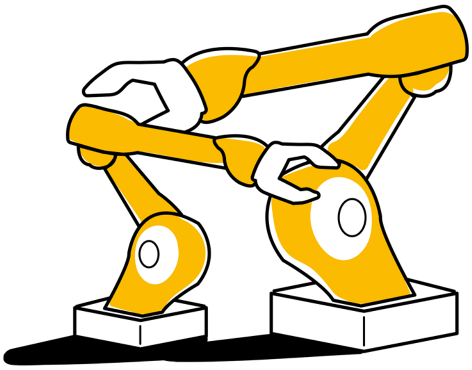
JULY 3, 2024 (REPORTING PERIOD: MAY 29 – JUNE 25)

MERICS China Industries



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MERICS TOP 5

1. Tighter conditions for the next batch of China's "Little Giants"

At a glance: China's treasury issued a notice that a key program supporting high-tech small and medium-sized enterprises (SMEs) should, during 2024-2026, focus on key industrial chains, the industrial "six foundations" (core basic parts, core basic components, key software, advanced basic processes, key basic materials, and industrial technology foundation), and strategic emerging and future industries. The notice:

- Sets parameters for 2024 "Little Giants" requiring them to not be publicly listed at home or overseas and that they focus on "new and innovative technology" or "strengthening the industrial chain."
- Aims to add more than 1,000 firms in 2024 to the current total of 13,000+.
- Stipulates policy support for improving research and development (R&D) and building ties with suppliers and customers while aiming to inject capital at a rate of up to CNY six million per firm over the three-year period.

MERICS comment: Beijing believes the initiative is still worth investing in, but that greater scrutiny is needed to ensure funds are used appropriately and in ways that deliver on the technologies China needs. While semiconductors, AI, and quantum get the most public coverage in China's tech self-reliance movement, Beijing aims for a much wider range of technologies like the industrial inputs, materials, machinery, and niche tech provided by SMEs in Europe, Japan, and the US. Simply put, it isn't enough to master lithography to print semiconductors if the machine depends on dozens or hundreds of highly niche advanced tech inputs from small-scale, advanced producers overseas.

China is attempting to emulate the German *Mittelstand* success model, albeit China seeks a top-down approach that can yield results more quickly. The initiative is also prone to opportunism from savvy firms, though some of the new evaluation systems may help weed out bad actors. We can expect standards to ratchet up steadily on the Little Giants initiative to cut back on waste, though this very venture capital-style initiative is likely to have a high rate of failure in general, as SMEs and start-ups are inherently less resilient than larger established firms.

Beijing is increasingly frustrated by limited innovation in key areas, while also facing budget constraints. Stricter evaluation criteria and even reclaiming of capital from firms that don't meet all goals will impose more discipline in the initiative. It is still unclear how effective these adjustments and the overall program will be. Because of its centrality to the tech self-reliance campaign, Beijing will continue to direct support towards it. Foreign firms are wise to scan the forthcoming lists of selected firms for potential competitors.

Article: Notice on Further Support for the High-quality Development of Specialized, Refined, Special, and New Amall and Medium-sized Enterprises (关于进一步支持专精特新中小企业高质量发展的通知) (Link)
Issuing body: Ministry of Finance, MIIT
Date: June 14, 2024

2. Beijing unveils a corporate sustainability system with Chinese characteristics

At a glance: China's Ministry of Finance called for comments on standards for Corporate Sustainability Disclosure. The draft aims to establish a nationwide basic disclosure framework providing stakeholders and investors with more standardized and reliable information on sustainable development and potential risks.

According to the draft, basic sustainable disclosure standards and climate-related disclosure standards for Chinese enterprises will be published by 2027, and a unified system will be completed by 2030. Additional sector-specific standards and guidelines will be worked out by relevant ministries. Key elements are:

- Gradual implementation, expanding from listed companies to unlisted companies, from large enterprises to small and medium-sized enterprises, from voluntary reporting to mandatory reporting.
- Reporting is structured around the four core elements of governance, strategy, risk and opportunity management as well as metrics and targets. This is consistent with the most common international standards such as the ISSB.

MERICS comment: This policy marks a shift in China's environmental, social and governance (ESG) policy from incidental success stories and marketing to a more structural and standardized approach. In February and March of this year, the three biggest stock markets in Shanghai, Shenzhen and Beijing separately issued sustainable development information standards for listed companies. Even though those are of uneven quality and the new draft remains vague on implementation, the overall trend sends an important signal to the industry and governments. The release of the draft was followed by the Municipality of Beijing announcing a three-year action plan to implement a high quality ESG reporting system.

China is answering a global trend of considering sustainability in evaluating business performance. According to the official explanation, the basic standards are compatible with the international IFRS S1 in terms of information quality, disclosure elements and related requirements.

European stakeholders and investors might profit from a standardized reporting system when making investment decisions. However, the proposed standards are likely to deviate from international norms in terms of scope of application and disclosure objectives – for example, employee rights are understood quite differently in China than in Europe, or the need to disclose contributions to "rural revitalization" may be something specific to the China market that companies need to adapt to. This could not only result in additional work for companies that have to adapt their reports to different standards but also in a politicized amendment of the guidelines.

Article: Corporate Sustainability Disclosure Standards—Basic Standards (Draft for Comments) (企业可持续披露准则——基本准则（征求意见稿）)(Link)
Issuing body: Ministry of Finance
Date: May 27, 2024

3. New fair competition review to solve problems, except where inconvenient

At a glance: As part of the implementation of China's Anti-monopoly law and its 2022 revisions, the State Council issued regulations on fair competition reviews for new and existing policies, rules, and regulations. These regulations coordinate and expand China's policy toolbox by:

- Standardizing a fair competition review system, promoting fair market competition, optimizing the business environment, and building a unified national market free from internal market access (and exit) barriers across jurisdictions.
- Requiring reviews at multiple stages, including for drafting new policies/measures/regulations as well as reviewing existing measures. However, the provisions from the draft version requiring third-party reviews were not included in the final text.

The regulations include carve-outs:

- To safeguard national security and development interests.
- To promote scientific and technological progress and enhance the country's independent innovation capabilities.
- To achieve social public interests such as energy conservation, environmental protection, and disaster relief.
- Other circumstances prescribed by laws and administrative regulations.

MERICS comment: These measures will improve the business environment for Chinese and foreign companies. China is plagued with internal market access and exit barriers established by protectionist local governments. At the very least, its publication is an acknowledgement by the central government that local protectionism is hampering its economic growth. Although the policy is primarily aimed at discrimination against "non-local" (外地) Chinese firms, foreign firms may also benefit.

A significant number of inefficiencies and overcapacities in China's economy stem from the balkanized internal market, and greater unification of the market could solve a lot of issues for Beijing. However, without sufficient political capital from Beijing to break through local vested interests and impose these new rules, local officials are still most likely to prioritize the status quo in the name of stability and employment, and the carve-outs to the review mechanism give them ample grounds to do so.

The effectiveness of these measures is undermined by the lack of third-party reviews and the extremely broad and vague carve-outs. This reflects a growing dissonance in China's economic policymaking where Beijing wants markets to perform more efficiently and fairly where possible, but not where it interferes with more important priorities. European firms may benefit from a more level playing field in non-sensitive areas but should not get their hopes up.

Article: Fair Competition Review Regulations (公平竞争审查条例) (Link)
Issuing body: State Council
Date: June 6, 2024

4. Better healthcare for more people at lower cost

At a glance: The State Council set tasks for the reform of the healthcare system in 2024.

- Expanding volume-based procurement (VBP) of pharmaceuticals to 500 items, while increasing VBP of medical consumables, realizing 2025 goals a year earlier.
- Implementing healthcare pricing reforms in Inner Mongolia, Zhejiang and Sichuan. Pilot projects in these provinces are to identify patients with similar diagnoses. These diagnosis-related groups (DRGs) should enable insurers to calculate standard costs. This model explicitly aims to disconnect medical staff's salaries from the sale of drugs and medical procedures, which leads to overmedication.
- Supporting public hospitals to build out the multi-tiered healthcare system, including local clinics and health stations.
- Encouraging public healthcare institutions to share medical data, including for innovation and drug discovery.
- Accelerating the review and approval of innovative medicines.
- Improving the coverage of basic public health insurance, while promoting the use of additional, commercial health insurance.

MERICS comment: These priorities balance healthcare coverage, quality, cost and innovation. Making healthcare more affordable and accessible is a key promise of Xi Jinping's common prosperity agenda. The 14th Five Year Plan for National Health (2022-2025) and similar plans aim for a similar life expectancy and five-year cancer survival rates as the West, which requires higher quality healthcare. However, these goals are costly. China spent 7 percent of GDP on healthcare in 2022, up from 6.6 percent in 2021, but much less than the 16.6 and 12.7 percent that the US and Germany spent in that year.

Beijing's response is multifaceted. DRG is part of a cost management system adapted from Western examples. Digitalization should also lead to efficiency gains. However, centralized procurement is the main instrument. Officials emphasized that VBP should be implemented aggressively but safely, calling for zero-tolerance on drug quality, discrimination by provincial governments against out-of-province and out-of-country providers, and corruption, e.g., false orders for reimbursement by healthcare institutions.

Given China's ageing population and rising labor cost, it is likely that healthcare costs will rise in the coming decades. However, the opportunities for foreign firms to benefit are limited by DRGs, the reimbursable drug list and other cost controls. Still, Chinese officials claim that the current approach increases China's access to the world's best treatments. 82 innovative drugs were approved in China in 2022-2023 and 20 in the first five months of 2024, including groundbreaking treatments like CAR-T and monoclonal antibodies.

Article: Deepening the Reform of the Medical and Health System 2024 Key Tasks (深化医药卫生体制改革 2024 年重点工作任务) (Link)
Issuing bodies: State Council
Date: June 3, 2024

5. Industrial policy and carbon goals intersect with green transportation plan

At a glance: The Ministry of Transport and 13 other agencies issued an action plan to support the green transition of heavy-duty vehicles (HDVs), ships, and locomotives. Key measures include:

- Replacement of old diesel trucks, ships, and locomotives with new-energy versions, as well as electrification of urban bus infrastructure.
- Logistics upgrades, such as more effective logistics hubs, green shipping facilities, as well as new-energy delivery vehicles.
- Improvement in energy efficiency and emissions standards for vehicles and ships to align with international standards.

MERICS comment: The policy kills two birds with one stone by tackling low domestic consumption and decarbonization efforts at the same time: shifting investment into new-energy heavy-duty vehicles now will, in the short term, get more orders in for manufacturers, and have much-needed domestic demand to soak up China's batteries and legacy chips, all the while furthering China's decarbonization efforts.

China aims for peak carbon emissions by 2030, and carbon neutrality by 2060, which will require significant progress in green tech. If it happens that taking a leading role in the relevant technologies is also good for China's exports and overall growth rate, then all the better. Heavy-duty vehicles are a huge source of emissions in China — they amounted to around half of greenhouse gas (GHG) emissions across all vehicles in China, and an estimated three percent of total GHG emissions from all industry, according to the 2019 census.

Implementation will be aided by the importance of state-owned enterprises and government procurement in these sectors. This also means that the government has more avenues to arrange subsidies, investments and other support mechanisms, making it harder to build a case for unfair competition than for instance with new energy passenger cars. Foreign manufacturers of transport equipment should prepare for intense competition with Chinese firms.

Transport equipment sales, especially in rail and shipping, is also an area where it is much easier for the central government to drive growth, as much of the economic activity happens through government procurement. Through these investments, China will either shore up its already strong position, such as in green shipping, or more effectively compete for market share in a new sector.

Article: Action Plan for Large-scale Equipment Renewal of Transportation (交通运输大规模设备更新行动方案) (Link)
Issuing body: MOT + 13 other agencies
Date: June 7, 2024

NOTEWORTHY

Policy news

- *May 29:* The CAC released an action plan to strengthen research and development standards on advanced chips, AI, quantum technology applications and computing power infrastructure. The plan also aims to step up China's participation in international organizations of this area. (CAC Notice)
- *June 4:* The MIIT released new measures to promote development in major technical equipment and new material industries by optimizing insurance policies. Key measures include expanding policy support, enhancing insurance protection and strengthening supervision. (MIIT notice)
- *June 6:* The State Council announced a plan to push reforms in the health system and seek "high-quality development." Measures include the improvement of basic medical insurance coverage and the development of the commercial health insurance system as well as the use of digital technologies for reforms in the medical system (State Council notice)
- *June 19:* The State Council released measures on promoting the development of venture capital. The document emphasizes the important role of VC in supporting technology standards and encourages industry leaders and research institutes to participate in VC investments, supporting international institutions to set up onshore yuan-denominated funds and giving more play to government-funded VCs. (State Council Notice)

Corporate news

- *June 12:* China's demand for Japanese semiconductor manufacturing equipment (SME) is increasing. According to a recent analysis, Japanese SME exports to China from January-March 2024 have increased by 82% compared to the same period last year, and China has accounted for over 50% of Japanese SME exports for three consecutive quarters (July 2023-March 2024). (Nikkei Asia article)
- *June 21:* Huawei Technologies expects HarmonyOS to break the dominance of Western mobile operating systems in mainland China after its next version ends support for Android apps. (South China Morning Post article)
- *June 24:* According to a survey by the China Chamber of Commerce, Chinese new-energy vehicle (NEV) manufacturers are more eager to build factories in Europe than before, as they remain optimistic about their long-term prospects in the region despite current headwinds. (Caixin article)
- *June 24:* The World Intelligence Expo, a four-day trade exhibition aimed at promoting the integration of artificial intelligence (AI) and industrial equipment, was held in Tianjin. The event has seen limited participation from foreign brands this year in a trend reminiscent of other technology trade shows in China amid a

deepening divide with Western countries. About 20 foreign firms, or four percent of the 550 exhibitors, had booths at the Tianjin expo. (South China Morning Post article)

- *June 25:* Since the issuance and implementation of the action plan to promote the trade-in of old consumer goods, the Ministry of Commerce has already received 113,000 applications for subsidies to trade in old cars against electric vehicles. In May, national automobile retails sales reached 2.271 million units, a year-on-year increase of 8.7%. (S&T Daily article)

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