2021 Two Sessions: From Recovery to Rejuvenation

BRUNSWICK
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Addressing Challenges in a 'Complicated' Environment

China's annual meetings of the National People's Congress (NPC) and Chinese People's Political Consultative Conference (CPPCC)—collectively known as the Two Sessions—convened this year in an atmosphere of guarded optimism about the direction of economic recovery, and confidence that Beijing has tackled the Covid-19 pandemic more successfully than China's toughest critics.

The Two Sessions arrived at a watershed moment for the state. The 100th anniversary of the Communist Party of China (CPC) will be celebrated in July, while Beijing prepares to host the Winter Olympic Games next February. The Two Sessions also approved the 14th Five-Year Plan (2021-25) ('14FYP'), whose goals include modernizing China's economy, with a focus on next-generation strategic technologies and an eye towards broadening the country's global influence.

At the Two Sessions, China's leadership acknowledged a 'complicated' domestic and global environment—aggravated by worsening relations with the United States, Beijing's biggest trading partner. The government has responded by shifting policy towards building domestic resiliency, especially in the manufacturing supply chain, and calling for strengthened unity around Xi Jinping and the CPC.

For 2021, maintaining economic momentum and social stability remain core objectives. China's economy grew by 2.3% in 2020—the only major economy to report growth—and the government benchmarked GDP growth at more than 6% for this year. The target falls about two percentage points below World Bank and International Monetary Fund projections. But it allows China to focus on 'high-quality development', Premier Li said.

Jobs are key—at least 11 million new urban jobs will be created in 2021, compared with 11.9 million last year—with the government setting the goal of holding urban unemployment under 5.5% for the next five years. The government unveiled an updated package of stimulus spending, tax cuts and debt issuance to address pandemic fallout, support small and medium-sized enterprises (SMEs), and smooth recovery for some hard-hit localities. General transfer payments from central to local governments will increase by 7.8%, while another RMB 3.65 trillion (USD 561 billion) in local government special-purpose bonds were approved. Budget deficits of RMB 3.57 trillion (USD 548.5 billion) are planned, or about 3.2% of GDP—slightly lower than last year.

Domestic innovation remains a top priority, with the government ploughing more resources into the critical semiconductor and software sectors, as well as artificial intelligence (AI) and quantum technology. Xi said the country would undertake 'more vigorous and practical measures' to accelerate 'self-reliance' in science and technology. That means more money for basic research and national laboratories.

The most contentious decision to many foreign observers was the decision to amend Hong Kong's Basic Law and revise the city's electoral system, representing the second major legislative initiative launched by the central government in response to 2019 political unrest.

The government also signaled continued opening to foreign investment, especially in the financial sector. The Work Report stated that the Negative List for foreign investment would be further reduced, allowing foreign companies more access to the manufacturing and service sectors. Expect any measures aimed at introducing greater competition to align with the government's focus on strengthening home markets.

Key Takeaways

- **'Dual circulation':** China continues to focus on boosting domestic consumption while increasing its technological capabilities as part of its 'dual circulation' strategy. Dual circulation is seen as cutting through global challenges and unpredictability by reducing China's reliance on external supply chains and markets.
- **National security across the board:** Enhancing national security was front-and-center through the Two Sessions and a key theme of the 14FYP, and the concept is expanding to include an increasing number of fields and activities. Food security, energy security and financial security are topline priorities, as is enhancing technological capacity.
- **Covid-19 response:** Despite a strong recovery from Covid-19, the pandemic exposed weaknesses in the emergency response and healthcare systems. Healthcare reforms are set to continue, providing new opportunities for foreign firms, as is further build-out of the national emergency response system.
- **Nation of innovators:** Made in China 2025 has been abandoned as a rallying cry, but the focus on innovation and next-generation industries is greater than ever. As China seeks to ensure technological self-reliance, the 14FYP targets 7% growth per annum on R&D across the economy for the next five years. AI, quantum information, genetics, aerospace, deep-earth and deep-sea exploration, biotech and brain science were earmarked for fresh support. Industry will also receive more tax breaks to offset R&D costs.
- **Foreign investment:** Premier Li committed to 'opening up more sectors of the economy' and further cutting the Negative List for foreign investment. In the months preceding the Two Sessions, China's state leaders ran a charm offensive with global business leaders. Opportunities for foreign investors continue. Yet strategically important sectors remain ringfenced and new policies such as the expanded national security review introduce new checks.
- **A burgeoning middle class:** The government wants the middle class to grow, and signaled it's developing an action plan that will focus on new graduates, and skilled and migrant workers. State economists predict the country's middle class will include over 800 million people by 2030, double current numbers.
- **From poverty alleviation to 'rural revitalization':** Xi Jinping has declared a 'complete victory' in the battle against extreme poverty, after China elevated its remaining 5.51 million impoverished rural residents. The government is now embarking on a widescale 'rural revitalization' strategy to secure the gains while unlocking the economic potential of the countryside. Modernization efforts will encompass the development of agricultural industries and the rural logistics systems that connect them with cities, alongside reforms to rural land governance and improvements to the rural living environment.
- **Employment first:** Creating jobs remains a fundamental priority, as does supporting the businesses that provide them. Policies to defer debt repayments for SMEs will continue, while large-scale commercial banks have been set a growth target of at least 30% for lending to SMEs this year. The government also targets creating more than 11 million new urban jobs each year for the next five years, maintaining an urban jobless rate of around 5.5% across the period.
- **Breaking monopolies:** In the year ahead expect more focus on breaking monopolies and tackling unfair competition. China's tech giants—and their use of data, algorithms and platform rules—stand at the front lines as the authorities 'strengthen regulation over financial holding companies and financial technology to ensure that financial innovations are made under prudent regulation'.
- **Balancing growth and reform:** With no explicit growth target set in the 14FYP and a below-expectations 6% goal for 2021, the government has left more space for its increasingly serious focus on economic 'quality' as opposed to speed or scale. This will entail weaning off debt and reducing reliance on fixed-asset investment to drive growth, while executing long-delayed reforms to boost household incomes and more widely open markets for land, labor and capital. The battle against pollution will also further intensify in the five years ahead.
- **Digital everything:** Digitalization of industry remains a key strategy in China's industrial transformation. 'We will both develop digital industry and transform traditional industries with digital technologies', Premier Li said. This will see increased investment in new infrastructure, including in 5G, blockchain, industrial internet, data and space.
- **Cooling down:** The 14FYP targets slashing energy intensity (measured as consumption per unit of GDP) by 13.5% and cutting carbon emissions intensity by 18% by 2025, while increasing the proportion of non-fossil fuels in China's energy mix to 20% across the same period. To effect the transition, the government will spearhead a major push to develop new energy sources, including wind, solar, hydropower and nuclear, while finally rolling out a national emissions trading scheme.

- **A muscular foreign policy:** Expect continued assertiveness in foreign affairs, particularly with the US, even as pragmatism may allow for areas of renewed cooperation in such areas as climate and education. Foreign Minister Wang Yi made clear that issues of national sovereignty, led by Taiwan independence, are not open to compromise. 'We will never allow our core interests to be infringed upon', he said.

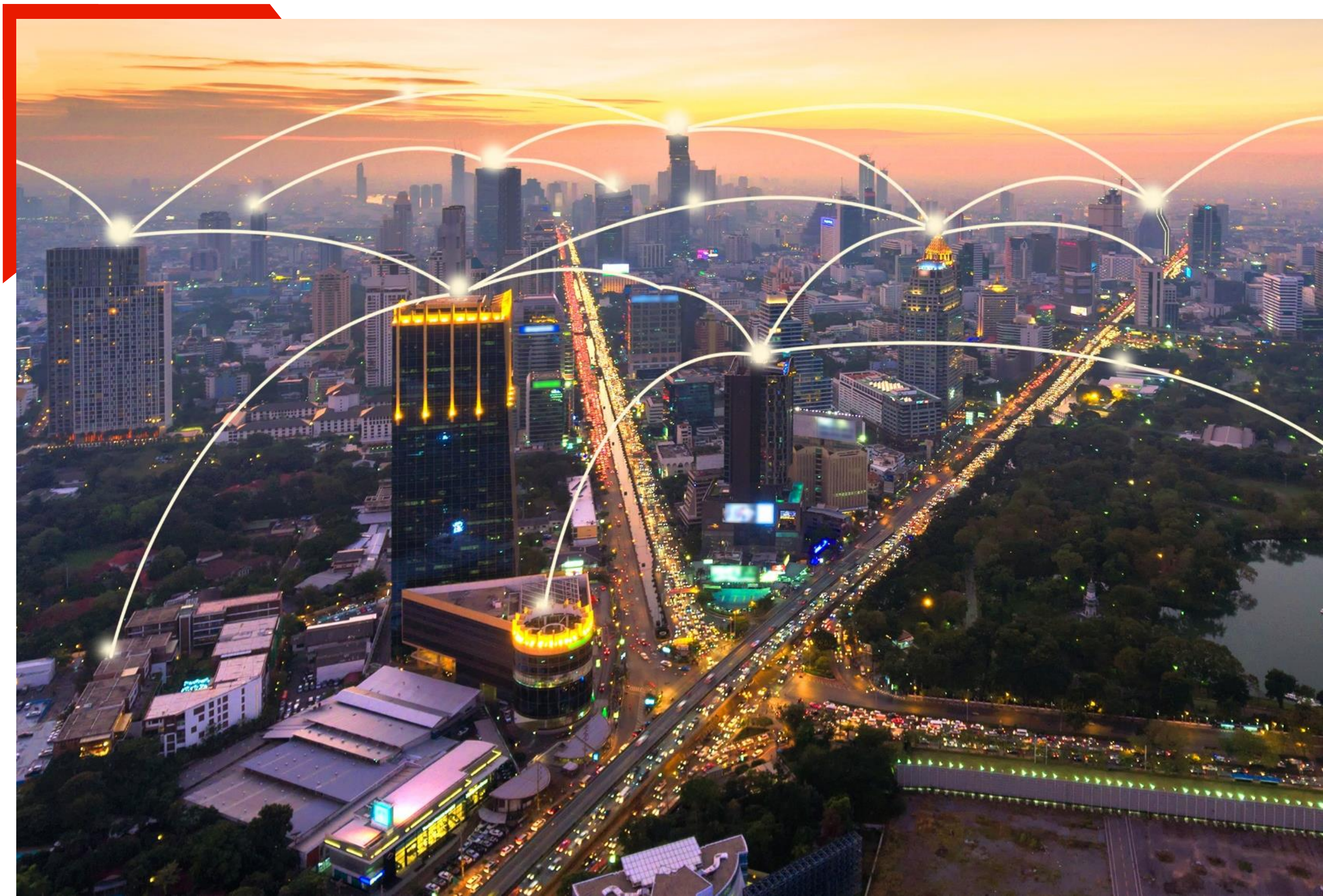
- **Laying the ground for a third term:** Xi Jinping is positioned to take a third presidential term in 2023 and over the next 18 months we should see momentum build towards that outcome. Xi was singled out in the Government Work Report for 'personally taking charge' of China's Covid-19 response. His signature achievement of overseeing China's eradication of extreme poverty, alongside programs such as the Belt and Road Initiative (BRI), rural revitalization and technology innovation will be on display at the CPC's 100th anniversary in July.

- **Approaching a demographic cliff:** China may get old before it gets wealthy, with an ageing population and shrinking workforce. The national fertility rate has dropped to 1.7 children per woman, on par with developed nations and well below the replacement rate. Achieving a birth rate of 'an appropriate level', as the government now stipulates, may not be simple. Look to additional urbanization, raising the retirement age and skilled migration solutions in the future. Meanwhile, as China grays, demand for quality elderly care services will boom.

- **New urbanization:** Further reform of the *hukou*, or household registration, system will be launched together with the National New Urbanization Plan (2021-35). By providing migrants who move to smaller cities with urban residency and access to local education and healthcare services, the government targets increasing the urbanization rate to 65% by 2025 from around 60% today.

- **Ethnic policies and national unity:** State leaders spoke about how cultural identity is inseparable from Chinese national unity under the CPC. Xi Jinping said the 'Han nationality is inseparable from the ethnic minorities, and ethnic minorities are inseparable from the Han nationality and from each other'. Premier Li noted that common language and values are equally critical and 'efforts to promote standard spoken and written Chinese will be stepped up'. Expect further promotion of a single national unity among China's ethnic groups.

- **Hong Kong electoral system overhaul:** A major shake-up of Hong Kong's political system was announced, including revamping of the committee that elects the chief executive (head of the Hong Kong government) and giving it powers to select candidates for the legislature (LegCo). In addition, a new committee will be set up to vet candidates for the Election Committee, Chief Executive and LegCo. The raft of significant changes is to ensure that 'patriots govern Hong Kong', and has already drawn stern rebuke from observers outside China.



14th Five-Year Plan: **What it is and why it matters**

What is a five-year plan?

China's five-year plans serve as blueprints for development policy, setting the direction and top priorities for the nation at the beginning and middle of each decade.

They also set specific targets, which officials work hard to meet, and serve as an indicator of the economic and social trajectory.

What is special about the 14th Five-Year Plan ?

The 14FYP comes at a major turning point for the country, as it seeks to execute a massive economic transition amid unprecedented external uncertainty and increasing geopolitical tensions.

Running at around 140 pages, the 14FYP also includes 'Long-Range Objectives to 2035' (see page 20), which are a new addition to the normally formulaic document.

Science & Innovation

- Establish national sci-tech projects in seven frontier areas
- Strengthen IPR & global cooperation
- Significant, continuous y-o-y increase in R&D spending

Opening

- Make greater efforts to attract and use foreign investment
- Open telecom, internet, education, culture and healthcare sectors
- Open banking, securities, insurance, funds and futures sectors
- Ensure fair and equitable competition and legal protections for companies

Urbanization

- Lift urbanization rate from 60% to 65%
- Break down barriers to rural–urban movement
- Develop megacity clusters
- Beautify cities and expand housing supply

Healthcare

- Increase healthcare services provision, especially in rural areas
- Improve quality and efficiency
- Develop more drugs and medical devices domestically

Education

- Increase high school enrollment to over 92%
- Guarantee inclusive preschool and special education
- Increase higher education enrollment to 60%

Manufacturing & Technology

- Boost domestic development of major technical equipment
- Make breakthroughs in key core technologies
- Promote smart, automated and networked manufacturing
- Build a nationally integrated data center system

Finance

- Improve financial inclusion
- Build a modern central banking system
- Strengthen corporate governance and supervision
- Improve the framework for cross-border capital flows

Rural Revitalization

- Extend more public services to villages and towns
- Improve rural infrastructure
- Reform and marketize the rural land system
- Integrate the countryside with cities via new infrastructure

Global Engagement

- Actively participate in the reform and construction of the global governance system
- Uphold the multilateral trading system and support greater integration into global industrial chains
- Actively develop global partnerships

Environment

- Cut energy intensity by 13.5%
- Cut carbon intensity by 18%
- Speed up development of the recycling and NEV industries
- Increase forest coverage to 24.1%

Covid-19 Recovery and the Road Ahead

Keeping growth flexible

By the middle of last year China had effectively brought Covid-19 under control and the economy had begun to rebound. Beijing reported growth of 2.3% in 2020—the only major economy to expand during the year. Stimulus played a big role. Large-scale tax and fee cuts reduced the burden on companies by more than RMB 2.6 trillion (USD 400 billion), while extra lending from banks amounted to RMB 1.5 trillion (USD 231 billion).

China recorded an official growth rate of 2.3% in 2020, making it the only major economy to expand during the year

The government more than doubled its issuance of special-purpose local government bonds to RMB 3.75 trillion (USD 576 billion) and established a RMB 1 trillion Covid-19 bond program. Local governments also received an additional RMB 2 trillion (USD 307 billion) to help businesses and residents. Separately, China's banks provided domestic borrowers with over RMB 6.6 trillion (USD 1 trillion) in deferrals in 2020, and the country's banking regulator said that banks transferred an additional RMB 1.5 trillion (USD 231 billion) of profits back into the economy.

In 2021, the government set a GDP growth target of above 6%, having dropped a growth target for the first time in decades in 2020. But the road to recovery remains long and some of the economic consequences of the pandemic are still emerging—a situation exacerbated by uncertainty in the external environment.

2021 TARGETS

> 6%

GDP growth target of over 6%

having set no target in 2020 due to the pandemic

The 14FYP reflected this caution, providing no other target than keeping growth within a 'reasonable range' and setting it each year, allowing Beijing to react to 'black swan' and 'gray rhino' events and leaving more room for broader reforms. An annual growth rate of around 6% over the next five years may be achievable.

A flexible growth target over the next five years gives the government flexibility to respond to 'black swan' and 'gray rhino' events

China also signaled it will develop an action plan to expand the middle class, focusing on new graduates, and skilled and migrant workers. Government economists predict the country's middle class will grow to over 800 million people by 2030, double current numbers, which would put China on the road to doubling its per capita GDP, to around USD 20,000, by 2035.

Maintaining economic stability

Premier Li acknowledged 'difficulties and challenges' and said his main goal for 2021 is to ensure the 'continuity, consistency and sustainability' of the economy. Macro policies will continue to avoid a 'sharp turn', while government expenditure will increase 1.8% to exceed RMB 25 trillion (USD 3.85 trillion). Some tax and fee cuts will also be extended, and monetary policy will continue to be 'prudent, flexible and targeted'.

Policies to defer debt repayments for SMEs will continue and large-scale commercial banks have been given a target to extend 30% more loans this year to SMEs. Economists predict that new lending to smaller enterprises will reach about RMB 1.45 trillion (USD 223 billion) in 2021.

Employment remains a focus, with the government targeting the creation of over 11 million new urban jobs in 2021, and a surveyed urban unemployment rate of approximately 5.5%—goals that will be held over the next five years. The government will allocate RMB 55.9 billion (USD 8.5 billion) in employment subsidies in 2021, an increase of RMB 2 billion (USD 307.4 million), with a view to helping local governments fund policies that support employment and business.

2021 TARGETS

Over 11 million new urban jobs created

11.86 million added in 2020, above target of 9 million

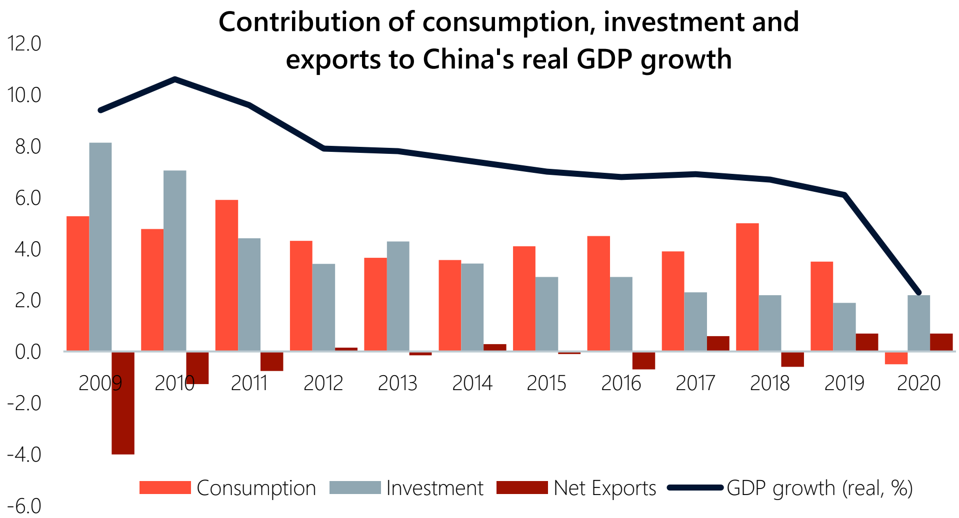
2021 TARGETS

Urban unemployment rate within 5.5%

the same as 2020 target

Getting smart with stimulus

China is scaling back some of the stimulus programs that powered 2020's economic growth as policymakers shift to the difficult work of rebalancing the economy. The government debt-to-GDP ratio last year soared by 19%, while corporate debt increased by about 10%. Household debt also rose to about 60% of GDP in the last third quarter, according to the National Institution for Finance and Development, exacerbated by families needing loans just to get by.



The government has halted issuance of Covid-19 bonds, while the quota for special-purpose local government bonds will shrink by RMB 100 billion (USD 15.37 billion), allowing the deficit-to-GDP ratio target to be lowered slightly to 3.2%. That should still provide the government with enough latitude to support struggling localities.

These measures 'send a clear signal that China is pursuing high-quality development rather than adopting a deluge of strong stimulus policies', the Ministry of Finance said in its Two Sessions report. They also provide 'policy space for responding to new risks and challenges in the future'.

2021 TARGETS

Deficit-to-GDP ratio of around 3.2%

following a ratio of 3.76% in 2020

2021 TARGETS

365 trillion yuan special-purpose bond quota

representing a RMB 100 billion decrease year-on-year

Foreign Investment

Market opening to continue

Market opening remains critical to China's broader economic transformation—not only for bringing capital and technology into the country but also for stabilizing the country's balance of trade.

The *Foreign Investment Law*, which came into force at the start of 2020, stipulates pre-establishment national treatment for foreign investors and emphasizes the protection of their rights and interests, particularly with respect to intellectual property.

Premier Li at the Two Sessions reaffirmed that China would continue 'opening up across the board', while undertaking wider efforts to participate more fully in international economic cooperation. Promoting the BRI and building a network of free-trade zones (FTZs) are among the priorities. Physical and capital markets will open wider, with both formal relaxation of entry restrictions and removal of hidden barriers to market entry in areas that remain only nominally open.

The government is developing a five-year plan on utilizing foreign investment, highlighting the ongoing importance of foreign capital, technology and know-how

China's Ministry of Commerce also announced this year that it will develop its first dedicated five-year plan on the utilization of foreign investment. In addition, it aims to provide new state support for specific projects, such as fast-track approvals and subsidies for land and energy costs. These incentives would complement general subsidies for investment in encouraged industries such as advanced manufacturing and production-oriented services like logistics, and in the underdeveloped central and western parts of the country.

Rolling out the red carpet for foreign investors

Reforms of China's financial sector and capital markets are among the most notable opportunities. Foreign firms, including Goldman Sachs Group, BlackRock and S&P Global Markets, have already made moves in the securities, asset management and credit ratings sectors, to take control of joint ventures, obtain wholly owned licenses, and establish wholly owned companies. China is also receiving increasing foreign capital inflows following inclusion of domestic stocks and bonds in MSCI, FTSE Russell and S&P indexes.

Additional financial sector opening is expected, including relaxation of shareholding ratio limits and lockup conditions, expansion of the qualified foreign institutional investor quota, and quality of life improvements in areas like currency exchange.

New measures are expected to further expand foreign investment in the financial sector

The full impact of these policies remains to be seen, particularly as many foreign companies are under increasing pressure to limit their investment or move their manufacturing out of China.

Linking up to the outside world

China is connecting its market opening programs with a fresh round of international trade agreements, led by the recently completed China-EU Comprehensive Agreement on Investment, the Regional Comprehensive Economic Partnership, and a trilateral free-trade agreement with Japan and Korea currently under negotiation. China is also 'actively studying' joining the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, according to the 14FYP.

Additional measures to internationalize the RMB are also under consideration. China's currency appreciated 6.3% percent in 2020. In February, the government announced it is considering lifting more restrictions that bar its citizens from investing in securities outside of mainland China, as it seeks to facilitate two-way capital flows. This would require weakening some control of the capital account, which the government uses to control the RMB exchange rate, the international balance sheet, and the size of its foreign reserves.

The government is piloting lifting some restrictions on its citizens investing in international capital markets

There are caveats to these market-opening measures. While the central government is eager to address pain points and improve the business environment, Beijing's moves must be considered alongside its embrace of its 'dual circulation' strategy—and should not be misread as a retreat from protectionist rules and policies that govern strategically important areas of the economy.

Moreover, after 'Measures for the Security Review of Foreign Investments' came into effect in January, foreign investments are now subject to expanded national security reviews triggered at lower thresholds and covering a wider range of sectors. The reviews will be conducted by a foreign investment security review office akin to the US's Committee on Foreign Investment in the United States (CFIUS). The government has also laid the groundwork for an Unreliable Entity List like the US's Entity List, and new blocking rules similar to the EU's blocking statute, which are both aimed at foreign investors and would create fresh risks for overseas companies doing business on the mainland (see below).

Foreign investment to become subject to tighten scrutiny, even as more market-opening measures are pursued

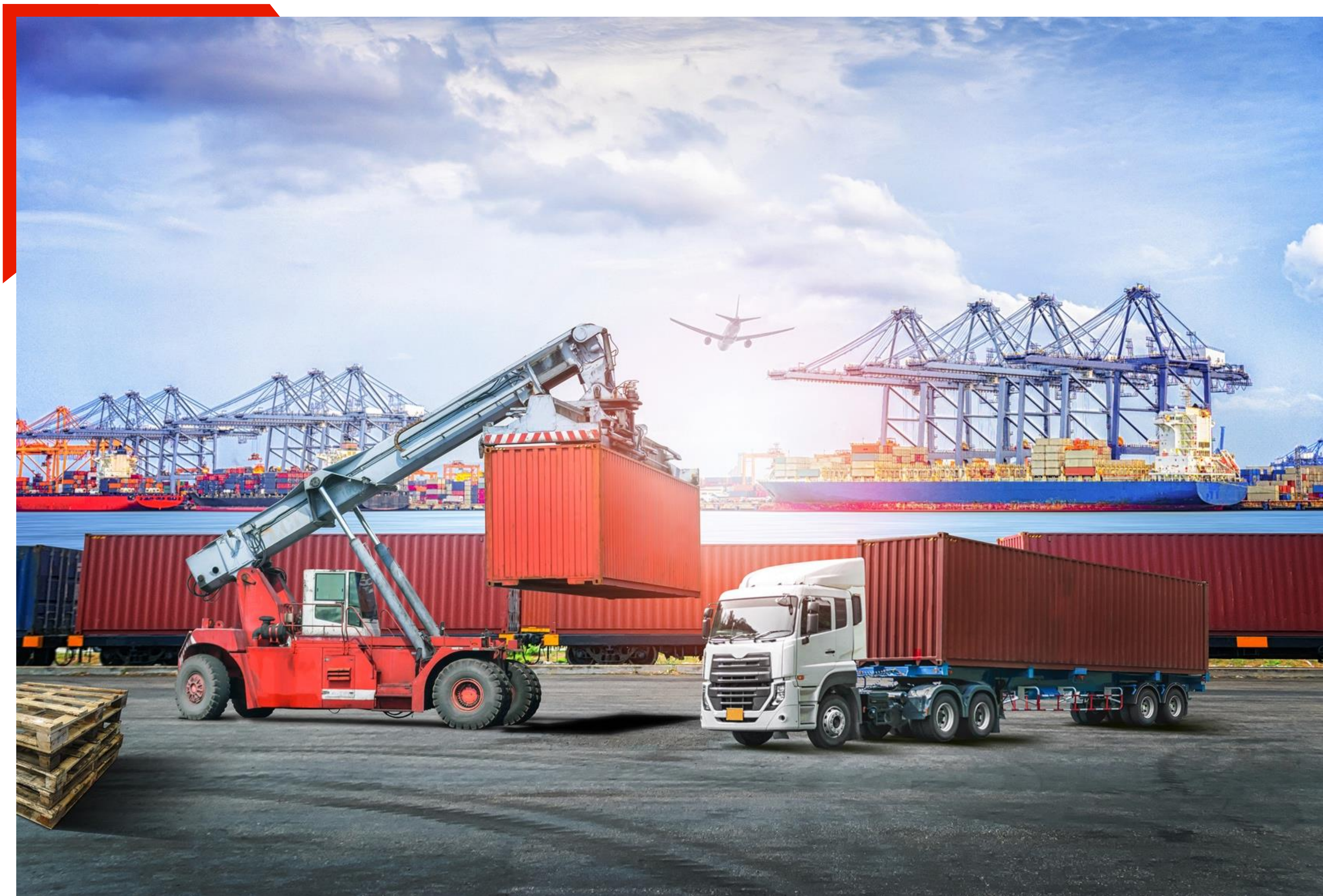
Dual Circulation

The 'dual circulation' strategy, first made public at a meeting of the 25-member Politburo last May and formulated to respond to an increasingly hostile and uncertain global environment, is a key component of the 14FYP. It calls for strengthening domestic consumption, making it the main economic pillar, while reducing China's reliance on international supply chains and demand, increasing the economy's resiliency against external shocks. It also wants to advance Chinese industry to the top of global technology value chains in strategic emerging industries, while still achieving selective integration in the world economy.

Xi Jinping, in a speech on the strategy last April, spelled out some of the government's key concerns and objectives. In sectors and segments related to national security, he said, China 'must build a domestic supply system that is independently controllable and secure and reliable, so that self-circulation can be accomplished at critical moments, and we can ensure that the economy operates normally in extreme situations'. At the same time, Xi noted the need for China to increase the dependence of international supply chains on China, to deter foreign countries from cutting off China's supply lines or complying with the sanction regimes of third countries.

Through the 'dual circulation' strategy, China wants to increase international reliance on China's markets and technology, and decrease China's own reliance on the world

China, by growing its domestic market and achieving dominance in new technologies, would not only decrease its reliance on global market and technologies, but would also make global markets more reliant on China's own market, technology and standards, increasing China's international influence.



Expanding Demand

While economic recovery in 2020 relied heavily on fixed-asset investment, China has now prioritized increasing domestic demand and removing barriers to the 'circulation of the factors of production'. Boosting demand will require addressing income inequality and expanding the middle class through robust use of taxation, social insurance and transfer payments, while encouraging consumption, especially on services, by freeing up spending with a stronger social safety net.

Rural revitalization

Accessing the potential of China's countryside as a new growth engine underpins these plans. 'Rural revitalization' has emerged as a signature initiative of the Xi administration and the centerpiece of rural policy in the 14FYP, after the government declared victory in its battle against extreme poverty in February. The National Rural Revitalization Bureau, which was established this year to spearhead the initiative, operates from the site of the former State Council Office of Poverty Alleviation and Development.

The macroeconomic policy agency (NDRC) set out the key goals of the initiative at the Two Sessions. They include increasing the quality and stock of livestock, poultry and seeds, alongside measures protecting farmland to prevent it from being used for purposes other than agriculture. Other measures call for the modernization of agricultural industries and rural logistics to link villages with cities, especially through construction of e-commerce logistical systems to move goods to and from the countryside.

The countryside has been earmarked as a new growth engine

Improving the rural living environment is also a key focus, and part of the 14FYP. This includes plans to build new, integrated urban–rural transportation and improve village facilities and services, along with better village housing.

While exploring ways to extend rural land contracts for another 30 years, the government is also planning to initiate the next round of land reform by promoting market-based transfers of rural collective land designated for business use, and completing rural collective property rights reform, all of which has the potential to unleash significant economic activity.

New urbanization

Rural revitalization is closely connected to 'new urbanization', a strategy that links a revitalized countryside more closely with small and midsize cities. This initiative, which will be rolled out under a National New Urbanization Plan (2021-35), intends to add tens of millions of newly urbanized Chinese to the ranks of urban consumers, while more closely integrating rural areas into the wider domestic and international economy. By the end of the 14FYP period in 2025, urbanization is targeted to have reached 65%, up from 60.6% in 2020.

The initiatives to promote urban modernization include measures that not only encourage rural migrants to move permanently to cities, but also incentivize cities to accept them. Modernization efforts aim to make China's cities more livable, with 'smart' cities offering better digital infrastructure, more cultural offerings, and greener landscapes.

2025 TARGETS

65% urbanization rate
up from 60.6% in 2020

China continues to explore changes to its *hukou* household registration system, including allowing rural migrants to freely settle in cities with less than three million residents, and lowering requirements for settlement in cities with populations between three and five million. Strict controls on movement to China's largest cities, however, will remain in place.

A 'National New Urbanization Plan (2021-35)' would see tens of millions of newly urbanized Chinese added to the ranks of urban consumers

The central government also said it will support urban migration by creating a RMB 35 billion (USD 5.4 billion) rewards fund for cities that provide *hukou* to existing residents who aren't locally registered, thereby sharing the costs of providing urban services between Beijing and localities. Separately, the central government committed to raising general transfer payments to local governments by 7.8%, significantly more than in 2020, which will include 11% year-on-year growth in payments specifically for equalizing access to public services.

Marketizing Factors of Production

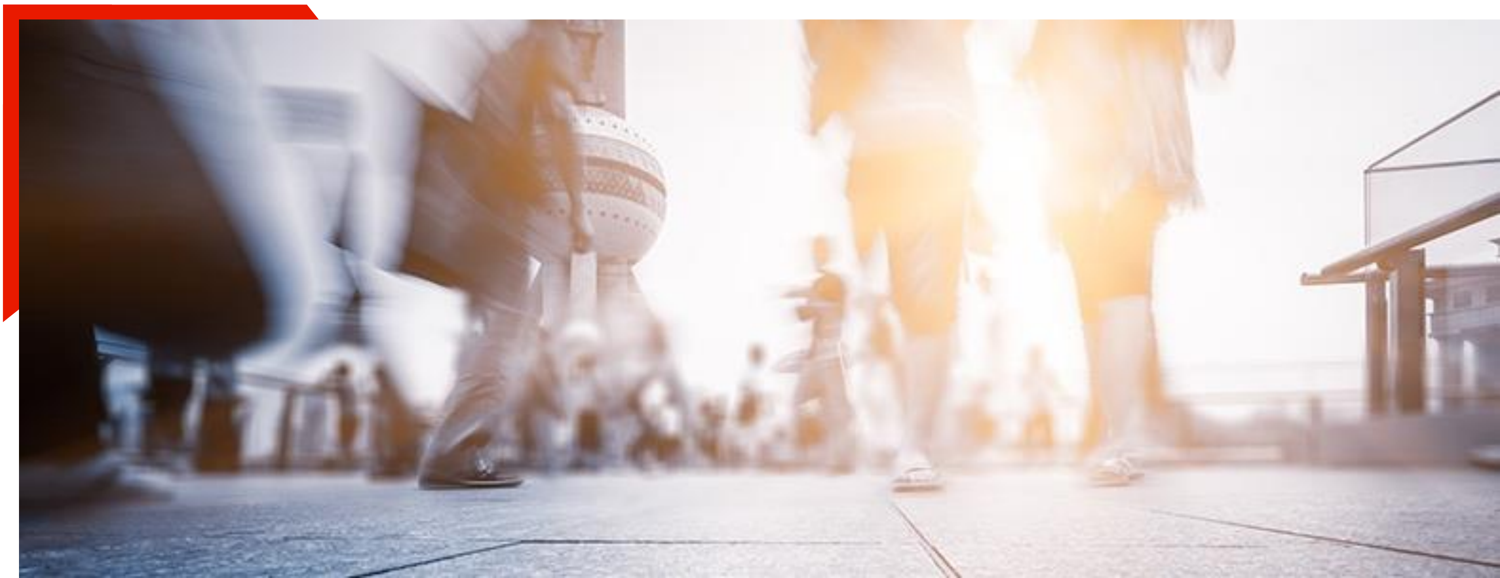
In its annual report at the Two Sessions, the NDRC dedicated more space to documenting its success in reducing barriers to the 'circulation of factors of production' than almost any other topic except pandemic relief. This initiative addresses foundational economic issues, covering such traditional factors of production as land, labor and capital, as well as new factors like technology and data. These factors have been constrained by administrative barriers, many of which are legacies of past administrations. At the Two Sessions, the government pointed to the following reforms:

On land, deregulation allowing for development of underutilized land owned by rural collectives, to form a more unified property market. This reform has been promoted by economists but faces substantial headwinds due to technical difficulties and political sensitivity.

On labor, long-awaited reform of the *hukou* household registration system to develop a more unified labor market, which continues to be divided by significant barriers that restrict movement to and between cities. This initiative coincides with efforts to develop the rental housing market and initiatives to re-skill or up-skill the workforce to address labor-market needs.

On capital, continued market opening to attract greater foreign investment, implementation of registration-based IPOs on domestic stock markets to ease access to funding, and increased bank lending to SMEs, which are underserved by financial institutions.

On technology and data, management is set to increase. This will include drafting legislation to govern data and its market development. IPR protections will be strengthened to better connect technology with capital, through venture capital funds and the use of IP as collateral for financing.



Securing the Future

Innovation nation

Economic tensions with the US—in particular the US moving to sanction big Chinese technology companies and restrict the sale and transfer of critical technologies in such areas as semiconductors—has accelerated Beijing's efforts to become more 'self-reliant' in critical technological components, while seeking to move up the technological value chain, in particular in strategic emerging industries, and advance Chinese technical standards abroad. 'Innovation', Premier Li said, remains at the heart of China's modernization drive'. Technological advancement and innovation have been elevated to core national priorities.

2025 TARGETS

Added value of strategic emerging industries to account for 17% of GDP

From target of 15.5% in the 13th Five-Year Plan (2016-20)

Nationwide spending on R&D reached 2.4% of GDP in 2020, according to the NDRC, and the contribution made by advances in science and technology is estimated to now account for 60.2% of economic growth. R&D spending is targeted to increase at an annualized rate of more than 7% over the next five years. Central government expenditure on basic research, meanwhile, will increase by 10.6% in 2021. Building national laboratories is one priority; establishing major science and technology innovation hubs is another.

2025 TARGETS

Economy-wide R&D spending growth of more than 7% annually

from a base of RMB 2.4 trillion in 2020

Pushing the frontiers

China targets major breakthroughs in core technologies over the next 15 years (see 'Long-Range Objectives to 2035', page 20). It is developing a series of sci-tech plans, including a ten-year action blueprint for basic research and a medium- and long-term plan for sci-tech development to 2035. AI, quantum information, genetics, aerospace, deep-earth and deep-sea exploration, biotech and brain science have been called out as areas of focus. The long-standing 'Sci-Tech Innovation 2030' agenda, which includes major state-led strategic sci-tech projects in cybersecurity, deep space exploration, smart grids, big data and more, will continue to be rolled out. China is also developing a blueprint for advancing its development of technical standards, dubbed China Standards 2035, which focuses on high-end manufacturing, next-generation information technology, cloud computing, big data, AI, and more.

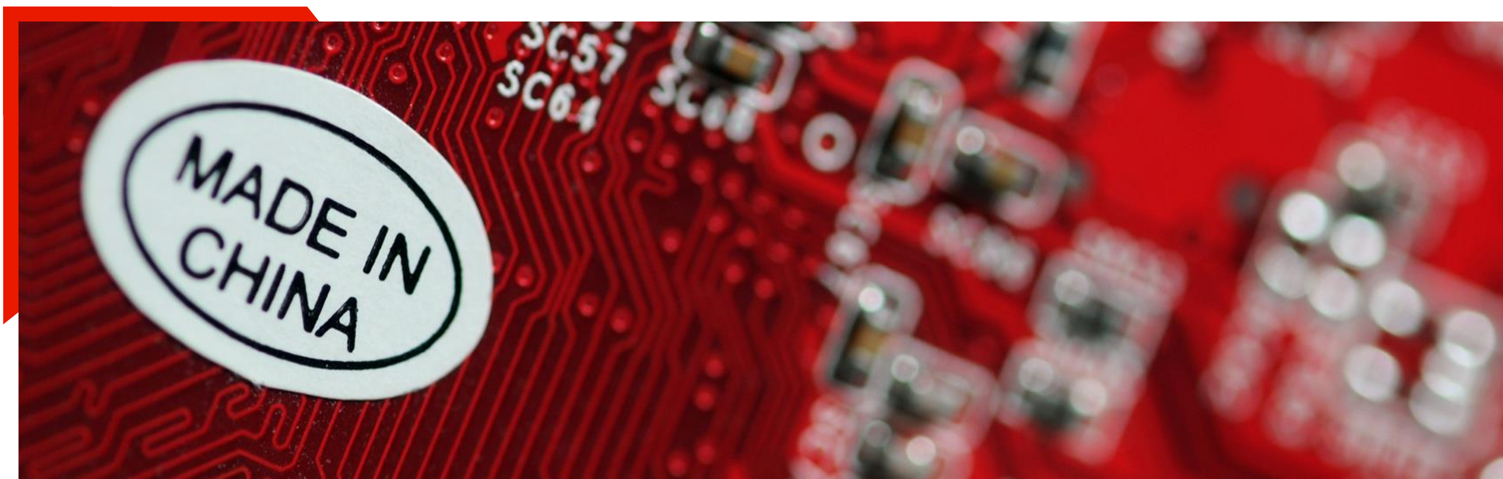
AI, quantum information, genetics, aerospace and biotech are some of the focuses of sci-tech development

Advancements in new materials, industrial machinery, smart manufacturing and robotics, new energy and intelligent vehicles, biotechnology, agricultural machinery and equipment and industrial software are targeted to provide new impetus to China's industrial overhaul. Strategic emerging industries are aimed to account for 17% of the economy by 2025.

Digital everything

Digitalization has emerged as a key strategy in China's industrial transformation, following Xi's call last April for digitalization-based optimization of industry. At the Two Sessions, Premier Li called for the transformation of traditional industries with digital technology and for the country to 'work faster to develop a digital society, digital government and healthy digital ecosystem'. China is preparing more investment in new infrastructure, including in 5G, industrial internet, data and space. The 14FYP also identified blockchain as a 'key industry of the digital economy'.

According to the State Information Center, China will hold the largest volume of data in the world by 2025, at which time it will account for more than 27% of the world's total. Regulation of the production, storage, transmission and use of this data will continue to tighten.



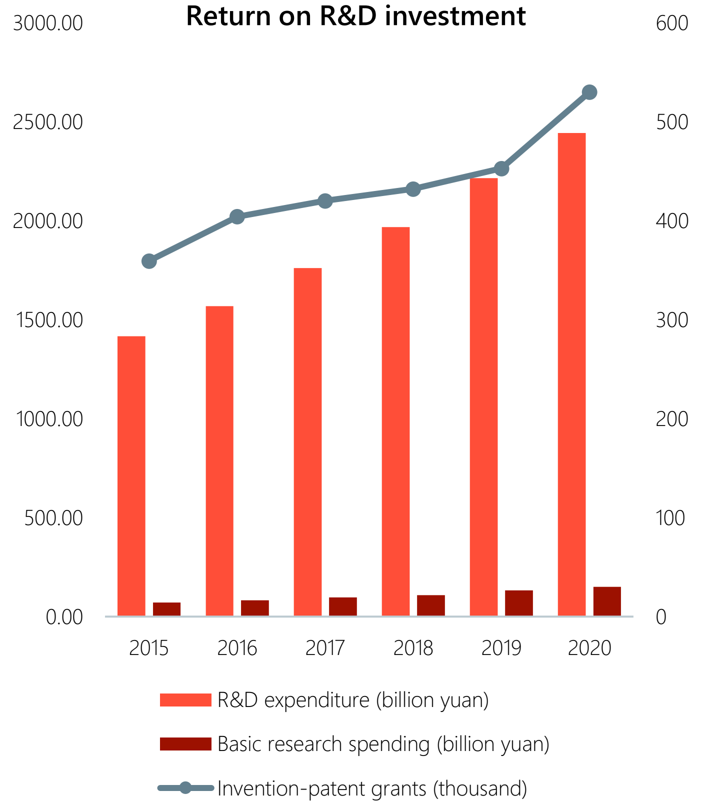
The market comes to the party

The Two Sessions highlighted measures to utilize broader market forces to realize national technological ambitions. ‘We will boost the principal role of enterprises in innovation, and encourage leading enterprises to establish innovation consortia’, Premier Li said. The state will encourage stronger linkages between enterprises, universities, research institutes and end-users. A recent tax deduction of 75% on enterprise R&D costs will be raised to 100% for manufacturing firms, while banks will drive more funds towards companies engaged in sci-tech innovation and green technologies. Foreign companies will also be eligible for R&D tax breaks, and invited to participate in, or lead, select major science and technology projects.

2025 TARGETS

High-value patents per 10,000 people to reach 12

up from 6.3 in 2020



The regulatory framework for venture capital will also be revamped, Premier Li said, to boost investment in promising high-tech start-ups. The goal is to make enterprises key drivers of technological development, mobilizing more parts of the economy to help realize China’s national technological goals. The government wants to invest more, but more importantly it also wants to invest broader and smarter. Civil-military fusion will also continue to be pursued. Over the next five years, innovation is to become a whole-of-nation affair.

Forcing state-sector innovation

State-owned enterprises (SOEs) will be placed at the center of China’s innovation drive, further solidifying their position at the center of the national economy. Regulators plan to roll out a new set of KPIs for the state sector that incentivize R&D spending, which is meant to outpace the national average. SOEs ‘are an important pillar and supporting force of the Party's governance and rejuvenation of the nation, and they must be made stronger, better and larger’, Xi said in a speech last April. The manifold roles of the state sector across the economy were further underscored in the 14FYP, which called for SOEs to focus on strategic security, industry leadership, the national economy, people’s livelihoods and public services.

The 14FYP further underscored SOEs’ central role in national economic development

National Security Across the Board

Under the Xi administration, the concept of national security has expanded to cover a growing number of areas and activities. The Two Sessions reflected this trend, with food security, energy security and financial security set as topline priorities.

Keeping stomachs full

'Seeds and cropland are crucial for safeguarding China's food security', Premier Li noted, announcing several initiatives to ensure supply for China's 1.4 billion people, including 'agricultural belts' for national food security and higher-yielding farmland. In addition to the redlines of ensuring 120 million hectares of land for agriculture and annual production of 650 metric tons of grain, China also aims to diversify sources of imported agricultural produce. At the same time, the country aims to increase self-reliance in seeds, setting a goal of developing internationally competitive domestic seed giants.

2025 TARGETS

Grain production above 650 million metric tons annually

Keeping the lights on

The NDRC announced it will promote the development of energy transportation routes and strengthen China's energy reserve capacity. 'We will refine energy contingency plans', the agency said, 'improve our risk and emergency response capabilities, and strengthen energy security and resilience'. 'We will enhance our overall energy production capacity', Premier Li said; the 14FYP sets a target of 4.6 billion metric tons of standard coal equivalent (SCE) in domestic capacity by 2025. Coal retains its 'basic role' in the energy grid, but the government also underscored the key role that nuclear would take in the energy mix.

Coal retains its basic role in China's energy security strategy, but nuclear is also set for a boost

Reining in the 'unregulated expansion of capital'

China continues to focus on controlling risks in the evolving financial system, which are now explicitly linked to national security. The government is concerned that financial regulation has not kept pace with the development of fintech innovation. In particular, internet finance companies such as Ant Financial, which have become *de facto* banks engaged in lending and other practices but without the same capital requirements and other restrictions as traditional banks, will continue to be targeted by regulators.

The financial sector to remain the ongoing subject of derisking, with tech giants in the crosshairs

Cognizant of the risks of what China calls the 'unregulated expansion of capital', Premier Li noted the government would strengthen regulation over these companies. One area the government has earmarked for particular focus is anti-trust and unfair competition, especially breaking down monopolies in the financial and tech sectors.

Rollout of the central bank's sovereign digital currency, which the government has already begun piloting in retail scenarios, will also play a part in reining in fintech conglomerates. The intention is for the currency to be used via digital wallets provided by the state banking sector.

Broad uptake of the digital currency would provide the government with greater, near real-time insight into the flow of money, goods and services in the economy. Equally important, however, is that it would also help the state to ultimately capture the digital payment market, which is now a key critical infrastructure, by putting payments back in the hands of the state banks, reducing the importance of private services like Alipay and WeChat Pay, which currently hold the lion's share (around 95%) of the market, making them too important to fail.

The government wants to use its sovereign digital currency to bring the payments market, currently dominated by Alipay and WeChat Pay, back under state control

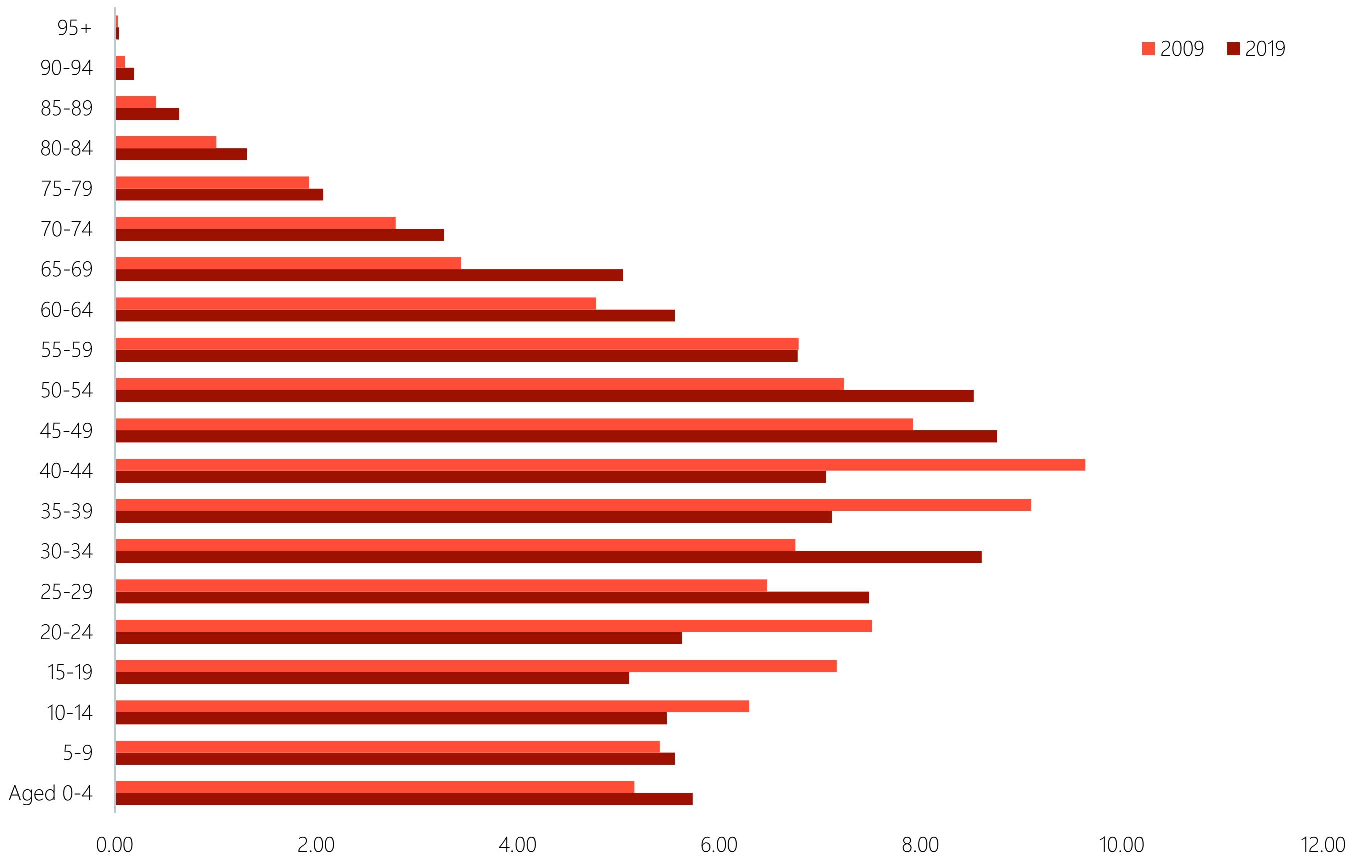
China is now also actively examining how digital currency can be expanded for use in cross-border trade.

Addressing Weak Links

A graying country

China faces the prospect of getting old before it gets wealthy, with a plummeting birth rate and an ageing population threatening a demographic breakdown. In 2020, China had 10.03 million new-born babies, according to data from the Ministry of Public Security, 1.75 million fewer than 2019 and the lowest number since 1949. 18.1% of the population was age 60 or over; some estimates suggest this number may exceed 33% by 2053. The work force is expected to shrink by 35 million people in the next five years.

Demographics of China 2009 vs. 2019 (% of the total population)



Premier Li said China will work to 'achieve an appropriate birth rate' as part of the national strategy for addressing population ageing. The government did not explain what an appropriate rate would be, but the fertility rate is around 1.7 births per woman, on par with that of developed countries and way below the 'replacement rate' of 2.1, at which a population remains stable. This marks the first time that fertility rates have been mentioned in the Government Work Report since China rolled out a universal two-child policy in 2016. Recent data, however, suggests the measure was too little, too late and has not brought the baby boom policymakers hoped for.

Fertility rates mentioned for the first time in years, as the government ramps up efforts to increase births

Nonetheless, the government is determined to increase the birth rate, underscoring that improving parental leave policies and reducing childcare costs are part of the solution. At the other end of the spectrum, the 14FYP signaled the statutory retirement age (currently 60 for men and 55 for women in the public sector) would be raised in a phased manner, likely to 65, while Premier Li stated that measures to improve policies and benefits for elderly care were forthcoming. Interestingly, skilled migration is also being explored as an option according to the 14FYP. Opportunities to tap the growing elderly care market are significant and will continue to expand.

Cutting greenhouse gas emissions

Xi pledged in September 2020 that China would bring its total greenhouse gas emissions to a peak by 'around 2030' and achieve carbon neutrality by 2060. To meet these goals, the 14FYP targets a a 13.5% reduction in energy intensity (measured as consumption per unit of GDP) and 18% cut in carbon emissions intensity by 2025.

To increase reliance on low-carbon alternatives, the country will also make a major push to develop new energy sources, boosting the use of wind and solar power, speeding up the construction of hydropower plants in the southwestern regions, and promoting the construction of nuclear power plants along the coast. China expects to increase the proportion of non-fossil fuels in its energy mix to 20% by 2025, from an estimated 15.8% at the end of 2020.

2025 TARGETS

13.3% cut in energy consumption per unit of GDP from 2021-2025

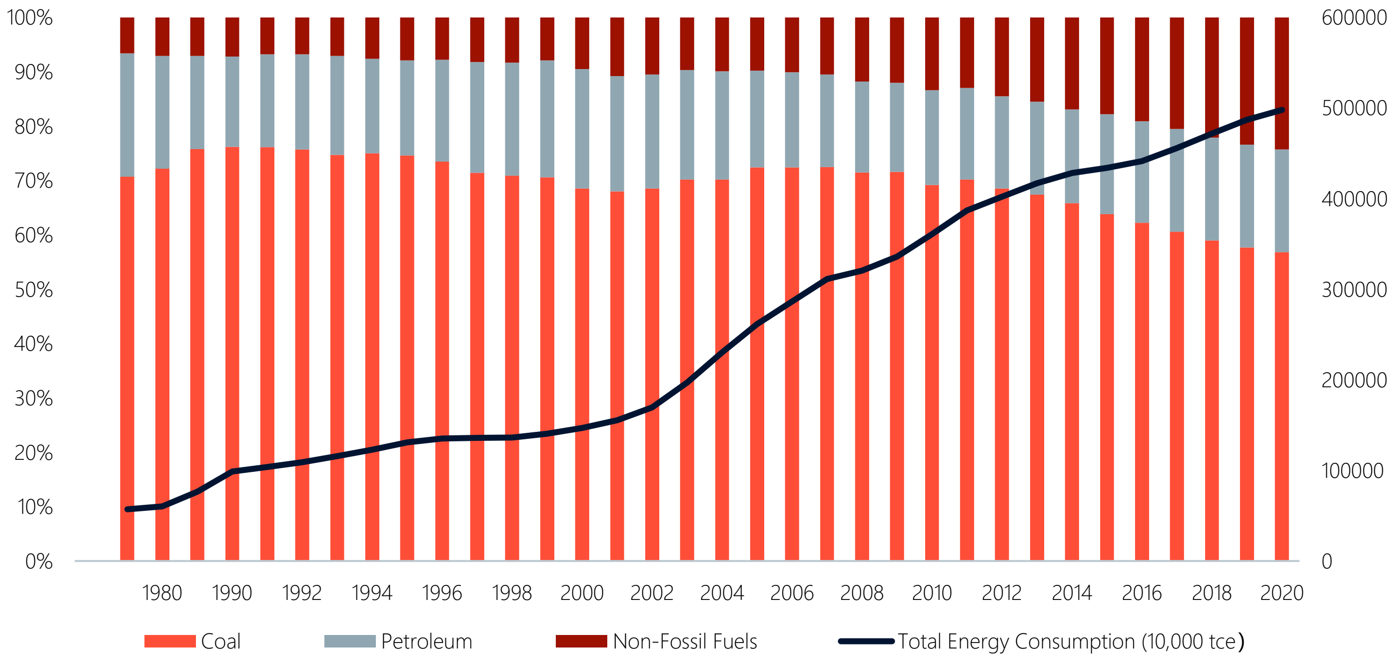
2025 TARGETS

Non-fossil fuels to make up 20% of total energy mix

compared to 15.3% in 2019

An emissions trading scheme will also launch in June, according to the Ministry of Ecology and Environment, initially focused on China's power sector but eventually expanding to include cement and construction materials, steel, petrochemical, chemical, non-ferrous metals, paper and aviation.

China's energy mix



Creating an 'ecological civilization'

Environmental protection, one of the Three Critical Battles (in addition to financial risk and poverty) remains at the top of the government's agenda. In keeping with its pledge to 'keep our skies blue, waters clear and land pollution-free', the central government will continue to plunge billions of RMB into tackling air, water and soil pollution. Some of the money will go to swapping coal with clean energy sources for winter heating, which Premier Li said will account for 70% of all heating in northern China by 2021.

The government plans to plunge billions of RMB into tackling widespread air, water and soil pollution

There is also more focus on recycling and promoting a circular economy. The NDRC said it will speed up the establishment of a recycling system for waste and used materials and promote garbage sorting. Plastic pollution was called out, with the delivery industry being urged to increase the use of green packaging. Corporate income tax credits will also be expanded for environmental protection and water and energy conservation.

New energy vehicles (NEVs) continued to receive focus as a technology, both in terms of advancing innovation goals and getting cleaner vehicles on the road. The government this year focused on electric vehicle battery charging stations, battery-swapping facilities and systems for recycling power batteries.

Boosting healthcare

The outbreak of Covid-19 drew massive attention to China's public health infrastructure. Despite a strong recovery last year, the pandemic exposed weaknesses that are now being addressed with a plan to significantly strengthen capacity and preparedness, as part of other ongoing reforms.

The centerpiece, a ten-year Healthy China initiative which launched in 2020, aims to overhaul the industry and increase focus on disease prevention and management of chronic illnesses like diabetes, alongside improving the quality of treatment.

Healthy China 2030 initiative will encourage preventive care and healthy lifestyles, helping to cut costs before they are incurred and address chronic conditions

Healthcare equity and access are also focal points. The Government Work Report noted that reforms have proceeded smoothly, with more local hospitals meeting standards alongside an increase in the number of beds available, and expansion of capacity with at least one clinic in every village and town. Costs have also been falling as a function of the expansion of the volume-based procurement of drugs and medical consumables, and the rollout of NRDL (national reimbursement drug list) negotiations, alongside higher subsidies for basic medical insurance.

2025 TARGETS

Average life expectancy of ~78

a one-year increase from 2020

The 14FYP aims to continue moving in the same direction, with further expansion of public healthcare and training of more nurses and physicians, greater research and development in clinical medicine and health tech, accelerated approval of drugs and medical devices, continuous improvement of the national medical insurance system and internet-based healthcare, and more active international cooperation. All of these present both opportunities and challenges for international firms: when market demand and potentiality continue to grow, more price pressure and local competition will also come.

China and the World

China faces its most challenging global environment in the last four decades, as tensions with the US, its biggest trading partner, show no signs of abating. US president Joe Biden's administration continues to identify China as a strategic competitor and adversary, and maintains Trump-era designations and sanctions against Chinese individuals, institutions and companies, limiting their access to US technology and markets.

Further complicating matters is China's increasingly tense relationship with other advanced industrial countries, including Great Britain, Canada and Australia, where criticism is worsening over Beijing's policies in Xinjiang, Hong Kong, Tibet, the South China Sea and Taiwan. Some western lawmakers, including former US Secretary of State Mike Pompeo, have called for a boycott of the Olympic Winter Games to be held in Beijing next February. The NPC's decision at the Two Sessions to revamp Hong Kong's election laws (see below) is certain to exacerbate frictions.

China has responded with a combination of opprobrium and enticements. On the one hand, Beijing has undertaken a robust public diplomacy that chastises the US and its allies for interfering in China's domestic matters and making baseless accusations. At the Two Sessions, Foreign Minister Wang Yi lambasted Washington for pursuing policies that resulted in 'turmoil and war' by having 'arbitrarily interfered in the affairs of other countries under the banner of democracy and human rights'.

Beijing called out the US for arbitrarily interfering in other countries' affairs

Taiwan was an issue of national sovereignty and a 'red line' that should not be crossed, Wang said, adding that Beijing had 'no room for compromise' on the One-China principle.

On the other hand, Beijing has proactively engaged its overseas allies by promoting Chinese outbound investment and initiating vaccination diplomacy. China had provided vaccine assistance to 69 countries, exporting vaccines to 28, by early March. At the Two Sessions, Premier Li said China will also continue to support the BRI, the government's signature global infrastructure, logistics and manufacturing program, which demands total funding between USD 50 and 100 billion annually.

Creating the regulatory underpinnings of a new sanctions regime

China also has put in place a series of policy tools that could be used to sanction overseas businesses operating in China, posing new risks and increasing uncertainty for foreign-invested companies.

These measures start with the Unreliable Entity List (UEL), for which Beijing published a draft working mechanism last year. The UEL would penalize individuals or entities that endanger China's national sovereignty, security, or development interests—including the boycott or halt of supplies to Chinese companies for non-commercial reasons.

An emerging system of new sanctions tools has further increased risks for foreign firms operating in China

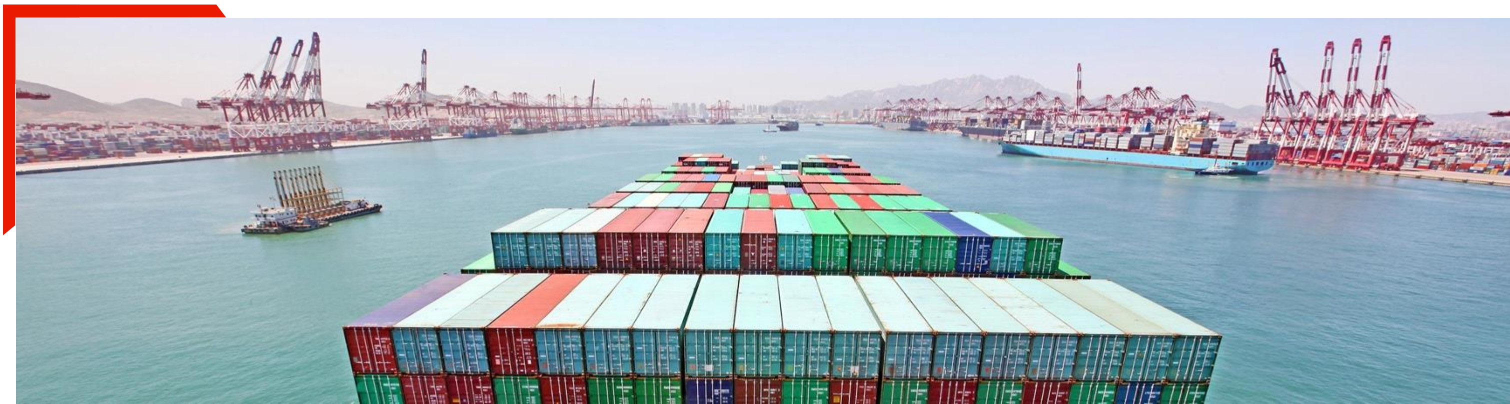
Moreover, China has revamped its national security review mechanism for foreign investment, significantly expanding the number of sectors subject to review, and earlier this year introduced blocking rules to counter the 'unjustified application' of foreign laws and other measures that prohibit or restrict Chinese firms from engaging in economic activities with a third country. Last year, it also tightened its export control regulations to restrict the overseas sale of more dual-use (military and civil) technologies and items.

Advancing multilateral trade

Separately, Beijing has turned to multinational treaties to advance its global interests, offering greater access to its domestic market of 1.4 billion consumers as a counterbalance to Washington and its calls for US companies to decouple their supply chains from China. That may create divisions within US-led alliances by providing significant new manufacturing and services opportunities for some overseas businesses.

In December, Beijing finished talks with the European Union for the China-EU Comprehensive Agreement on Investment (CAI), which provides for the elimination of quantitative restrictions and join-venture requirements in some sectors, led by manufacturing. It is now pressing European governments for ratification of the deal.

A month earlier, China completed the Regional Comprehensive Economic Partnership (RCEP) free trade agreement with 15 Asia-Pacific countries, including Japan, South Korea, Australia, Malaysia, Thailand and Singapore. At the Two Sessions, Premier Li said Beijing will accelerate China's free-trade negotiations with Japan and South Korea and will 'actively consider joining' the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.



Hong Kong SAR

Hong Kong was a top agenda item at this year's Two Sessions, with the NPC passing a resolution to overhaul the Special Administrative Region's (SAR) political system. Officials said the revamp will improve the 'one country, two systems' policy for Hong Kong, prevent subversion and promote prosperity and stability. It is Beijing's second major surgery to the SAR following its enactment last June of national security legislation in response to the city's 2019 political unrest.

The measure drew immediate criticism from the US, United Kingdom, Japan and Australia, while foreign ministers from the Group of Seven (G-7), which also includes Germany, France and Italy, issued a joint statement with the European Union High Commissioner expressing 'grave concerns'.

On top of an electoral shake-up, Beijing has signaled a high-level intention to solve the city's housing problem, a source of major discontent. Away from the political headlines, the 14FYP for the first time noted the central government's support for Hong Kong to enhance its status as an international aviation hub, while developing into an international innovation and technology hub and a regional intellectual property trading center. Impetus will also be given to further integrating Hong Kong with the mainland Chinese economy as part of the Guangdong-Hong Kong-Macao Greater Bay Area.

Hong Kong will continue to be integrated with the mainland economy as part of the Guangdong-Hong Kong-Macao-Greater Bay Area

Political system overhaul

The NPC approved a major shake-up of Hong Kong's political system, revamping the committee that elects the chief executive (head of the HKSAR government) and giving it powers to select candidates for the LegCo.

In addition, a new committee will be set up to vet candidates for the Election Committee, Chief Executive and LegCo. The raft of significant changes is to ensure that 'patriots govern Hong Kong'.

Key to the revamp is the expansion of the 1,200-strong Election Committee to 1,500 members. It will have a new, fifth sector comprising Hong Kong delegates to the NPC, CPPCC and prominent mainland organizations, on top of the existing business, professional, social and political groupings. Aspiring chief executive candidates must obtain a minimum of 188 nominations, with at least 15 from each of committee's five sectors. Previously, 150 nominations from the committee would suffice, regardless of which sectors they came from. The changes look set to dilute the power of the traditional conglomerates lobby in Hong Kong, removing their ability to be a so-called kingmaker in picking the city's leader.

The NPC passed a resolution to overhaul Hong Kong's electoral system, sparking international criticism

The LegCo will be expanded to 90 members from the current 70. Some lawmakers will come from the Election Committee. Currently half of the legislature is directly elected, a proportion that will fall with the extra seats picked by the Election Committee. The other half represents industries, professions and other special interest groups. While the exact distribution of seats among the different types of lawmakers remains to be decided, the influence of the old business elite in Hong Kong is set to be diluted, along with the presence of any major political opposition.

The electoral system overhaul, which will involve amendments to local laws and Annexes I and II of the Basic Law—Hong Kong's mini-constitution—is expected to be complete in 12 months, in time for the HKSAR's 25th anniversary in July 2022.

Long-Range Objectives to 2035

- Basically realize 'socialist modernization'
- Realize major gains in economic strength, scientific and technological strength, and comprehensive national power
- Significantly increase national GDP
- Achieve major breakthroughs in key core technologies and rise to the forefront of global innovation
- Basically realize new industrialization, informationization, urbanization, and agricultural modernization, and build a modern economic system
- Build a society, state and government governed by the rule of law
- Boost cultural soft power
- Make major gains in environmental protection, eco-consciousness and green industry
- Continue reducing total carbon emissions after a 2030 peak
- Achieve a new state of economic openness to the outside world
- Hit the per capita GDP level of 'moderately developed' countries, significantly expanding the middle-income group, equalizing basic public services, and reducing the gap between urban and rural regional development and living standards
- Achieve basic modernization of national defense and the military
- Make substantial progress in improving people's lives and achieving common prosperity

Two Sessions Backgrounder

What are the Two Sessions?

The Two Sessions, or *Lianghui* (*两会*) as the sessions are commonly known in China, are the annual gathering of the National People's Congress (全国人民代表大会全国人民代表大会) and the Chinese People's Political Consultative Conference (中国人民政治协商会议中国人民政治协商会议). Typically held during the first two weeks in March, they were delayed in 2020 due to the outbreak of COVID-19, and held from May 21 to 28. In 2021, they returned to their usual March timeslot, taking place from March 4 to 11.

What is the NPC?

The National People's Congress (NPC) is China's highest legislative body and has sole responsibility for enacting legislation in the country. The full NPC meets once a year in March and enacts and amends basic laws relating to the Constitution, criminal offences, civil affairs, state organs and other relevant matters. When the NPC is not in session, the Standing Committee of the NPC is tasked with enacting and amending laws, except for basic laws which must be enacted by the NPC.

The NPC is also responsible for electing and appointing members to central state organs—including the Standing Committee of the NPC, the President of the People's Republic of China (currently Xi Jinping) and the Premier of the State Council (currently Li Keqiang). Based on nominations by the Premier, the NPC is also responsible for appointing China's vice premiers, state councilors and ministers. This year was the 4th Session of the 13th NPC. The 13th NPC was formed in March 2018 and will serve a five-year term. This year's session was held from March 5 to 11.

What is the CPPCC?

The Chinese People's Political Consultative Conference (CPPCC) is a political advisory body that consists of representatives from industry, academia, business, entertainment, politics, and other areas. The National Committee of the Chinese People's Political Consultative Conference (中国人民政治协商会议全国委员会会) meets on an annual basis in parallel with the NPC. This year was the 4th Session of 13th CPPCC, held from March 4 to 10.

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