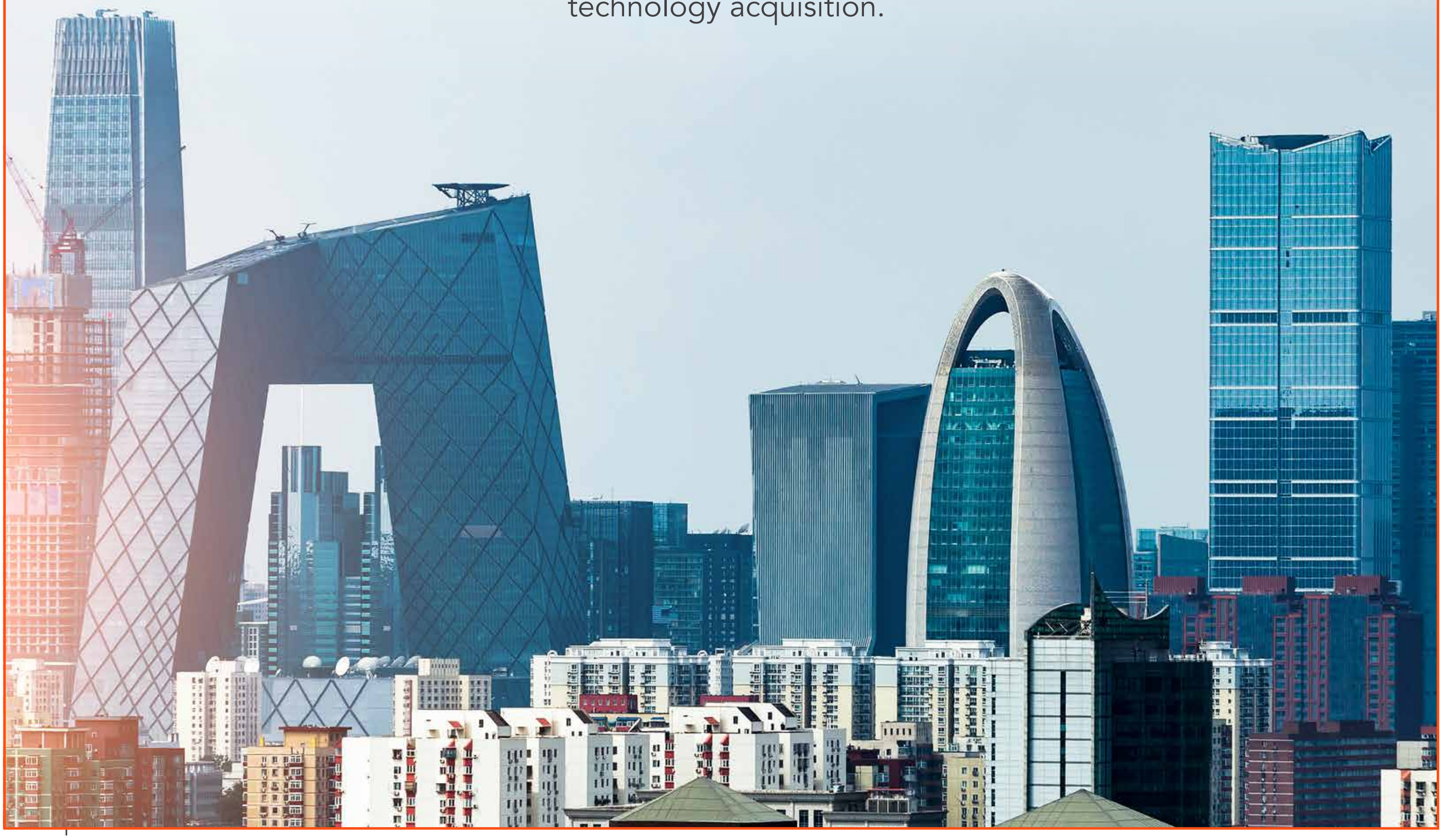
APCO worldwide®

Two Sessions:

Consolidating the "Core" While Slow-walking Reforms

James McGregor, Chairman, APCO Worldwide in Greater China

The recently completed annual "Two Sessions" of China's legislature and advisory bodies contained two notable highlights. On the political side, both confabs were resplendent with "core of the core" choreography ensuring everybody is in lock-step with President Xi Jinping as the unquestioned leader of the Chinese Communist party, with the party in turn as the undisputed overlord of every government entity and action. On the policy side, the prevailing narrative was to "make progress while keeping performance stable." Or in other words, slow-walking reforms while fast-tracking state-led entrepreneurship and top-shelf technology acquisition.



"CORE OF THE CORE"

President Xi sees himself as the party's third transformative leader behind Mao Zedong and Deng Xiaoping. This was cemented in party nomenclature last October when a party meeting declared President Xi as the "core" of the party.

For the most part, both the National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC) this year were tightly stage-managed rehearsals for the much anticipated 19th party Congress later this year at which the new leadership lineup will take to the stage.

This was abundantly clear as every public utterance carried a pledge of allegiance that all things will take place "under the firm leadership of the Central Committee of the Communist party of China with Comrade Xi Jinping at its core." As the official Xinhua news agency put it, "safeguarding Xi's core status is a political issue of utmost importance."

In preparation for the party Congress, the leadership also clarified that President Xi would not follow Deng's path on separating party and government powers. "Under the party's leadership, there is only division of labor between the party and government, not separation of powers," President Xi loyalist and party anti-corruption czar Wang Qishan declared. "Within the party, the government, the army, the people, academics, and east, west, south, north, center – the party leads everything."

"Under the Party's leadership, there is only division of labor between the party and government, not separation of powers… Within the Party, the government, the army, the people, academics, and east, west, south, north, center – the party leads everything."

– Wang Qishan

Premier Li Keqiang, who is rumored to be at odds with President Xi and facing the possibility of not surviving for a second term, praised President Xi's "new vision, thinking and strategies for China's governance" to make it clear that he is on board with the "core" construct. At the same time, he also raised eyebrows of the rank-and-file cadres when leaving the stage of his annual press conference with this quip: "See you again, if there's the opportunity."

SLOW-WALKING REFORM

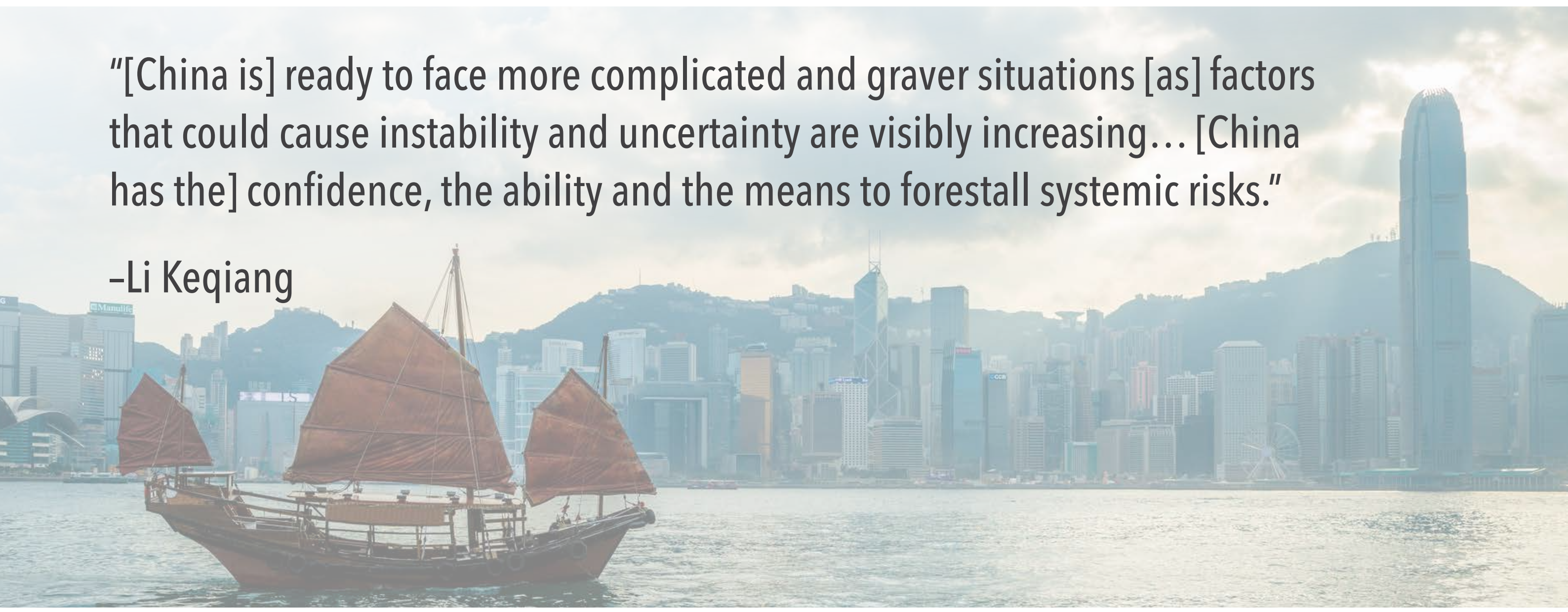
Hanging like the Beijing smog over the proceedings was the Twitter-tainted visage of President Donald Trump and the unpredictability he brings to U.S.–China ties and world affairs. Faced with such a foreboding landscape, the party signaled that the extensive economic reforms put forth in 2013 will mostly remain on the shelf for at least another year.

Without pointing fingers at the United States, Premier Li declared that China is "ready to face more complicated and graver situations" as "factors that could cause instability and uncertainty are visibly increasing." Nonetheless, Premier Li also assured delegates that China has the "confidence, the ability and the means to forestall systemic risks."

Risk management was certainly high on the agenda of financial regulators, who promised "steady reforms" but seem determined to not trigger investor losses or any financial instability. They promised to reign in shadow banking and impose controls on the risky wealth management products that are estimated to have grown to a size equal to 40 percent of GDP. But the leadership didn't push forward with plans to create a "Financial Supervisory Commission" to oversee and coordinate the activities of the Central Bank (PBOC) and the banking, insurance and the financial market regulators (CSRC, CBRC, CIRC).

In celebrating the achievements of 2016, party officials heralded 6.7 percent growth last year, with the service sector accounting for more than 50 percent of GDP and China accounting for 30 percent of global growth. But Premier Li also highlighted "major structural problems" and "prominent risks and dangers" while emphasizing that the "government-market relationship" will be the "pivotal issue in economic and structural reform."

At times the Chinese leadership talked like traditional U.S. Republicans, promising to cut taxes, reduce fees and cut red



"[China is] ready to face more complicated and graver situations [as] factors that could cause instability and uncertainty are visibly increasing… [China has the] confidence, the ability and the means to forestall systemic risks."

–Li Keqiang

tape for businesses, while reducing government spending and to "keep pushing hard" on expanding entrepreneurship and encouraging innovation. While there was much talk of private-public partnerships to encourage private companies to co-invest with state-owned enterprises (SOEs), it was also clear that the party plans for SOE reforms will continue to be a drawn-out process in order to control the pace of layoffs and keep the party's grip on the business world.

The great growth hope is entrepreneurship. The central and local governments are accelerating the formation of venture capital funds with an emphasis on supporting forward-leaning sectors such as cloud computing, smart manufacturing, artificial intelligence, virtual reality and big data. Seed money funds are forming to help the country's eight million annual college graduates form new ventures as they face shrinking job prospects. Premier Li boasted that in 2016, approximately 15,000 new businesses were being registered per day in China.

Boosting the consumer sector is a continued priority, and it is gaining traction, accounting for about two-thirds of China's GDP growth in 2016. Initiatives outlined by the National Development Reform Commission (NDRC) during the NPC to boost consumer spending included: improving national logistics to speed quality products to the third and fourth tier cities, pushing e-commerce in rural areas, promoting tourism, elderly care, vocational training and entertainment services and facilities.

Regarding real estate, the government is caught between existing property owners who will be indignant about a price tumble and those who are unable to get into the ridiculously priced market. A huge inventory of unsold apartments in secondary cities led to a buying frenzy last year as mortgage terms were eased, with much of the purchasing being speculation by funds smelling growth opportunities. This led Premier Li to declare that: "Houses are built to be lived in, not for speculation." President Xi made similar statements.

The government's pronouncements on level playing fields, equal treatment and win-win cooperation are now falling on deaf ears.

Extensive infrastructure investments are still a key part of keeping the economy perking along. This includes the One Belt, One Road campaign which has China pushing into Southeast Asia, Central Asia, Africa, the Middle East, India, Russia and Europe with highways, railways, pipelines, information networks, port facilities and other massive infrastructure projects. Worries about ballooning debt, which has gone from 160 percent of GDP in 2008 to 260 percent in 2016, has created a predilection for public-private partnerships. So far, no small amount of this involves state-owned enterprises and the government, which really adds up to public-public partnerships. In short, infrastructure will keep rolling along to absorb overcapacity in the construction industry and help the party keep "performance stable."

MADE IN CHINA 2025: GOING OFF SCRIPT

The smooth and steady "Two Sessions" tenor was thrown off script by vocal opposition to the government's signature technology initiative known as Made in China 2025. The EU Chamber shrewdly issued its critical China 2025 report just as the NPC opened, and came amid similarly scathing studies from the U.S. Chamber of Commerce, the Mercator Institute, and others. All portray China 2025 as a protectionist blueprint aimed at gutting high-end manufacturing in the United States, Europe, Japan and other developed economies. As the German think tank Mercator Institute described it: "China wants to obtain control over the most profitable segments of the global supply chains and production networks."

The plan calls for Chinese companies to produce 40 percent of core components and materials in China's manufacturing chain by 2020 and 70 percent by 2025. This onslaught of criticism led Premier Li to promise equal treatment for foreign companies. Ministry of Industry and Information Technology (MIIT) Minister Miao Wei said the criticism was a "misunderstanding" and the domestic targets are "projections" not to be taken literally. "It is meant to allow the market to play a decisive role in allocating resources." Miao Wei said.

BOTTOM LINE FOR MNCS: A RHETORICAL GAP

In their speeches and remarks, President Xi and Premier Li emphasized that China is offering expanded opportunities for foreign companies in China. They reiterated a document issued by the State Council in January that outlines loosened restrictions on foreign access to a wide range of sectors and industries in which China needs foreign help to develop domestic competitors, such as banking, securities and fund management, mining, unconventional oil and gas, among others. The document also encourages foreign investment in China 2025 areas of high-end manufacturing, smart manufacturing, industrial design, modern logistics, test and certification, constructing R&D centers, enterprise technology centers, and even post-doctoral research centers. All very positive if only China did not have a zero-sum, self-sufficiency mindset.

Foreign business has become exhausted by the rhetoric of reform and opening while their on-the-ground existence more resembles reform and closing. The government's pronouncements on level

playing fields, equal treatment, and win-win cooperation are now falling on deaf ears. The question in the minds of foreign business is if the next wave of investment openings will turn out like the previous ones. Once China learns from the foreigners and builds its own industries and enterprises, will they once again be squeezed out of the market?

As the United States appears to retreat from leading the multilateral trade agenda, globalization is top of mind for Chinese leaders. No country is more dependent on continued multilateral trade regimes and open markets. Premier Li said that China must "firmly uphold the authority of the multilateral architecture and see that it works effectively; and oppose protectionism in its different forms."

WHAT'S NEXT?

The Chinese government and foreign business community is focused on what happens after the 19th party Congress, slated for October or November. Chinese governing patterns are often the opposite of the United States. In their first term, American presidents come in with a mandate and the political capital to get things done. The second term is the lame duck period as the focus turns to who comes next. For China, the first term is lame duck – Beijing duck style – with the focus on eliminating political enemies and potential challengers and installing loyalists across the bureaucracy. President Xi has been a virtuoso performer in this stage, with his anti-corruption campaign aiming at toppling "tigers" and "flies" and every form of political life in-between that could constitute a threat.

Along the way, he has given organizational structure to an authoritarian ideology and governing system that allows and encourages individual fulfillment within the framework of what is good for China as a whole. But President Xi still must deal with the economic distortions resulting from three decades of growth-at-all-cost economics, and every-man-for-himself greed before they implode.

Saving the party has been his top priority for his first five-year term, with the focus being discipline, repression and obedience. Saving the country will likely be at the top of his agenda for his second, that means building a sustainable system that provides sufficient rewards for the citizenry.

In a system in which the leadership appoints itself, power is very fragile. The emergence of Donald Trump and other nationalist political movements in the West has handed China a global leadership role it neither sought, nor is ready for. But now China sits as the leading proponent of globalization and free trade, ironic for a country that has been building ever higher protectionist barriers to foreign business.

But those are matters to sort out in the international arena. This year's "Two Sessions" and the upcoming 19th party Congress are only mired in the consolidation of party power under President Xi Jinping as the "core" leader of anything and everything in China.

As President Xi and his inner circle plan how to move forward after the party Congress, they may want to pay at least passing attention to the one American China-hand who has been willing to speak truth to power:

> "Empires persist if repression gives way to consensus."
>
> – Henry Kissinger

James McGregor is chairman of APCO Worldwide's greater China region and author of two highly regarded books: *No Ancient Wisdom, No Followers: The Challenges of Chinese Authoritarian Capitalism*, and *One Billion Customers: Lessons from the Front Lines of Doing Business in China*. He also wrote the noted APCO monograph *China's Drive for Indigenous Innovation — A Web of Industrial Policies*.

Prior to joining APCO, Mr. McGregor was the founder and CEO of a China-focused consulting and research firm for hedge funds, a reporter for The Wall Street Journal and a chief executive of Dow Jones & Company in China. Mr. McGregor is also a former chairman of the American Chamber of Commerce in China, and has long served as a leader of AmCham's U.S, government relations. He is a member of the Council on Foreign Relations, National Committee on U.S.-China Relations, the International Council of Asia Society and a board member of the U.S.-China Education Trust.

Mr. McGregor is a professional speaker, regular television and radio commentator and a contributor of essays and opinion articles for a variety of publications. He has lived in China for nearly three decades and is fluent in Chinese. He splits his time between Shanghai and Beijing.

Online Consumption

Gary Li

As China transitions from an economic model driven by investment and manufacturing to one that is more services oriented, the consumer economy is slated to stand in for the slack left by heavy industry. Consumption has been the primary driver of the economy since 2014, and accounted for 64.4 percent of GDP growth in 2016.[1] This trend is set to continue as China sets out to double its nationwide 2010 GDP and per-capita income by 2020[2] to enable greater consumer spending. However, these ambitions are beset by prospects of a rapidly ageing population and mass layoffs in smokestack industries, which could adversely impact household incomes and broader economic growth. To counter these risks and traverse the middle-income trap, China is attempting to harness currently underexploited interior markets and utilize innovation and online technology to boost consumer spending.

“[Last year], we…built 12 new integrated experimental zones for cross-border e-commerce, bringing about a steady recovery in the volume of import and export.”[3]

– Li Keqiang

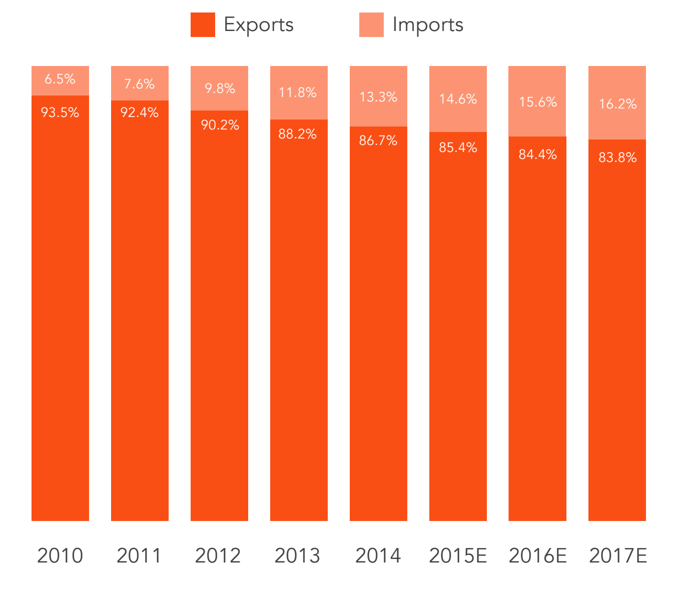
THE RISE OF THE ONLINE ECONOMY

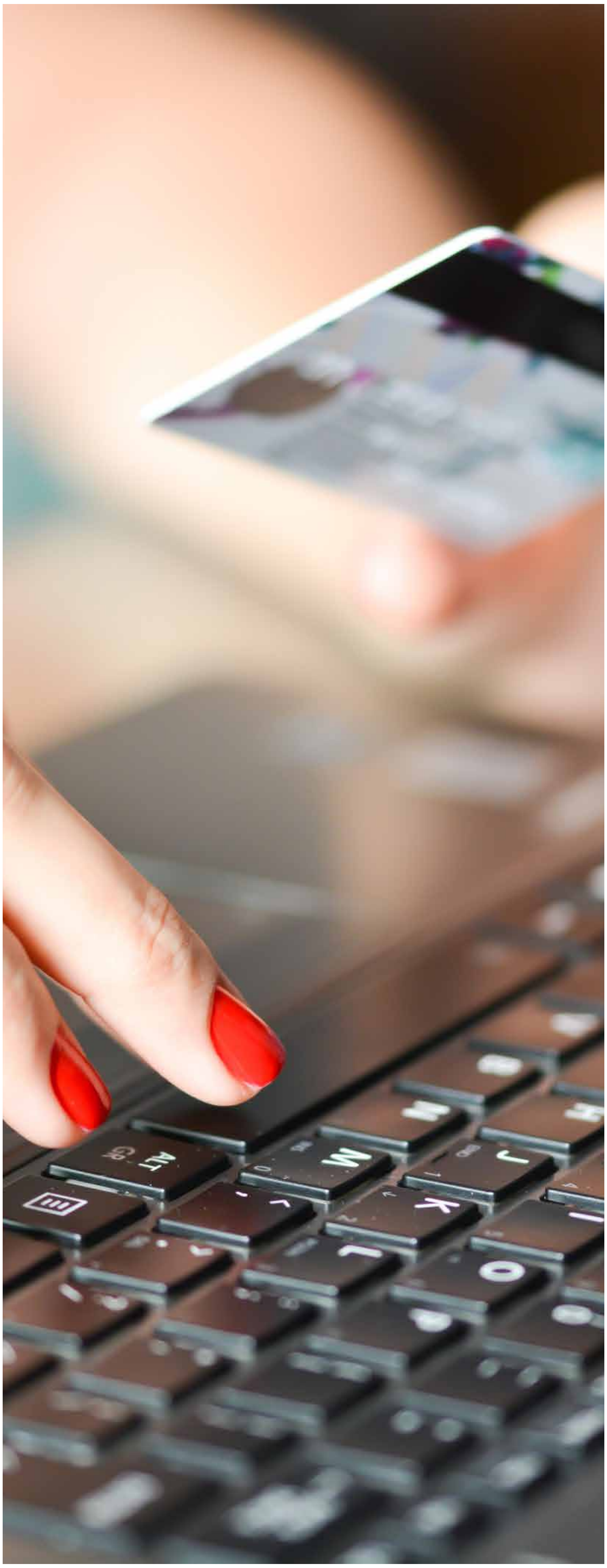
With roughly $40 billion worth of trade in 2015,[4] China’s cross border e-commerce sector (CBEC) is a huge enabler for consumption-driven growth. In the wake of an announcement from the Ministry of Commerce’s predicting that CBEC will be a conduit for 30-40 percent of total trade by 2020,[5] recent years have seen a surge of private investment as well as government-created pilot zones. However, sudden changes to customs policies in April 2016 threw many Chinese CBEC firms into disarray, as the preferential tax rates applied to bonded imports were phased out. Industry observers have suggested that this implies a preference among government policymakers in favor of export-driven growth, using CBEC primarily as a channel to increase demand for the country’s struggling manufacturing sector.

HIDDEN CONSUMERS

Nonetheless, e-commerce will certainly continue to play a key role in China’s maturing economy, empowering Chinese retailers to compete on global markets and allowing foreign multinationals to tap into China’s vast online consumer ecosystem. E-commerce giants Alibaba and JD.com are also targeting the roughly 600 million-large rural population in China as the next frontier of growth, whose incomes are rising faster than their urban counterparts.[6] Recent research claims that 160 million people in low-tier cities who, despite using online services, have yet to begin shopping online.[7] The Ministry of Commerce has also announced its intention to establish relevant training programs and infrastructure development in rural locations.[8] E-commerce may feasibly play a key role in the development of 10 megacity clusters across large swathes of the country, both rural and urban, which aims to strengthen strategic infrastructural and economic links between regions.

CBEC IMPORTS VS EXPORTS[9]





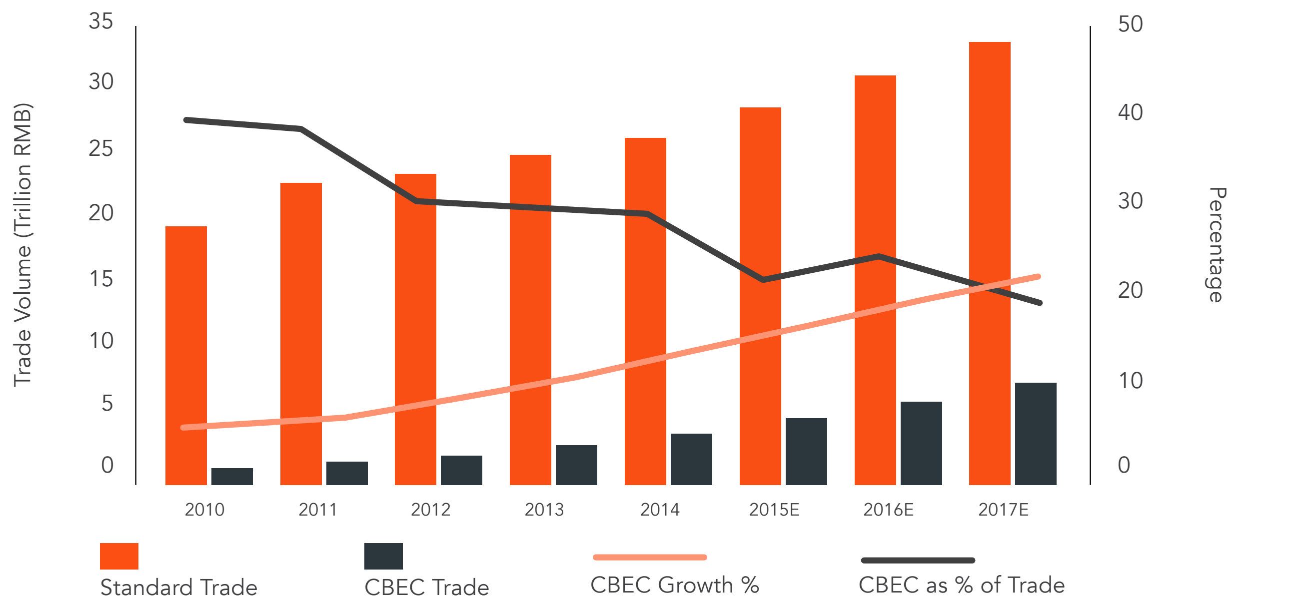
PLUGGING INTO INTERIOR MARKETS

Foreign multinationals in China should explore how best they can adapt and contribute to China's evolving online consumer environment. In the sector's ongoing rural expansion for example, current limitations in logistics, payment systems and product diversity may provide unique opportunities for development.[10] In China's urban areas, companies may need to localize their marketing and enhance their product segments to appeal to a more diverse and demanding Chinese consumer. For those looking to enter or expand the market, setting up a presence on online platforms such as Tmall – Alibaba's B2C online platform – can enable swift and cost-effective penetration. Lastly, goods manufacturers in China may also look to take advantage of the government's push to increase exports on e-commerce platforms.

With assistance from Jonathan Dove and Rachel Hou.

1 http://www.chinadaily.com.cn/business/2017-02/21/content_28288559.htm
2 http://news.xinhuanet.com/english/2015-10/29/c_134763506.htm
3 2017 NPC Work Report, Li Keqiang
4 http://www.mckinsey.com/industries/high-tech/our-insights/crossborder-ecommerce-is-luring-chinese-shoppers
5 http://www.amchamchina.org/news/china-twists-cross-border-e-commerce-for-its-gain
6 https://www.wsj.com/articles/alibaba-jd-com-target-rural-china-for-e-commerce-growth-1440980597
7 http://www.mckinsey.com/industries/retail/our-insights/how-savvy-social-shoppers-are-transforming-chinese-e-commerce
8 http://www.chinadaily.com.cn/business/tech/2016-10/18/content_27093026.htm
9 Chinese state, trade and industry media
10 http://www.scmp.com/business/article/1965944/how-e-commerce-changes-lives-rural-china

CBEC GROWTH[9]



Made in China 2025

Ryan Morgan

"Made in China 2025" is an ambitious industrial master plan released in 2014 with the explicit goal of turning China into a manufacturing superpower and challenging the market dominance of advanced economies, while at the same time holding off rising competition from other developing countries. Premier Li Keqiang, in his opening address of the Two Sessions, stated that international companies were welcome to participate and would "enjoy the same preferential policies under Made in China 2025." However, domestic market-share targets, large-scale subsidies for domestic firms, and government financing of overseas technology acquisitions have led many to see the initiative as a form of economic nationalism.

Unlike the West, China intends on keeping its manufacturing base, from textiles to low-end electronics, even as the country aims to move up the value chain.

CONQUERING TOMORROW WHILE KEEPING THE PAST

Made in China 2025 is forward-looking and aims to control tomorrow's technologies, particularly those related to smart manufacturing. The plan envisions a mastery of high-end technology segments such as robotics, semiconductor chips and big data analytics, among other identified 'winners.' The head of the National Development and Reform Commission (NDRC), Ning Jizhe, stated during the Two Sessions that: "Made in China 2025 is focusing on high-end, intelligent, and sustainable manufacturing." The plan is also a defensive strategy to protect low-end manufacturing segments that are threatened by other developing countries as Chinese wages rise. Advanced manufacturing and digital transformation have been identified as the best way of maintaining an advantage. Unlike the West, China intends on keeping its manufacturing base, from textiles to low-end electronics, even as the country aims to move up the value chain.

GOVERNMENT TOOLKIT

To meet the goals laid out in Made in China 2025, the government is using a mix of policy measures that favor domestic companies. These include various forms of market access barriers. Large swathes of China's economy have been labelled off-limits to foreign participation. These include areas often designated as "critical infrastructure" such as telecom, energy, finance, and have also been extending to other sectors such as the internet, entertainment and education. Indirect barriers such as cybersecurity regulations and standards also provide the government with tailored instruments to create advantages for domestic players. Perhaps the most crucial part of Made in China 2025 has been overseas technology acquisition, often politically driven and financially supported by Chinese government funds. This is crucial if China is to meet its Made in China 2025 objectives.

PRESSURE ON FOREIGN BUSINESSES

Foreign companies in China are increasingly being pressured, if not required, to contribute to China's technology upgrading agenda laid out in Made in China 2025. Businesses in China are not only facing competition from domestic firms that are slowly catching up, but also face the risk of Chinese firms acquiring their international competitor. A business that becomes Chinese through acquisition can then receive government support and other domestic advantages, potentially putting their foreign business competition at an immediate and severe competitive disadvantage both domestically and globally.

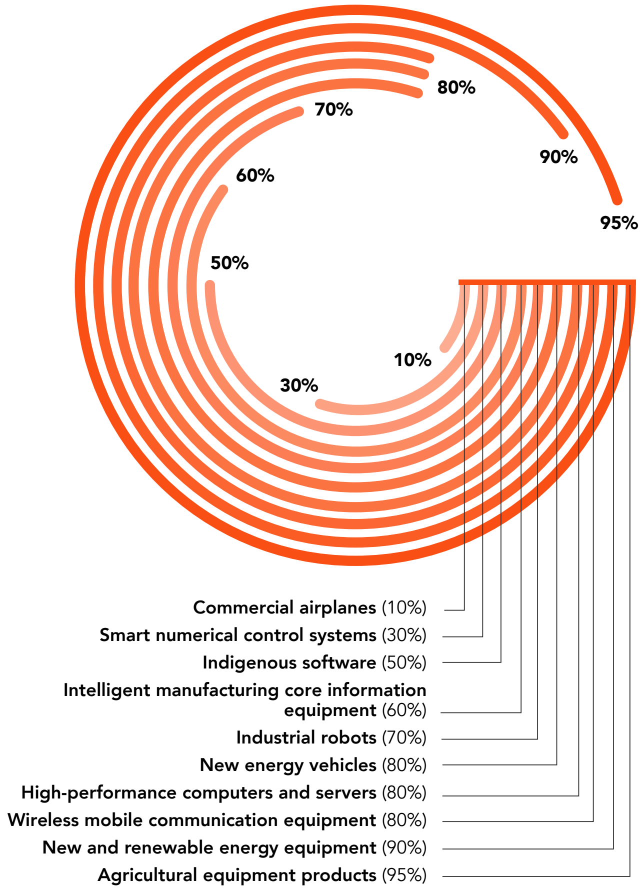
PUSHBACK 2017

In the face of Made in China 2025 and other industrial upgrading policies, there are increasing calls for trade and investment reciprocity. Several recent high-profile acquisition attempts by Chinese firms in Europe and the United States have been blocked, including the purchase of the semiconductor company Aixtron by the Fujian Grand Chip Company. As China 2025 cannot succeed without the technology and participation of foreign companies, the time might be right for the country to craft a new type of relationship with multinational companies, one which matches the win-win rhetoric of this year's Two Sessions.

With assistance from Yining Yuan.

> "We will endeavor to transform and upgrade traditional industries. We will intensify efforts to implement the Made in China 2025 initiative, promote accelerated application of big data, cloud computing, and the Internet of Things… to bring about transformation in the production, management, and marketing models of traditional industries"
>
> – Li Keqiang

2025 Percentage Market Share Target[1]



1 http://www.miit.gov.cn/n1146290/n4388791/c4391777/part/4393103.pdf
https://www.uschina.org/sites/default/files/2-2-16%20Sector%20and%20Localization%20Targets%20for%20Made%20in%20China%202025.pdf

Financial Reform

Benjamin Jacobs, Yvonne Yu

After two years spent responding to stock market volatility, capital outflows and acute risks in sectors such as P2P lending, China's government has now placed medium-to-long term financial risk management at the front of its policy agenda. At this year's Two Sessions promises to deleverage, crack down on shadow banking, and tighten supervision over questionable wealth management products (WMPs) have featured prominently. However, as China has repeatedly demonstrated, recognizing these problems is simple; fixing them is harder. As the politically sensitive 19th party Congress approaches, economic stability will remain the government's number one priority, making it unlikely that any of the financial reforms that have been proposed will be carried out aggressively. This was apparent in China Securities Regulatory Commission (CSRC) Director Liu Shiyu's Two Sessions press conference, during which he voiced support for steady reforms rather than "long strides."[1]

However, as China has repeatedly demonstrated, recognizing these problems is simple; fixing them is harder.

"SUPER COMMISSION" ON HOLD

One of the most discussed reforms heading into the Two Sessions was the creation of a "Financial Supervisory Commission" to oversee all financial transactions, an idea proposed during a February meeting of the Central Leading Group on Finance and Economic Affairs.[2] However, due to the difficulty of getting both the central bank (PBOC) and China's three financial watchdogs (CSRC, CBRC, CIRC) to cede authority to a new organization, it appears this plan has been temporarily sidelined in favor of granting the PBOC more power to lead and coordinate regulatory activity among the three commissions.[3]

This enhanced coordination is already underway to a degree, with the PBOC taking a leading role in drafting new regulations to rein in China's RMB 60 trillion asset management industry by consolidating all asset management products and investment schemes under one regulatory umbrella.[4] Additionally, the PBOC has voiced support for modest interest rate increases to bring corporate leverage under control, tighter regulation of WMPs and further facilitation of bankruptcies for failing enterprises.

RISK HIDING VS. RISK MITIGATION

These actions constitute important initial steps toward reducing corporate debt and financial risks that could hobble the Chinese economy in the medium-to-long term, but truly implementing the deleveraging required to effectively tame China's financial risks remains an extraordinarily challenging task. China's four major asset management companies are currently aggressively selling bonds to fund their cleanup of toxic debt, compounding leverage and causing their balance sheets to expand 400 percent between 2012 and 2016.[5] These asset management companies have simply become "too big to fail", and will almost certainly be bailed out by the government if necessary. This moral hazard is also implicitly assumed by China's major banks, which rely on risky off-balance sheet WMPs—now estimated to total nearly $4 trillion, or approximately 40 percent of China's GDP—for their liquidity needs. If China's regulators were to require the inclusion of WMPs on balance sheets, it would create a cash crunch as banks would be forced to substantially increase their reserves to meet capital requirements. Until the Chinese government builds the capacity and resolve necessary to confront these dilemmas, risk will merely continue to be accumulated and moved around the economy, not truly reduced.

CHINA'S ASSET-MANAGEMENT PRODUCTS TOTALED ABOUT **60 TRILLION YUAN ($8.7 TRILLION)**

FOR LIQUIDITY NEEDS, RISKY OFF-BALANCE SHEET WEALTH MANAGEMENT PRODUCTS (WMPS) ESTIMATED TO TOTAL NEARLY **$4 TRILLION** OR APPROXIMATELY **40% OF CHINA'S GDP**

THE GOVERNMENT AIMED TO CUT COMPANIES' TAX BURDEN **BY ABOUT 350 BILLION YUAN** ($51 BILLION) IN 2017[7]

NEW YUAN LOANS **HIT 2.03 TRILLION YUAN IN** JANUARY 2017

FIXED-ASSET INVESTMENT IS EXPECTED TO RISE **ABOUT 9% IN 2017,** DOWN FROM LAST YEAR'S **TARGET OF 10.5%**

CHINA'S CORPORATE DEBT HAS SOARED TO **169% OF GDP**[8]

WHO BLINKS LAST, WINS?

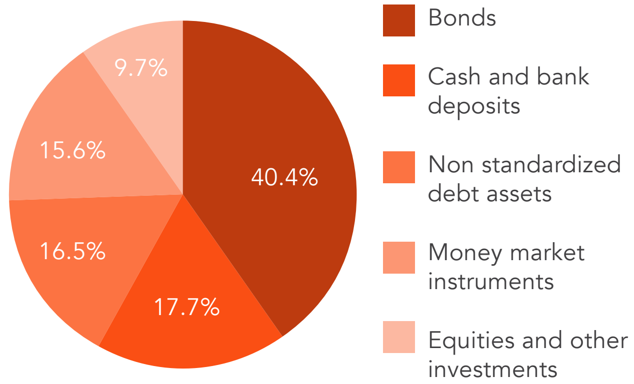
In the words of China specialist Christopher Balding, "China's government is now engaged in a game of chicken. Impose losses on investors, and it risks triggering a run on the bank; continue bailing out investors, and it risks creating a problem that will swallow the economy whole."[6] As Li Keqiang's calls to impose discipline on unruly investors and financial markets reverberate across China's state media, local bankers and regulators remain paralyzed between ambitious short-term growth targets and the long-term necessity of forcing painful losses on investors. While the government will almost certainly avoid causing a stir over the months leading up to the 19th party Congress, eventually, it will be forced to reckon with this unpalatable choice.

FINANCIAL REFORM INDICATORS

- Upcoming National Financial Work Conference to clarify financial regulatory reform
- Further opening of bond market to foreign investors, including Li's proposed HK-China Bond Connect
- More efforts in securing RMB stability, with more capital control and overseas ODI restrictions if necessary
- To-be-released "Guiding Opinions on Regulating Financial Institutions' Asset Management Businesses", which aims to overhaul the whole of the asset management sector
- Four-tier VAT system reduced to three tiers
- More measures to curb house prices in tier one and two cities

With assistance from Abby Bi, Yuchen Yang, Xinhui Zhai, and Meihui Zhang.

Wealth Management Product (WMP)[9]



The People's Bank of China (PBOC) estimates that WMPs grew 30 percent in 2016, outstripping normal lending, which grew only 10 per cent. WMPs by sector of final borrower as of the end of the first half 2016.

1 http://news.xinhuanet.com/english/2017-03/07/c_136110106.htm
2 http://www.chinadailyasia.com/business/2017-03/08/content_15582522.html
3 http://cn.reuters.com/article/financial-insight-pboc-regulators-0315-w-idCNKBS16M0PQ
4 http://www.scmp.com/news/china/economy/article/2072754/chinas-central-bank-leads-charge-shine-regulatory-light-risky
5 https://www.wsj.com/articles/bad-banks-spread-across-china-1488195939
6 https://www.bloombergquint.com/opinion/2017/03/06/china-s-hidden-risks-rise
7 http://www.reuters.com/article/us-china-parliament-idUSKBN16C007
8 http://www.cnbc.com/2017/03/09/china-will-strengthen-control-of-risks-in-asset-management-industry-central-bank-governor.html
9 Chinese state, trade and industry media

Entrepreneurship

Feng Feng, Gina Pan

China's national strategy to address emerging problems of unemployment and slowing economic growth has identified entrepreneurship as a critical component. After initiating the "mass entrepreneurship and innovation" campaign in 2014, Premier Li Keqiang announced in his 2017 government work report that approximately 15,000 new businesses per day were registered during 2016, a 24.5 percent year on year increase. Government support has played a critical role in driving entrepreneurship growth and is likely to continue. In 2015 the central government announced its intention to establish a RMB 40 billion national entrepreneurship fund, which was quickly emulated by local governments. This drastic investment in top-down entrepreneurship has not always been met with success however, and has inherent risks.

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TECHNOLOGY DRIVEN ENTREPRENEURSHIP

Entrepreneurship is closely connected with innovation and technology in China. The government encourages entrepreneurs to participate in emerging industries such as big data, VR/AR, cloud computing, AI, and smart manufacturing. The government's interest in these industries is motivated by its Made in China 2025 strategy and Internet Plus initiative, both of which aim to upgrade China's position in the global supply chain through technological innovation. Following Shenzhen's designation as a pioneer city aimed at promoting entrepreneurship, it set up a government venture capital investment fund which has placed RMB 500 million annually into start-up programs. Over 60 percent of the 140 programs financed by this fund by 2016 were related to these emerging industries.[1]

SHORT AND MEDIUM TERM RISKS

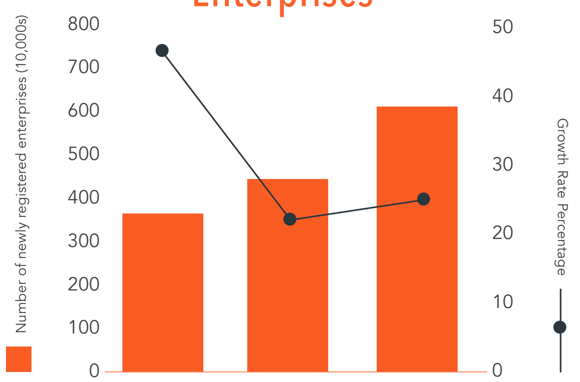
Despite the promising data released by the government celebrating the success of its entrepreneurship policy, its ability to hurdle the "middle income trap" is not assured. Government-favored industries run the risk of forming bubble economies as investors rush to capitalize on incentives, while high-risk business models that can nonetheless access government funding can lead to waste. An official from the National People's Political Consulate Economic Policy Committee stated that around 30 percent of newly registered business in China never take off, with another 20 percent shutting down within a year. On average, only 2 percent of college student entrepreneurs succeed.[2]

BRAIN DRAIN

While China's entrepreneurship policy primarily impacts domestic players, multinationals need to be aware of potential talent loss and increased competition from Chinese start-ups. As talented workers, many of them middle-senior managers, leave multinationals to begin their own startups, their familiarity with foreign technology and management makes them potential competitors of tomorrow. The Chinese government's efforts at cracking down on cybersecurity threats and reducing foreign influence in China's cyberspace may also offer Chinese high-tech startups an upper hand on multinationals.

With assistance from Keran Shao, Xinhui Zhai, and Nancy Zhang.

Growth of Newly Registered Enterprises[3]



1 http://www.szsti.gov.cn/notices/2016/8/12/1
2 http://www.stdaily.com/kjrb/kjrbbm/2017-03/11/content_523575.shtml
3 Source: National Bureau of Statistics and 2017 Government Work Report
4 Chinese state, trade and industry media

Some Government-led Entrepreneurship Funds (in RMB)[4]

100 Billion

Owner: Ministry of Education (MOE) and China Construction Bank (CCB)

Fund Name: *China University Innovation and Entrepreneurship Industry Investment Fund*

Establishment Year: 2016

40 Billion

Owner: NDRC

Fund Name: *National Emerging Industry Entrepreneurship Investment Guiding Fund*

Establishment Year: Announced in 2015, not launched yet

3.5 Billion

Owner: Sichuan

Fund Name: *Sichuan Innovation and Entrepreneurship Investment Guiding Fund*

Establishment Year: 2015

2 Billion

Owner: Shanghai

Fund Name: *Shanghai Innovation and Entrepreneurship Incubation Fund*

Establishment Year: 2016

1 Billion

Owner: Wenzhou

Fund Name: *Wenzhou Technology, Innovation and Entrepreneurship Investment Fund*

Establishment Year: 2016

1 Billion

Owner: Nanhai District, Foshan

Fund Name: *Nanhai Innovation and Entrepreneurship Investment Guiding Fund*

Establishment Year: 2016

.5 Billion

Owner: Dalian

Fund Name: *Dalian Innovation and Entrepreneurship Equity Investment Fund*

Establishment Year: 2016