China's Leadership Transition

An analysis by Fleishman-Hillard in Brussels and Beijing

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Introduction

The conclusion of the 18th National Congress on 15 November 2012 provides a window into the inner workings of the Chinese Communist Party (CCP). The selection of the seven members of the country's powerful Politburo Standing Committee (PSC, or politburo) not only illustrates the tensions in China's leadership, it also emphasises the ideological struggles – and differences – in core ideas and values, different approaches to the country's openness and fundamental questions regarding reciprocity for investments.

The current global economic slowdown has dramatically increased attention to China's market prospects and its moves both inside and outside the country. This paper analyses the key changes to the new leadership and the internal and external implications for foreign players and broader Sino-European relations.

Internally, China's shift towards a "post-industrial" phase will offer opportunities to foreign companies operating in the country. However, a key hurdle remains the privileges granted to State-Owned Enterprises. As China cautiously proceeds with political reform, a central question is whether these systemic changes will benefit foreign companies operating in China and begin to level the playing field.

Externally, while Europe views itself as having remained resiliently open during the current crisis; the continuation of asymmetric Sino-EU trade relations could ultimately lead to some "pendulum" reciprocity if China does not open up its market. At the same time, closer collaboration between governments and business could help address key common challenges - energy and food security, resource scarcity, environmental issues and the consequences of an ageing population amongst them.

The conclusions of the last EU-China Business Summit in September 2012 highlighted mutual willingness to negotiate an EU-China investment agreement with the ultimate objective to better integrate two of the largest global trading blocks. While scoping exercises are being carried on both sides, it is critical for the industry to convey its interests at an early stage.

A broad range of sectors – retail, finance, telecoms, transport, pharmaceutical, automotive, chemicals and construction among them – have high stakes in the future of EU-China relations. This leadership change creates further opportunities and impetus to build and nurture solid relationships with decision-makers in order to secure a favourable business environment between Brussels and Beijing.

Key changes: Towards a new leadership style?

Pressure is mounting on China's new leadership to infuse change in terms of both management style and political priorities.

In terms of structural change, the Standing Committee has shrunk from nine members to seven, a step taken to streamline decision making and avoid political gridlock. Nevertheless, the Committee is divided by factions, containing representatives both of former President Jiang Zemin's more liberal market-oriented economics and departing President Hu Jintao's more conservative, socialist principles of government.

Regardless of which way the balance tips, the weight of ideology and direct Party influence are decreasing as leaders struggle to cope with external events such as financial crises and epidemics that force them to operate in a more pragmatic mode. Also, the rise of social media has to an extent brought more accountability into China's political culture, and drawn greater public scrutiny to a wide range of policy decisions.

THE PERSONALITIES OF THE KEY CCP NEW FIGURES

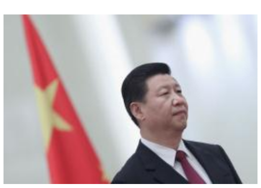
Figure 2: Foreign Policy

New President Xi Jinping will lead the government, the military, and the Communist Party, making him China's paramount leader. His ideological roots are closer to Mao's conception of socialism than to the market-based style of stewardship laid out by Deng Xiaoping. Sometimes referred to as a member of the New Left, Mr. Xi is expected to approach economic reform from the perspective of restructuring some sectors dominated by state-owned enterprises (SOEs), and to focus on maintaining the Party's monopoly on power. During the first of his two expected terms, Mr. Xi will likely follow in former President Hu Jintao's footsteps, focusing on sustaining economic growth and employment as he consolidates power.


Figure 1: Bloomberg

Incoming Premier Li Keqiang is widely considered to be a reformer. His recent speeches and statements show a clear awareness of the difficulties China faces and his efforts will likely focus on long-term economic growth, especially with regard to the financial system, corporate taxation, healthcare, telecommunications, railway transport, and domestic income disparity. However, Li is seen as a firm supporter of China's State-Owned Enterprises, which could be a challenge for foreign companies operating in China.

Figure 3: Bloomberg

Wang Qishan is the current Deputy Premier in charge of finance and trade, and has been designated as head of the Central Commission for Discipline Inspection, the country's new anti-corruption body. Wang advocates the use of market mechanisms to encourage the flow of private capital into the financial system, and has emphasised the importance of innovation, and of learning from the experience of international capital markets. It remains to be seen whether his stance in favour of private capital also encompasses foreign capital.

While the Party has tried to minimise the weight of individual personalities, factors such as the global economic pressures and the rapid spread of the Internet in China have weakened the CPC's capacity to maintain ideological purity. The leadership is not monolithic, but instead is divided along factional and sometimes even regional lines, a division sure to result in deliberate and sometimes contentious decision-making over the next few years.

The leadership transition has triggered speculation about China's future, with some observers anticipating that the policies of the new leadership will not diverge significantly from those of its predecessors. The new leaders will need a few years to consolidate power before they are able to initiate major policy changes. In addition, China's outgoing senior leaders are likely to maintain their political influence for a period of time. As a result, the immediate transition period is likely to be marked by cautious policy, with a view toward maintaining economic and social stability.

MILESTONES IN THE COMING DECADE

The new leadership will reach several critical milestones in the next decade:

2017: Five of the seven members on the PSC will retire because of mandatory age limits

2020: China's GDP is expected to surpass that of the US, making it the world's largest economy

2020: China's population will reach its peak of 1.5 billion, assuming current growth rates remain unchanged, putting 65% of its population over age 60

Decoding China's new leadership: Impact and analysis

THE INTERNAL DIMENSION

Addressing internal challenges: opportunities for foreign players?

While the legitimacy of the country's leadership rests on its ability to foster economic growth, the leadership transition comes at a time when China's economy has been slowing. Outgoing supreme leader Hu Jintao gave a speech that served as his final report to the 18th Party Congress. Closely scrutinized for clues about China's future direction, the speech takes stock of the five years since the last Party Congress and sets broad parameters for the upcoming five years, most notably:

- ***Accelerate China's transformation to a market economy*** and encourage the growth of the non-state sector. While a "socialist market economy" will continue to be a guiding principle, this could give foreign companies greater market access and help protect information and intellectual property.
- ***Grow China's middle class***. Income for both urban and rural residents is planned to double between 2010 and 2020. If the Chinese government is able to meet this ambitious target, consumers will have more disposable income, to the benefit of both Chinese and foreign consumer good companies.
- ***Further urbanization***. There is a plan in place to stimulate the migration of about 300 million residents from the countryside to the cities in the next decade, a development that will promote consumer growth and consumption, but will also necessitate the creation of significant additional infrastructure – a project as large as re-building Europe in 10 years.
- ***Foster scientific innovation*** to raise national productivity, with potential opportunities for tech-sector companies in particular.
- ***Create an "Ecological civilization"***. This new concept, introduced by the Chinese government, will impact companies operating or planning operations in China as the Constitution was amended to emphasise the strategic role sustainability will play in China's overall development.

UNTAPPED POTENTIAL FOR FOREIGN COMPANIES?

As China cautiously proceeds with political reform, economic growth will to a significant extent depend on the government's ability to address these challenges. While foreign companies' margin of manoeuvre is curtailed by the legislative framework, China's growing consumer base will offer untapped growth potential for foreign consumer goods and services companies. Moreover, as the country continues to shift towards a "post-industrial" phase, the Chinese government could leverage the expertise of the foreign companies who have worked closely with governments in Europe and the US to identify and implement workable schemes.

Foreign enterprises operating in China: Impediments to market access

Over the past few years, the State's grip on the economy has tightened. Although the number of private companies has grown, State-Owned Enterprises (SOEs) have grown more powerful, to the detriment of private domestic companies and Foreign-Invested Enterprises (FIEs). SOEs not only receive regulatory and procurement advantages, they also benefit from abundant supplies of cheap energy and raw materials, as well as favourable administrative price controls.

Today, FIEs face restricted market access in a growing number of sectors, owing to joint-venture and licensing requirements, as well as restrictions to their activities on national security grounds. As noted by the Confederation of British Industry, "FIEs are also frequently forced to transfer technology in exchange for market access; are less able to qualify for subsidies, R&D funds, and public procurement contracts; and are frequently unable even to take part in standards-drafting processes." (EU experts estimate that only 40% of China's standards align with international norms).

In the following areas, the business environment has actually deteriorated over the past years:

- ***Public procurement:*** Many multinationals complain that they are locked out of the market for government procurement contracts — (estimated size: $1.3 trillion).
- ***Logistics:*** Domestic express delivery services for letters have been added to the prohibited category in the Foreign Investment Catalogue released in December 2011.

- ***Private equity:*** In April 2012, the government overruled the 'Shanghai Circular 38' which regulates a Qualified Foreign Limited Partner pilot program that had been previously welcomed as a positive development for encouraging foreign investment.
- ***Transport:*** While in May 2012, the Chinese government hinted that the role of private capital in railways, energy and other industries might be expanded, foreign companies were told that measures to encourage private capital were completely unconnected with foreign investment. While foreign express delivery firms can now offer certain domestic services, the government has installed video cameras in warehouses on security grounds.
- ***Pharmaceuticals:*** The current 'cost-plus' pricing system will potentially eliminate price differentials between innovative and generic drugs thus hampering innovation and negatively impacting on drug quality in China.
- ***Automotive:*** Foreign brands, and foreign brand-vehicles produced in China by Sino-foreign joint venture companies, were not included in the 2012 draft catalogue for government automobile procurement and thus excluded from this large market.
- ***IPR:*** While the "well-known trademark" is a legal concept that provides protection to certain reputed trademarks, "local famous trademarks" are an award granted by the local Chinese Administration to help Chinese enterprises promote their products/services.
- ***Insurance:*** While the market for vehicle insurance has opened up to foreign insurers, unlike local rivals, they must still negotiate their expansion province by province.

WILL THE NEW LEADERSHIP EMBRACE LIBERAL REFORM?

As highlighted by the IMF, ending State monopolies could boost income per person tenfold in the long run. New Premier Li Keqiang acknowledged him-self that reform and opening up must 'continue to lead the way in removing the institutional obstacles that hamper the shift of the growth model'. The question remains whether this reform will benefit foreign companies operating in China and begin to level the playing field.

THE EXTERNAL DIMENSION

Implications for Sino-EU Relations

The question at the heart of the economic relationship between the EU and China is whether the new government will be able to muster the political willpower to overcome its vested interests in its current trade relationship with the EU. Although China has been a member of the WTO since 2001, it still maintains industrial policies and non-tariff barriers such as product certifications, labelling standards, import approval requirements and customs clearance delays. These extend to a wide range of service sectors, including construction, banking, insurance, telecommunications, and postal services.

On the political front, challenges also remain. While the EU hopes for investment from China to help relieve its debt crisis, it has also launched numerous anti-dumping investigations against China. President Xi has already expressed his view of the EU as a strategic partner and his desire to assist the EU in constructively solving its debt crisis, but trade protectionism is seen as unhelpful to continued cooperation. An encouraging example of how such compromise could be reached can be found in common solutions to carbon emission and global warming concerns. In response to pressure from the EU and other governing bodies, the 18th National Congress has already launched policies designed to proactively lower energy use and tighten controls on carbon emissions, as well as on air and water pollution. China hopes that similar compromises can be reached on restrictions of arms sales to China. In all cases, the incoming leadership views the strengthening of Chinese culture and education, and their spread to western countries, as a force that will build trust and facilitate this type of partnership.

POTENTIAL TRADE TENSIONS AHEAD?

While the EU is, at present, proactively engaged in the negotiation of FTAs with key trading partners, China seems to be less interested in reciprocal trade. However, their search for natural resources could push them to build stronger global trade relations.

Chinese companies are also increasingly looking to invest in Europe to acquire brands and technology. They are also showing their capabilities to bid for major participation in infrastructure projects in Europe. Against the context of a WTO with significantly reduced influence and a trade round seemingly on permanent hiatus, growing protectionism in some markets make calls for trade sanctions against China increasingly likely. While Europe views itself as having remained resiliently open during the current crisis, it sees this point of asymmetry as a major sticking point for Sino-EU relations and could ultimately lead to some “pendulum” reciprocity if China does not open up its market.

Navigating through challenging waters together?

China is today a leading player in the global economy: what happens in China is intimately tied to events in the rest of the world. The Chinese government's current reform priorities confirm that ultimately, China will have to continue its efforts to open up its economy in a measured way. While this will undoubtedly benefit foreign players operating in China, it will also ultimately have a positive outcome for Chinese companies and consumers.

China and the EU face a number of similar challenges – energy and food security, resource scarcity, environmental issues and the challenges posed by an ageing population amongst them. With the globalisation of the supply chain, China has become a major, if not the most important, production hub for many multinational companies operating in Europe. Any shift in labour or environmental legislation taking place in China has an impact on foreign companies producing there, and China is looking at the EU as a benchmark for matters like the classification of chemicals or product safety legislation. Healthy competition in an open market place would notably:

- Bolster productivity, innovation and economic efficiency.
- Lead to further transfer of valuable know-how in the field of green technologies and products and services but also innovation to tackle health and societal challenges.
- Increase safety and quality standards to the benefit of consumers.

THE ROLE OF PUBLIC AFFAIRS

While EU-China trade relations are carried at the highest diplomatic level, the bottom-up effect should not be downplayed. Every public affairs win is another brick towards the opening-up of the Chinese economy. Multinational companies navigate in a globalised economy which implies that a silo approach to public affairs is no longer viable. Chinese companies rely on public affairs strategies to benefit from a favourable regulatory environment in Europe and the same applies to European companies operating in China. As a result, the future of EU-China trade relations also starts by building a climate of mutual understanding, dialogue and cooperation between foreign companies and decision-makers, in Brussels, Beijing and beyond.

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