Executive summary

Economic trends

- China’s economy got off to a steady start this year and there was a sharp rebound in industrial growth
- Real estate investment remained strong, and infrastructure investment stabilised and rebounded
- Consumption generally picking up, dragged down by automobiles
- Rebound in social financing, improvement in the corporate financing environment
- Exports are better than expected, and the probability of RMB appreciation has increased

Policy analysis

- Shanghai Stock Exchange Sci-tech Innovation Board Officially Launched
- New additions to energy system reform
- The State-owned Assets Supervision and Administration Commission stated that 10 central enterprises were to create “world-class model enterprises”
- Official release of the Outline Development Plan for Guangdong-Hong Kong-Macao Greater Bay Area

Case study: trends and prospects of foreign investment

- Review of FDI in China
- Introduction of the “Foreign Investment Law”
- Suggestions for further improving the business environment in China

Appendix: Key indicators
Executive Summary

China’s economic growth stabilised in Q1, with real GDP expanding by 6.4%. It was the same pace as in Q4 2018, reversing the deceleration trend that started last year. Various economic indicators accelerated and market sentiment improved in March. Growth of the service industry continued to lead other sectors and was up 7.0% year-on-year. The growth rate was down slightly by 0.4 percentage points from Q4 last year, but contributed to 61.3% of GDP growth.

- Consumption continued to play an important role in achieving growth stabilisation, contributing 65.1% to economic growth in Q1. In March, nominal social retail sales grew at 8.7% — the fastest rate in the past five months. Car sales continued the downward trend from the second half of last year, but the decline narrowed in March. Driven by the value-added tax cut, some automobile manufacturers have lowered prices, and the government is also introducing policies to support automobile consumption — these measures are expected to help stabilise auto sales in the second half of the year.

- Investment continued to show a modest rebound. In Q1, fixed asset investment grew by 6.3% year-on-year, 0.4 percentage points higher than in 2018. Looking into the breakdown, manufacturing investment growth dropped, infrastructure investment recovered slightly, and real estate investment remained high. The overall investment structure continued to improve and investment in high-tech manufacturing and pharmaceutical industries grew rapidly.

- In Q1, exports increased by 1.4% year-on-year. Its performance in March was particularly impressive, with year-on-year growth of 14.2%. At the same time, imports fell by 4.8% in Q1. China’s trade surplus in Q1 reached USD76.3 billion, an increase of USD31.6 billion over Q1 last year, which also helped stabilise economic growth.

- In Q1, industrial production was strong. It registered an increase of 6.5% year-on-year and 0.8 percentage points compared with Q4 last year. March industrial production increased by 8.5% year-on-year, the highest since August 2014. Of this, the growth rates of the high-tech industry and strategic emerging industries in Q1 were 7.8% and 6.7%, respectively — higher than the growth rate of industrial firms. The shift from old to new economic drivers continued.

The improvement in economic indicators in Q1 shows that China’s steady growth policies have begun to take effect. However, we believe that the improvement in Q1’s economic data was partly driven by short-term factors and that the foundation of the recovery is still weak. For example:

- At the end of 2018, the National People’s Congress authorised the State Council to issue part of 2019 local government debt quotas ahead of the normal annual schedule. This prompted the net financing of local government bonds in Q1 to hit 1.2 trillion yuan — much higher than the 219.5 billion yuan in the same period last year. The early approval boosted infrastructure financing and helped infrastructure investment.

- In January 2019, the individual income tax (IIT) reform was implemented nationwide. One new IIT tax scheme and six new deduction categories, such as children’s education, were introduced. In addition, the value-added tax rate was lowered for manufacturing and other industries, effective 1 April. These tax cuts will help boost consumption and production; however, some of the benefits were frontloaded and made the Q1 year-over-year comparison more favourable.

- In December 2018, after the leaders of China and the United States met at the G20 summit in Argentina, the US postponed the decision to impose tariffs on 200 billion US dollars of Chinese imports. Imports in Q1 were better than market expectations due to the temporary truce.
Therefore, we believe the recovery of China’s economy is still in its early stages and economic growth continues to face significant pressure. At the same time, the re-escalation of the US-China trade friction has also increased the risks and uncertainties from the external environment. On 10 May, the US government hiked tariffs on USD200 billion worth of Chinese imports to 25% from 10%. On 13 May, the US Trade Representative Office (USTR) proposed a potential duty of up to 25% on China for goods with an annual trade value of roughly USD300 billion, and public hearings and comments will be held. The list of goods covers almost all Chinese exports to the United States. The Chinese Ministry of Finance immediately retaliated by raising the tariffs on USD60 billion worth of US imports to 25% and 20%, with some remaining at the previous 10%, effective 1 June. This has led to major uncertainties over US-China trade friction.

In the external environment, global economic growth is expected to continue to slow down. According to the latest IMF forecast, 70% of the world economy will see slower economic growth in 2019 compared to last year. In its March meeting, the Federal Open Market Committee (FOMC) lowered its forecast on US economic growth and indicated that there will be no more rate hikes this year. The Eurozone Manufacturing Purchasing Managers’ Index (PMI) has fallen for nine consecutive months and has been in the contraction zone since February 2019. The German Manufacturing PMI has been below the expansion threshold for four consecutive months, and the German Ministry of Economics has lowered its 2019 GDP forecast from 1% to 0.5%. The slowdown in world economic growth will also impact the continued growth of the Chinese economy.

Faced with significant downward pressure, China is expected to adopt both proactive fiscal policies and accommodative monetary policies to counter the slowdown. Fiscal policy will focus primarily on tax cuts and increasing government spending. The 2019 government work report has set a target of another 2 trillion yuan in cuts to taxes and fees this year, on top of last year’s 1.3 trillion yuan reduction. According to government estimates, tax cuts in Q1 have already amounted to 341.1 billion yuan, but there is still ample room for further reductions in the coming months. In addition, local governments will be able to issue 2.15 trillion yuan worth of special purpose bonds to fund infrastructure, an increase of 800 billion yuan over last year.

On the monetary policy front, the People’s Bank of China (PBoC) lowered the reserve requirement ratio (RRR) by 1 percentage point in January 2019, making it the fifth RRR cut since 2018. The liquidity situation has improved. In Q1 this year, the growth of total social financing (TSF) and M2 rose to 10.7% and 8.6%, respectively, both higher than Q1’s nominal growth of 7.8%. We believe that monetary policy will remain accommodative in the coming months and more RRR cuts are expected. The government work report also underscored “deepening interest rate marketisation reform and lowering the real interest rate.” Meanwhile, monetary policy should be pursued with “appropriate intensity” to increase financing support for the private sector, small- and medium-sized companies, as well as high-tech enterprises.

The US-China trade friction not only poses significant challenges to the Chinese economy but also impedes the growth of the US economy as well as that of the rest of the world. However, China’s significant domestic market can help mitigate some of the external impacts. Consumption has surpassed investment for five consecutive years and become the cornerstone of China’s economic growth. In 2018, consumption contributed 76.2% to GDP growth, the highest since 2001. Deeper economic reforms and further opening up would enable China to stabilise market expectation amid the escalating US-China trade war. China’s economic growth in the long term may only be achieved when structural and institutional reforms are carried out. Apart from using the right combination of fiscal, monetary and employment policies to counter the cyclical slowdown, the Chinese government should also take steps to solve structural and systematic issues to achieve long-term growth.
Case study: trends and prospects of foreign investment in China

On March 15, 2019, the 13th People’s Congress passed the “Foreign Investment Law of the People’s Republic of China”. The Foreign Investment Law provides legal clarification of the “pre-access national treatment plus negative list administration system” and focuses on optimising China’s overall investment environment in terms of market access, investment promotion, investment protection and investment management. The Foreign Investment Law will be officially implemented on January 1, 2020, when it will replace the long-standing “three foreign laws” and become the basic law for the use of foreign capital in China.

Foreign direct investment (FDI) has been a major force in China’s economic and social development over the past 40 years. In particular, the last decade (2008-2017) has seen continuous optimisation of the structure of foreign investment. The scale of funds flowing to the service industry is significantly larger than to the manufacturing industry, reflecting changes in China’s industrial structure. From the perspective of fund sources, due to the impact of the 2008 financial crisis, the proportion of investment from Latin America has dropped sharply from 23% to 5%, while the proportion of funds from Asia has increased sharply from 62% to 83% — of which the contribution from Hong Kong cannot be ignored.

In recent years, the growth rate of China’s FDI has slowed, and the existing “three foreign laws” have become less effective in catering to the requirements of reform and development. The Foreign Investment Law was introduced against this background, and its promulgation reflects China’s determination to promote a new round of high-level opening up and create a world-class business environment. It is also an important factor in promoting China’s next major step from “open flow of goods and factors” to “institutional openness”.

However, it should also be noted that the content of the Foreign Investment Law is more of a framework and set of principles. In the future, it will be necessary to introduce relevant supporting laws and implementation regulations to make continued improvements. In addition, there exist many legal practices in urgent need of resolution. In response to the further implementation and improved business environment provided by the Foreign Investment Law, KPMG recommends that the government focus on the following two aspects: First, to release the implementation details of the law. Second, a change in perception and more targeted measures to improve the foreign investment management system.
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Economic trends
In Q1 2019, China’s real GDP grew by 6.4% year-on-year, which was the same as that in Q4 2018 but slightly lower than that for the whole of 2018 (6.6%), thus ending the last year’s sustained decline in GDP growth. At current prices, nominal GDP growth in Q1 was 7.8% year-on-year, down 1.3 percentage points from Q4 last year.

**Figure 1: GDP growth rate, quarterly YOY, %**

Growth in the service industry continues to lead other sectors, though this growth rate has declined. In Q1, the service industry grew by 7.0% year-on-year, down 0.4 percentage points from Q4 last year. Its contribution to GDP growth continued to increase to 61.3%. Secondary industry grew by 6.1% year-on-year, up 0.3 percentage points from Q4 last year; its contribution to GDP growth increased from 36.1% in 2018 to 36.9%. Primary industry grew by 2.7% year-on-year, down 0.8 percentage points from Q4 last year; its contribution to GDP growth fell from 4.2% in 2018 to 1.8%. Among these industries, the information transmission and software and IT services industry maintained rapid growth, up 21.2% year-on-year.
From the demand side, consumption continues to be the mainstay of stable economic growth among the other two major drivers including investment and exports. In Q1, the contribution of final consumption expenditure to GDP reached 65.1%, driving economic growth by 4.2 percentage points; total capital formation’s contribution to GDP fell sharply to 12.1%, driving economic growth by 0.8 percentage points; and due to the significant expansion of the trade surplus compared with last year, the contribution of net exports to GDP turned positive, rising sharply to 22.8% and driving economic growth by 1.5 percentage points. In addition, of total household spending and service consumption accounted for 47.7%, which was an increase of 1.4 percentage points over the same period last year and indicates that upgrades in consumption are still ongoing.
March saw a sharp rebound in the growth rate of industrial output, which reached a new high. In Q1, the industrial added value of industrial enterprises above a designated size grew by 6.5% year-on-year, up 0.8 percentage points from Q4 last year. The monthly data shows that in March, industrial added value increased by 8.5% year-on-year, up 3.2 percentage points from January to February and a new high since August 2014.

There are three main reasons for the unexpected increase in industrial growth in March. First, in March, the growth rate of the troika on the demand side rebounded, driving a significant increase in industrial production. Second, the 2019 Spring Festival was celebrated earlier than last year, which meant people returned to work earlier; the difference in dates led to a low base in the same period last year, causing the sharp rebound in industrial growth in March. Third, since 1 April, the manufacturing VAT rate has been lowered, and some enterprises have taken the initiative to increase stocks in order to take advantage of the tax reduction, objectively requiring upstream companies to increase production.

In March, China’s Manufacturing PMI crossed the 50-point threshold for the first time since the end of 2018 by recording 50.5 — a six-month high. All the PMI items rebounded. In particular, the production index and the new order index increased by 3.2 and 1.0 percentage points, respectively, compared with February; this indicated a strong willingness to return to work after the holiday period among supply-side enterprises and steady recovery on the demand side.

**Figure 4: Industrial value added for enterprises above designated size, monthly YOY, %**

![Graph showing industrial value added for enterprises above designated size, monthly YOY, %]

*Source: Wind, KPMG analysis*
From the perspective of industrial structure, the structural transformation continued apace. In Q1, the added value growth rates of high-tech industries and strategic emerging industries were 7.8% and 6.7%, respectively, which were higher than the growth rate of all industrial firms (6.5%).
The growth rate of fixed asset investment remained low, but there were some signs of recovery. In Q1, the growth of fixed investment was 6.3% year-on-year. This was significantly lower than the 7.5% in the same period of last year, but 0.2 and 0.4 percentage points higher than the figures for January and the whole of 2018, respectively. The growth rate of private fixed investment declined in Q1; the year-on-year growth rate was 6.4%, down 1.1 percentage points from January to February, and down 2.3 percentage points from the previous year — this implies that domestic investment remained lacklustre. Private investment was mainly concentrated in manufacturing, and the decline in private investment is consistent with the decline in manufacturing investment growth over the same period.

**Figure 6: Fixed asset investment, cumulative YOY, %**

![Fixed asset investment, cumulative YOY, %](source)

**Figure 7: Fixed asset investment in subsectors, cumulative YOY, %**

![Fixed asset investment in subsectors, cumulative YOY, %](source)
Manufacturing investment declines, high-tech investment grows faster

Early-stage industrial enterprise earnings continued to weaken, PPI fell and external demand slumped, dragging down growth in manufacturing investment. In Q1, manufacturing investment grew by 4.6% year-on-year, down 1.3 percentage points from January to February, and a drop of 4.9 percentage points compared with the whole of last year.

In terms of subsectors, the year-on-year growth rates of non-ferrous metals, transportation equipment and metal products in Q1 2019 were -17.1%, -8.7% and 2.7%, respectively, down 11.8, 15.7 and 10.5 percentage points compared with Q1 2018. Pharmaceutical and chemical investment grew 9.7% and 11.3%, respectively, which were 22.2 and 11.5 percentage points higher than Q1 2018. As a result, in comparison with the same period last year, in manufacturing investment for Q1 2019, investment in the pharmaceutical industry rose significantly, whereas that in non-ferrous metals and transportation equipment declined considerably. At the same time, high-tech manufacturing investment grew by 11.4% year-on-year, 5.1 percentage points more than overall fixed asset investment (FAI), making it the primary driver in upgrading the manufacturing industry.

**Figure 8: Investment growth rate of manufacturing subsectors, cumulative YOY, %**

![Image of investment growth rate of manufacturing subsectors](image-url)

Source: Wind, KPMG analysis
From April 1 this year, the VAT rate of the manufacturing industry and other industries continued to drop from 16% to 13%. Coupled with the introduction of social security fees in May, a new round of tax cuts and reductions will improve profitability of industrial enterprises. With the recovery of domestic demand and the increase in PPI, the profits of industrial enterprises are expected to rebound in the second half of the year, thus alleviating the downward pressure on investment growth in the manufacturing industry. During the CPC Central Committee Political Bureau meeting held in 19 April this year, promoting high-quality development of the manufacturing industry as a basis for steady growth was emphasized. The government’s direct burden reduction measures will encourage manufacturing enterprises to increase investment in technology R&D and will accelerate the transformation and upgrading of industrial structure, boosting the high-quality development of China’s manufacturing industry. In addition, the manufacturing industry is most affected by the Sino-US trade friction. Lowering the manufacturing VAT rate will boost the confidence of companies and help them cope with changes in the external environment.

Fiscal expenditures accelerated and infrastructure investment rebounded slightly

As counter-cyclical policies continued to be carried out and infrastructure sector continued to bolster the area of weakness, growth in infrastructure investment continued its upwards trend since Q4 last year. From January to March, infrastructure investment (excluding electricity) grew by 4.4% year-on-year, up 0.1 percentage points from the previous two months and 0.6 percentage points higher than the whole of last year. The cumulative year-on-year growth rate has risen for five consecutive months.

At the end of last year, the NPC authorised the State Council to issue a new local government debt limit in 2019 ahead of the NPC and CPPCC conferences. This year, local bond issuance was opened ahead of schedule. The total amount of local government bonds issued in the first quarter was about 1.4 trillion yuan, a significant increase from the 220 billion yuan during the same period last year. The net financing of local government bonds reached 1.2 trillion yuan, much higher than the 219.5 billion yuan during the same period last year; of this, the net issuance of local government bonds in March was 477.3 billion yuan, compared with 191 billion yuan in the same period last year, providing a source of funds for the construction of local infrastructure projects. Growth of fiscal expenditure in Q1 was 15%, much higher than the income growth rate of 6.2% and 6.3% higher than the whole of last year. The acceleration of fiscal expenditure provided strong support for infrastructure investment. The deficit in Q1 was 497.3 billion yuan, significantly more than the 45.1 billion yuan in the same period last year and a historical high.

Figure 9: Local government debt net financing amount, in RMB billions

Source: Wind, KPMG analysis
According to the 2019 Government Work Report, this year the Central Government will focus on key infrastructure projects in three directions. First is accelerating the implementation of a number of major projects such as the Sichuan-Tibet Railway. Second is infrastructure investment in intercity transport, logistics, municipal government, disaster prevention, and civil and general aviation. Third is the construction of a new generation of information infrastructure (proposed at the end of 2018: “Strengthening the construction of new infrastructure such as artificial intelligence, the industrial Internet, and the Internet of Things”), which was clarified in this year’s government work report, with a focus on “the construction of a new generation of information infrastructure”). The National Development and Reform Commission said that this year’s central budget investment arrangement was 577.6 billion yuan, an increase of 40 billion yuan over last year. In Q1, 80% of the allocated central budget was exhausted, thus guaranteeing the capital requirements of major projects; infrastructure investment such as intercity transport and logistics will mainly rely on new financing approaches, such as local financing at each level and PPP. According to this year’s Government Work Report, local government special bonds of 2.15 trillion yuan are planned for 2019. This is an increase of 800 billion yuan over last year and will provide financial support for key projects. Both central and local governments have taken steps towards the construction of the new generation of information infrastructure. Multiple local government work reports also mention that investment in this area should be increased. As per data, 50 fixed asset projects were reviewed and approved in Q1 with a total investment of 370.3 billion yuan — 34 of these projects were reviewed and 16 were approved, mainly in the fields of energy, transportation and high technology.

This year’s Government Work Report also pointed out that the deficit rate rebounded to 2.8% in 2019, up 0.2 percentage points over last year. The deficit itself hit 2.76 trillion yuan, which is 380 billion yuan more than last year and strengthened counter-cyclical adjustment. The continued rebound in infrastructure investment will be driven by proactive fiscal policies, such as large-scale expansion in special bond issuance and eased restrictions on how to use the proceeds of special bonds, innovations in project financing methods, appropriate reduction in the capital ratio requirements of infrastructure investment, implementation of private investment support policies and promotion of PPP in an orderly manner. A proactive fiscal policy is expected to result in some recovery in infrastructure investment in 2019; however, an overall rebound to the high growth of around 20% would be difficult. According to our calculations, about 60% of capital investment funds — worth about 15 trillion yuan in 2017 — rely on self-financing. Assuming there are no significant changes in financial supervision as a whole, the scale of non-standard financing is not expected to improve significantly in 2019. As such, infrastructure investment will remain subject to certain restrictions.

Real estate development investment is still high, housing sales are picking up

In Q1, growth in real estate development investment increased by 11.8% year-on-year, 0.2 percentage points higher than in January and February, and 2.3 percentage points more than last year. In 2018, growth in land acquisition fees that have supported the high investment in real estate development dropped significantly. This figure fell to 34.5% in January and February, a year-on-year drop of 32.7% for Q1. This was chiefly due to high capital pressures, which curtailed purchases by property companies and caused a significant increase in the land purchase area in Q1. After excluding land acquisition fees, the real estate investment growth rate rebounded to 5.9% in January and February, rising by 5% in Q1.

In addition, due to factors such as the decline in sales of commercial housing in the previous period and decrease in land purchases, the growth rate of new construction area of housing in Q1 fell by 11.9%, down 5.3 percentage points from the whole of the previous year. However, since March, the improvement in housing sales has been accompanied by an uptick in enthusiasm for land acquisition among enterprises, and there has been a significant rebound in the growth rate of new housing projects. In Q1, the saleable floor area fell by 0.9% year-on-year, down 2.2 percentage points from last year; however, the decline was significantly narrower than the -3.6% during January–February, which indicated a marginal improvement in housing sales in March.
Real estate investment has increased in the short term thanks to a rebound in real estate sales, improvements in financing, historical lows in inventory, and real estate regulation. However, to avoid the same mistakes that led to the bursting of the real estate bubble, the government’s strict regulation of the real estate market will remain unchanged in 2019, and a sharp rebound in real estate investment is not expected in 2019. The meeting of the Central Politburo of the Communist Party of China held on 19 April once again made arrangements for the real estate market, emphasizing that “we must adhere to the position that the property is used for living, not for speculation, implementing the long-term regulation mechanisms of one city, one policy; city-based policy implementation; a city assuming chief responsibility for debt”. This means that against the backdrop of a reprieve in downward pressure on the economy, it is unlikely that policies to encourage real estate investment will be carried out at the national level. At the decision-making level, preventing a real estate bubble will still take pride of place. In the context of this year’s major tax cuts and reductions, the real estate tax is also expected to be carried out soon, which will help ease short-term financial pressure.
In March, the total retail sales of social consumer goods grew by 8.7% year-on-year, the fastest growth rate in the past five months. Based on the stabilisation during January–February (8.2%), retail sales of social consumers goods in March rebounded significantly. Apart from the increase in CPI this month, the rebound was also consistent with income trends among residents. In addition, March saw a rebound in housing sales, driving growth in furniture, home appliances, audio visual equipment, construction, interior design etc., which helped support consumption. Moreover, the stock market has continued to warm up since the beginning of this year, and the evidence of the wealth effect has also played a certain role in boosting consumer spending. According to quarterly data, in Q1, social retail sales increased by 8.3% year-on-year, which was less than the 9.0% for the whole of last year.

Figure 12: Total retail sales of consumer goods, YOY, %

Retail sales of enterprises above designated size increased by 5.0% year-on-year in March, up 1.8 percentage points from January–February. The year-on-year growth rate was 3.8% in Q1, down 1.9 percentage points from the previous year. Of this, growth in automobile consumption was -4.4%, which was 1.6 percentage points higher than that in January–February and dragged down consumption. The data shows that the decline in vehicle sales in March narrowed by 8.6 percentage points. The decline in automobile consumption and automobile sales was contrary to the year-on-year decline. This was mainly attributable to the lowering of China’s VAT rate, due to which the auto industry carried out a wave of price cuts in advance. Since March 15, Mercedes-Benz, BMW, Land Rover, Volvo and other luxury car brands have made price cuts ranging from 6,000 to 85,000 yuan.

Source: Wind, KPMG analysis
The proportion of online retail sales continued to rise and was one of the main drivers of consumption growth. In Q1, online retail sales grew by 21.0% year-on-year. Although down from the 25.4% growth in 2018, it was still much higher than the overall growth rate of social retail sales. Its proportion of total social consumption remained stable at 18.2%.

Figure 14: Online consumption of physical goods and YOY growth rate, %

Source: Wind, KPMG analysis
Disposable income growth in the household sector rebounded. The new tax law was implemented on January 1, 2019; with deductions in various areas such as pensions, children’s education, housing interest and major medical care, this has helped increase the disposable income of residents and boost consumption. In Q1, personal income tax revenue in state finances decreased by -29.7% compared with the same period of last year. The actual growth rate of per capita disposable income among national residents was 6.8%, which was 0.3 percentage points higher than last year and exceeded the actual GDP growth rate. The per capita consumption expenditure growth rate in Q1 was 5.4%, which was same as that of the corresponding period of last year.

However, it should be noted that the new tax law implements the “accumulated withholding method”. Unlike in the past, when each month’s tax burden was basically the same (assuming monthly income remained unchanged), under the new tax law there will be a difference between the monthly applicable tax rate and the withholding tax. Under normal circumstances, the tax burden is small every month at the beginning of the year and becomes large at the end of the year. Although the new tax law generally reduces the personal income tax amount, which is conducive to the release of consumption potential, the new tax law is characterised by a low-to-high tax burden. It is worth keeping an eye on whether future consumption will maintain steady growth.

Figure 15: Growth rate of per capita household disposable income and per capita household consumption expenditure, cumulative YOY, %
Rebound in social financing, improvement in the corporate financing environment

Total Social Financing (TSF), which reflects the financial system’s support for the financing of the real economy, has stabilised. After the stock growth rate fell to single digits for the first time (up 9.9% year-on-year) in November, stock growth in Q1 returned to double digits and increased by 10.7% in March, indicating an improvement in the financing environment of the real economy. In line with the recovery of social welfare, the growth rate of M2 in March was 8.6%, which was 0.6 percentage points higher than in February.

**Figure 16: TSF stock, YOY, %**

![Graph showing TSF stock percentage change](image)

*Source: Wind, KPMG analysis*

**Figure 17: Broad money (M2): YOY, %**

![Graph showing M2 percentage change](image)

*Source: Wind, KPMG analysis*

In Q1, TSF increased by 8.3 trillion yuan, which was over 2.3 trillion yuan more than the same period last year, representing an increase of nearly 40%. From the perspective of specific financing structures, the biggest contribution to TSF’s sharp recovery came from credit, followed by direct financing. Of this, new RMB loans totalled 6.2 trillion yuan, an increase of 1.4 trillion yuan over the same period last year; new direct financing (including corporate bond issuance, local government special bond issuance, local government special bond issuance and stocks) was 1.5 trillion yuan, a total increase of 772.2 billion over the same period last
year; and non-standard financing (including entrusted loans, trust loans and undiscounted bank acceptance bills) stopped shrinking by turning from negative to positive, going from -133.5 billion yuan in the same period last year to 60.6 billion yuan, an increase of 194.2 billion yuan year-on-year.

Figure 18: Composition of newly added financing, RMB trillions

The substantial expansion of RMB loans is mainly due to the rebound in short-term financing needs. In Q1, bill financing and short-term loans increased by 1.3 trillion yuan year-on-year, and the contribution rate of these two loans to the year-on-year increase of RMB loans reached 93%. At present, due to the requirements of the Banking Insurance Regulatory Commission on the proportion and amount of loans for small and micro enterprises in the banking industry (“three no less than” and “two increases and two controls”¹), banks will choose to issue short-term loans to small and micro enterprises in order to pass government’s assessment at the end of the quarter or will provide bill financing to achieve targets. After the assessment, banks may regain their appetite for risk and the continued growth of short-term credit is still on the cards. Medium- and long-term loans among residents increased by 90 billion yuan year-on-year, which was relatively better than the trend in real estate sales and related to growth in the sales area of first-tier cities. Medium- and long-term loans by enterprises increased by 120 billion yuan, reflecting how the improvement in the production environment has encouraged enterprises to invest. At the same time, fiscal investment also provides support for long-term credit. In March, financial institutions' financial deposits decreased by 692.8 billion yuan, a year-on-year decrease of 212.6 billion yuan. The growth rate of infrastructure investment also rebounded slightly.

¹“Three no less than” means that on the basis of effectively increasing the loan increment, efforts should be made to achieve the growth rate of small and micro enterprise loans not lower than the average growth rate of various loans; the number of small and micro enterprise loans is not lower than that of the same period of the previous year; small and micro enterprises’ loan acquisition rate is not lower than the same period of the previous year. The “two increase” means that the growth rate of loans of small and micro enterprises with total single-funded credits of 10 million yuan and below is not lower than the year-on-year growth rate of various loans; the number of loan households is not lower than that in the same period of the previous year. The “two control” is to rationally control the quality of loan assets of small and micro enterprises and the comprehensive cost of loans, and highlight the regulatory orientation of dual focus on quality and quantity, and sustainable growth.
In Q1, the increase in the issuance of local government special bonds was one of the main drivers of TSF. According to the 2019 government work report, this year’s new special debt limit is 2.15 trillion yuan. As of the end of March, the local government had issued special bonds of 666 billion yuan, accounting for 31% of the annual limit. If the speed of special bond issuance slows down in Q2, this will put pressure on the growth rate of TSF. The decline in non-standard financing has narrowed. Due to the base effect in Q2 of last year, this year’s non-standard growth rate is expected to increase marginally. However, as de-leveraging and risk control remains the government’s priority for 2019, a sharp rebound is unlikely.

According to the 2019 Government Work Report, “The sound monetary policy should be tight and moderate. Increases in M2 money supply and aggregate financing should be in keeping with nominal GDP growth to keep major indicators within an appropriate range.” This point was reiterated at the PBOC’s first quarterly monetary policy meeting held on April 12. In Q1 of this year, the growth rate of TSF rebounded to 10.7% and the growth rate of M2 reached 8.6%, both of which were higher than the nominal growth rate of 7.8% of GDP in Q1. From this perspective, given the overall stability of the policy environment, there will be less space for PBOC to further loosen monetary policy in Q2, meaning limited room for subsequent substantial growth in TSF.

The PBOC has gradually improved the creation of the interest rate corridor mechanism and set the standing loan facility (SLF) interest rate as the upper limit of the interest rate corridor. As the most important monetary interest rate indicators representing the average financing cost of the market in the second half of the year, the seven-day interbank pledge-style repo rate (R007) and the deposit institutions’ seven-day pledge-style repo rate (DR007) are both low, and a long way from the upper limit of the interest rate corridor. In the past 19 years, the two major interest rate indicators — in particular R007 — have gradually moved closer to the upper limit. The average value of R007 in March was 2.79; this was higher than PBOC’s seven-day reverse repo rate of 2.55% and indicated a slight downward trend in the liquidity of the interbank market.

In Q1, the consumer price index (CPI) increased by 1.8% year-on-year, a slight decrease of 0.37 percentage points from Q4 2018. Of this, March saw a rise of 2.3% year-on-year, up 0.8 percentage points from the previous month. The increase in vegetable and pork prices was the main reason for pushing up the growth rate of CPI. Specifically, food prices rose by 4.1% year-on-year, with fresh vegetable prices increasing by 16.2%. This in turn led to an increase of about 0.42 percentage points in CPI. Panic over African swine fever caused a drop in the number of live pigs, leading to a 5.1% year-on-year increase in pork prices in March. Non-food prices remained stable overall. The domestic VAT reduction policy will be implemented on April 1, prompting an immediate reduction in the price of some commodities, which is expected to ease the pressure on future price increases.

Figure 19: Interbank market interest rate: %

![Interbank market interest rate chart]

Source: Wind, KPMG analysis
The producer price index (PPI) rose 0.2% year-on-year in Q1, down 2.1 percentage points from Q4 2018. In March, the PPI growth rate turned from negative to positive, rising by 0.1% and driving the year-on-year growth rate to increase to 0.4%, which was mainly related to the rise in oil prices. Although after the Spring Festival, the gradual introduction of proactive fiscal policy coupled with companies picking up the pace after their return to work will help the PPI rebound year-on-year, the rise in crude oil price is the main driver of PPI growth. Looking ahead, with the gradual recovery of business demand and the continued rise in crude oil prices, the PPI will continue to rise slightly.

At present, there are different views on the direction of future policies in the market. Some people believe that the Chinese economy has stabilised; the “turning point” of the economy and policy has arrived, and future monetary policy will be tightened. We believe that although China’s economic growth rate showed signs of recovery in Q1, this recovery is still in the early stages, the foundation remains weak and the external economic environment remains uncertain. As a result, future monetary policy must continue to remain neutral and loose to ensure sustained economic recovery. However, the strength and frequency of future easing will slow down, and will be determined, to a greater extent, by real-time changes in the economy. Recently, PBOC hinted that the space for further RRR reduction has narrowed. However, we do not believe that monetary policy will be significantly tightened. Monetary policy will be more targeted, with increased financing support for private enterprises, small- and medium-sized enterprises, the real economy, high-tech enterprises and other departments to prevent the emergence of so-called “irrigation by flooding”.

Figure 20: Food and non-food CPI, YOY, %

Source: Wind, KPMG analysis

Figure 21: Industrial PPI, YOY, %

Source: Wind, KPMG analysis
Exports are better than expected, and the probability of RMB appreciation has increased

In Q1, China achieved a trade surplus of USD76 billion, an increase of USD31.6 billion over the same period last year. In term of exports, due to the influence of the date of Spring Festival and the base effect, export growth rates in Q1 fluctuated, with high figures for January and March and a low figure for February. In Q1, cumulative exports increased by 1.4% year-on-year, lower than the 2.6 percentage points in Q4 2018. Export performance in March was a bright spot, achieving a year-on-year increase of 14.2%, a sharp increase of 18.8 percentage points from January–February.

The year-on-year growth rate of imports in Q1 was -4.8%, down from the 9.2 percentage points in Q4 of last year. The year-on-year growth rate of imports in March was -7.6%, down 4.4 percentage points from January–February. Weak imports may be attributable to the adjustment of import VAT rate on April 1 to reduce the operating costs of import intermediaries, prompting the postponement of import plans.

The effects of early exports in the second half of the year to avoid the increase in tariffs imposed by the US government began to appear. In Q1, the cumulative growth rate of China’s exports to the US was -8.5%, down 15 percentage points from Q4 2018. In contrast, the export growth rate to the EU in the first quarter was 8.8%, up 2 percentage points from Q4 2018. The export growth rate to Japan was 2.2%, a slight decrease of 1.3 percentage points over Q4 2018.

Against a background of slowing global economic growth, export growth over the next period remains under pressure; however, with Sino-US trade talks approaching their end, the possibility of achieving positive results is increasing. The price of bulk commodities such as crude oil is rebounding, and the possibility of a sharp decline in exports is greater.

Figure 22: Import and export activities, current month value

Source: Wind, KPMG analysis
There has been a swift rebound in the RMB’s exchange rate since the beginning of 2019, from 6.8658 on December 28, 2018, to the recent lowest level of 6.6835 on February 27, 2019. The CFETS RMB exchange rate index also rose from 93.28 on December 28 to the most recent high of 95.2 on March 15. This was mainly attributable to the ease in the Sino-US trade war, which lead the market to revise its earlier pessimism.

Looking into the future from the perspective of exchange rate policy, Sino-US trade negotiations are coming to an end, and the domestic economy is picking up. There will be further loosening of monetary policy and a significant reduction in the exchange rate. From the US dollar index, the Fed has stopped raising interest rates, and the US and European trade negotiations have led to a weaker dollar. From the perspective of international payments, this year’s oil price remains at a low level compared with the same period last year. There is less lag in crude oil imports, and the balance of payments is expected to improve. In summary, pressure on the depreciation of the RMB exchange rate has decreased and the probability of appreciation has increased.

**Figure 23: USD index and RMB exchange rate**

![USD index and RMB exchange rate graph](source)

**Figure 24: CFETS exchange rate index**

![CFETS exchange rate index graph](source)
Policy analysis
In Q1 2019, a series of policies for the Shanghai Stock Exchange Sci-tech Innovation Board were introduced, which attracted widespread interest in the market. As of April 30, 2019 — less than half a year after it was announced during President Xi Jinping’s opening speech at the China International Import Expo last year — the board already had 98 companies. The Shanghai Equity Custody Trading Center launched a Sci-tech Innovation Board back in 2015; using other new sci-tech boards and the once-popular "strategic emerging board" as the prototype, the launch of the Shanghai Sci-tech Innovation Board has now been expedited and aims to attract technological and innovative companies in their early and growth stages. This is another important initiative in China’s creation of multi-tiered capital markets and support of innovative enterprises.

<table>
<thead>
<tr>
<th>Table 1: Sci-tech board history (pictured below)</th>
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</thead>
<tbody>
<tr>
<td><strong>November 2018</strong></td>
</tr>
<tr>
<td>On 5 November, President Xi Jinping officially announced during the opening ceremony of the first China International Import Expo that a sci-tech innovation board and pilot registration system would be set up on the Shanghai Stock Exchange.</td>
</tr>
<tr>
<td><strong>January 2019</strong></td>
</tr>
<tr>
<td>On 23 January, the Central Committee for Deepening Reform created an overall implementation program for the Shanghai Stock Exchange Sci-tech Innovation Board and pilot registration system; on 30 January, the China Securities Regulatory Commission officially issued Measures for the Administration of the Registration of IPO Stocks on the Science and Technology Innovation Board (for Trial Implementation) and Implementation Opinions on Setting up the Science and Technology Innovation Board and Launching the Pilot Program of the Registration System on the Shanghai Stock Exchange.</td>
</tr>
<tr>
<td><strong>March 2019</strong></td>
</tr>
</tbody>
</table>

*Source: Public Information, KPMG analysis*
The official Sci-tech Board rules released in March contain several main differences from the Implementation Opinions issued at the end of January: changes in the listing criteria for holding reduction and red chip companies and in the area of public funds.

- **Optimisation of shareholding reduction**: “Combining rigor with lenience” makes the shareholding reduction system more rational and enhances the flexibility of shareholding for the core personnel and shareholders of tech companies.

- **Red chip listings**: It stipulates that red chip companies not listed abroad must have an "estimated market value of no less than 10 billion yuan, or a market value of no less than 5 billion yuan and an operating income in the most recent year of no less than 500 million yuan." This change is intended to attract more quality tech companies to list in-country and provides the possibility for "unicorns" to return to the domestic Chinese depository receipts (CDR).

- **Public fund products**: It stipulates that public funds with investable A-shares can invest in the Sci-tech Innovation Board’s stocks, encouraging small and medium investors to get involved in tech investment through public funds and to benefit from the growth of innovative companies. The CSRC has indicated that as of 12 April, there were 74 tech-themed funds, from 34 firms, had applied to Shanghai Stock Exchange. Compared with large-scale public offerings in March, from April onwards, small and medium-sized companies were getting ready to sign up for tech funds.

- **Sponsorship supervision**: It lifts restrictions on sponsor organisations’ issuance of investment research reports during the continuous supervision period as well as lifts the mandatory requirement of the sponsor institution to express opinions on the replacement of the accounting firm by the listed company, further rationalising the definition of continuous supervision responsibilities.

On the whole, the Sci-tech Innovation Board will be oriented towards the forefront of global tech, the chief battlegrounds of the economy, and major national demand. It primarily serves innovative tech companies that are prioritised in the national 2025 strategy and have made breakthroughs in key core technologies, as well as being widely recognised in the market. The focus is on supporting high-tech industries and strategic emerging industries in areas such as next-generation information technology, high-end equipment, new materials, new energy, energy conservation and environmental protection, and biomedicine. This is aimed at promoting the deep integration of the Internet, big data, cloud computing, AI, and manufacturing; leading high-end consumption; and driving change in quality, efficiency, and dynamism.

Compared with other A-share boards, the Sci-tech Innovation Board has a more inclusive principle towards listings, formulating differentiated listing standards and allowing listings by high-quality loss-making enterprises, companies with different rights and shares, and red chip enterprises. This will invigorate innovative companies and smooth their way to join the market. With regard to the Sci-tech Innovation Board pilot registration system, company listings are audited by the Shanghai Stock Exchange and registered by the CSRC, helping to improve China’s multi-tiered capital market structure, eliminating “empty shell” enterprises, and optimising the efficiency of capital market investment.
KPMG analysis

The Sci-tech Innovation Board is a new capital market that has been set up to deepen the implementation of the innovation-based development strategy. The establishment of the board offers a new financing channel for Chinese high-tech companies and is conducive to tech companies’ use of capital to help them grow. A major highlight of the Sci-tech Innovation Board is the adoption of differentiated listing standards. Market capitalisation has been combined with financial indicators such as income, cash flow, net profit, and R&D investment to design five listing criteria that also allow unprofitable companies and enterprises with the same shares but different rights to go public. Overall, for companies with a larger market cap, the requirements for profitability are relatively lower. The diversification of issuance terms and conditions allows companies that have innovative tech but are not profitable in the short term to join the capital markets.

Table 2: Sci-tech Innovation Board Listing Criteria – General Criteria

If an issuer applies for an initial public offering and is listed on the Sci-tech Innovation Board, it should meet at least one of the following criteria:

<table>
<thead>
<tr>
<th>Criterion / indicator</th>
<th>Market cap</th>
<th>Net profit (Note)</th>
<th>Revenue</th>
<th>R&amp;D expenditure</th>
<th>Net operational activity amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Criterion 1</td>
<td>No less than RMB1 billion</td>
<td>Positive net profits for the last two years and cumulative net profits of no less than RMB50 million</td>
<td>Or, positive net profits for the last year and operating income of no less than RMB100 million</td>
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<tr>
<td>Criterion 2</td>
<td>No less than RMB1.5 billion</td>
<td>No less than RMB200 million for the last year</td>
<td>R&amp;D investment over the last three years no less than 15% of revenue for the last three years</td>
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<tr>
<td>Criterion 3</td>
<td>No less than RMB2 billion</td>
<td>No less than RMB300 million for the last year</td>
<td></td>
<td>Cumulative net operational activity cash flow of no less than RMB100 million for the last three years</td>
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<tr>
<td>Criterion 4</td>
<td>No less than RMB3 billion</td>
<td>No less than RMB300 million for the last year</td>
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<tr>
<td>Criterion 5</td>
<td>No less than RMB4 billion</td>
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Note: Net profit is the lower one between the two amounts before and after deducting non-recurring profit and loss

Source: “Shanghai Stock Exchange Science and Technology Innovation Board Stock Issuance and Listing Review Rules”, KPMG analysis
To determine R&D investments in Listing Criterion 2, Question 7 of the Questions and Answers by the Shanghai Stock Exchange on Examination of the Issuance and Listing of Stocks on the Science and Technology Innovation Board states, “R&D investment forms the total expenditure incurred by the enterprise's research and development activities. R&D investment usually includes R&D personnel salary, direct input expenses, depreciation expenses and long-term deferred expenses, design expenses, equipment commissioning fees, amortisation expenses of intangible assets, and commissioned external research and development expenses. R&D investment is the sum of expensed R&D fees and capitalised R&D expenditure for this period.”

For Listing Criterion 5, enterprises with an estimated market value of no less than 4 billion yuan should meet the following conditions:
• Their main business or product must have been approved by the relevant state departments, they must have a large market, and they must have results to show for each stage of their growth.
• For companies in the pharmaceutical industry, they must have at least one core product that has been approved for phase II trials.
• Other companies that qualify for the Sci-tech Innovation Board must have clear technical advantages and meet the corresponding conditions.

The Sci-tech Innovation Board listing criteria lifted restrictions on profitability performance, the absence of unrecovered losses, and the proportion of intangible assets in the current A-share listing criteria. A closer look reveals that for applicants with a market cap of 1–1.5 billion yuan, the focus is on net profit; for those with a market cap of over 1.5 billion yuan, there are no requirements for net profit, with the focus on R&D investment instead; for those with a market cap of more than 4 billion yuan, there are no requirements for profit or scale — the focus is on technical advantages instead.

Among the 93 companies on the Sci-tech Innovation Board, more than 40 firms are manufacturers of computers, telecommunications and other digital devices not specified. Among these firms, software and service has the biggest share, following by hardware and equipment, semiconductor and semiconductor manufacturing equipment, and telecommunications. There are also more than 20 firms specialising in medical equipment, pharmaceuticals, biotechnology and life science. In terms of R&D, there are more than 20 companies with R&D expenditure over 100 million yuan, and more than 50 enterprises with expenditure of less than 50 million yuan.2

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2 As of April 30, 2019
The Sci-tech Innovation Board will further improve vitality and effectiveness of capital markets

The establishment of the Sci-tech Innovation Board and pilot registration system is a major breakthrough in the reform of the A-share capital market. It not only enables China’s “hard-tech” companies to achieve better growth using capital markets but also brings a change to these capital markets themselves. The biggest difference between the Sci-tech Innovation Board and the existing audit system in China’s domestic capital markets is that the registration system no longer relies on the regulatory authorities to appraise listed companies; instead, intermediaries provide their professional opinion on the authenticity, accuracy, and completeness of application documents. It is upon this basis that the market judges value. As such, the registration system lays the institutional foundation for tech company listings and will further enhance the vitality and effectiveness of capital markets. At the same time, the reforms of the Sci-tech Innovation Board’s delisting system make non-compliance delisting requirements more stringent, requiring companies on the Sci-tech Innovation Board to strictly adhere to legal and regulatory requirements for their ongoing listing while maintaining “scientific and technological innovation”, which will help improve the quality of tech companies.

Figure 25: Industry distribution of companies registered for the Sci-tech Innovation Board

Data source: The Shanghai Stock Exchange Science and Technology Innovation Board Stock Issuance and Listing Review Rules issued by the Shanghai Stock Exchange, KPMG analysis
On 5 January, the National Development and Reform Commission and the National Energy Administration issued the Notice on Further Promoting the Reform of Incremental Power Distribution. In this Notice, they made further requirements concerning the determination of the owners of incremental distribution service schemes, the definition of the range of increments and inventory, the proper planning of incremental distribution networks, and the standardisation of the investment, construction and operation of incremental distribution networks. These requirements are aimed at providing a clear direction for deepening reforms of incremental power distribution.

In a government report released on 5 March, State Council Premier Li Keqiang proposed deeper reforms in the areas of electricity, oil and gas, and railways. He said that there should be “network separation” based on the characteristics of different industries, with competitive businesses fully opened up to the market.

On 8 March, the General Affairs Department of the National Energy Administration issued Opinions on Further Promoting the Pilot Work of the Construction of the Power Spot Market (Consultation Draft). It requested improvements to the supporting mechanisms of the power spot market, the creation of a catalogue price adjustment mechanism connected to the power spot market, and the gradual solution of the problem of double-track prices on the user side.

Several energy reform documents were issued in Q1 2019, with reform entering the difficult “deep-water” phase.

Electricity is an integral part of economic development. The continued growth of China’s economy has prompted the ceaseless expansion of the power industry. In 2018, China’s full-calibre power generation and electricity consumption growth rate increased by 1.9 percentage points over the previous year.

**Figure 26: National power generation and electricity consumption in 2014-2018 (unit: trillion kWh)**

Source: Wind, CEC, KPMG analysis
At the end of 2014, President Xi Jinping explicitly proposed the "Four Revolutions and One Collaboration" strategic approach for national energy security and development. In March 2015, the CPC Central Committee and the State Council issued Several Recommendations for Deepening Reform of the Power System (Zhong Fa [2015] ] No. 9) (hereinafter referred to as the 'No. 9 Document'). The official release of the No. 9 Document opened the door for a new round of power reform and has now been in process for four years. These four years have seen the promotion of various pilot reforms including the transmission and distribution price reform pilots, comprehensive power reform pilots, and power sales reform pilots — this has created a pattern of multi-modal exploration led by comprehensive pilot projects. At present, there is the gradual establishment of a market-based foundation for power system reforms, deepening market awareness for associated entities, and comprehensive promotion of reforms in various areas; and the national market-based trading electricity has increased year by year.

**Figure 27: National marketised trading electricity volume and social electricity marketisation rate (2016-2018)**

![Graph showing marketised trading electricity volume and social electricity marketisation rate](image)

Source: National Development and Reform Commission, KPMG analysis

### Main Achievements in the Latest Round of Power System Reforms

The new round of power system reforms has achieved significant results after several years of development. In particular, the following are the most notable achievements:

- **Reform of transmission and distribution prices has gradually hit the mark:**

  On 10 February 2002, the "Power System Reform Plan" (Guo Fa [2002] No. 5) was officially released. As a suite of policies for implementing grid separation and on-grid bidding, it created a new power tariff formation mechanism, dividing power tariffs into online tariffs, transmission tariffs, distribution tariffs, and end sales tariffs. The on-grid tariff is set by the state and the capacity tariff is generated by the market bidding; the transmission and distribution tariffs form the basis of the above tariffs, establishing a mechanism for connection to the on-grid tariff. So far, a three-stage power pricing structure consisting of an on-grid tariff, power transmission tariff, and sales tariff has been formed.

  **Figure 28: Power system diagram**

  ![Power system diagram](image)

  Source: Public Information, KPMG analysis

  These reforms to the transmission and distribution tariff are aimed at creating an independent transmission and distribution system. This system would break the existing "individual purchase" and "single sale" model, control the "excess network tariff" stage, and, for the first time, create a triple-tiered tariff system spanning provinces, regional power grids, and provincial power grids — marking the creation of an independent transmission and distribution tariff for the first time in China. Since the Shenzhen Power Grid and Mengxi Power Grid began pilot transmission and distribution tariff reforms in 2015, the top-level design of transmission and distribution price reform has covered every stage and the entire field of power transmission and distribution, including inter-provincial and inter-regional special projects, regional power grids, provincial power grids, local power grids and incremental distribution networks.
Reform of power trading mechanism: power trading institutions introduced in various provinces

China’s first power trading institution, the Beijing Electric Power Trading Centre, was officially unveiled in 2016. By the end of 2017, China’s final provincial-level power trading institution, the Hainan Electric Power Trading Centre, was formally established. Power trading institutions have been set up in 31 provincial-level administrative regions, not including Hong Kong, Macau, and Taiwan. With the exception of Tibet, all have carried out substantive transactions.

Reform of the electricity-sales side releases the distribution of electricity business to social capital

China’s power industry completed the separation of plant and grid in 2002. Following the separation, the power system was divided into two major power grids (the State Grid and China Southern Power Grid), five major power generation groups (Huaneng, Datang, Huadian, Guodian and National Power Investment), and one auxiliary industry group. The plant-grid separation broke the pattern of the exclusive purchase of power by power grid companies, created a competitive and open regional power market, and formed new bidding mechanisms. At this stage, the cultivation of the main body of the power generation side has been completed. As such, in the new round of power reforms that began in 2014, the focus has been on liberalising the power generation side of the market. Reform of the power generation side of the market is also the most active area of social capital. Breaking through the model of “regular purchase and sales” of traditional power grid enterprises, power sales companies quickly entered the field. China’s first electricity retailer was founded in Shenzhen in 2015. By the end of 2018, more than 3,000 electricity retailers had been registered at power trading institutions.

Renewable energy generation enjoys guaranteed purchases

According to 2016 policies, the annual generation capacity of renewable energy and network power generation projects was divided into guaranteed purchases of capacity and market trading of capacity. Of this, guaranteed purchase of capacity guarantees the full amount of the benchmark on-grid tariff via prioritising annual power generation plans and the signing of preferential power generation contracts with power grid corporations (material contracts or differentiated price contracts). In the market trading of the capacity part, renewable energy power generation companies obtain power generation contracts by participating in market competition, and power grid enterprises perform power generation contracts according to preferential adjustments. In March 2019, the National Development and Reform Commission issued the Administrative Measures for Guaranteed Full Purchase of Renewable Energy Generation. The Measures described methods for the execution of guaranteed renewable energy purchases and clarified the responsibilities of the Government, power generation companies, and grid companies. This laid a foundation for resolving the curtailment of solar power and promoting renewable energy.

KPMG analysis

In March 2019, at the first press conference of the Second Session of the 13th NPC, Lian Weiliang, Deputy Director of the National Development and Reform Commission, introduced 20 key reform tasks for the year. In addition, he proposed the main tasks of future power reform, including “full liberalisation of generation output planning for operational industries and the wide-scale implementation of county-level pilot projects for the reform of incremental power distribution”

Full liberalisation of generation output planning for operational industries:

In this year’s Government Work Report, Premier Li Keqiang emphasized “deepening reforms for power ‘marketisation’, eliminating additional charges for electricity tariffs, reducing the cost of electricity for the manufacturing industry, and reducing the cost of electricity for general industrial and commercial industries by another 10%.” This is the second time that “reducing the average cost of electricity for industrial and commercial industries by another 10%” has been mentioned since 2018. The full liberalisation of generation output planning for operational industries will help reduce the cost of power for the manufacturing industry as well as for general and commercial industries. This liberalisation depends on deepening power marketisation reforms and promotes the marketisation of general output planning.
Deepening promotion of reform of incremental power distribution:

Between November 2016 and January 2019, the National Development and Reform Commission and the National Energy Administration launched three batches of 320 incremental power distribution reform pilot projects, achieving full coverage of cities above the prefecture level. Since the second half of 2018, a series of work has been carried out at the national level to promote the specific implementation of pilot projects. Talks have also been held with provincial power grid companies in which they were asked to make more effort to support the reform of incremental power distribution. At the end of 2018, the National Development and Reform Commission and the National Energy Administration issued the Notice of Submissions for the Fourth Batch of Incremental Power Distribution Reform Pilot Projects. This was the first time the significance of incremental power distribution reform pilot projects had been elevated to the level of "supporting the development of private enterprises". It has actively encouraged the participation of social capital in incremental power distribution, and made it clear that areas with relatively favourable conditions should strive to achieve coverage of pilot projects at the county level.

Deep contradictions still remain in incremental power distribution reform. These include lack of standardisation in owner bidding, difficulties in the handling of the stock capital of power grids affected by the scheme, difficulties in the division of distribution areas, as well as lack of clarity in the mechanisms and procedures at the power grid stage. The Notice on Further Promoting Reform of Incremental Distribution Business was released in January. It aims at improving and upgrading the top-level design of incremental power distribution reforms, as well as providing detailed guidance for incremental power distribution reform pilot projects. The Notice clarifies that grid companies and local governments are not recommended to invest in pilot projects without clear owners; projects for which work had already begun, and for which there had been less than 10% investment during the valid period, can be included in the scope of pilot projects; incremental power distribution pilot projects with power distribution under 220 (330) KV within the normal development mode are not limited to user-specific substations and terminal substations. However, it is worth noting that the increased input of social capital was a highlight of the document. It provided favourable conditions for solar and wind energy’s inclusion in energy market trading and improving comprehensive energy utilisation.

3 Interpretation of the Notice on Further Promoting the Reform of Incremental Distribution Business, China Energy News, January 2019
The State-owned Assets Supervision and Administration Commission stated that 10 central enterprises were to create “world-class model enterprises”

In January 2019, the State-owned Assets Supervision and Administration Commission of the State Council identified 10 central enterprises that are to be transformed into “world-class model enterprises”. Over the next three years, there will be a targeted roll-out of comprehensive reform measures across multiple sectors, with a focus on making these enterprises globally competitive and world-class. The enterprises are Aerospace Science and Technology, China National Petroleum Corporation, State Grid, China Three Gorges Group, National Energy Group, China Mobile, China Aviation Group, China Construction, China CRRC and China Guangdong Nuclear Power Group. The inaugural batch of 10 model enterprises were selected from the aviation, energy, investment and construction sectors, and will effectively promote the setting up of globally competitive world-class enterprises in the future. The new round of state-owned enterprise reform officially entered its sixth year. In Q1 this year, central enterprises recorded a total operating income of 6.8 trillion yuan (up 6.3% year-on-year) and total profits of 426.5 billion yuan (up 13.1% year-on-year). Operating income showed strong monthly growth momentum, while central enterprises got off to a flying start at the beginning of the year.

Table 3: Main achievements of state-owned enterprises in reform

<table>
<thead>
<tr>
<th>Type of Reform</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td><strong>In terms of systemic reform</strong></td>
<td>In January 2019, the State-owned Assets Supervision and Administration Commission of the State Council identified 10 central enterprises that are to be transformed into “world-class model enterprises”. Over the next three years, there will be a targeted roll-out of comprehensive reform measures across multiple sectors, with a focus on making these enterprises globally competitive and world-class. The enterprises are Aerospace Science and Technology, China National Petroleum Corporation, State Grid, China Three Gorges Group, National Energy Group, China Mobile, China Aviation Group, China Construction, China CRRC and China Guangdong Nuclear Power Group. The inaugural batch of 10 model enterprises were selected from the aviation, energy, investment and construction sectors, and will effectively promote the setting up of globally competitive world-class enterprises in the future. The new round of state-owned enterprise reform officially entered its sixth year. In Q1 this year, central enterprises recorded a total operating income of 6.8 trillion yuan (up 6.3% year-on-year) and total profits of 426.5 billion yuan (up 13.1% year-on-year). Operating income showed strong monthly growth momentum, while central enterprises got off to a flying start at the beginning of the year.</td>
</tr>
<tr>
<td><strong>In terms of mixed ownership reform</strong></td>
<td>During 2013-2016, the proportion of mixed-ownership enterprises in central enterprises increased from 65.7% to 68.9%. Since 2017, about 900 households have been added, and more than 420 billion yuan of social capital has been introduced.</td>
</tr>
<tr>
<td><strong>In terms of corporate governance</strong></td>
<td>As of February 2019, a standardised board of directors had been established in 83 central enterprises, as well as in the secondary and tertiary units of 15,035 central enterprises.</td>
</tr>
<tr>
<td><strong>In terms of strategic restructuring</strong></td>
<td>Since the 18th National Congress, 20 groups of 38 central enterprises have been reorganised and integrated into the newly established China Aviation. The number of central enterprises has been reduced from 116 to 96. The reorganisation and integration of enterprises has promoted structural optimisation and produced synergies, improving resource allocation.</td>
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<tr>
<td><strong>In terms of de-capacity</strong></td>
<td>State-owned enterprises have undertaken the task of reducing 80% of their steel production capacity and 70% of their coal production capacity. In the first half of 2018, the coal production capacity was 3.4 million tons; the task of resolving excess steel capacity had been fully accomplished.</td>
</tr>
</tbody>
</table>

Source: State-owned Assets Supervision and Administration Commission of the State Council, KPMG analysis
Since the release of the Guiding Opinions on Deepening the Reform of State-Owned Enterprises in 2015, the reform of mixed ownership has become one of the important measures for the reform of state-owned enterprises. From the determination of mixed-ownership reform in 2015 to the “Double Hundred Actions” for over 400 central enterprises and local state-owned enterprises in 2018, the reform of state-owned enterprises has shifted from “pilot launch and steady expansion” to the “deepening comprehensive promotion stage”. The direction of mixed-ownership reforms is gradually extending to the corporate group level of quality assets. The 19th National Congress of the Communist Party of China proposed the setting up of globally competitive, world-class enterprises. Currently, state-owned enterprise reform is mainly focused on actively and steadily promoting mixed-ownership reform; accelerating the transition from “managing enterprises” to “managing capital”; and cultivating globally competitive, world-class enterprises.

► What is a world-class enterprise?
A world-class enterprise is one that can adapt well to the market requirements, as well as show strong market growth, competitiveness and the ability to innovate. Such enterprises have the following characteristics:

- First-class independent innovation capabilities
- First-class product and service quality capabilities
- First-class profitability
- First-class international management capabilities
- First-class strategic management capabilities
- First-class risk control capabilities
- First-class human resource management capabilities
- First-class corporate culture and awareness of public service

► Gap between China’s and the world’s first-class companies:
China has many enterprises among the Fortune Global 500, which are benchmarked against the top globally competitive companies. The number of Chinese companies in the Fortune Global 500 increased from 115 in 2017 to 120 in 2018 — only six less than the US (which was at the top of the list) and more than double the number of Japan’s (which was third). Clearly, China’s large-scale enterprises are not in the minority, and some of them have reached world-class levels in certain products and technologies. However, compared with top companies from other parts of the world, there is still disparity in terms of industry leadership, brand influence and culture. In particular, they are clearly behind when it comes to the level of “internationalisation”, competitiveness in innovation is still lacking, and there remains room for improvement in the efficiency of enterprises.

In terms of “internationalisation”, world-class enterprises are able to effectively integrate natural resources and factors of production including talent, technology, management and finance, forming a global operational structure and business layout. According to the list of China’s Top 100 Multinational Corporations, released on September 2, 2018, the threshold for Chinese enterprises is 7.22 billion yuan, up 17.49% over 2018; however, the proportions of overseas assets, overseas operating income and overseas employees were 18.79%, 20.86%, and 9.76%, respectively — though higher than last year, they were still far below international levels.

Figure 29: Trends in China’s Top 100 and Fortune Global 500

Source: “2018 Chinese Enterprises Top 500 Analysis Report”, KPMG analysis
In terms of innovation, in 2018 China’s Top 500 enterprises filed for a total of 345,500 patents, a significant increase of 51.72% year-on-year and a 31.79-percentage point increase in the growth rate over the previous year. However, China’s Top 500 enterprises accounted for just 36.16% of patents, which is far less than the more than 90% in developed economies such as Europe, America and Japan.

In terms of corporate performance, the operating income margin and return on equity of China’s Top 500 were 4.5% and 9.6%, respectively, which were 1.8 and 1.3 percentage points lower than the Global 500. The average profits of the Global 500 were 3.8 billion US dollars, while the average profits of China’s Top 500 were a quarter of this.

KPMG analysis
The discrepancies in growth between Chinese enterprises and top companies from other parts of the world is connected to China’s stage of economic development. At the same time as getting bigger, China’s enterprises should also try to be more competitive. As the concept of high-quality growth gradually becomes a key criterion for enterprise development, these enterprises will shift from the single-minded pursuit of scale to the cultivation of “inner strength” at the same time as growing size, gradually closing the gap with the world’s top companies.

Through the development of high-class globally competitive companies, state-owned enterprises plan to achieve sustainable growth, continuous innovation and improvement, focusing on Chinese companies “going global” and the “Belt and Road” initiatives, in turn increasing their participation in the global division of labour and achieving global resource allocation. State-owned enterprises are expected to seize this historic opportunity and take advantage of the “fast track” approach for setting up world-class enterprises. In addition, they are expected to focus on strengthening capacities in ROE, revenue margin, R&D investment and value-added. SOEs should also work on the accumulation of human capital, the management and control of enterprise risk, and the international allocation of resources, enhancing their power to achieve sustainable, stable development.

In this highly volatile time for global development, we believe that the core competitiveness of world-class companies lies in technological innovation and development. Central enterprises must strive to lead international resource allocation and then guide global technological innovation and work on becoming influential leaders. This requires world-class companies to master both the key and the common technologies of their industries and improve their core competitiveness. In addition, they must be able to overcome bottlenecks and achieve key technological breakthroughs in strategic and forward-looking areas in order to lead the future development of industries.

4 “The 2018 Chinese Enterprises Top 500” List Announces Striving for World-Class Enterprises, Renminbi Daily, September 2018
5 “Deepening the Reform of State-owned Enterprises and State-Owned Enterprises to Cultivate World-Class Enterprises”, SASAC, April 2019
On 18 February 2019, the Central Government and State Council issued the Outline Development Plan for Guangdong-Hong Kong-Macau Greater Bay Area, indicating that the deep integration of the Pearl River Delta is rapidly entering a new phase. It included the extension of short-term planning from 2022 to 2035. The Guangdong-Hong Kong-Macau Greater Bay Area is a key national strategic deployment aimed at promoting in-depth cooperation between the nine cities in Guangdong Province, along with Hong Kong and Macau, encouraging integrated development within the bay area, and creating a synergistically developed, interconnected world-class urban cluster through innovation and increased openness.

► Development goals:
• Forming a world-class bay area and urban cluster framework by 2022.
• Creating a world-class bay area that is resident friendly, business friendly and tourist friendly by 2035.

► Spatial layout:
• Driving at each end: Leading and driving the strong connection between Hong Kong-Shenzhen, Guangzhou-Foshan and Macau-Zhuhai.
• Supporting the Axle belt: Ensuring the use of high-speed railway, inter-city railway and high-grade highways as the main fast transportation network, and using the port and airport groups to build a regional economic development axis, forming a networked pattern of efficient connection among major cities.
• Optimising and upgrading core cities: Driving regional development mainly through the four central cities of Hong Kong, Macau, Guangzhou and Shenzhen.
• Building important node cities: Supporting Zhuhai, Foshan, Huizhou, Dongguan, Zhongshan, Jiangmen, Zhaoqing and other cities to highlight every city’s positive points and enhance their attractiveness.

At present, the nine cities of the Pearl River Delta have formed an industrial structure in which strategic emerging industries are the vanguard while the advanced manufacturing and modern service industries are the mainstay. This industrial system is fully formed, exhibits clear “cluster advantages”, has robust economic strengths and is the most outward-facing economy in the mainland. It is an important window for opening up to the outside world. A centre for international finance, shipping and trade as well as an international aviation hub, Hong Kong is one of the world’s freest economies. It boasts a highly international, law-based business environment and a global network of businesses. Macau is a centre for global tourism and leisure, and a platform for collaboration between China and Portuguese-speaking countries; its role in multicultural interaction is growing by the day. The complementarity of the three means that there are strong prospects for economic development in the Guangdong-Hong Kong-Macau Greater Bay Area.
The Guangdong-Hong Kong-Macau Greater Bay Area strategy includes the creation of a new, globally influential international centre for technological innovation. The Outline proposes the creation of an open, interoperable and rationally distributed regional innovation system that gives full play to the advantages in technology and industry offered by Guangzhou, Hong Kong and Macau, as well as actively attracting and connecting with global innovation resources. It promotes the creation of a Guangzhou-Shenzhen-Hong Kong-Macau science and technology innovation corridor; explores policy initiatives that facilitate cross-border flows and regional integration of innovative elements such as talent, capital, information and technology; as well as jointly creating the Guangdong-Hong Kong-Macao Greater Bay Area big data centre and international innovation platform. It supports the construction of major science and technology infrastructure, major scientific research institutions and major innovation platforms in the Greater Bay Area. The Greater Bay Area plan also allows Hong Kong and Macau to gradually have access to the major scientific research infrastructure and large-scale scientific research instruments in Guangdong. In February of this year, Ma Xingrui, Governor of Guangdong Province, revealed in a Government Work Report that to promote the creation of the Guangdong-Hong Kong-Macao Greater Bay Area, a number of joint laboratories for Guangdong, Hong Kong and Macao will be established that will carry out research on cutting-edge technologies and key common technologies in the industry.

In terms of development of innovative technology industries, the Greater Bay Area boasts high-quality talent, advanced R&D labs, and a broad development base for emerging industries. The future will see wide-scale promotion of the industrial transformation and upgrading of the Bay Area, diversification of industry, and development in the direction of integration of industry, cities, and people. According to Science and Technology Cities in the 2018 edition of the Nature Index, of the world’s top 50 cities for scientific research, Guangzhou and Hong Kong were among the 10 Chinese cities featured, ranked 25th and 26th, respectively. Guangzhou’s traditional manufacturing industry will be transformed and upgraded amid the wave of industrial upgrading.

| Table 4: Comparison of Major World Bay Area Indicators (2018) |
|-----------------|-----------------|-----------------|-----------------|
| Population (million people) | 69.6 | 44.0 | 7.7 | 23.4 |
| GDP (trillion USD) | 1.5 | 1.9 | 0.8 | 1.4 |
| Per capita GDP (USD1,000) | 2.2 | 4.3 | 10.2 | 6.0 |
| Coverage (10,000 square kilometres) | 5.6 | 3.7 | 1.8 | 2.2 |

Source: United Nations, KPMG analysis
accelerating the development of new-generation information technology, artificial intelligence, biomedicine, new energy, new materials and other emerging industries, coupled with strong education and scientific research resources, causing the city to transform from the traditional business center to the new innovation center of the Guangdong-Hong Kong-Macau Greater Bay Area. Owing to its international business model and service system as well as its highly developed financial markets, Hong Kong has become the first stop for Bay Area tech companies looking to "go global". This has enabled the Greater Bay Area’s tech industry to effectively access overseas capital.

In terms of finance, the Outline touches upon three aspects of the Greater Bay Area’s economic development plan — creation of an international financial hub, large-scale development of a specialty financial industry, and orderly promotion of interconnected financial markets. At the same time, based on the characteristics of the resource endowments and industrial development of different regions, the Outline also focuses on the various positionings of the financial functions of different regions.

- **Hong Kong:** Creating an investment and finance platform serving the "Belt and Road" initiative and building a "green financial centre" for the Greater Bay Area.
- **Macau:** Developing a leasing business; creating an RMB clearing centre for Portuguese-speaking countries; and establishing a securities market with RMB-denominated settlement, a green financial platform and a Sino-Portuguese financial services platform.
- **Guangzhou:** Building a regional private equity trading market and a regional trading centre for property rights and commodities, as well as researching and setting up an innovative futures exchange with carbon emissions as the first commodity goal.
- **Shenzhen:** Creating an insurance innovation and development pilot zone, as well as strengthening its positioning as the incubator of fintech.

The Outline stated that the international tech innovation centre and international financial hub would be the two driving forces for the Greater Bay Area’s thriving growth. Against the backdrop of construction of the Guangdong-Hong Kong-Macau Greater Bay Area, the financial industry has taken on a historic mission and welcomed the historic opportunity to develop itself. The financial industry will accelerate open innovation and interconnection, as well as deepen the penetration of financial technology in order to achieve rapid development.
Case study: trends and prospects of foreign investment
Review of FDI in China

FDI has become a major force in China’s economic and social development over the last 40 years. According to United Nations Conference on Trade and Development (UNCTAD) statistics, since 1992, China’s actual use of foreign capital has ranked first in developing countries for 27 consecutive years. As at the end of 2018, a total of 960,000 foreign-invested enterprises had been established in China, and the accumulated actual use of foreign capital exceeded 2.1 trillion US dollars.6

In recent years, China’s global FDI inflows have continued to grow despite sluggish global FDI activity. According to UNCTAD, global FDI flows stood at USD1.19 trillion in 2018. The scale of investment has shrunk for the third consecutive year and has fallen to the second lowest since the global financial crisis in 2008; it is only slightly higher than the USD1.18 trillion in 2009. In this context, China’s attractiveness to foreign investment remains undiminished. According to UNCTAD data, China’s FDI inflows reached USD142 billion in 2018, an increase of USD5 billion from the previous year, accounting for a record high of 11.95% of global FDI, second only to the USD226 billion flowing into the US (corresponding to global FDI share of 19.02%).7

Figure 30: Top 10 FDI inflows to countries and regions (USD billion)

Source: UNCTAD, KPMG analysis
Note: The 2018 data is a preliminary estimate of UNCTAD.

7 According to the data disclosed by the Ministry of Commerce, the actual amount of foreign investment in China in 2018 is 135 billion US dollars. The data does not include FDI data from the fields of banking, securities and insurance. See http://www.mofcom.gov.cn/publications/201901/01/content_3737680.htm.
From the perspective of investment structure, in the past 10 years, the changes in FDI flow to China have also reflected the changes in its industrial structure, and the scale of FDI flowing to the service industry was significantly larger than for manufacturing. During 2009-2018, FDI in the service industry increased from USD40.3 billion to USD85.85 billion; the scale more than doubled, and the compound annual growth rate reached 8.8%. In 2010, the proportion of FDI to the service industry exceeded that to the manufacturing sector for the first time, reaching 48.7%; by the end of 2018, the ratio rose to 63.6%. In contrast, the total value of FDI to the manufacturing industry declined from USD46.77 billion in 2009 to USD41.17 billion in 2018 — a drop of 12%.
By subsector, annual FDI flows in 2018 to the textile, chemical and general equipment sectors in the manufacturing industry declined from 10 years ago; the annual FDI flows to special equipment manufacturing, information and electronic equipment manufacturing, etc. increased from 10 years ago, but the increase is relatively limited. In contrast, the FDI flows to industries such as information transmission, computer service and software, wholesale and retail, finance, leasing and business services, scientific research, technical services and geological exploration, transportation, warehousing and postal services, education, health, social security and social welfare in 2018 were significantly higher than 10 years ago.

► **Hong Kong is an important source of FDI for China**

During 2008-2017, the proportion of FDI from Latin America dropped sharply, from 23% before the financial crisis to 5% in 2017. On the other hand, the proportion of FDI from Asia increased significantly, from 62% in 2008 to 83% in 2017 — this is mainly attributable to the contribution from Hong Kong. As a “free port” for international finance, Hong Kong has played a vital role as an “international capital transfer station” for attracting foreign investment. For foreign businesses looking to mitigate incompatibility with China’s political and economic system, investing in mainland China from Hong Kong has become the preferred means of investment for international capital in recent years. At the same time, in line with its own international strategy, and when seeking overseas listings and tax incentives, some Mainland Chinese capital has also chosen to register in Hong Kong and then re-invest in China, which has objectively pushed up the proportion of FDI in Hong Kong. The past 10 years have seen rapid growth in FDI from Hong Kong. FDI traffic increased from USD41 billion in 2008 to USD94.5 billion in 2017, and its share of China’s annual FDI traffic increased from 45% to 72%.

![Figure 35: Changes in FDI flow by major industry segment, in USD billions](image-url)
Foreign investment is closely related to high-quality growth of China’s economy

Thanks to its significant economic volume and rapid economic growth, China has become one of the world’s most attractive investment destinations. Despite concerns about the recent downward pressure on the Chinese economy, most European and American companies still believe that China is the top priority of their global investment plans. As per 2018 survey data from the American Chamber of Commerce in China and the European Chamber of Commerce in China, 60% and 61% of member companies, respectively, regard China as one of their top three investment destinations; in the latest survey of the American Chamber of Commerce in China, the ratio further rose to 62% in 2019.
FDI has driven China’s economic growth, job creation and industrial upgrading. Related data indicates that foreign-funded enterprises have created nearly half of China’s foreign trade, a quarter of industrial output, one-fifth of fiscal revenue and one-seventh of urban employment. According to statistics from the Ministry of Commerce, the actual growth rate of China’s high-tech manufacturing industry in real use in 2018 was 35.1%, which was significantly higher than the year-on-year growth rate of FDI and manufacturing FDI.\textsuperscript{8,10}

**Figure 37: Proportion of companies regarding China as one of their three major investment destinations**

![Figure 37: Proportion of companies regarding China as one of their three major investment destinations](image)

\textit{Source: China Chamber of Commerce, China Business Environment Survey Report, China Chamber of Commerce, Business Confidence Survey}

\textsuperscript{8} See: https://pl.ifeng.com/a/20190310/60316714_0.shtml.

\textsuperscript{10} See: https://baijiahao.baidu.com/s?id=1622633974662896557&wfr=spider&for=pc.
Introduction of the "Foreign Investment Law"

Recent years have seen a slowdown in China’s FDI growth. From 2011 to 2018, the average growth rate of China’s FDI fell to 2.8%, significantly lower than the 8.4% for the first decade of the century. In one respect, this relates to the increase in the volume of China’s FDI. In 2018, China attracted 3.2 times more foreign capital than in 2000 (according to the Ministry of Commerce). In another respect, this is also connected to the overall trend of international capital flows in recent years; uncertainty in international politics and the international economic environment has slowed the growth of cross-border investment.

To maintain its attractiveness to foreign investment, China is stepping up its efforts to strengthen its legal system and improve the business environment. On March 15, 2019, the NPC passed the "Foreign Investment Law of the People’s Republic of China" (the "Foreign Investment Law"), which provides legal clarification for the pre-entry national treatment with a negative list for foreign investment. To the outside world, this is widely regarded as an important milestone for China in becoming more open and promoting FDI.

**Background of the "Foreign Investment Law"**

After its reform and opening up, China has gradually formed a foreign investment legal system based on the Sino-foreign Joint Venture Enterprise Law (1979), the Foreign Investment Enterprise Law (1986) and the Sino-foreign Joint Venture Enterprise Law (1988). These laws — referred to as the ‘three foreign laws’ — have provided effective legal protection for China’s promotion of reform and opening up and active use of foreign capital.

The "three foreign laws" were formed during the early stages of reform and opening up, and chiefly normalised principles for the organisational form, operational activities of foreign-invested enterprises. However, with the establishment and continuous improvement of the socialist market economic system and the socialist legal system with Chinese characteristics, the associated norms of the "three foreign laws" have gradually been covered by laws such as the Company Law, the Partnership Enterprise Law and the General Principles of Civil Law. Since the “three foreign laws” mix multiple legal content, they often overlap or even conflict with other laws and regulations. In addition, China has fully implemented the Foreign Investment Negative List system, making the existing “three foreign laws” harder to adapt to the requirements of reform and development.11

With changes in the external environment, some countries and economies have misinterpreted China’s technological incorporation and intellectual property protection. At this point, it is imperative to give foreign-invested enterprises more legal protection and investment convenience in the form of the "Foreign Investment Law", thus enhancing foreign confidence and prompting domestic reform.

As a basic law in the field of foreign investment, the draft Foreign Investment Law was initiated in 2011, and was publicly consulted through the official website of the Ministry of Commerce in January 2015. At that time, it was known as the Foreign Investment Law (Draft). Overall, it had a total of 11 chapters and 170 articles, covering general principles, foreign capital, foreign investment, access management, national security review, information reporting, investment promotion, investment protection, complaint coordination, supervision and inspection, legal responsibility, and supplementary provisions.12

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11 On 25 December 2018, the National Development and Reform Commission and the Ministry of Commerce issued the "Negative List of Market Access (2018 Edition)" which marked the full implementation of the market entry negative list system in China, and industries, fields, businesses, etc. outside the negative list, all types of market entities can enter under the law.
12 The full name is the Foreign Investment Law of the People’s Republic of China (draft for comments).
Compared with the previous version, the Foreign Investment Law voted for by the NPC has, in terms of chapters and content, been significantly streamlined; in terms of direction, it gives greater prominence to boosting and protecting foreign investment and simplifies the management of foreign business investment, reflecting China’s reform ideas for promoting “decentralisation, strengthening supervision and optimising services” in the field of foreign investment. In terms of specific content, the Foreign Investment Law includes six chapters and 42 articles covering general provisions, investment promotion, investment protection, investment management, legal responsibility and provisions. The Foreign Business Investment Law will be implemented on January 1, 2020, when it will officially replace the long-standing "three foreign laws" and become the basic law for the use of foreign capital in China.

Policy points of the Foreign Investment Law

The Foreign Investment Law has made clear protective provisions to address the issues of general concern among foreign investors such as investment solicitation and compensation, intellectual property protection and technology transfer. It also focuses on optimising China’s overall investment environment in terms of market access, investment promotion, investment protection and investment management.

Market entry:

- Foreign investment is subject to “pre-entry national treatment” plus the “negative list management system”. In the investment access phase, the treatment of foreign investors and their investments must not be lower than the domestic investors and their investment; foreign investment in the negative list is subject to the filing system, with Chinese and foreign investments enjoying the same treatment.
- Sectors where foreign investment is prohibited or restricted can be specified in the negative list; there is full openness outside the list.

Investment promotion:

- The policies that stipulate that the state supports enterprise development are equally applicable to foreign-invested enterprises.
- Foreign-invested enterprises equally participate in the work of setting up industry standards.
- Government procurement shall treat products and services provided by foreign-invested enterprises in China in accordance with law.
- Foreign-invested enterprises may, through law, publicly issue securities such as stocks, corporate bonds and other means of financing.

Investment protection:

- Intellectual property rights of foreign investors, along with legitimate rights and interests of intellectual property rights holders and related rights holders, are protected in accordance with law. Administrative organs and their staff members shall not use administrative means to force the transfer of technology.
- The administrative organs and their staff members shall not disclose or share with others any confidential data related to foreign investors and foreign-invested enterprises that are known through the performance of their duties. Foreign investors’ capital contribution, profits, capital gains, intellectual property rights and lawful remedies and compensations may be transferred freely according to law.
- A complaint mechanism for foreign-invested enterprises is established.

Investment management:

- Stipulate that foreign investment access is outside the negative list, and implement management in accordance with the principle of consistent domestic and foreign investment.
- Clarify the organisational form and structure of foreign-invested enterprises, as well as apply the provisions of the Company Law of the Peoples’ Republic of China and the Law of the Partnership Enterprise of the People’s Republic of China.
- Through the establishment of a foreign investment security review system, the previously dispersed regulatory and review provisions will be unified to provide more convenience for those enterprises that have normalised operations.
Influence and prospect of the Foreign Investment Law

The release of the Foreign Investment Law reflects China’s determination to push forward a new round of high-level opening up and create a world-class business environment. It also helps promote China’s shift from the “open flow of goods and factors” to “institutional openness”.

In recent years, China has been increasing efforts to open up to the outside world. In 2018, it hosted the world’s first large-scale national exhibition based on the theme of imports. The Foreign Investment Law was quickly passed during this year’s NPC and CPPCC conferences. This provided legal clarification regarding China’s protection of the rights and interests of foreign investors, which will boost foreign investment confidence and optimise China’s business environment.

The Foreign Investment Law clarifies the pre-entry national treatment plus negative list management system for foreign investment, which will enable foreign capital to enter a wider range of industries and attract investors from different countries. In addition, the prohibition on compulsory technology transfer will help attract high-tech industries, service industries and other industries that emphasize innovation, as well as improve the increase the amount of foreign investment in China in China.

However, it should also be noted that the current content of the Foreign Investment Law is more of a framework and set of principles. In the future, relevant regulations will continue to be improved, such as the specific rules of the foreign investment information reporting system and the specific rules of the foreign investment security review system. In addition, foreign-invested enterprises established under the original “three foreign laws” must, in accordance with the relevant laws, including the Enterprise Law or the Partnership Enterprise Law, complete the transformation of their organisational form, structure and activity standards within five years. Many practical problems remain to be resolved, such as:

- Law application: What laws apply to foreign-invested enterprises that retain the original enterprise organisation form, governance structure and activity rules after the abolition of the “three foreign laws” on January 1, 2020; how to deal with enterprises that have not completed the adjustment after the transition period expires.
- Adjustment of corporate governance structure: It is necessary to adjust and standardise the governance structure, which includes amending the articles of association, replacing the existing governing body with the board, adding powers to the board, the rules of procedure and voting procedures, adding supervisors or the board of supervisors, etc., adjusting the powers of the board of directors, the means by which directors are selected, and voting methods.
Suggestions for further improving the business environment in China

In the "World Business Environment Report 2019: Training for Reform" released by the World Bank in October 2018, China ranked 46th. This was 32 places higher than the previous year and put it among the top 50 economies in the world. China is also the only country in East Asia and the Pacific to be listed among the 10 best reformers. As the world’s second largest economy, China has a large number of entities and its commercial regulations are highly complex.

These achievements are inseparable from the series of reform measures that the government has been pursuing to improve the business environment. For example, in the “starting a business” field, China cancelled three procedures in 2017 and, as a result, it now takes just nine days to start a business. This puts China in 28th position and tied with a number of OECD high-income countries.13

It is foreseeable that the business environment will be further improved if, during the implementation process of the newly enacted Foreign Investment Law, China can effectively address the concerns of foreign investors related to equal treatment, technology transfers, legal protection, access mechanisms and complaint mechanisms for foreign-invested enterprises. This will ensure China continues to be a highly sought-after destination for overseas capital among foreign investors.

With its experience in serving Chinese and foreign corporate customers, KPMG has observed that optimising the business environment should improve the relationship between government and enterprises while raising service efficiency. The government should keep the needs of enterprises in mind; promote the formulation, implementation and evaluation of the business environment policy around the needs of the enterprise; and not be trapped in the competition for facilitation measures. Focusing only on simplifying processes and reducing time requirements will invariably result in difficulties in policy implementation. Businesses will still be subject to various implicit constraints, creating a business environment that is still not conducive to attracting investment or helpful to the vitality of the market. In response to the next iteration of the Foreign Investment Law and the further improvement in the business environment, we recommend that the government pay particular attention to two areas:

First, implementation details are still expected. In terms of specific implementation, it may be necessary to supplement and create more specific relevant supporting systems. For example, in the areas of investment information reporting systems, security reviews and “actual control” (i.e., the VIE structure), the new law has few provisions to elaborate upon. Additional detailed rules are expected to be introduced to guide the actual implementation.

Second, a change in perception and more targeted measures would improve the foreign investment management system. Governments at all levels need to be more aware of how to best assist firms. Good use must also be made of all kinds of think tanks and third-party institutions so as to genuinely and accurately understand the needs of enterprises. The implementation of robust, practicable plans will help optimise the business environment and improve China’s economic vitality.

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## Appendix: Key indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Unit</th>
<th>2017</th>
<th>2018</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Economic activity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nominal GDP</td>
<td>Trillion RMB</td>
<td>82.1</td>
<td>90.0</td>
<td>25.4</td>
<td>21.3</td>
</tr>
<tr>
<td>Real GDP</td>
<td>% YOY</td>
<td>6.8</td>
<td>6.6</td>
<td>6.4</td>
<td>6.4</td>
</tr>
<tr>
<td>Industrial production</td>
<td>% YOY</td>
<td>6.6</td>
<td>6.2</td>
<td>5.9</td>
<td>5.4</td>
</tr>
<tr>
<td>Industrial profit</td>
<td>% YOY YTD</td>
<td>21.0</td>
<td>22.0</td>
<td>13.6</td>
<td>11.8</td>
</tr>
<tr>
<td>Retail sales</td>
<td>% YOY</td>
<td>10.2</td>
<td>9.0</td>
<td>8.6</td>
<td>8.1</td>
</tr>
<tr>
<td>Fixed asset investment</td>
<td>% YOY YTD</td>
<td>7.2</td>
<td>5.9</td>
<td>5.7</td>
<td>5.9</td>
</tr>
<tr>
<td>Property starts</td>
<td>% YOY YTD</td>
<td>7.0</td>
<td>17.2</td>
<td>16.3</td>
<td>16.8</td>
</tr>
<tr>
<td>Property sales</td>
<td>% YOY YTD</td>
<td>7.7</td>
<td>1.3</td>
<td>2.2</td>
<td>1.4</td>
</tr>
<tr>
<td>Land purchases</td>
<td>% YOY YTD</td>
<td>15.8</td>
<td>14.2</td>
<td>15.3</td>
<td>14.3</td>
</tr>
<tr>
<td>Manufacturing PMI</td>
<td>Index</td>
<td>51.6</td>
<td>50.9</td>
<td>50.2</td>
<td>50.0</td>
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<td><strong>International trade and investments</strong></td>
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<td></td>
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<tr>
<td>Exports</td>
<td>% YOY</td>
<td>7.9</td>
<td>9.9</td>
<td>14.3</td>
<td>3.9</td>
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<tr>
<td>Imports</td>
<td>% YOY</td>
<td>16.1</td>
<td>15.8</td>
<td>20.4</td>
<td>2.8</td>
</tr>
<tr>
<td>Trade balance</td>
<td>USD billion</td>
<td>419.6</td>
<td>350.9</td>
<td>33.0</td>
<td>41.9</td>
</tr>
<tr>
<td>Foreign direct investment (FDI)</td>
<td>USD billion</td>
<td>131.0</td>
<td>132.0</td>
<td>9.7</td>
<td>13.6</td>
</tr>
<tr>
<td>Outbound direct investment (ODI)</td>
<td>USD billion</td>
<td>120.1</td>
<td>120.5</td>
<td>7.6</td>
<td>14.9</td>
</tr>
<tr>
<td><strong>Financial market</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RMB exchange rate</td>
<td>USD/RMB</td>
<td>6.75</td>
<td>6.62</td>
<td>6.93</td>
<td>6.94</td>
</tr>
<tr>
<td>RMB real effective exchange rate</td>
<td>Index</td>
<td>121.0</td>
<td>122.6</td>
<td>120.0</td>
<td>120.0</td>
</tr>
<tr>
<td>Shanghai Composite Index (Period end)</td>
<td>Index</td>
<td>3307</td>
<td>2494</td>
<td>2603</td>
<td>2588</td>
</tr>
<tr>
<td>Money supply (M2)</td>
<td>% YOY</td>
<td>8.1</td>
<td>8.1</td>
<td>8.0</td>
<td>8.0</td>
</tr>
<tr>
<td>Stock of Total Social Financing (TSF)</td>
<td>% YOY</td>
<td>12.0</td>
<td>12.0</td>
<td>10.2</td>
<td>9.9</td>
</tr>
<tr>
<td>New TSF</td>
<td>RMB billion</td>
<td>19440</td>
<td>19440</td>
<td>742</td>
<td>1524</td>
</tr>
<tr>
<td>New bank loans</td>
<td>RMB billion</td>
<td>13523</td>
<td>16166</td>
<td>697</td>
<td>1250</td>
</tr>
<tr>
<td>Shibor (overnight)</td>
<td>%</td>
<td>2.63</td>
<td>2.48</td>
<td>2.3</td>
<td>2.4</td>
</tr>
<tr>
<td><strong>Price</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer price index (CPI)</td>
<td>% YOY</td>
<td>1.6</td>
<td>2.1</td>
<td>2.5</td>
<td>2.2</td>
</tr>
<tr>
<td>Produce price index (PPI)</td>
<td>% YOY</td>
<td>6.3</td>
<td>3.5</td>
<td>3.3</td>
<td>2.7</td>
</tr>
<tr>
<td>Crude oil (WTI)</td>
<td>USD/barrel</td>
<td>50.9</td>
<td>64.9</td>
<td>70.8</td>
<td>56.6</td>
</tr>
<tr>
<td>Steel (rebar)</td>
<td>RMB/ ton</td>
<td>3878</td>
<td>4177</td>
<td>4579</td>
<td>4367</td>
</tr>
<tr>
<td>Housing price index (70 cities)</td>
<td>% YOY</td>
<td>8.5</td>
<td>7.3</td>
<td>9.7</td>
<td>10.3</td>
</tr>
</tbody>
</table>

Source: Wind, KPMG Analysis
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