Hong Kong Security Law coming
4. Three-year action plan on SOE reform to be launched this year
5. More reforms to improve business environment
6. Further opening up, as negative list to be significantly reduced
7. Technology and innovation a strong focus
8. Domestic demand to be strengthened
9. Emphasis on green development

Source: NPC Government Work Report 2020

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Reductions in taxes, fees and other corporate costs are set to be implemented and investments in infrastructure lifted. This includes 'new infrastructure' in next-generation information networks, 5G applications and charging facilities for electric vehicles.

Comment: The stimulus was in line with what we assumed in our GDP forecast. It will likely be adjusted as needed to sustain a certain level of employment. We believe it is positive that we are not seeing the all-out big stimulus seen in 2008-09, which led much wasteful investments. It is clear, the stimulus will lead to more debt but this inevitable and is the case in all countries currently.

3. **Hong Kong National Security Law.** The new National Security Law has grabbed the most headlines, with the US now preparing sanctions on China. US Secretary of State Mike Pompeo said last Wednesday that it is clear Hong Kong is no longer autonomous and should therefore no longer have a special status, and Trump later revealed that Hong Kong's special status will be removed, although he did not take any concrete steps to do it. The special status gives Hong Kong lower tariffs than China and more access to American technology. The National Security Law is actually not written yet but a draft decision was made at the NPC, which paves the way for a new law to be written for Hong Kong, to prohibit 'separatism, subversion, terrorism, any behaviour that gravely threatens national security and foreign interference'. The law will bypass the Hong Kong legislature.

   Comment: The plans for the new law has added yet another area of strain between US and China and possibly also led to critique from the EU. It is also a clear signal from China that it will not bow to US pressure and sanctions and will do what it finds necessary to defend its interests. China has stated that most Western countries have similar laws and that it is simply closing a hole in the Chinese legislation, which has proven necessary due to the character of the violence in Hong Kong and signs of foreign interference, that threatens the sovereignty of China. The move risks adding to the violence in Hong Kong, though, and will probably add to the structural headwinds for Hong Kong's economy.

Goals set in the Work Report

- 9m urban jobs
- CPI increase of around 3.5%
- Growth in personal income basically in step with economic growth
- Elimination of poverty
- Effective prevention and control of major financial risks
- A further drop in energy consumption per unit of GDP
- No growth target set for 2020

Source: NPC Government Work Report 2020

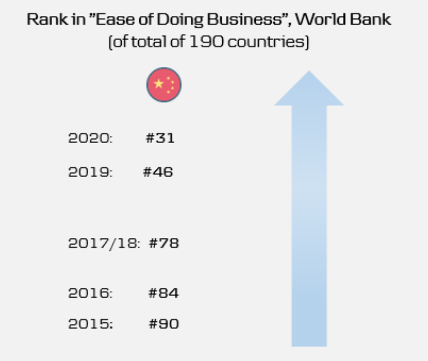
Further emphasis on private sector and entrepreneurship

It has become an increasingly general belief that China wants more state and less markets. However, I would challenge this notion. In my view, China wants a strong and more efficient state *alongside* the market playing a bigger role. It may sound like a contradiction but China's reform plans, as I read them, are more about putting greater competitive pressure on state owned enterprises (SOEs) while improving the business environment for all companies, including the private sector.

It is easier said than done, and especially when it comes to reform of SOEs, progress has been slow (more on this below). There are still strong vested interests both in the big SOEs and in the local regions where many of them operate.

However, when it comes to easing of regulations for the private sector, not least SMEs, reforms have been made over the past decade. The changes have resulted in **China moving to a rank of 31 in the World Bank's Ease of Doing Business index out of 190 countries, from number 90 five years ago**. In the latest report, the World Bank wrote *'China has undertaken substantial efforts to improve the domestic business climate for small and medium-size enterprises, maintaining an active pace of reforms.'*

Micro reforms lifted China's ranking in Ease of Doing Business index



Source: World Bank

The Government Work Report continues to stress the need for deepening supply-side reforms and opening up. It rarely reaches the headlines of news coverage but it is nevertheless important for the understanding of which economic model China is actually aiming for.

The report **highlights that China has more than 100m market entities and 10,000 new companies opening every day in China.** At the press conference, Premier Li Keqiang said this number should be watched closely because it is an important indicator of China's vitality. By far the most jobs are created in the private sector (around 90%) and, with employment being a corner stone in providing better lives and securing stability, it would make sense that China wants a vibrant private sector. Of course, the distinction between state and private can be fluid in China, but it is likely that most Chinese jobs are created by Chinese entrepreneurs rather than big SOEs. Much of the stimulus over the past year has been aimed at private small and medium enterprises (SMEs) and just this week another relending programme was announced by the PBoC, in which the central bank funds commercial bank loans to SMEs at zero interest. This is in line with the goal stated in the Work Report that highlighted the importance of better financing access for the SMEs.

The term 'market entities', entrepreneurs or private sector is mentioned 30 times in the 24-page document and I've listed some of them in the box below. The emphasis on market entities has been there for some years but it tends to fly under the radar and drown in other news on China.

Quotes from the Government Work Report on 'market entities', private sector and entrepreneurs (bolding is my own).

1. Section IV in the report has the headline **'*Energizing market entities through reform and strengthening new drivers of growth*'.** The sections starts by saying '*the greater the difficulties and challenges we face, the more important it is for us to go further in reform, get rid of institutional barriers, and boost internal forces driving development*'.
2. '*We will **foster an enabling environment for the development of the private sector**. We will see that private businesses have equal access to production factors and policy support.*'
3. When addressing fiscal stimulus the report says, '*we will scrutinize all expenditure items and see that every cent is used where it is needed most* **and *where market entities and the people will feel the greatest benefit from it.*'**
4. On the implementation of macro policies it says, '*To ensure employment and people's wellbeing, **we must instil confidence in over one hundred million market entities;** and we must do our utmost to help enterprises, particularly micro, small and medium businesses, and self-employed people get through this challenging time.*'
5. On the same topic: '*We will aggressively implement current policies… to **create a more enabling environment and help market entities** overcome difficulties* and achieve development.'
6. On monetary policy, it says, '***To support market entities**, we must ensure that micro, small, and medium businesses have significantly better access to loans and that overall financing costs drop markedly.*'
7. On micro reform, it states: '***Entrepreneurs of all kinds will find it easier to register** and start a business and access timely policy support.*'
8. On the issue of security in six areas, '*operations of market entities'* is mentioned as one of the six.
9. On allocation of factors: ***'We will advance reforms to promote market-based allocation of production factors.'***

Source: NPC Government Work Report 2020

Three-year action plan for SOE reform to be launched

One of the areas of slowest reform in recent years has been within SOE reform. Profitability is still much lower in most SOEs compared with their private counterparts and reform attempts, such as more public-private partnerships, have so far not been successful in dealing with this. In the Work Report, Premier Li Keqiang stated the following points on SOE reform:

- **A three-year action plan will be launched** this year for SOE reform
- **Mixed ownership will be intensified**
- The task of **relieving SOEs of social programme obligations** will be completed

The report emphasises that SOEs should focus on their core business and establish sound market-operating mechanisms. Finally, it is underlined that '*we will see that private businesses have equal access to production factors and policy support*' and that regulations that unfairly differentiate enterprises according to ownership will be abolished.

This is of course all nice words and ambitions and worth nothing if not implemented. Many reform attempts have been made in the area of SOEs with limited success, partly because those who are supposed to implement this often have vested interests and will lose out if the reform is passed. SOEs are also powerful and well connected with local governments and state banks, which raises the entry barrier for private players and often creates an uneven playing field. However, we sense an impatience in the central leadership in Beijing on this and the emphasis on profitability in KPIs among SOE CEOs has played a bigger role in recent years. Time will tell if China is able to cut through the vested interests and secure a more level playing field between private and state actors.

One area that is unlikely to be part of SOE reform is outright privatisation within strategic industries. These are typically related to mining, oil and gas, coal and cement, infrastructure, telecom, banking, aviation, car industry etc. What China aims for, though, is more room for private players in these sectors and more competitive pressure on the SOEs. China still wants a strong state sector but not an inefficient one. And since reforms started, 'the market' has been the key driver in pushing development in China. Judging from the Work Report, Chinese leaders still believe this to be the case and key for future development and competitiveness. At least Li Keqiang at the press conference talked a lot about creating an enabling business environment that can foster continued vitality and better competitiveness.

Opening up to continue according to NPC

As expected, the Work Report also continued to emphasise further opening up. The trade war with the US and complaints from the EU have exerted pressure on China to accelerate the opening up. Many both foreign and Chinese economists highlight that it is very much in China's interest to do so because China needs to increase the competitive pressure.

The government seems to share this view, as the so-called negative list for foreign investments has been shortened over the past years, partly due to significant pressure from the US, which has led to new opportunities in China within finance and the auto sector. Tesla's factory in Shanghai built in only a year is testimony to this.

The Work Report stated that '*the negative list for foreign investment will be significantly shortened*, *while a negative list will also be drawn up for cross-border trade in services*'. It also says that China will '*foster an enabling market environment in which all companies, Chinese and foreign, are treated as equals and engaged in fair competition*.'

With **rising pressure for global companies to diversify supply chains** and move at least some production out of China, the pressure to make it more attractive for foreign businesses has increased.

Again, the main obstacle to this lies in the vested interests and the fact that connections matter a lot when doing business in China. Many local companies are better connected with local authorities and other local companies and can get advantages this way. Hence, despite the apparent good intentions of the central leadership, the implementation is difficult. Even if the leadership knows it is in the interest of China, certain things are difficult to change.

Technology at the core of China's development strategy

Innovation and technology are cornerstones in what China labels a 'high-quality development' strategy, and it has been so for many years. With the US-China tech war accelerating lately, the drive for technological development has only become more urgent. China has come far in certain areas such as 5G and quantum computing but overall is still lagging when it comes to certain core technologies, not least semiconductors where China is still dependent on US technology. This dependency is now threatening one of its biggest tech companies, Huawei, following the tightening of a US export ban, that cuts off Huawei from any product that has American content or design. China's President Xi Jinping has increasingly talked about self-reliance after the US moved to a very confrontational stance towards China and further restricted access to US technology. A consequence of this is that **China is likely to work towards technology independence from the US.** It will take time, not least within semi-conductors, which is a very complex technology. But a lot of money and more measures to attract the necessary talent will no doubt be thrown at this in the years ahead.

In the Work Report, China states that '*we will boost our capacity to support technological innovation*' and lists a number of ways this will be done (support for basic research, increased R&D, intensified cooperation, encouraging business start-ups, supporting growth of venture capital, increasing guaranteed loans for start-ups, accelerating development of national laboratories and increasing protection of property rights). China does not put numbers on the support but it is already significant and we believe is not likely to get smaller in the future.

The expression Made in China 2025 is not used any more as it is a red flag to the West, but the expression of growth in 'strategic emerging industries' covers pretty much the same industries as those referred to in the Made in China 2025 strategy. Actually, the latter was just a new label for a strategy China had followed all along, namely **focusing on supporting and upgrading traditional industries and investing in what are called 'Strategic Emerging Industries'**. The Made in China 2025 strategy put very clear goals on this, though, in terms of China's high tech ambitions globally, which made the alarm bells ring in the US and Europe. The strategic emerging industries include what is called 'next-generation information technology', big data services, AI, high-end equipment manufacturing, new materials, new-energy vehicles, bio-tech and digital innovation, see a full list *here*. Within semiconductors, China has *set up funds* that could reach a total of USD70bn, with the aim of building an independent, self-sufficient, and controllable industrial chain for the Chinese IC industry.

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