

China Briefing

China's Two Meetings offer a sneak peak at a changing China

Foreword

Once a year, China's legislature and official advisory body meet (the "Two Meetings") to propose and decide what China's laws will be for the coming year. This year's Two Meetings just finished yesterday.

We are writing with some early thoughts on these meetings for two reasons: firstly, we think that the Two Meetings are fundamental for investors. This year, as covered widely, the legislature passed a bill mandating that it would write and pass security legislation on behalf of Hong Kong, contrary to the one country, two systems framework. This is a significant shift. However, there were other changes. The government outlined how it assessed its work, and what it would focus on for the coming year. And China introduced, after decades of trying, a new Civil Code. It also dropped economic growth target measures for officials, a radical new step.

Secondly, Xi Jinping likes using laws to rule far more than previous leaders. China's 2018 constitutional changes give the legislature unprecedented powers. It is essential that these decisions be taken seriously. Yet they are rarely understood, even by dedicated analysts. This is a rare opportunity to find insights beyond what may be commonly available.

In this Monthly, we will explain how the Two Meetings work, what happened at them, and what we think it might mean for you.

What are the Two Meetings, and what did they do?

China's legislature, the 13th National People's Congress (NPC) and China's official advisory body, the Chinese People's Political Consultative Conference (CPPCC) hold their national meetings together, annually, at the same time. This is traditionally known as the so-called "Two Meetings". This year the meetings were delayed, and shortened from their customary ten-day duration due to the COVID-19 pandemic.

Both the Two Meetings have around 3,000 delegates. But of the two meetings, the NPC is far more important. It is the only chance in the year where laws can be passed in full session. The advisory body CPPCC meets at the same time, but it consists more of famous and influential people giving their thoughts, and has no binding power.

What is less understood is where the two meetings sit within China's overall governance structure. Diagram 1 in the following page describes.

It shows that the National People's Congress, the legislature, is the peak body of the government system. But the NPC still answers to the ruling Communist Party of China. This occurs through individual affiliations trumping official obligations: All but one National People's Congress delegates also have Communist Party membership, and therefore are bound by the rules of the Party. Hence, the Party can send what it thinks to the legislature, where it is debated on and passed by Party members, bound by Party rules. So the legislature is not the place where laws are debated and made open for scrutiny and testing.

Rather, the legislature is where the skeletal outlines of where China should go is made flesh. This can either occur where the legislature passes a concrete vision of something that has already been foregrounded, such as how this year's Hong Kong legislation was preceded by last year's November statement by the Communist Party. Or else it can happen through bills proposed by the delegates themselves, or drafted by smaller subcommittees (full-time legislative

bodies that bring in experienced officials as writers).

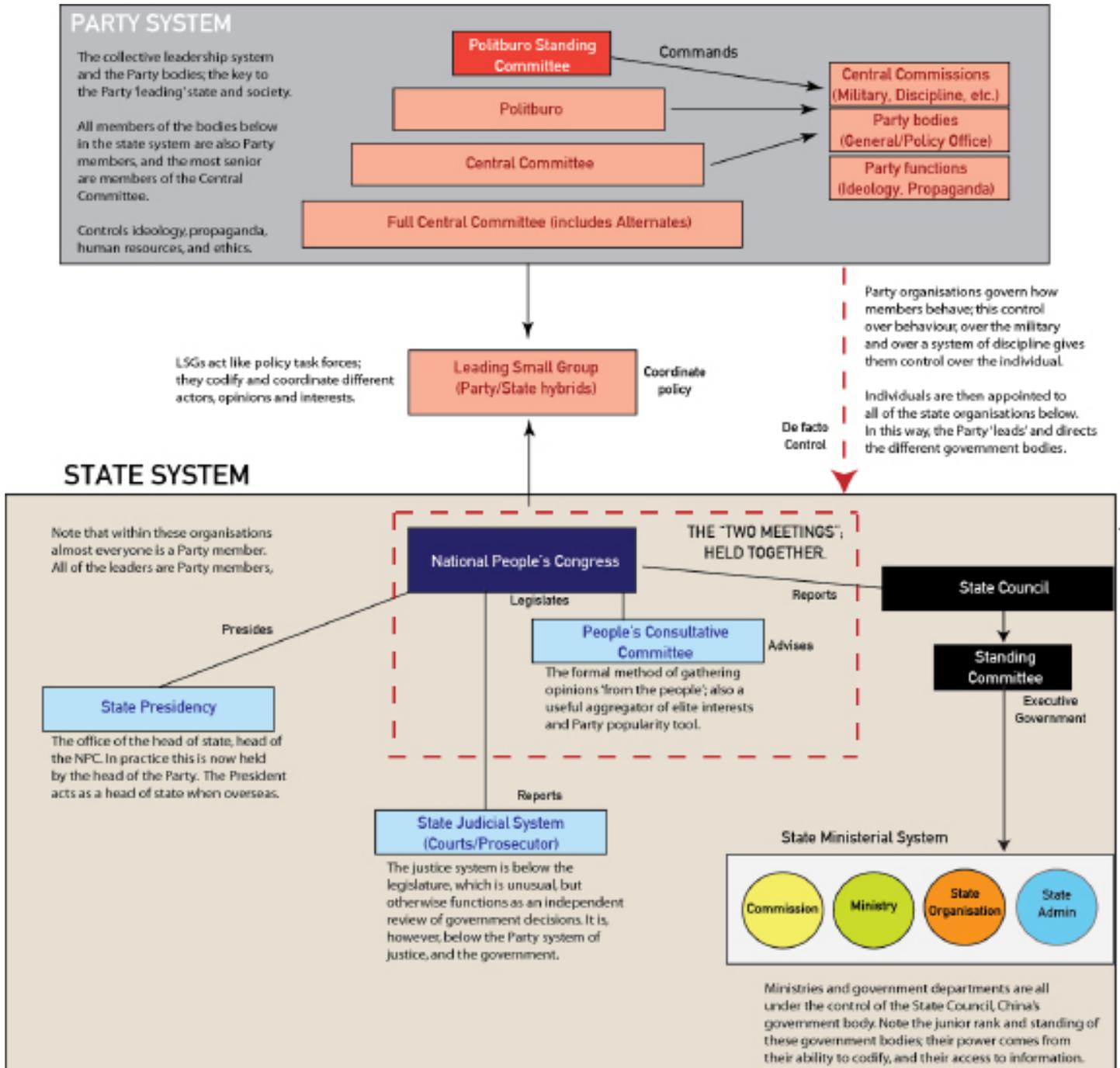
While such debate happens — the NPC's committees were once described as being "packed full of retired bureaucrats with a deep understanding of issues, strong opinions, and a knack for finding controversial areas for knock-down, drag-out arguments"¹ — it is during the drafting process. The Two Meetings themselves only happen once a year. Their public role is to legitimate what has already been drafted, not decide what is going on. For us outsiders, their role is to use these meetings to figure out what that all means.

The best way to do that is through the preliminary local government people's congress meetings leading up to the National People's Congress. Every level of China's government must hold its own Two Meetings. One of the tasks of these is to elect the relevant delegates to attend the Two Meetings for the next political level up. This spirals up until it ends in the national Two Meetings. It also, usefully for investors, provide an update of everything that happened in that local government. So, each level has its Two Meetings, passes up their delegates and reports to the next level's Two Meetings, until finally it reaches the big show in Beijing.

Being a delegate more than a personal honour: it is a vital chance for lower level governments to plead their case to Beijing and the central bodies. Every delegation gets a private meeting with one of China's seven most powerful leaders, in which they can prosecute and argue their own interests, their one chance for the year to hold the central government to account. China's leaders are forced to go from delegation to delegation to hear their reports, concerns and suggestions. These private meetings usually have far more substance than the public readings of the legislation.

The process of legislative drafting and the issuing of proposals and reports both mean that occasionally word leaks as to what is going on. (For interested investors, early warning of these deliberations is provided in provincial level newspapers, useful when there is considerable exposure in one city or province).

Figure 1 | Overview of China's central governance bodies



What happened this year and what does it mean?

Each Congress starts with China's Premier, the head of China's government and therefore analogous to a prime minister, giving his account of China's government actions in 2019-2020. After that, the finance and national development ministries outline China's fiscal position and how they see China's economic and social development progressing.² The whole thing is something like a cross between the US State of the Union, and the Budget Address to the UK Parliament. It is most useful for understanding China's macroeconomy.

This year, China did not send an economic growth target, instead focusing on employment and its recovery from the pandemic. This

is perhaps the biggest shift from previous years. For the past four decades, China was governed solely with reference to meeting local growth targets. Removing GDP targets would have been unthinkable just last year. It is perhaps the most tangible sign of China's economic rebalancing.

China also gave signals that it would try and turn on some liquidity taps without flooding the economy. This will be done through central, not local, government bonds and an increase in government spending. China's nearly 3,000 counties have been told to use new monies for social welfare payments, and to ensure that the doors of small businesses remained open. They were also told to cut all nonessential

expenditure, which has been a decree for nearly all Chinese dynasties in the past 2000 years, and thus likely to be followed more in the breach. We expect China to spend more than was announced.

Obviously, the most commented-upon legislation for this year was the passing of legislation on Hong Kong. We have written on this elsewhere, but in a nutshell, it mandated that the China's legislature draft a national security law for Hong Kong, bypassing Hong Kong's own legislature, which should under the one country, two systems structure be the body writing the rules. The major impact of this is to shake faith in Hong Kong's legal system. It also bedevils China's foreign relations, an issue given that the government also wants to "prevent the development of a Cold War mentality" with the United States, as the fallout from the deterioration in bilateral relations deepens.

Yet despite this array of legislation, the world's eyes were largely on Hong Kong, such that the other reforms were rarely discussed. Why?

Why investors should pay attention to the Two Sessions

In our view, people misread the Two Meetings because they are looking at it the wrong way. Traditionally, the legislature is seen as a "rubber stamp",³ and the advisory body, the CPPCC, yet less useful. This judgment is perhaps a misunderstanding of what the "two meetings" are actually designed to do. They are aimed at forcing China's government leaders to report and clarify, rather than alter, policy settings. As policy decision makers, the legislature and advisory bodies themselves lack institutional clout centrally. Hence, when watching central meetings, the details are the most useful thing, not the decisions.

Take this year's Two Meetings: the Hong Kong Bill was passed from the Party, which made a central decision, to the legislature for "deliberation and promulgation". But if all the decision makers are Party members and therefore must support Party decisions (under the Charter you sign when you become a member), it is most unlikely that anyone will push back very hard. So why use the NPC? Why not just give a Party order? Because the point of the Two Meetings is to specify matters.

As a result, we must look at the detailed plans and implementation procedures rule by rule to determine its impact on investment. The legislature provides the rules of the game, the method of how exactly China thinks it will get what it wants.

¹ Barry Naughton (2014) "It's all in the execution: struggling with the reform agenda", China Leadership Monitor, vol. 45, available online: https://www.hoover.org/sites/default/files/research/docs/clm45bn-its_all_in_the_execution-struggling_with_the_reform_agenda.pdf

² The content of the three, in practice, overlaps greatly.

³ For example, the BBC's guide to Chinese politics: http://news.bbc.co.uk/2/shared/spl/hi/in_depth/china_politics/government/html/7.stm

⁴ In 2018, the current Xi administration changed China's constitution to create new National Supervision Commissions (these combine the roles of ministerial and Party inspectors, with a wide array of extra-judicial powers). The Commissions' report to, and have their leaders appointed by, the local legislature (rather than the Party). This also formally gave local legislatures the right to execute laws rather than merely write them. (This was an extension of a 2015 law giving China's urban subnational legislatures the powers to execute laws, as well as make them).

⁵ Article 17, Law on NPC Standing Committee and Local Government. "Where ... the budget needs to be partially adjusted during implementation, the State Council and the local governments at or above the county level shall submit a plan ... Adjustment of budgetary funds between different headings shall strictly be controlled. Where the funds arranged in the budget for agriculture, education, science and technology, culture, public health, social security and the like need to be reduced, the State Council and the local governments at or above the county level shall submit the matter to the standing committees of the people's congresses at the corresponding levels for examination and approval.

⁶ The Party intends to remain completely in control. Party rules released after granting the legislature extra formal powers force the head of the legislature to report directly to the Party central office. But it is very hard to enforce this sort of relationship. In particular, the December 26 2018 tiao li 中国共产党政法工作条例, which itself is designed to ensure absolute Party leadership over all legal and political affairs ("为了明确党对政法工作的绝对领导"). This is but one of a raft of recent decrees demanding greater loyalty to the Party. See also Xi's speeches at the CCDI plenum, and recent ideological seminars at the Central Party School.

This year, the key problem was the nation's first-ever Civil Code, a massive piece of legislation including some 1,250 articles. The product of many years of debate (it received more than 900,000 public comments during drafting), it gives an entire framework to civil disputes. For investors, it will change how we look at property ownership and commercial contracts (an update to the 1999 Law). This is the most fundamental change in how China sees itself in many years. It outlines how you are seen under the law, as well as how to do business, write contracts, marry and do any other array of everyday tasks.

If we think about the role of the Two Meetings as to provide specific drafting, then the absence of commentary on this Civil Code seems a glaring oversight.

Finally, this idea that we can focus on the power of the pen rather than where power flows is something that applies mostly in Beijing, the central level. There is a different system for local governments. The Xi Jinping administration has embraced the role of the legislature as a part of running China at the local level.⁴ Local PCs, the bodies who make the plans that are submitted up to the 'two meetings' currently beginning, have the power to set budgets,⁵ draft and execute legislation, and to supervise and appoint the inspector responsible for enforcing the behaviour of all public servants. This is a formidable array of powers. It makes legislation a particularly effective lever of power for Xi Jinping, and the legislature far more than just a "rubber stamp".⁶ The local PCs, for example, will be charged with drawing up new budgets for a world without local economic growth targets.

Local governments are essential as they are where almost all business takes place. How legislation is interpreted, how budgets are applied and how business is regulated are all essential questions. The Two Meetings in this way provide the blueprint of what these local governments will seek.

More broadly, we seek certainty in regulations. It is essential that the rules of the game are as well understood as possible to accurately assess future cash flows and the value of any assessment. And knowing the ins and outs of what the law says is essential to that. However, often even more useful is knowing the spirit in which things were created, and the way it has been discussed. For that, the Two Meetings gives a rare chance to peel back the curtain.

Glossary of terms

A		L	
AI	Artificial Intelligence	LP	Limited Partner
APAC	Asia Pacific	LTM	Last Twelve Months
API	Application Programming Interface	LTV	Loan to Value Ratio
APJ	Asia Pacific and Japan	M	
APR	Annual Percentage Rate	M&A	Merger and Acquisition
ARPU	Average Revenue Per User	MAUs	Monthly Active Users
ARPPU	Average Revenue Per Paying User	MHE	Mid to High End
ARR	Annual Recurring Revenue	MOIC	Multiple on Invested Capital
ASEAN	Association of Southeast Asian Nations	MoM	Month on Month
ASP	Average Sales Price	MRR	Monthly Recurring Revenue
AUM	Assets Under Management	MSCI	Morgan Stanley Capital International
B		MSME	Micro, Small and Medium Enterprise
B2B	Business to Business	MTD	Month to Date
B2C	Business to Consumer	N	
BOD	Board of Directors	NAV	Net Asset Value
BVI	British Virgin Islands	NPV	Net Present Value
C		O	
C2C	Consumer to Consumer	O2O	Online to Offline
CAGR	Compound Annual Growth Rate	OEM	Original Equipment Manufacturer
CLA	Convertible Loan Agreement	P	
CV	Curriculum Vitae	P&C	Property and Casualty
D		P2P	Peer to Peer
DAUs	Daily Active Users	PARx	Portfolio at Risk more than x days
DACH	Deutschland, Austria & Switzerland	PMS	Property Management System
DD	Due Diligence	Q	
E		QoQ	Quarter on Quarter
EBITDA	Earnings Before Interest, Tax, Amortisation and Depreciation	QTD	Quarter to Date
ECB	European Central Bank	R	
ELN	Equity Linked Notes	R&D	Research & Development
ESOP	Employee Stock Ownership Plan	S	
EU	European Union	SAFE	Simple Agreement for Future Equity
F		SaaS	Software as a Service
FAV	Fair Appraisal Value	SFC	Securities and Futures Commission
FY	Financial Year	SFO	Securities and Futures Ordinance
G		SI	Since Inception
GAAP	Generally Accepted Accounting Principles	SME	Small to Medium Enterprise
GDP	Gross Domestic Product	SOE	State-owned Enterprise
GMV	Gross Merchandise Volume	SPC	Segregated Portfolio Company
GWP	Gross Written Premium	SPV	Special Purpose Vehicle
GP	General Partner	T	
H		TER	Total Expense Ratio
HIBOR	Hong Kong Interbank Offered Rate	TTV	Total Transaction Value
HKMA	Hong Kong Monetary Authority	U	
HR	Human Resources	UCITs	Undertakings for Collective Investment in Transferable Securities
HY	High Yield	V	
I		VIE	Variable Interest Entity
IG	Investment Grade	W	
IPO	Initial Public Offering	X	
IRR	Internal Rate of Return	Y	
IT	Information Technology	YTD	Year to Date
ITD	Inception to Date	YTM	Yield to Maturity
J		YoY	Year on Year
JACI	J.P. Morgan Asia Credit Index Core	Z	
K			
KPI	Key Performance Indicator		

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