

China in 2008

Current political, economic and social environment

Presented to CBBC

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Introduction to APCO

China Overview

Politics and Government

Changing Operating Environment

Olympic Issues

About APCO

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Introduction to APCO

2008 China Overview

Politics and Government

Changing Operating Environment

Olympic Issues

“Peaceful Rise”



Political Generations



- 1st Generation - Mao Zedong (1949-1976)
 - Close Soviet ties 1949-1960, emphasis on state planning and industrial development
 - Personality cult - Mao as the centre of power



- 2nd Generation - Deng Xiaoping (1978-1994)
 - Economic opening, “to get rich is glorious” – pragmatism prevails over ideology
 - Deng as supreme leader, but without Maoist style personality cult



- 3rd Generation - Jiang Zemin (1994-2003)
 - Technocracy and economic reform emphasized over ideology
 - “Three Represents”, an ideological justification for a market economy
 - Economic growth and increased prosperity sustain legitimacy of the Party



- 4th Generation - Hu Jintao (2003-present)
 - Broad trend of economic reform and global integration sustained, but awareness that the model is not sustainable
 - Striving for a “harmonious society” (sustainable development, narrowing income divide, tighter political control) to ensure even development and maintain Party rule

Economic Transition

1949 – 1978 – Central Planning

- Centrally planned economy – dominated by SOEs & collectives
- Administrative orders, quotas and procurement are main characteristics of China's economy



1978 – Early 1990s – Reform and Opening of the Economy

- Deng Xiaoping prioritized growth, modernization and reform
- Many price controls and quotas removed, greater foreign investment permitted
- The coastal areas benefited most from the reform process

Mid 1990s – 2000 – Continued Reform

- The “socialist market economy” principle promoted
- Foreign investment and technology transfer encouraged

2001 – Present – Equitable Development

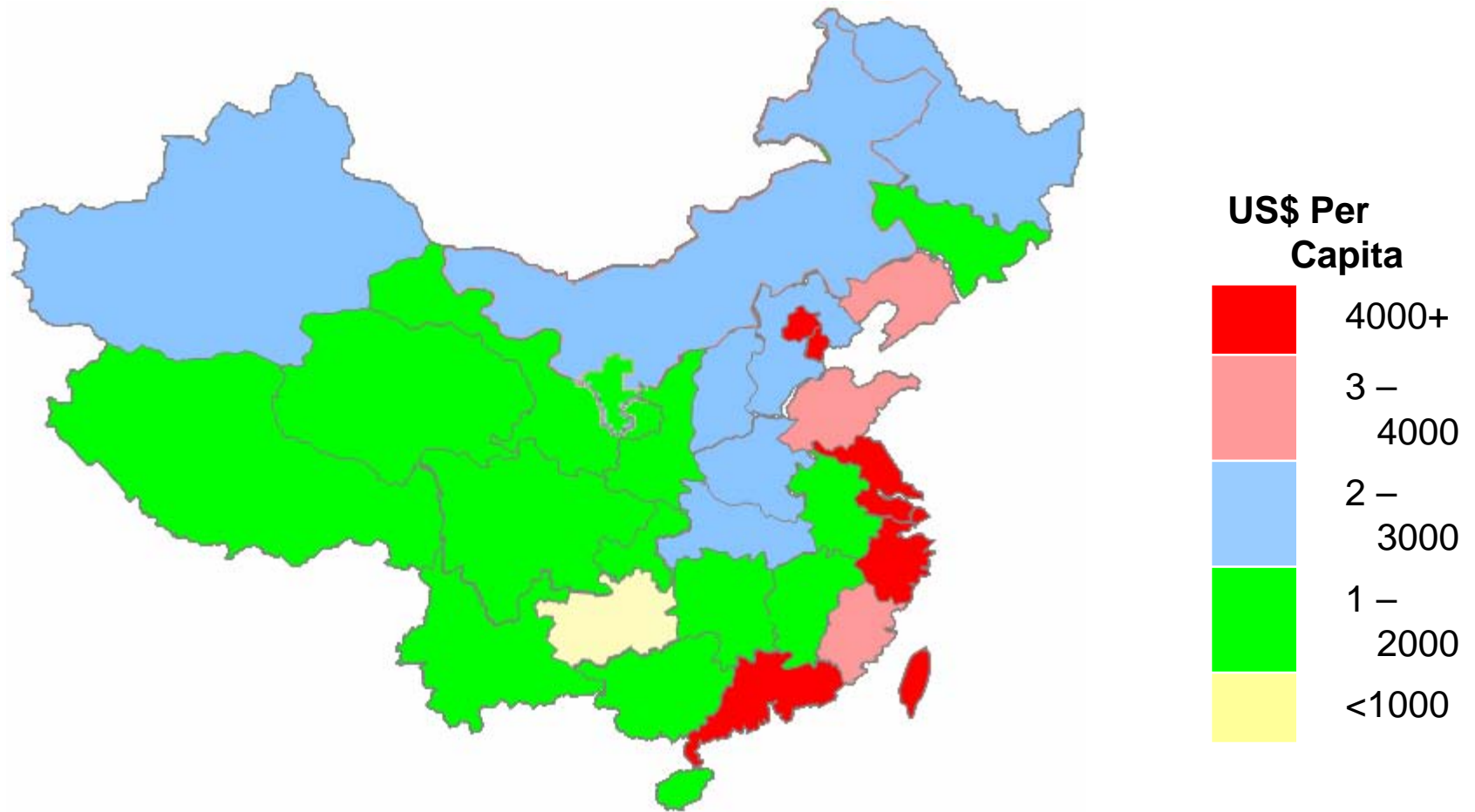
- WTO accession & globalization
- Economic overheating, resource inefficiency & environmental degradation
- Focus no longer on growth at any cost, but on sustainable development



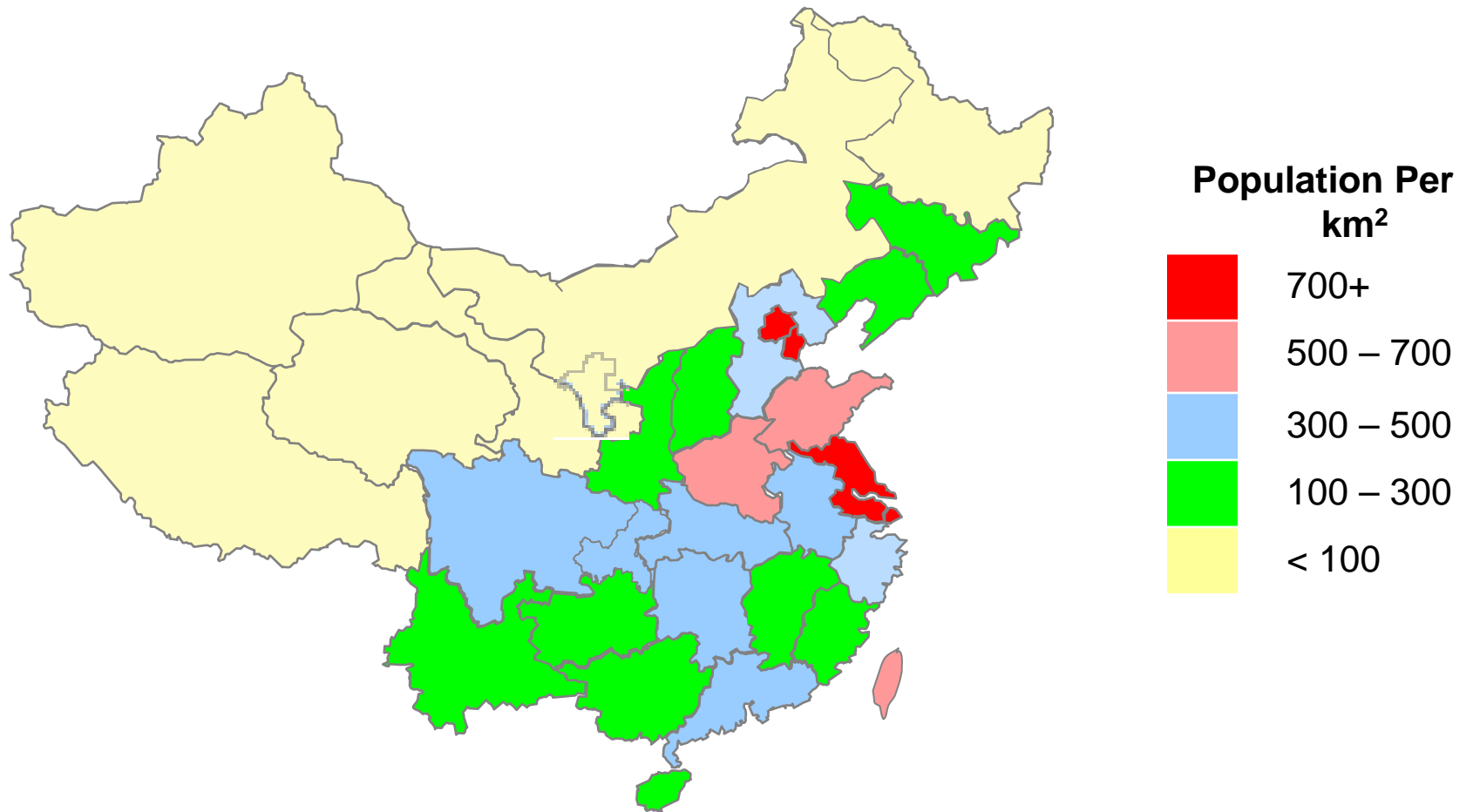
Economic Performance

Major Economic Indicators (Y2006-2007)		
	2006	2007
Utilized Foreign Direct Investment	\$ 65.8 billion <i>Y-o-y increase of 4.5%</i>	\$ 74.8 billion <i>Y-o-y increase of 13.5%</i>
GDP	\$2.7 trillion <i>Y-o-y increase of 10.7%</i>	\$3 trillion <i>Y-o-y increase of 11.4%</i>
Trade Balance	\$177 billion	\$262 billion
Fixed Assets Investment	\$1.41 trillion <i>Y-o-y increase of 24.5%</i>	\$1.8 trillion <i>Y-o-y increase of 24.8%</i>
Foreign Exchange Reserves	\$1 trillion	\$1.5 trillion
Consumer Price Index	<i>Y-o-y increase of 1.5%</i>	<i>Y-o-y increase of 4.8%</i>
Added Value (Agriculture)	\$317.787 billion <i>Y-o-y increase of 12.4%</i>	\$330.8 billion <i>Y-o-y increase of 4.1%</i>
Added Value (Industrial)	\$ 1.312 trillion <i>Y-o-y increase of 22.6%</i>	\$ 1.555 trillion <i>Y-o-y increase of 18.5%</i>
Added Value (Services)	\$1.064 trillion <i>Y-o-y increase of 8.0%</i>	\$1.2 trillion <i>Y-o-y increase of 11.3%</i>

GDP Per Capita 2007

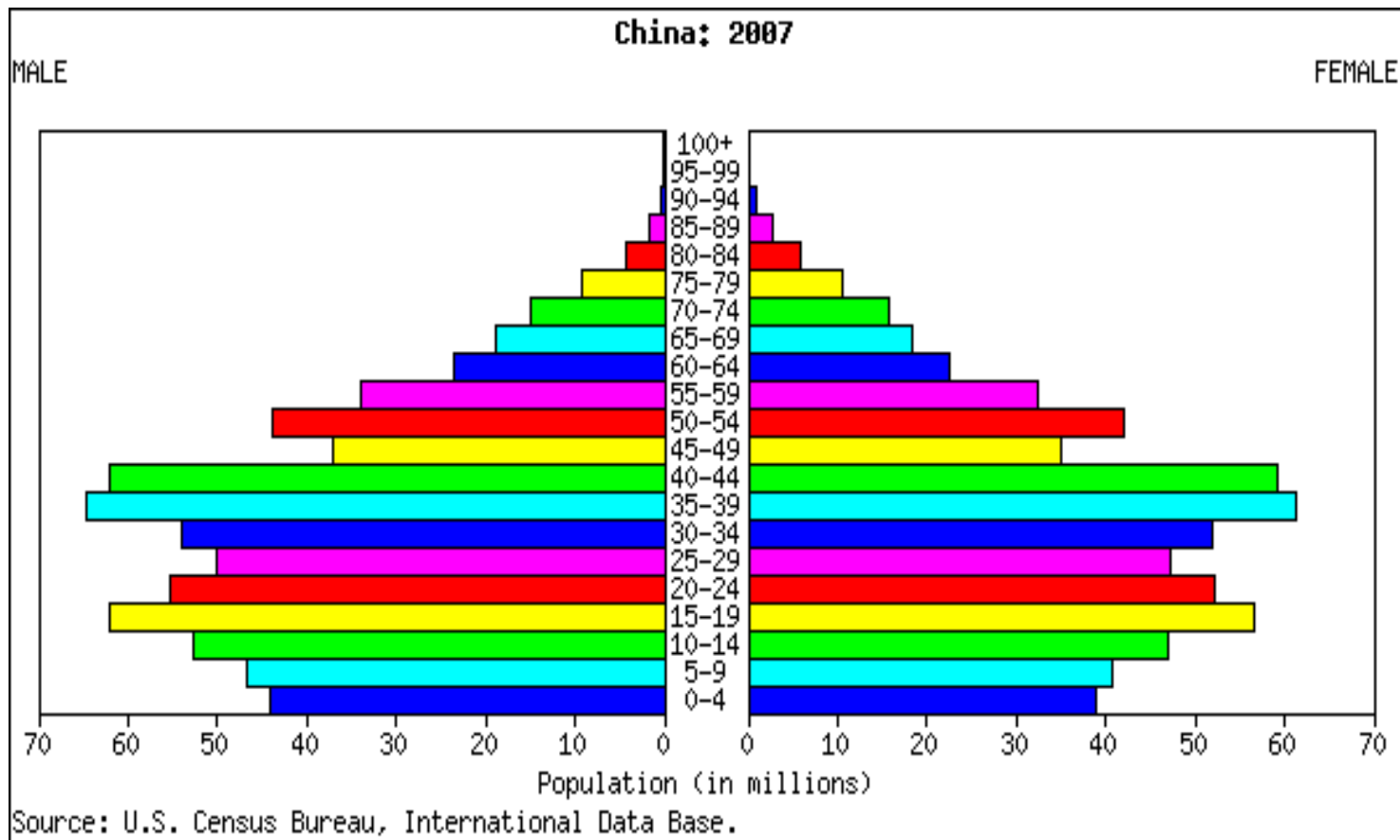


Population Density 2007

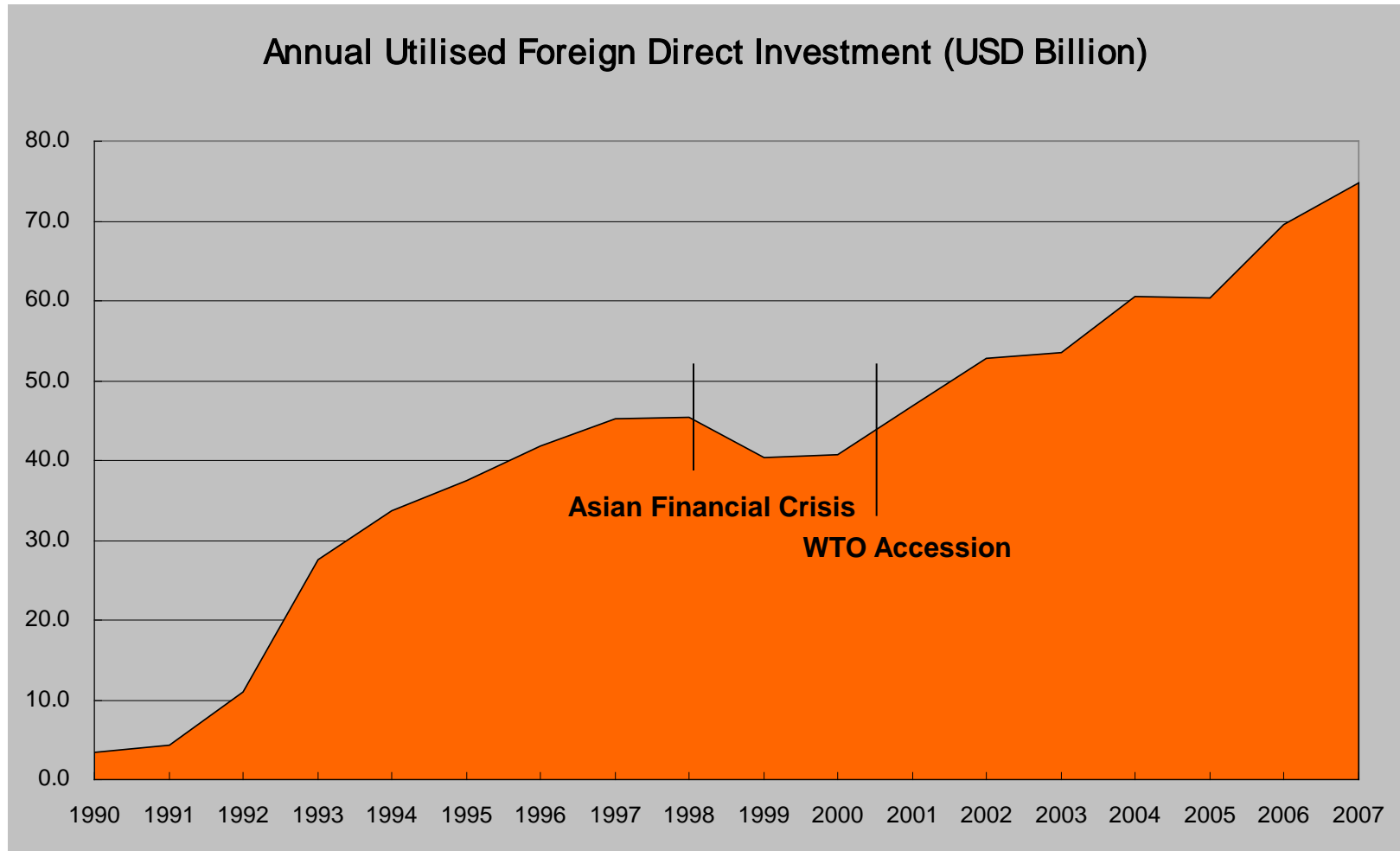


China Demographics 2007

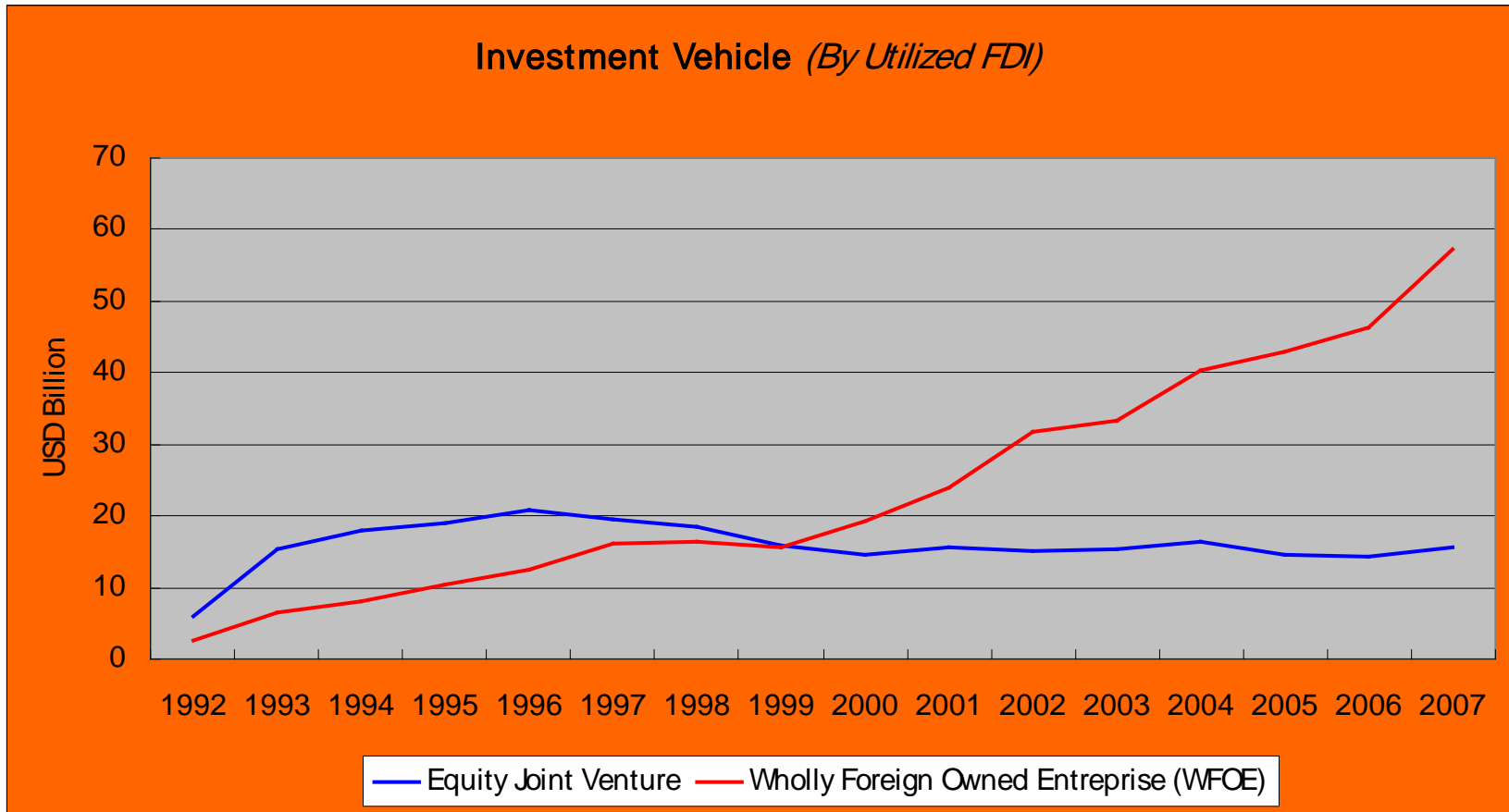
Fragmentation – Demographics & Experience



Foreign Direct Investment



Foreign Investment Vehicles



Source: MOFCOM and Invest in China

Foreign Direct Investment Catalogue

- **FDI Catalogue**

- Guidelines to provide clear understanding to MNCs of barriers to entry and restrictions for growth
- 2007 revisions based on changing industry and economic policy objectives.

- **Three Investment Classifications**

- Encouraged
- Permitted (default)
- Restricted
- Prohibited

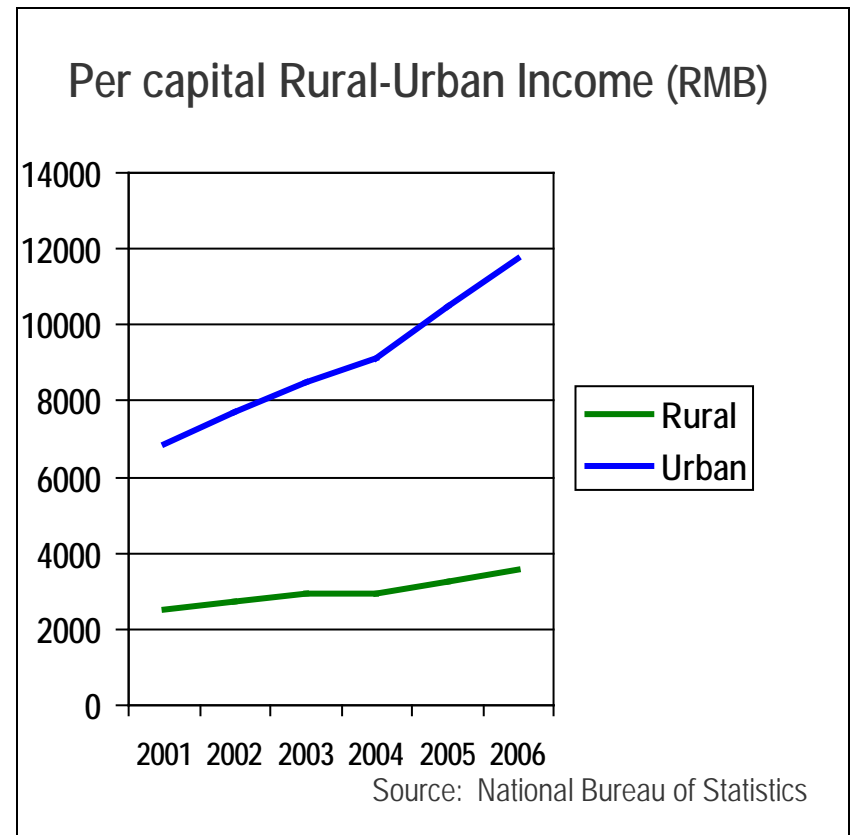
Classification	2004	2007
Encouraged/ Permitted	257	351
Restricted	78	87
Prohibited	35	40

- **Policies Driving Revisions**

- Balanced/Equitable growth
- Sustainable development
- Transition from investment and export-led growth, to consumption-led growth
- Increase tertiary industry growth
- Focus on encouraging “modern logistics” to reduce transportation bottlenecks
- “Indigenous Innovation”
- “Economic Security”
- Development of national champions

Current Challenges

- **Unbalanced growth:** rapid, but unbalanced growth leading to discontent with the status quo
 - This is played out in a growing coastal-interior, urban-rural and skilled-unskilled divide



Current Challenges

- **Social stability:** number of protests and demonstrations in China grew from 58,000 in 2003 to around 100,000 in 2006
- **Maintaining media control:** modest liberalization of media sector over last few years as a result of commercialization has been rolled back to ensure greater control over information
 - As technology (and expectations) advance, it is not clear how the Party can continue with this policy indefinitely
 - Political obstacles remain to criticize government and policies; however the media has become more assertive and willing to attack companies
- **Changing the growth model:** shift to domestic demand, improve capital allocation and adjust to environmental constraints – all while meeting the employment challenge
 - Transition from low-cost, mass production to innovative, high-value economy
 - Transition from investment/export driven growth, to consumption-led model
 - Emphasis on quality, not quantity of growth
 - Reducing the current account surplus
 - Further develop the tertiary sector



Current Challenges

- **Finance sector stability:** banks have improved in terms of risk management, and reducing non-performing loans; however, problems remain
- **Inflation and monetary reform:** increasing liquidity in market sparking inflationary fears and potential asset bubbles; however monetary policy hampered by weaknesses in the banking sector, as well as still rigid currency and interest rate controls
- **Labor market competitiveness:** abundant cheap labor one of China's key competitive advantages in past; however, rising wage costs and limited pool of skilled workers could undermine future competitiveness
 - Job creation government's key focus, and recent policies are geared towards maintaining employment growth and protecting employee welfare
 - However, labor market competitiveness stems ultimately from reforming China's education system, as well as increasing labor market mobility

Current Challenges

- **Corruption:** eroding government and Party credibility and affecting implementation of all central policies
 - New willingness to fight corruption and build a clean government (Corruption Prevention Bureau and Anti-graft campaign across China)
- **Environmental degradation and energy sustainability:** economic growth and rapid urbanization have strained natural resources (water, energy, labor) and led to environmental degradation
 - Sustainability objectives often seen as in conflict with growth objectives at the local level
- **Cross-straits relations:** March 2008 election of KMT presents significant opportunity for renewed dialogue on Cross-straits relations
- **Product quality and safety:** product safety issues negatively impacting foreign trade relations with major trading partners



Key Government Responses

- **“Harmonious Society”**: mitigating risk of social instability by reducing income divides between the urban and rural areas, and developing the social welfare system
- **“Scientific Concept of Development”**: promoting environmental protection, addressing resource bottlenecks and improving resource efficiency
- **“Indigenous Innovation”**: increasing R&D investments: by 2010, the government plans that the total amount of R&D investment will be 2% of GDP (approximately US\$80 billion). Currently R&D investment is 1.4% of GDP
- **Brand China**: public relation initiative to soften international reputation damage on issues from product safety to Tibet



Introduction to APCO

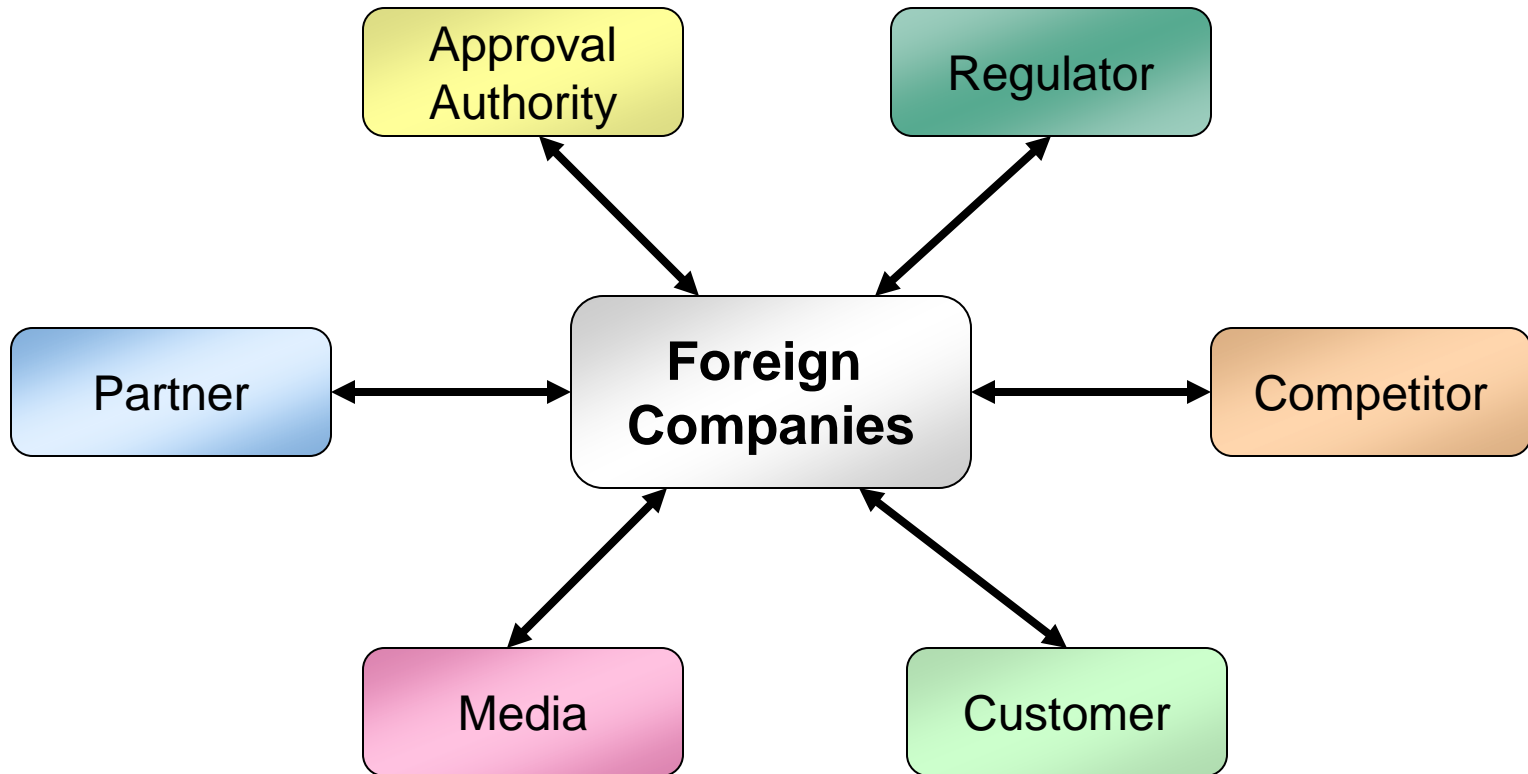
China Overview

Politics and Government

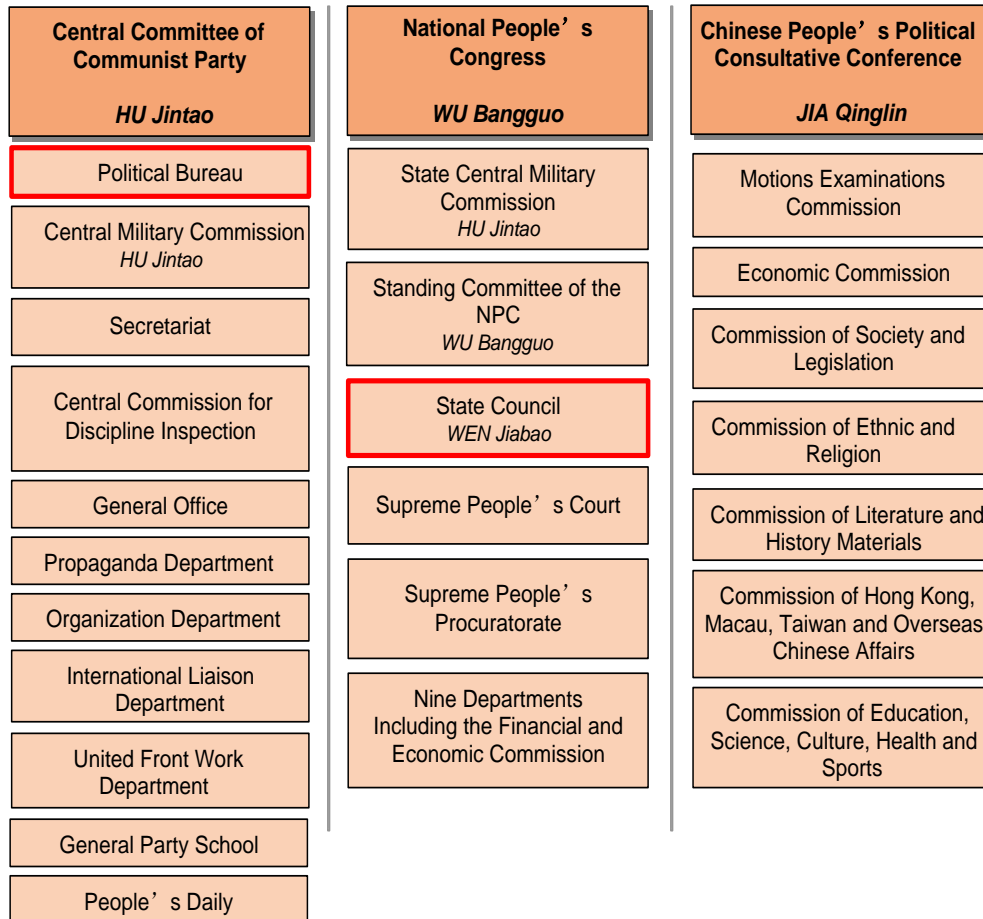
Changing Operating Environment

Olympic Issues

The Role of Government



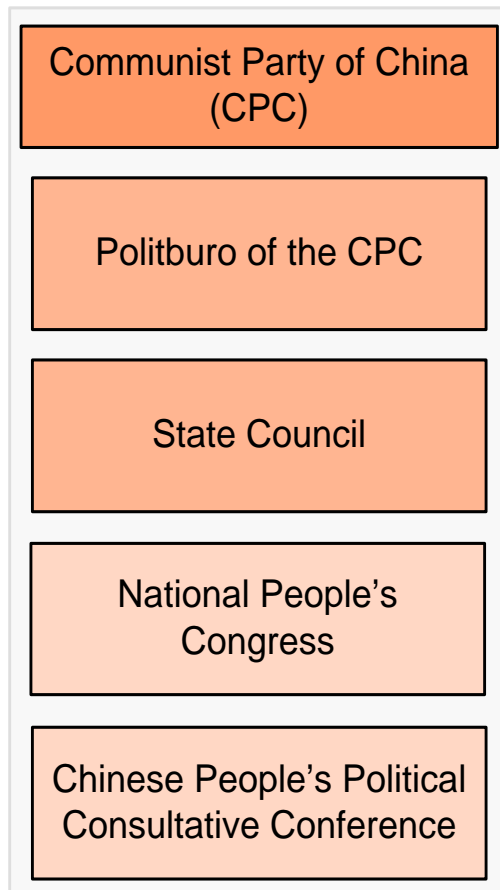
Government Structure



- In theory, China has most of the elements of a multi-party parliamentary democracy:
 - Parliament / legislature – the National People’s Congress (NPC)
 - Executive – the State Council
 - Upper House – the Chinese People’s Consultative Conference (CPPCC)
 - Political parties – The Communist Party of China (CPC) and others

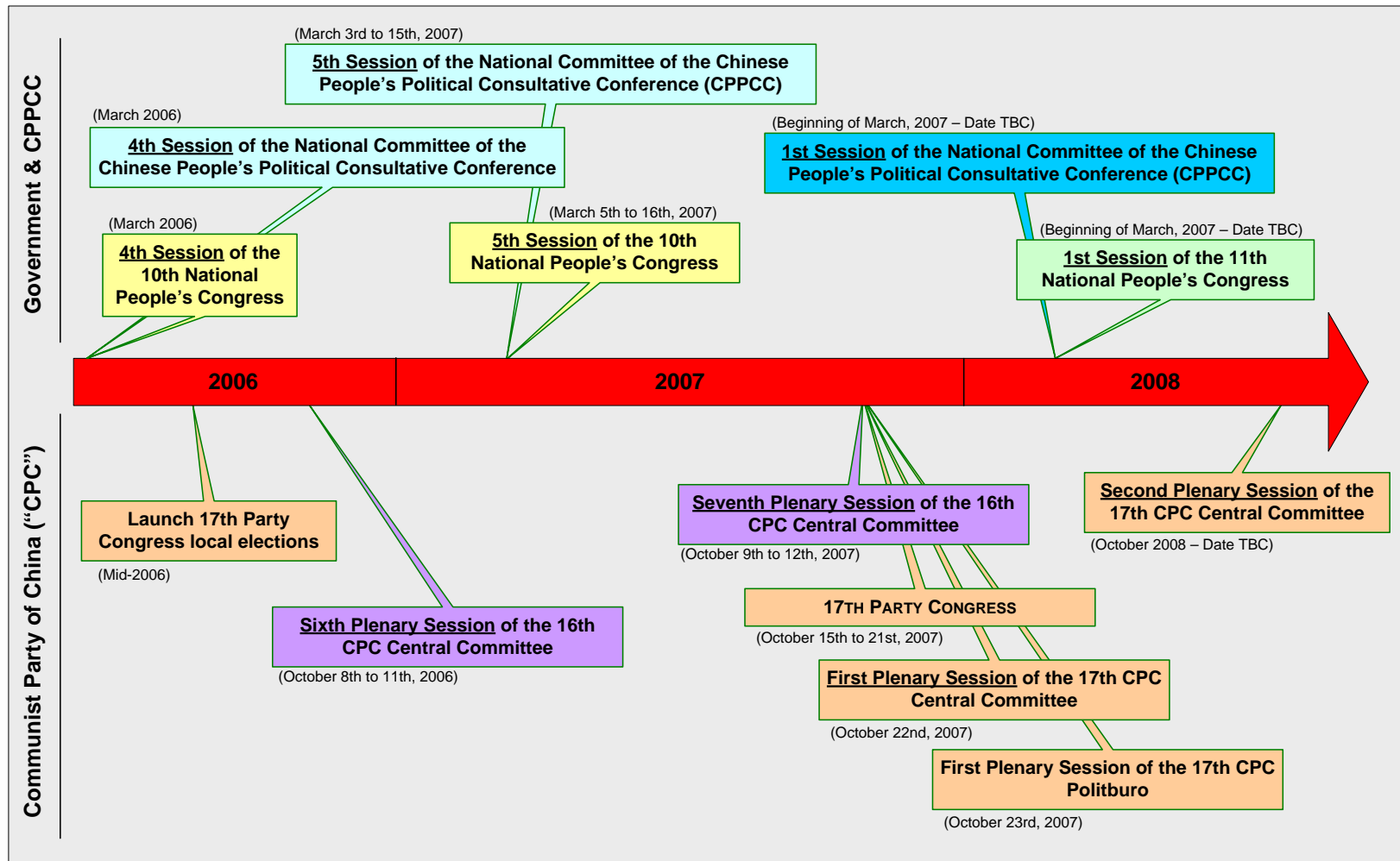
- In reality, political power resides within the Communist Party – it wraps around and above the government:
 - Central Committee of the Communist Party of China (CCCCP), and the 9 man Standing Committee of its Political Bureau, is the ultimate authority
 - State Council follows the CPC’s guidance to develop and implement policy
 - NPC is the ‘rubber stamp’ to render policy into law
 - CPPCC consists of influential individuals but has no executive or legislative authority

Government Structure

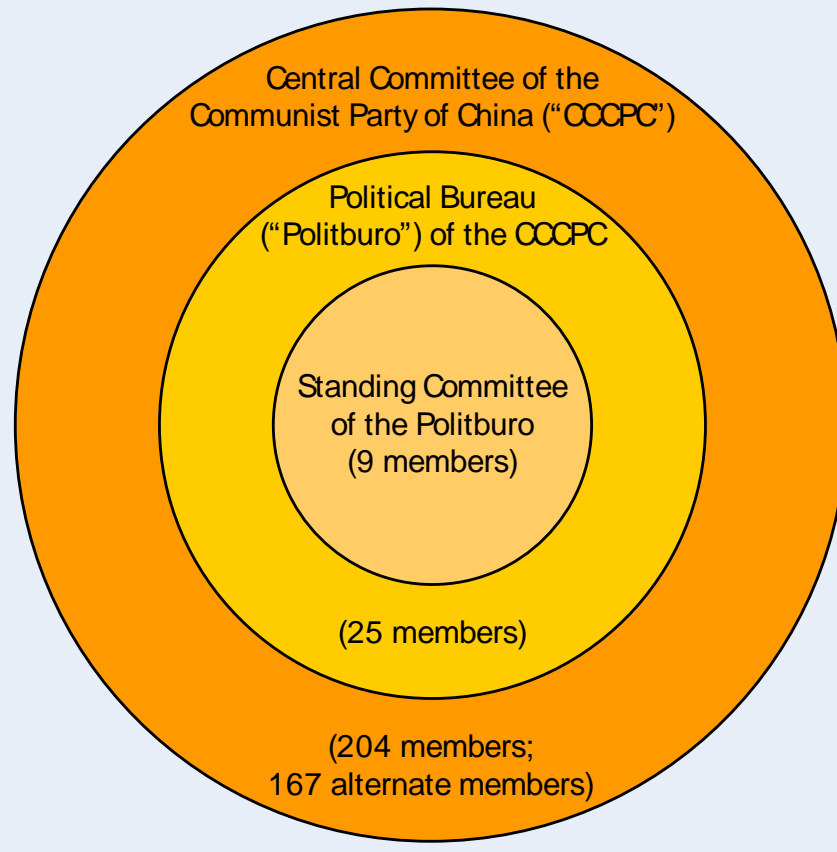


- Parallel hierarchies in which Party post is senior to the state post. Party leads on major policy decisions, personnel, and political work.
- Sets policy and controls all administrative, legal and executive appointments. Nine-member politburo standing committee is focus of power.
- State Council (China's executive branch) wields influence in policy development and implementation. It is the public face of government.
- Formally an annual legislative session of 2,985 delegates in 31 provincial delegations, in practice the NPC is a rubber stamp legislature that the leadership uses as a mechanism to communicate priorities and mobilize.
- Consists of both Party members and non-Party members. Has an advisory role, but little direct authority.

China's Political Calendar



Structure and Leadership of the Central Committee of the Communist Party of China



**Central Committee
of
Communist Party
(CCCPC)**

■ **Highlights**

- Continuation of “harmonious society” and “scientific concept of development” principles in the Party constitution
- Sustainable growth, greater “democracy”
- First mention of “religion”
- Hu vows to “reverse growing income disparity”
- Hu promises to promote more non-Communists to leading positions
- Hu advocates “conservation culture” for first time in keynote political document
- Innovation tops economic agenda
- Set goal of quadrupling per capita GDP under environment and resource restrictions
- Appeal for “peace agreement” with Taiwan
- Continuation of anti-corruption drive within the Party
- Modernization of army for self-defense and world peace

China's Political Structure

Politburo: Standing Committee

Politburo Standing Committee of the CPC Central Committee



Notes

- ◇ Listed in order of seniority (left to right top row; left to right bottom row)
- ◇ Yellow shading indicates newly appointed to the Standing Committee during the 17th Party Congress

- **Politburo Standing Committee:**

- **Xi Jinping (54)**

- » Recently approved as State Vice President, and slated to take Hu Jintao's position in 2013
 - » Party Secretary in Zhejiang in 2002-07, and recently stepped down as Party Secretary in Shanghai
 - » Regarded as having a relatively liberal attitude towards economic and political reform
 - » Low-key, consensus-building style that has made him acceptable to most other major factions
 - » Maintains some ties to the Shanghai faction, however, is identified as a "princeling"
 - » Educational background in chemical engineering, Tsinghua University

- **Li Keqiang (52)**

- » Recently approved as Executive Vice Premier of the State Council, and slated to take Wen Jiabao's position in 2013
 - » Former Party Secretary of Liaoning Province
 - » Reputation as a competent administrator
 - » Previous leadership roles in the Communist Youth League (1993-1998)
 - » A close political ally of Hu in the Tuanpai faction, and will be a front-runner for premiership
 - » Regarded as fairly conservative, very much in the same mould as President Hu
 - » Holds a BA in law and a PhD in economics from Peking University

17th Party Congress

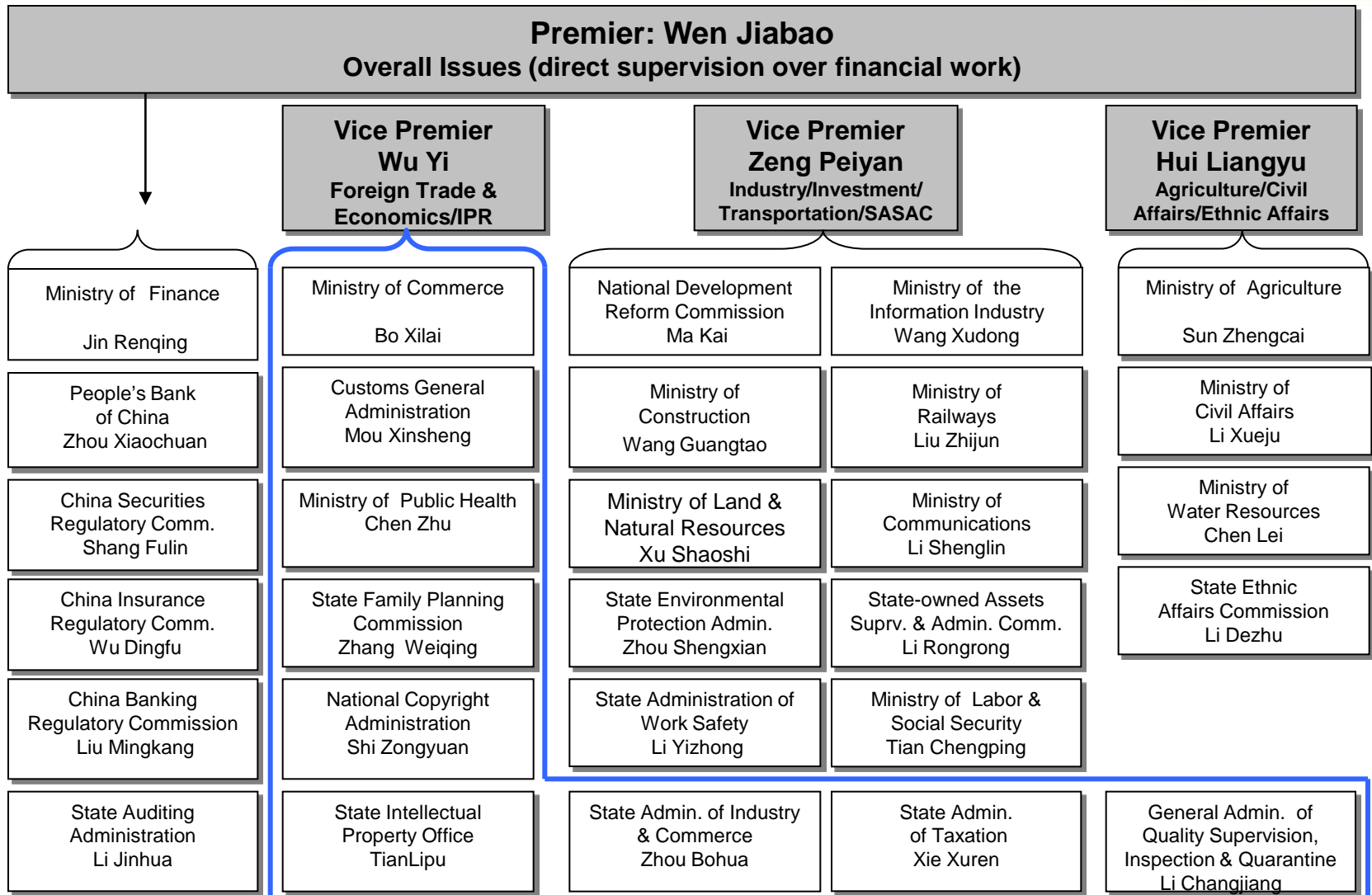
Leadership Changes

- Other notable Politburo changes:

Name	Previous Position	New Position
<i>Departing</i>		
Wu Yi (68)	Vice Premier	Trade & Investment, Health portfolio
Zeng Peiyan (68)	Vice Premier	Industrial development, macro planning portfolio
<i>New Members</i>		
Wang Qishan (59)	Beijing Mayor	Vice Premier; rumored to take Wu Yi's portfolio
Bo Xilai (58)	Minister of Commerce	Party Secretary of Chongqing
Wang Yang (59)	Party Secretary, Chongqing	Party Secretary of Guangdong; tuanpai faction; strong backing of Deng and Zhu Rongji
<i>Current Members</i>		
Zhang Dejiang (61)	Party Secretary, GD	Vice Premier, rumored to take Zeng Peiyan's portfolio
Yu Zhengsheng (62)	Party Secretary, SH	Recently promoted as PS of Shanghai; former PS of Hubei and Minister of Construction; closely tied to Deng family

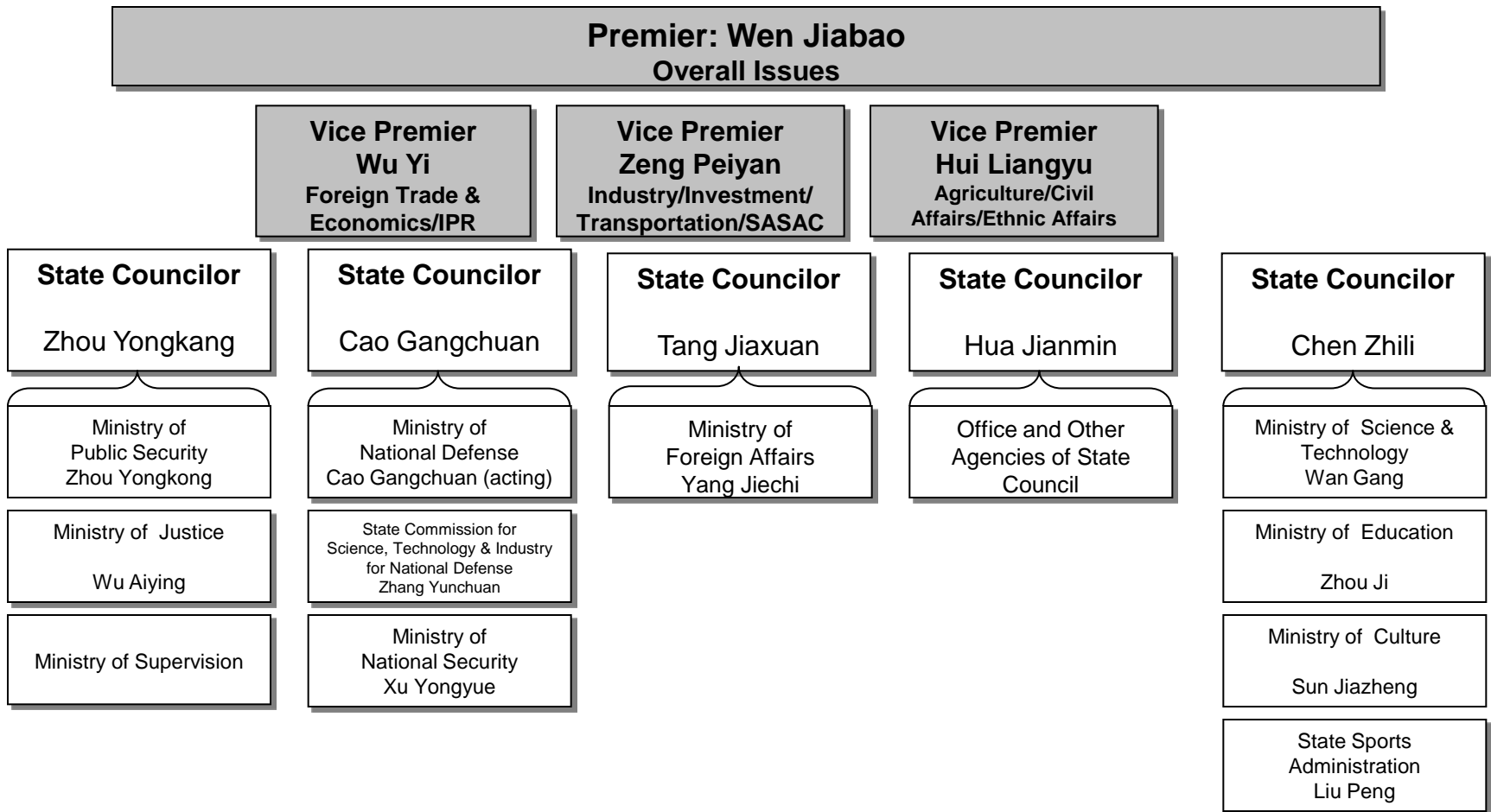
Political and Government Structure (pre-NPC)

State Council – Responsibilities



Political and Government Structure (pre-NPC)

State Council – Responsibilities

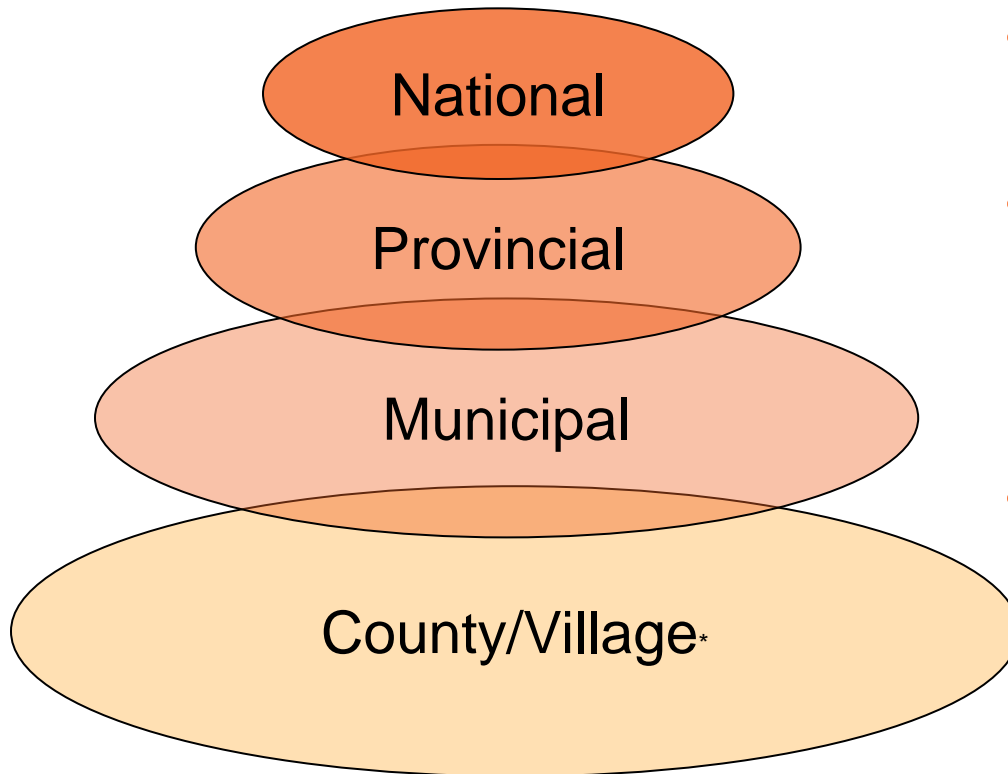


- **NPC Functions**

- Formulation of laws
- Election of state leaders
- Approval of national economic and social development plans and government budgets
- Forum for leaders that serves as the official annual meeting of the Chinese government
- Nominally China's highest organ of state power
- Convenes each March in Beijing for two-week session that draws together nearly 3000 delegates



National
People's Congress
(NPC)



* Only level with direct elections by voters

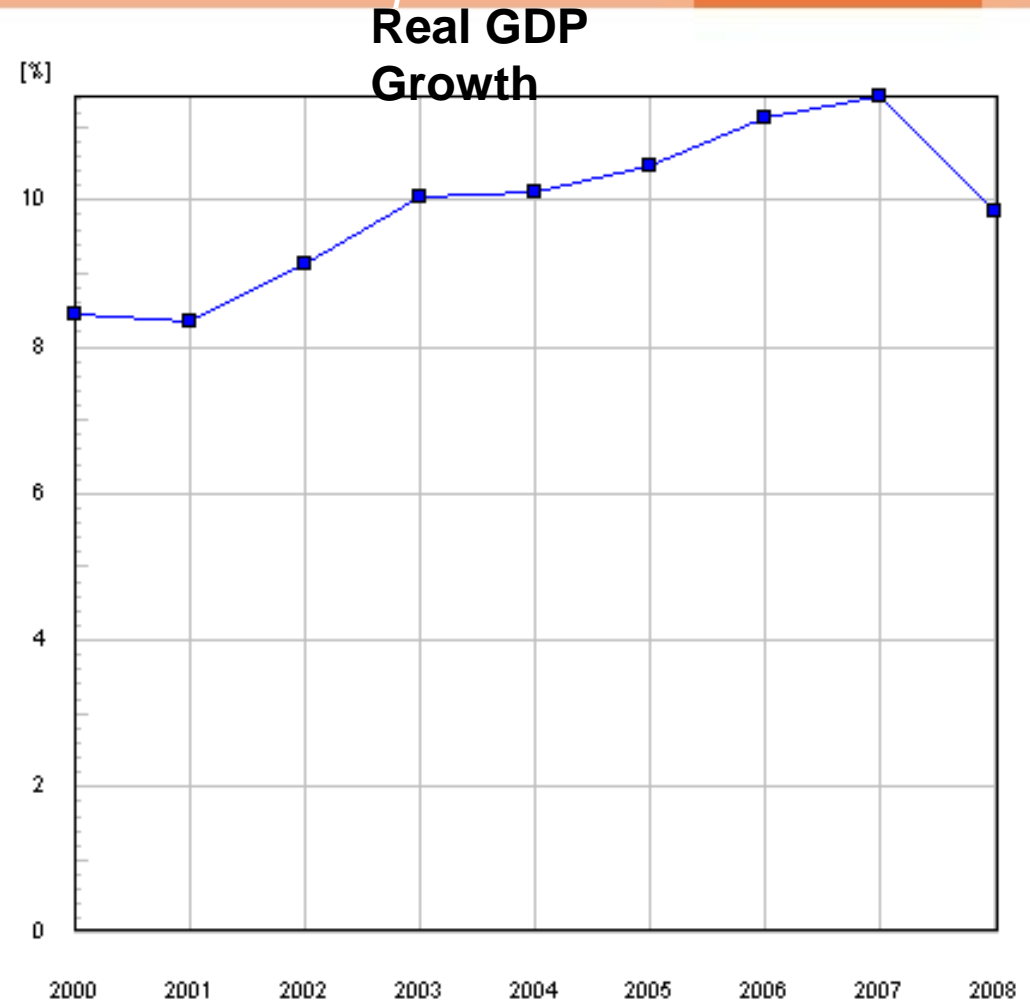
- Just a “rubber stamp” for the CPC?
- While claiming to be the highest state body in the PRC, membership is largely determined by the CPC
- CPC control wielded through:
 - Limiting number of candidates to the number of seats available
 - CPC control over composition of 150 member NPC Standing Committee
 - Some non-CPC members (e.g. technical experts), but do not function as political opposition

- **2008 National Economic & Social Development Plan:**
 - GDP growth of around 8%
 - CPI target of 4.8%
 - Slowdown in export growth; focus on consumption-led growth
 - Expansion in outward investment
 - Ensuring food safety and supply (update of over 7700 standards)
 - Pushing forward energy and environmental targets
 - Further banking sector reform, with focus on CDB and ABC
 - Ensuring a successful Olympics
 - Higher scrutiny/bans of foreign investments
 - In energy intensive/highly polluting projects
 - Resource exploitation
 - Reining in “illegal” foreign investment practices (e.g. round-tripping)

11th Session of the National People's Congress

Key Outcomes – 2008 Economic & Social Development Plan

- GDP of 8% is same target set in recent years, however, consistent overshooting.
- Global economic downturn alongside inflationary environment will result in slower growth, but still above 8%.
- As government adopts monetary measures, liquidity in the market, investment and exports will experience gradual decline.
- Already signs of slower growth in Feb:
 - Merchandise trade surplus narrowed to US\$8.6 bil.
 - Export revenue slipped 6.5% yoy.
 - Slowdown in industrial production

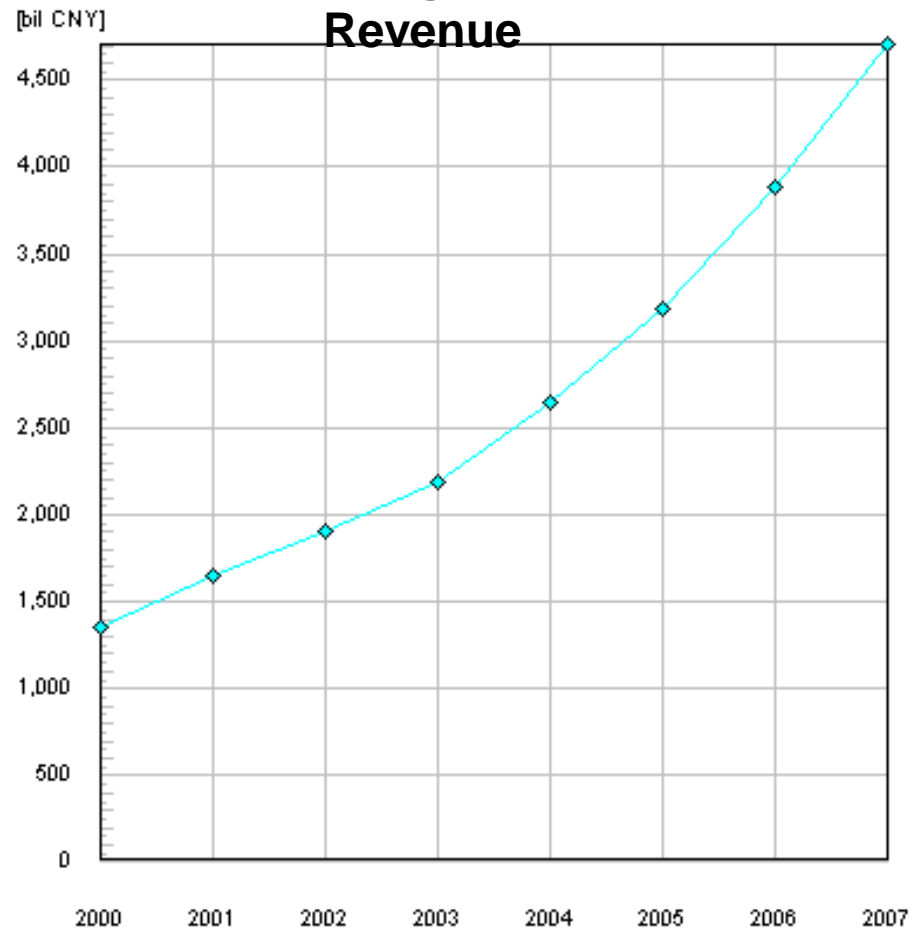


11th Session of the National People's Congress

Key Outcomes – 2008 Economic & Social Development Plan

- China's strong fiscal position can help counter external demand and internal supply shocks.
- 2008 central government expenditure targets:
 - Raise overall expenditure by 15.4%.
 - RMB 562 bil. to be spent on rural development (31% yoy increase).
 - RMB 113 bil. earmarked for S&T (26% yoy increase).
 - RMB 156 bil. earmarked for education (45% yoy increase).
 - RMB 83 bil. earmarked for healthcare (25.2% yoy increase).
 - RMB 276 bil. earmarked for social security & employment assistance (24% yoy increase).

Budget Revenue



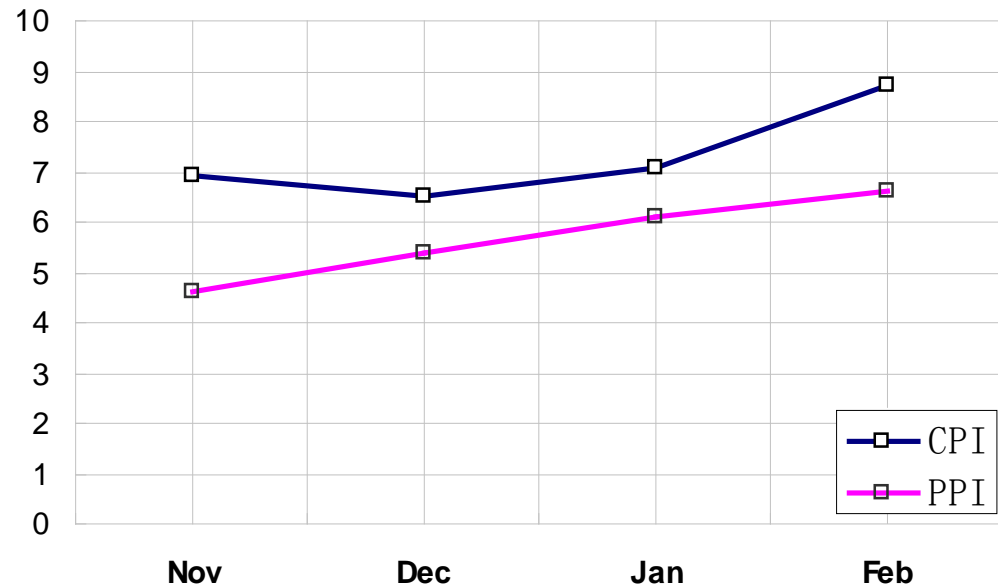
Source: EIU

11th Session of the National People's Congress

Key Outcomes – The Challenge of Inflation

- Monetary policy complicated by downturn in US economy (interest rate differentials).
- Emergence of political factions over policy.
- PBOC, banking sector and borrowers: blame CA surplus and increasing commodity prices; promote faster RMB appreciation.
- Agriculture sector: blame credit growth and over-investment; promote higher interest rates, and administrative directives.
- More strenuous tightening expected? Not at the expense of growth and stability.
- Expected policy tools
 - Interest rate
 - RMB liberalization

CPI vs. PPI



Source: JP
Morgan

11th Session of the National People's Congress

Key Outcomes – New State Council Leadership

Premier



Wen Jiabao

Vice

Premier



Li Keqiang



Zhang Dejiang



Wang Qishan



Hui Liangyu

State



Liang Guanglie



Liu Yandong



Dai Bingguo



Meng Jianzhu



Ma Kai

11th Session of the National People's Congress

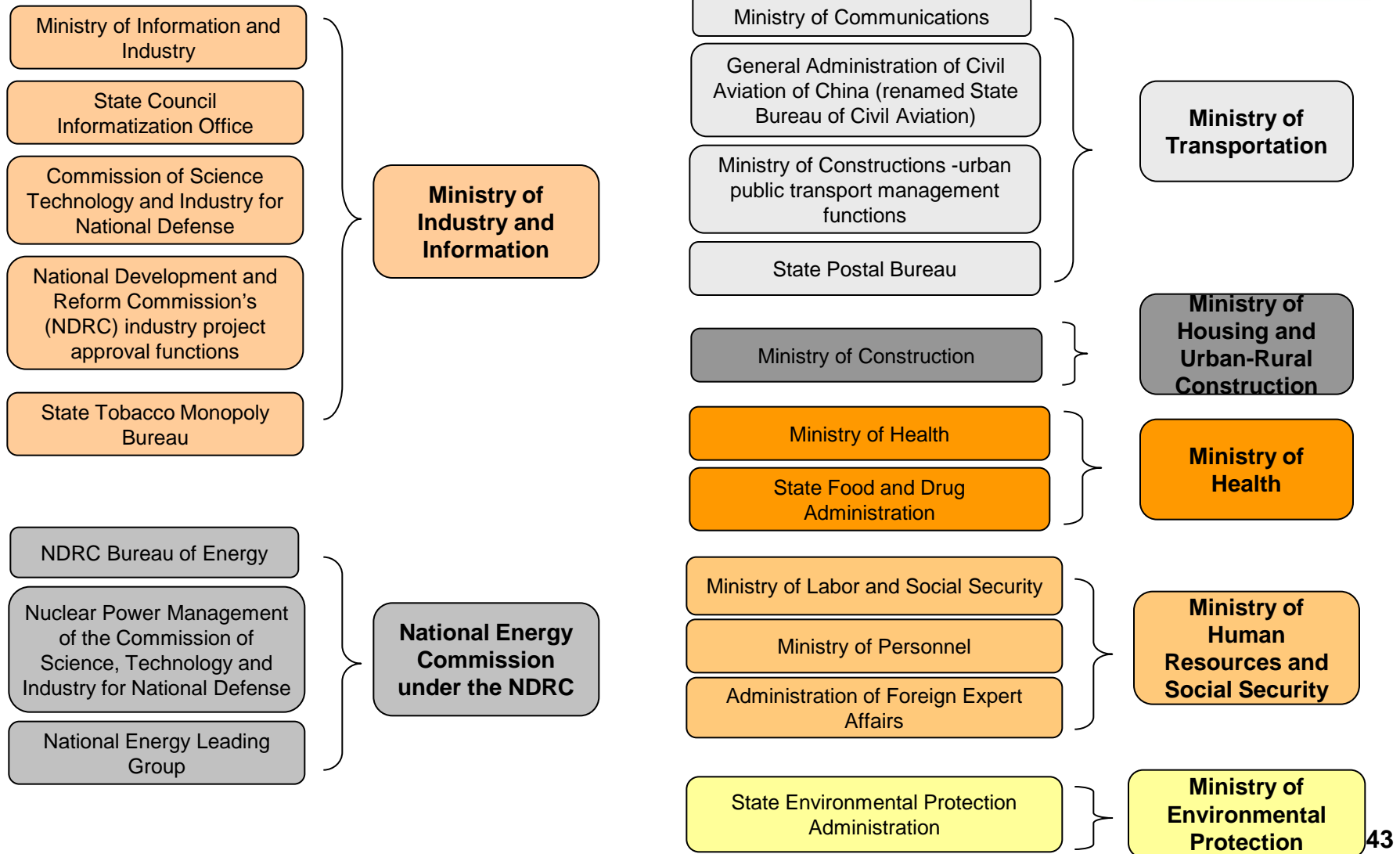
Key Outcomes – Confirmed Leadership

China's New Economic Team (in Yellow)

Name	Position	Remark	Experience	
Hu Jintao	President	2nd term	Political	Inland
Wen Jiabao	SC Premier	2nd term	Land & resources	Beijing/Inland
Xi Jinping	Vice President	Replacing Zeng Qinghong	Political/Military	Coastal
Li Keqiang	Exec. Vice Premier	Overall economic affairs	Political	Inland
Wang Qishan	Vice Premier	Finance/foreign trade (Wu Yi)	Finance/Econ affairs	Coastal
Zhang Dejiang	Vice Premier	Industrial policy (Zeng Peiyan)	Political/Civil affairs	NE/Coastal
Hui Liangyu	Vice Premier	2 nd term, Agriculture	Agriculture	NE/Inland
Ma Kai	State Councilor	Former NDRC chairman	Econ affairs/pricing	Beijing
Zhang Ping	NDRC Chairman	Former SC Secretary General	Finance/Trade	Inland
Chen Deming	Minister of Commerce	Former NDRC vice chairman	Economic affairs	Diverse
Zhou Xiaochuan	PBOC Governor	2nd term	Finance/Monetary	Beijing

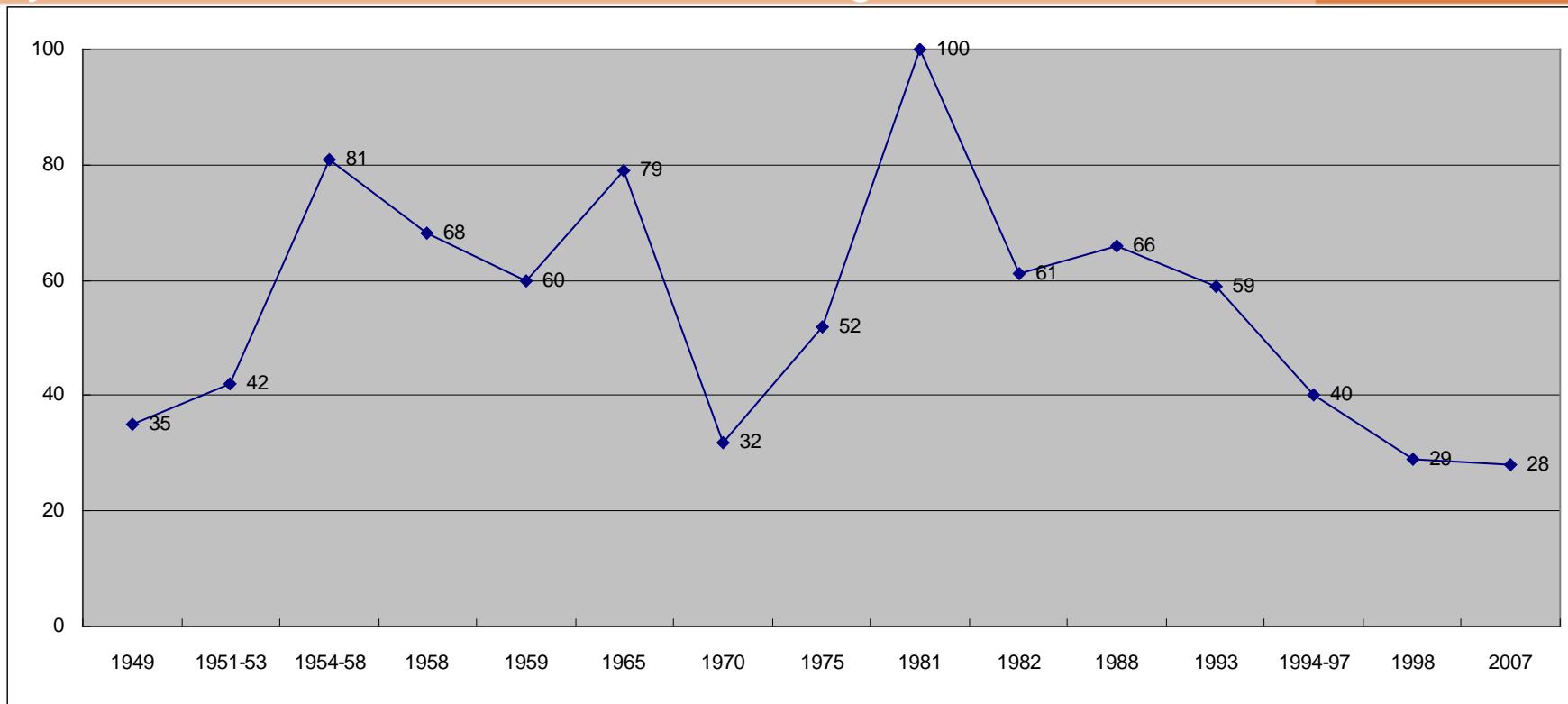
11th Session of the National People's Congress

Key Outcomes – Institutional Restructuring



11th Session of the National People's Congress

Key Outcomes – Institutional Restructuring



Political
Generations

1st Generation

2nd Generation

3rd Generation

4th Generation

Economic
Transition

Central planning

Reform and opening the
country

Equitable
development

- Key motives:
 - Rapid economic growth versus imbalanced social and economic development, resource scarcity and environmental degradation
 - Rapid growth of social demands versus insufficient public resources and services
 - » Food & product safety
 - » Environmental concerns
 - » Public healthcare system
 - Address overlapping roles and responsibilities in current institutional framework
 - Economic security
 - » Energy

New regulations tackle issues “reactively”; however, in order to address issues “proactively” institutional reform is required

- A positive step forward, but is it enough?
 - Unmet expectations
 - » Ministry of Energy
 - » Merger of regulators covering telecom, broadcast, and content
 - Dilution of NDRC's power?
 - » Investment project approvals transferred to newly-established MII
 - » Energy sector oversight under remit of newly-established NEC; however still under NDRC's umbrella
 - Reflection of leadership's preference for incremental change and gradual reform



Introduction to APCO

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Olympic Issues

Changing Operating Environment

■ Taxation

- New Corporate Income Tax Law:
 - » 25% for most FIEs; 15% for companies with high and new-tech status
 - » “2+3” holidays remain, but must commence in 2008
 - » 10% withholding tax on dividends
 - » Preferential treatment in most investment zones lost
 - » Depends upon region (e.g. northeast/central/west)
 - » “2+3” holidays remain for high-tech enterprises
 - » More implementing rules to come (e.g. consolidated filing and payment)
- New transfer pricing rules
- Overseas restructuring that involves ownership transfers of China entities can result in China tax liability
- New tax residence rule – tax liabilities based upon residency of “effective management control”

Transition Period	
2008	18%
2009	20%
2010	22%
2011	24%
2012	25%

Changing Operating Environment

- **High and new-tech criteria**
 - High and new-tech criteria
 - » Currently being revised by MOFCOM, MOST and SAT
 - » Fall within sectors included in encouraged catalogue
 - » Requires ownership of IP
 - » Companies currently with high tech status will be re-evaluated
 - » Other criteria:
 - » Amount spent on R&D
 - » Number of employees with higher education
 - » Amount of revenue from high and new-tech products

Changing Operating Environment

- **New labor laws and regulations**
 - Labor Contract Law (implementing rules yet to come)
 - Labor Dispute Mediation and Arbitration Law (implementing rules yet to come)
 - Employment Promotion Law
 - Collective Contract Regulations

- **In the pipeline**
 - Salary Adjustment Regulation
 - Social Insurance Law
 - Working Hour Statute

- **Labor Contract Law key provisions:**
 - All employees to have written contracts
 - Collective contracts
 - Enhancing role of unions and promoting unionization
 - Promotes collective bargaining and negotiation of contracts
 - Legal remedy for non payment of wages
 - Open ended of renewal of contracts

Changing Operating Environment

- **Increasing protectionism?**
 - “Indigenous Innovation”
 - » Transitioning economic model – products no longer just “made in China”, but “conceived, designed and produced in China”
 - » Ensuring that new IP is developed domestically
 - » Effort to create national champions
 - » Response to dissatisfaction with foreign technology transfers?
 - Anti-monopoly and M&A Laws
 - » “National Security” card
 - » Recent formation of a State Council, 25-member committee to oversee M&A
 - » Charged with reviewing and approving M&A activity involving foreign firms
 - Government procurement rules
 - » Administrative Regulations on Government Purchase of Imported Products
 - » Favors procurement of domestically-produced products over imports
 - Creation of national champions
 - » “Go Global” initiatives

Changing Operating Environment

- **Top 10 issues of concern to FIEs:**
 - Human resources; recruitment and retention
 - Administrative licensing and business approvals
 - Intellectual property rights – enforcement
 - Competition and overcapacity
 - Regulatory transparency
 - Standards
 - Domestic protectionism (e.g. lack of level playing field)
 - Logistics bottlenecks
 - Market access in services
 - Protectionism in the United States

US-China Business Council 2007

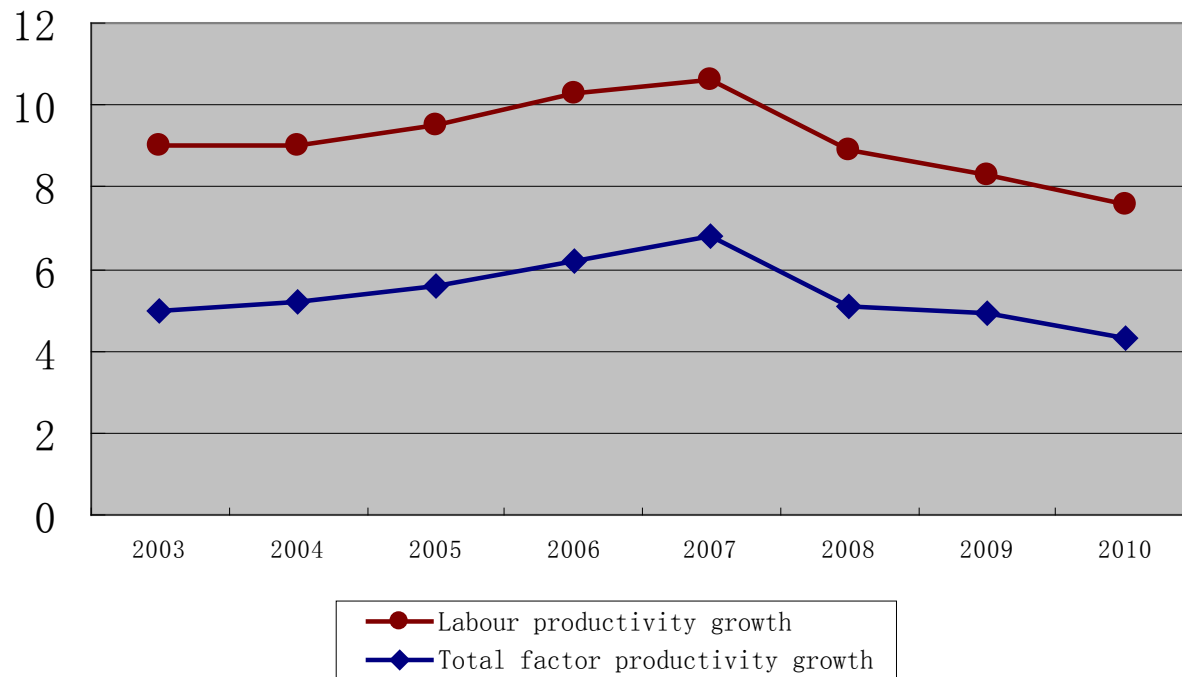
Changing Operating Environment

- **Increasing operating costs (USCBC 2008 estimates)**
 - Human resources
 - » Senior management: 15%
 - » Middle management: 10-15%
 - » Blue-collar labor: 8-10%
 - Trade-related
 - » Export VAT rebates reduced
 - » Export subsidies reduced
 - Inflation (avg. 5% as low benchmark for 2008)
 - » Raw materials and resources: 2-10%
 - » Currency appreciation
 - » RMB 6.2?: USD 1.0 for end of period 2008
 - » Utilities (water, gas, electricity): 5%
 - » Transportation: 5-10%
 - Taxation
 - » CIT – increase of 5% on avg. in 2008

Changing Operating Environment

- **Higher operating costs, but...**
 - Continued high levels of productivity
 - Strong infrastructure relative to other developing markets
 - The dream of 1 billion customers – increasing consumption and retail sales
 - Opportunities in 2nd and 3rd tier cities

Competitiveness (%)





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Olympic Issues

Olympic Games Controversy

External Priority Issues



Olympic Games Controversy

Politicization of Issues

Issues

HUMAN RIGHTS	GLOBAL POLITICS	GAMES-SPECIFIC	ENVIRONMENT	BUSINESS
<ul style="list-style-type: none"> • Supply Chains • Sweatshops • Political Repression • Media Censorship • Fa Lun Gong • Tibet/ Xinjiang 	<ul style="list-style-type: none"> • Globalization • Darfur/ Sudan • Global Terrorism • The Iraq War • Third-world Poverty • Chinese Nationalism 	<ul style="list-style-type: none"> • Commercialization • Broadcast Issues • Corruption • Athlete Doping • Marketing Issues 	<ul style="list-style-type: none"> • Water, Land, Energy • Climate Change • Waste Management • CO₂ Emissions • Games' Local Impact 	<ul style="list-style-type: none"> • Intellectual Property • Product Quality • Counterfeiting • Corporate Corruption • Trade and Currency

Channels

- | | |
|---|---|
| <ul style="list-style-type: none"> ▪ Use of mass media ▪ Online media, blogs ▪ Direct action campaigns (mail, email, phone, SMS) ▪ Use of public figures ▪ Word of mouth | <ul style="list-style-type: none"> ▪ Boycotts ▪ Petitions ▪ Demonstrations ▪ Civil disobedience provoking crackdown ▪ Violent protest or terrorism |
|---|---|

Related NGOs/Advocacy Groups

<ul style="list-style-type: none"> •Amnesty International •Human Rights Watch •Human Rights in China •Free Tibet •Reporters Without Borders •Fair Play •United Students Against Sweatshops 	<ul style="list-style-type: none"> •Dream For Darfur •Save Darfur •Oxfam •Interfaith Centre on Corporate Responsibility •UN organizations •Global Compact •Save the Children 	<ul style="list-style-type: none"> •Greenpeace •Good Electronics •Pacific Environment •Friends of the Earth •Earth Watch •China-US Energy Efficiency Alliance •World Wildlife Fund •Rainforest Network 	<ul style="list-style-type: none"> •US-China Business Council •American Chamber of Commerce •US Chamber of Commerce •Corporate Accountability International
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Olympic Games Controversy

Politicization of Issues



Hottest Issues:

- Tibet (and Xinjiang)
- Darfur / China's investments in Africa
- Human Rights in China
- Chinese product / food safety

Issues to Watch:

- Censorship, freedom of the press
- Environmental concerns in China
- Trade with China / currency valuation
- Sweatshops, factory conditions

Back-burner Issues:

- Religious freedoms in China
- Poverty
- Terrorism
- Athlete doping

Possible tactics:

- Integration with other campaigns
- Mass media
- Online media, blogs
- Direct action campaigns (mail, email, phone, SMS)
- Word of mouth
- Boycotts / divestment
- Petitions and direct action to government
- Leveraging of third parties and public figures
- Demonstrations
- Civil disobedience provoking violent crackdown

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