

# ***MIZUHO CHINA MONTHLY***

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Advisory Department

## - Executive Summary -

<b>China's Economy</b>	<b>Chinese Housing Market: Entering an Adjustment Phase</b>
<p>In China, even though that the basic policy of “Houses are for living, not for speculation” is maintained, the growth of home prices rose in 2018. Most notably, recently, such growth is particularly high in second- and third-tier cities. This home price increase is caused by various factors, including: shantytown redevelopment, talent attraction measures, reselling of new homes taking advantage of rising second-hand home prices, and real estate investment by enterprises triggered by monetary easing. As result of these, speculation demand sparked in certain cities is also a cause. In 2019, the Chinese housing market is expected to enter an adjustment phase. However, we will need to pay close attention to the risks of the Chinese housing market overheating again due to the moves of local governments to ease current tightening policies and the expansion of monetary easing to support the economy.</p>	
<b>Industrial and Regional Policies</b>	<b>Foreign direct investment in China: Development outcomes and the outlook for the future Part 2</b>
<p>As China marks the fortieth anniversary of its shift to a policy of reform and opening up at the end of 1978, this two-part report offers an overview of the outcomes and challenges that have come with growth in foreign direct investment in China (inbound), which rivals that in China's FDI (outbound; examined here previously), and the adjustments that are being made to China's foreign policy as its economy transitions into a “new normal” of slower growth, and discusses the outlook for the future of FDI against a protracted trade war between China and the United States.</p>	

# Chinese Housing Market: Entering an Adjustment Phase

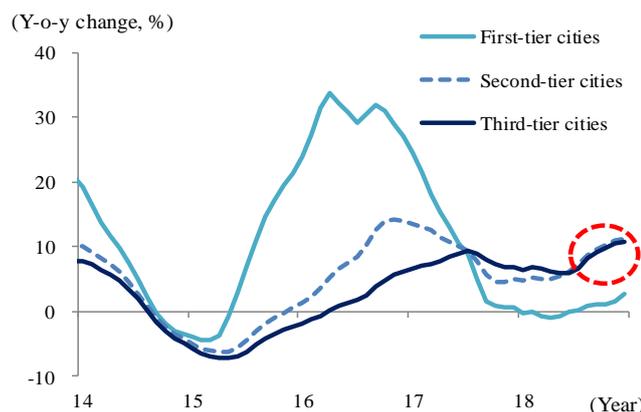
## Factors for Rising Home Prices in 2018 and the Future Prospects

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### 1. Home prices in China: On the rise

Since the latter half of 2016, China has implemented measures to control speculative investment in the real estate market against the backdrop of increasingly overheated investment activities. The Central Economic Work Conference held in December 2016 concluded that “Houses are for living, not for speculation,<sup>1</sup>” and measures against speculative investment have been fully implemented. As a result, the growth of home prices (on a year-on-year basis; the same applies hereinafter) slowed down in 2017. Since 2018, however, the home price rise has been accelerating again despite the continuing tight real estate policy. Most notably, recently, growth is particularly high in second- and third-tier cities. (Fig. 1)

**Figure 1: Sales price indices of newly constructed commercial residential buildings in 70 cities**



Note 1: As of December 2018

Note 2: First-tier cities: four cities (Beijing, Shanghai, Guangzhou, Shenzhen); second-tier cities: 31 cities (Tianjin, Chongqing, Hangzhou, Nanjing, etc.); third-tier cities: 35 cities other than first-tier and second-tier cities

Source: Prepared by Mizuho Research Institute based on materials from the National Bureau of Statistics of China and on CEIC data

If home prices continue to increase going forward, the household housing loan burden, which is already increasing, will become heavier, and this could heighten downward pressure on personal consumption.<sup>2</sup> Moreover, the management of monetary policy,<sup>3</sup> which has shifted to monetary easing so as to support the economy, might be restricted. For these reasons, the trend of home prices serves as an important factor toward forecasting the future of China's economy and its macroeconomic policy.

<sup>1</sup> 中央经济工作会议明确楼市发展方向：“房子是用来住的，不是用来炒的”（“新华社” December 16, 2016, [http://www.xinhuanet.com/fortune/2016-12/16/c\\_1120134160.htm](http://www.xinhuanet.com/fortune/2016-12/16/c_1120134160.htm))

<sup>2</sup> As for the concern over growing downward pressure on personal consumption due to the increasing housing loan burden, please consult (大和香織 (2018) “中国で低迷が続く自動車販売～2019年半ばまでは調整が続く見込み” (みずほ総合研究所 “みずほインサイト” December 26, 2018)).

<sup>3</sup> As for monetary policy positions for 2019, please consult (三浦祐介・大和香織 (2018) “2019年の中国の経済政策方針～中央経済工作会議で『安定重視』路線の継続を確認” (みずほ総合研究所 “みずほインサイト” December 27, 2018)).

This article will thus analyze factors for the increasing Chinese home prices since 2018 and will explore the future of China's housing market.

## 2. Factors relating to the resurgence in home prices

### (1) Shantytown redevelopment

The first factor related to the increase in home prices is shantytown redevelopment. "Shantytown" refers to an area crowded with simple-structured residential buildings that are inherent safety risks due to aging and lacking in basic facilities such as toilet.<sup>4</sup> A policy to redevelop such areas has been implemented since 2005 as part of efforts to promote China's urbanization.<sup>5</sup> At the National People's Congress (NPC) in 2014, China set a goal of renovating the country's shantytowns, which are home to about 100 million people,<sup>6</sup> while the 13<sup>th</sup> Five-year Plan released in 2016 set forth numerical targets for shantytown redevelopment to be achieved by 2020.<sup>7</sup> These targets serve as guidelines for recent policies. Under such guidelines, the Chinese government announced a three-year plan to renovate 18 million dwellings in shantytowns from 2015 to 2017,<sup>8</sup> and actually, 18.16 million homes were renovated. Furthermore, the government released in May 2017 another three-year plan to renovate additional 15 million units in shantytowns from 2018 to 2020.<sup>9</sup> According to a survey by a local research institute, the rates of redeveloped dwellings in shantytowns by city type are 1% for first-tier cities, 18% for second-tier cities, and 81% for third-tier cities. This result shows that the redevelopment is conducted mainly in regional areas, including third-tier cities.<sup>10</sup>

Methods for shantytown redevelopment are largely divided into two types: one method involves rebuilding (实物化安置), while the other involves the provision of monetary compensation (货币化安置). The former method involves demolishing dwellings in shantytowns, building new residential buildings on the same location or at different location and to have the residents that vacated the old dwellings live in the new buildings. The rebuilding method was mainstream from 2005 until mid-2015. It had the effect of boosting demand for housing construction. However, it also had the disadvantage that it takes a certain amount of time for residents to change their dwellings. On the other hand, the latter method provides monetary compensation for residents in shantytowns and allows them to move to existing housing inventories for sale. This method helps shorten the time required for residents to change homes, and it reduces the costs needed for such a change of dwellings. In addition, this method was also able to accommodate various needs and allowed people to benefit from better housing services. For such advantages, the Chinese government began promoting the monetary compensation method in July 2015.<sup>11</sup> Since then, the method

<sup>4</sup> 解读《国务院关于加快棚户区改造工作的意见》（“住房和城乡建设部” July 12, 2013, [http://www.gov.cn/zwhd/2013-07/12/content\\_2445702.htm](http://www.gov.cn/zwhd/2013-07/12/content_2445702.htm))

<sup>5</sup> 关于推进东北地区棚户区改造工作的指导意见（“住房和城乡建设部” October 7, 2005, [http://www.mohurd.gov.cn/wjfb/200611/t20061101\\_157755.html](http://www.mohurd.gov.cn/wjfb/200611/t20061101_157755.html))

<sup>6</sup> 政府工作报告（全文）（“国务院” March 14, 2014 [http://www.gov.cn/guowuyuan/2014-03/14/content\\_2638989.htm](http://www.gov.cn/guowuyuan/2014-03/14/content_2638989.htm))

<sup>7</sup> 中华人民共和国国民经济和社会发展第十三个五年规划纲要（“新华社” March 17, 2016 [http://www.xinhuanet.com/politics/2016lh/2016-03/17/c\\_1118366322\\_2.htm](http://www.xinhuanet.com/politics/2016lh/2016-03/17/c_1118366322_2.htm))

<sup>8</sup> 国务院关于进一步做好城镇棚户区和城乡危房改造及配套基础设施建设有关工作的意见（“国务院” June 25, 2015, [http://www.gov.cn/zhengce/content/2015-06/30/content\\_9991.htm](http://www.gov.cn/zhengce/content/2015-06/30/content_9991.htm))

<sup>9</sup> 我国未来3年将改造棚户区1500万套（“新华社” May 24, 2017, [http://www.xinhuanet.com/politics/2017-05/24/c\\_1121030312.htm](http://www.xinhuanet.com/politics/2017-05/24/c_1121030312.htm))

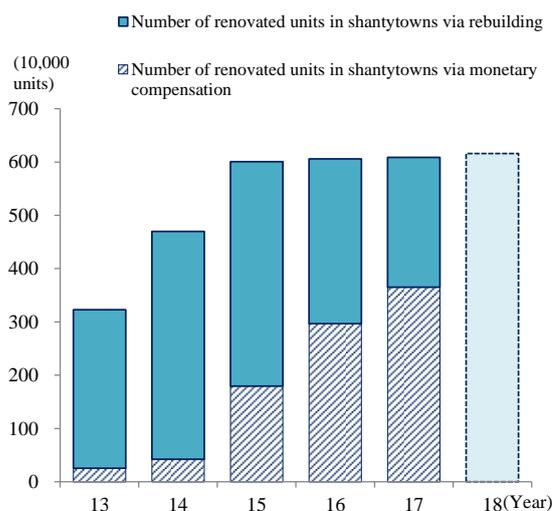
<sup>10</sup> 行业报告 测算棚改货币化对于地产销售的影响（“凤凰网” July 7, 2018, <http://wemedia.ifeng.com/68236920/wemedia.shtml>)

<sup>11</sup> 国务院：3年内棚改1800万套 力推PPP模式参与改造（“National Bureau of Statistics”, July 1, 2015, [http://www.stats.gov.cn/wzgl/ywzd/201507/t20150703\\_1205221.html](http://www.stats.gov.cn/wzgl/ywzd/201507/t20150703_1205221.html))

has rapidly become widespread, and the rate of shantytown redevelopment projects conducted via this method grew from 9% in 2014 to about 60% in 2017 (Fig. 2)<sup>12</sup>.

As a result, the number of unsold home inventories has rapidly declined, mainly in regional areas, including third-tier cities. This led to tight supply & demand in the housing market, and this accelerated the home price increase. In that process, demand for speculative investments was stimulated, apparently leading to further price increases.<sup>13</sup> Figure 3 summarizes the factors for the increase and decrease in the floor space of work-in-process housing units (estimates). As the estimates were calculated based on a certain assumption regarding the floor space of residential buildings sold as a result of shantytown redevelopment via the monetary compensation method, we must be aware that there is a certain range of fluctuation in the estimates. Even so, with regard to the decline in the floor space of work-in-process housing units seen in 2015 and 2016, the below figures indicate that housing demand associated with shantytown redevelopment had contributed to the decline, in addition to the supply-side factor of shrinking floor space in residential buildings under construction.

**Figure 2: No. of redeveloped units in shantytowns (breakdown by method)**

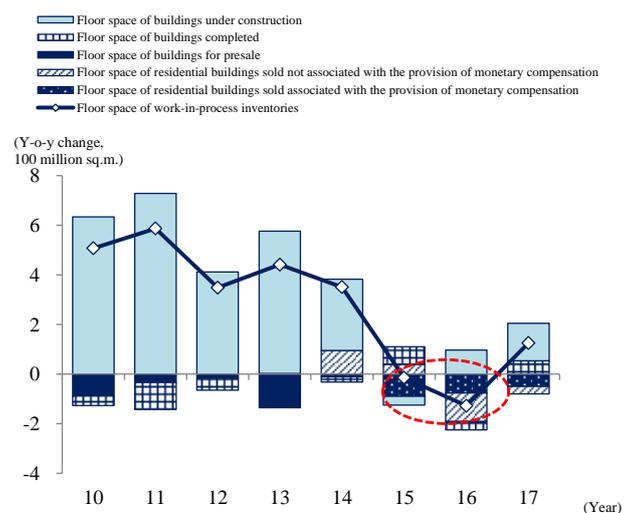


Note 1: No. of redeveloped dwellings in shantytowns via the monetary compensation method is calculated by multiplying the entire number of redeveloped homes in shantytowns by the rate of redevelopment projects conducted via the monetary compensation method.

Note 2: Since the rate of redevelopment projects conducted via the monetary compensation method in 2018 has not been released, the figure for 2018 shows the entire number of redeveloped units in shantytowns as of November 2018.

Source: Prepared by Mizuho Research Institute based on CEIC data and various media reports<sup>12</sup>

**Figure 3: Year-on-year changes in the floor space of work-in-process inventories (estimates)**



Note 1: Floor space of work-in-process inventories = Floor space of buildings under construction – floor space of buildings completed – floor space of buildings for presale

Note 2: Floor space of buildings for presale after 2014 is categorized into two groups of floor space of residential buildings sold associated with the provision of monetary compensation and other floor space of residential buildings sold

Note 3: Floor space of buildings sold associated with the provision of monetary compensation is calculated by multiplying the number of redeveloped units in shantytowns by the rate of redevelopment projects conducted via the monetary

<sup>12</sup> 2018 年我国房地产行业棚改安置方式分析 货币化安置成为主流 (“中国报告网” July 12, 2018, <http://market.chinabaogao.com/fangchan/0G234Wc2018.html>), 棚改货币化安置不踩“急刹车” (锐财经) (“人民网” July 16, 2018, <http://finance.people.com.cn/n1/2018/0716/c1004-30148068.html>)

<sup>13</sup> According to a family budget survey conducted by the Southwestern University of Finance and Economics, only about 20% of all families used monetary compensation provided to buy new homes. Given this result, it points out that speculation demand taking advantage of shantytown redevelopment helped increase home prices, rather than the redevelopment itself. (为什么应该坚持棚改货币化 (“西南财经大学” July 16, 2018, <https://chfs.swufe.edu.cn/xiangqing.aspx?id=1816>))

compensation method, by floor space per unit (75m<sup>2</sup>), by the rate of floor space of residential buildings for presale to the entire floor space of residential buildings sold for each year  
Source: Prepared by Mizuho Research Institute based on CEIC data

## **(2) Talent attraction policy**

The second factor for the rising home prices is the policy to attract excellent talent. In regional cities, the labor shortage caused by the population outflow to major cities and the progress of an aging society was seen as a problem. Since around 2017, some cities, including Xian and Wuhan, have implemented policies to attract excellent talent as a labor force for the purpose of revitalizing local economies. Major policy measures include easing conditions for granting household registration according to age, academic qualifications, etc., providing housing allowance, and providing subsidies for promoting business startups, among other incentives.<sup>14</sup> As of May 2018, such talent attraction measures are in place in more than 50 cities.<sup>15</sup> Some observers point out that the overeagerness of such cities to attract talent has resulted in boosting housing demand in regional cities, which also stimulated demand for speculation. Some local media outlets<sup>16</sup> refer to the current situation as a “competition for human resources.”

## **(3) Revitalization of the second-hand home market**

Moreover, the increase in second-hand home prices apparently affected new home prices in certain cities. This is because the growth of new home prices was controlled in cities that saw an excessive increase in the prices of new homes, while no particular restrictions were imposed on the growth rate of second-hand home prices. For example, in Wuhan, new home prices in principle were restricted to levels not exceeding the price recorded in October 2016,<sup>17</sup> while in Nanjing, the growth rate of new home prices was kept at around 10%.<sup>18</sup> As a result, the growth of second-hand home prices surpassed that of new home prices, which led to the price difference between second-hand and new homes. Amid such circumstances, more and more people bought new homes and resold them as second-hand homes in an attempt to earn profits from such resale.<sup>19</sup> Actually, in such cities,<sup>20</sup> the growth of second-hand home prices surpassed that of new home prices in 2017. Subsequently, the growth in the floor space of new residential buildings sold hit the bottom in mid-2017, and then new home prices turned around, with a certain time lag. (Fig. 4)

<sup>14</sup> 送房、送户口、送钱 主流二线城市上演“抢人大战”（“中国新闻网” August 8, 2017, <http://www.chinanews.com/sh/2017/08-08/8298236.shtml>)

<sup>15</sup> 超50城“抢人”大战背后 新一二线城市的“升级”竞争焦虑（“21世纪经济报道” May 21, 2018, [http://epaper.21jingji.com/html/2018-05/21/content\\_86595.htm](http://epaper.21jingji.com/html/2018-05/21/content_86595.htm))

<sup>16</sup> 二线城市缘何开打“人才争夺战”（“人民网” July 20, 2017, <http://theory.people.com.cn/n1/2017/0720/c40531-29416938.html>)

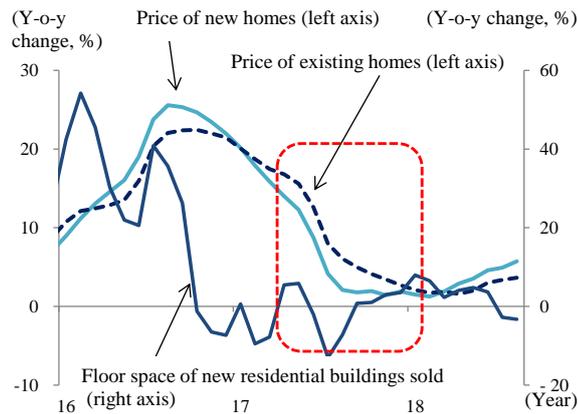
<sup>17</sup> 武汉：新开楼盘房价一律不能涨 不高于去年10月价格（“人民网” April 21, 2017, <http://house.people.com.cn/n1/2017/0421/c164220-29227834.html>)

<sup>18</sup> “抢房”背后的南京楼市怪象：价格倒挂现象严重（“中国新闻网” November 21, 2017, <http://www.chinanews.com/cj/2017/11-21/8381440.shtml>)

<sup>19</sup> “限价令”下楼市又生新乱象 变相加价手段翻新（“新华社” July 13, 2017, [http://www.xinhuanet.com/fortune/2017-07/13/c\\_1121309731.htm](http://www.xinhuanet.com/fortune/2017-07/13/c_1121309731.htm))

<sup>20</sup> 诸多城市先后实施限价令 房价进入稳定通道（“房天下” February 26, 2017, <https://www.fang.com/news/2017-02-26/24503195.htm>), 2017 楼市大事记：限购、限贷、限售、限价……（“房天下” December 25, 2017, [https://qd.newhouse.fang.com/2017-12-25/27428897\\_all.htm](https://qd.newhouse.fang.com/2017-12-25/27428897_all.htm)), 2017 白皮书①：限价/限售/限贷/限购/限价政策收紧 调控不断升级（“房天下” January 2, 2018, <https://nn.newhouse.fang.com/2018-01-02/27481154.htm>), 限价令使郑州新楼盘价格低于市场价20%（“大纪元” July 1, 2017, <http://www.epochtimes.com/gb/17/7/1/n9342926.htm>)

**Figure 4: Home prices and floor spaces of residential buildings sold in cities restricting new home prices**



Note 1: The figures of six cities (Beijing, Nanjing, Qingdao, Zhengzhou, Wuhan, Nanning) where price restriction measures were confirmed as of September 2017 are combined.

Note 2: The price growth is a simple average.

Note 3: The floor space of residential buildings sold is the backward three-month moving average.

Source: Prepared by Mizuho Research Institute based on CEIC data and on various media reports<sup>21</sup>

**(4) Speculative investment in real estate by enterprises**

Finally, the increasing number of homes purchased by enterprises appears to be another factor for the rising home prices. Against the backdrop of a series of monetary easing measures launched after basic interest rate cuts in November 2014, more enterprises seemingly invested in real estate so as to use their surplus funds to increase profits. As of September 2018, 1,692, or about 47.6%, of the 3,556 A-share listed companies have properties for investment. On the other hand, the abovementioned price difference between new and second-hand homes is believed to have encouraged enterprises to invest in real estate.<sup>21</sup>

**3. Future outlook: Adjustment phase of the housing market likely to continue in 2019**

As for the future outlook, the growth of home prices is expected to slow down. This is because a tight housing policy will be maintained in order to achieve the healthy development of the real estate market, and measures to address the abovementioned factors that caused the price increase in 2018 have been taken in sequence.

First of all, the impact of shantytown redevelopment on home prices is likely to be weakened. The number of redeveloped dwellings in 2018 stood at 6.16 million units as of November 2018.<sup>22</sup> Under the three-year plan, the number of units to be renovated will decline to 4.42 million units a year on average in 2019 and 2020. In addition, the rate of redevelopment projects conducted via the monetary compensation method is expected to decrease. For example, at a meeting of the Standing Committee of the State Council held on October 8, 2018, it was pointed out that the monetary compensation method should be adjusted so that it is carried out in accordance with the situations of respective cities, and that in cities where the shortage of

<sup>21</sup> 乱象！超千家上市公司“炒房”近万亿，对企业投机“炒房”如何围堵？（“新华社” August 1, 2018, [http://www.xinhuanet.com/fortune/2018-08/01/c\\_1123204891.htm](http://www.xinhuanet.com/fortune/2018-08/01/c_1123204891.htm))

<sup>22</sup> 1-11 月全国棚户区改造开工超过 610 万套（“住房和城乡建设部” December 14, 2018, [http://www.mohurd.gov.cn/zxydt/201812/t20181214\\_238858.html](http://www.mohurd.gov.cn/zxydt/201812/t20181214_238858.html))

housing inventory puts upward pressure on home prices, the promotion of the monetary compensation method should be stopped as soon as possible. As seen in the statement, the Chinese government has already announced that it would review shantytown redevelopment projects via the monetary compensation method.<sup>23</sup>

Next, in areas where stimulated speculation is concerned, the thorough implementation of stimulation control measures has been strengthened after 2018. More specifically, as for areas where excessive talent attraction measures were carried out, such as Chongqing, Wuhan, and Changsha, the central government instructed these areas to be careful regarding the excessive easing of home purchase restrictions.<sup>24</sup> Furthermore, citing that housing investment by enterprises has led to a tighter supply & demand situation than the actual situation, and that this has resulted in rising home prices, the Chinese government restricted housing investment by enterprises in Hangzhou, Xian, and Changsha<sup>25</sup> at the end of June 2018. In addition, given that the Central Economic Work Conference in December 2018 reconfirmed the basic policy that “Houses are for living, not for speculation,”<sup>26</sup> speculation control measures will likely be maintained going forward.

With these policies being implemented, the home price rise is expected to slow down in second- and third-tier cities where the increase has been remarkable since 2018. The home prices in first-tier cities are expected to continue moderate growth for the time being. Home price growth tends to lag behind growth in the floor space of residential buildings sold by about three quarters. As the floor space of residential buildings sold continued to increase since the beginning of 2018 until mid-2018, home prices are likely to continue to increase. (Fig. 5) However, in first-tier cities, tight housing policies are expected to be maintained. In addition, home prices are still high. For these reasons, an excessive price increase could be avoided. (Fig. 6)

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<sup>23</sup> 严格把好棚改范围和标准 调整完善棚改货币化安置政策——国务院常务会议传递棚改工作新动向 (“中央人民政府网” October 8, 2018, [http://www.gov.cn/zhengce/2018-10/08/content\\_5328636.htm](http://www.gov.cn/zhengce/2018-10/08/content_5328636.htm))

<sup>24</sup> 调控进入新阶段 “反炒房”控房价 (“新华社” July 6, 2018, [http://m.xinhuanet.com/house/2018-07/06/c\\_1123086182.htm](http://m.xinhuanet.com/house/2018-07/06/c_1123086182.htm))

<sup>25</sup> Same as above

<sup>26</sup> 中央经济工作会议举行 习近平李克强作重要讲话 (“新华社” December 21, 2018, [http://www.gov.cn/xinwen/2018-12/21/content\\_5350934.htm](http://www.gov.cn/xinwen/2018-12/21/content_5350934.htm))

**Figure 5: Floor space of residential buildings sold and the sales prices of residential buildings (first-tier cities)**

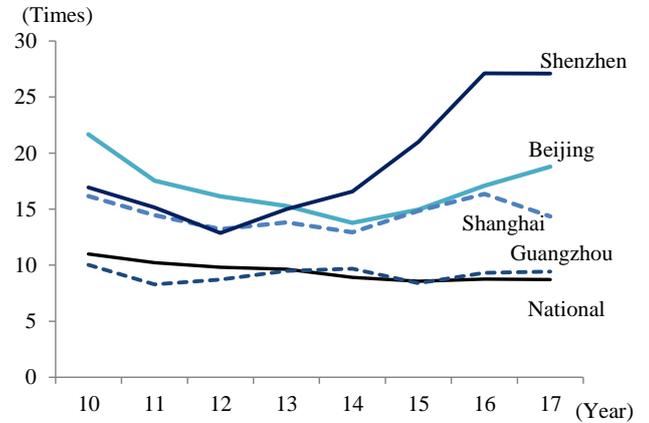


Note 1: As of December 2018

Note 2: The sales prices are the backward three-month moving averages.

Source: Prepared by Mizuho Research Institute based on CEIC data

**Figure 6: Comparison between home prices and disposable income (first-tier cities)**



Note 1: Home prices are calculated by estimating a unit price per 1 m<sup>2</sup>, calculated by dividing the sales amount of residential buildings by the floor space of the residential buildings sold and assuming that the average floor space per home is about 90 m<sup>2</sup>.

Note 2: Disposable income is calculated by multiplying per capita disposable income by the average number of people per household (each year).

Source: Prepared by Mizuho Research Institute based on CEIC data

In conclusion, the Chinese housing market will likely enter an adjustment phase regarding the national average in the future. Furthermore, along with the adjustment of the housing market, the recent downtrend in housing development investment is likely to continue in the future. The year-on-year growth of investment tends to lag behind that of sales by about two quarters, and thus the effect of the sales slowdown that began in mid-2018 will become visible in the future (Fig. 7). During 2019, housing development investment will put downward pressure on the economy.

**Figure 7: Housing development investment/floor space of residential buildings sold (nationwide)**



Note 1: The data shows backward three-month moving averages.

Note 2: As of December 2018

Source: Prepared by Mizuho Research Institute based on CEIC data

Meanwhile, by around October 2018, the effect of monetary easing began appearing on the housing market in Beijing and other cities, such as in declining housing loan interests<sup>27</sup> and shorter screening time.<sup>28</sup> In addition, in Guangzhou Province and other places, there are moves to review certain restrictions since around December last year because the control policies that have been adopted so far were too strict.<sup>29</sup> From here on, it is also possible that more local governments will ease current tight housing policies due to concern over declining income from the sales of land use rights as a result of adjustments of the housing market. As a result, the actual demand could expand, and demand for speculation could also be stimulated. In addition, excessive liquidity associated with monetary easing could go to the real estate market. These could lead to further home price increase without being adjusted sufficiently, resulting in the overheating of the market. Given such risks, close attention should be paid to future developments.

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<sup>27</sup> 多地房贷首现松动：利率微降 放款加速（“21 世纪经济报道” October 25, 2018, [http://epaper.21jingji.com/html/2018-10/25/content\\_95189.htm](http://epaper.21jingji.com/html/2018-10/25/content_95189.htm))

<sup>28</sup> 南京部分银行下调房贷利率（“人民网” November 21, 2018, <http://house.people.com.cn/n1/2018/1121/c164220-30413109.html>)

<sup>29</sup> 2019 年房地产展望：调控已至最严 市场空间仍然巨大（“凤凰网财经” December 26, 2018 [http://finance.ifeng.com/a/20181226/16641485\\_0.shtml](http://finance.ifeng.com/a/20181226/16641485_0.shtml))

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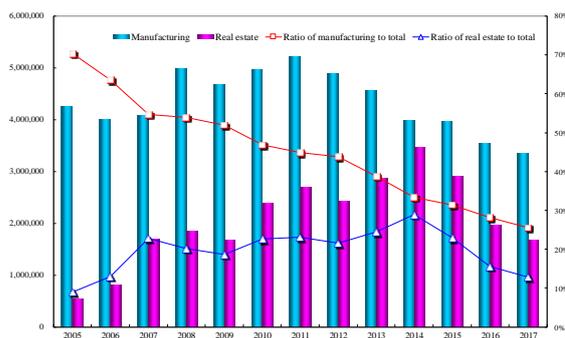
**Yongyu Shao, Ph.D. and Economist**  
**China Business Promotion**  
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**5. The characteristics and trends of sectoral  
distribution of FDI inflows into China**

As “the world’s factory floor”, China’s manufacturing industry maintains its central position in the economy, but the change of the sectoral distribution of FDI inflows into China offers some unmistakable insights into its ongoing transformation into “the world’s market”.

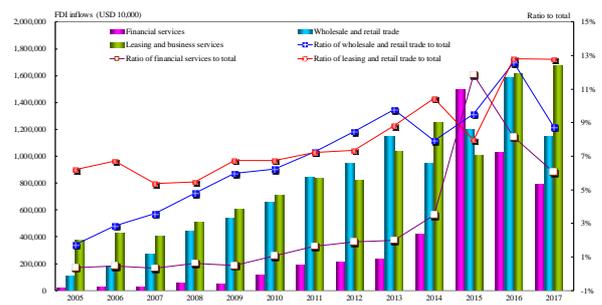
**Figure 17** shows FDI inflows (by value and ratio to total) into two major industries over time: manufacturing, which is labor utilization oriented, and real estate, which is local market oriented. FDI inflows into manufacturing peaked in 2011 and have been diminishing ever since and its share of total investment began to slip before 2015, whilst investment in real estate peaked in 2014 (both in terms of actual inflows and share of total investment) but began to drop off thereafter. The real estate industry is easily influenced by numerous factors, including economic growth and currency fluctuations, and is thus considered to be afforded a disproportionate weighting in considerations of the sectoral distribution of foreign investment, but three service sector industries are beginning to account for a growing percentage of FDI inflows into China, namely, wholesale and retail trade, leasing and business services, and financial services (**Fig. 18**). Specifically, FDI inflows in leasing and business services and the wholesale and retail trade is soaring (individual fiscal years excluding), and now accounts for around 10 percent of total. Investment in financial intermediation has also increased significantly since 2014, peaking in 2015 (when its share of total FDI inflows leapt to 12% from around 3% the previous year) before dropping into a two-year decline. There is a strong possibility that investment in these three industries will continue to expand going forward as foreign investors look to tap into the Chinese market.

Figure 17: Trends in FDI inflows into manufacturing and real estate (utilized)



Source: Compiled from the National Bureau of Statistics’ “National Data” website. Ratios are theoretical values.

Figure 18: Trends in FDI inflows into wholesale and retail trade, financial intermediation and leasing and business services



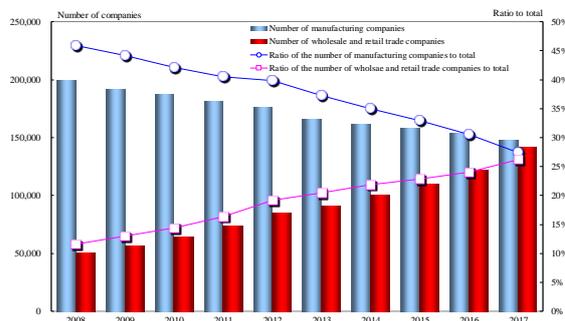
Source: Compiled from the National Bureau of Statistics’ “National Data” website. Ratios are theoretical values.

The above (**Figures 17 and 18**) offers a look at sectoral trends in foreign investment in terms of FDI inflows, but trends in the number of companies established as a factor in investments utilized reveal a decrease in both the number of manufacturing companies being set up and the ratio to the total, in marked contrast to the wholesale and retail trade where the number of companies being established and the ratio to the total are both on the increase (**Fig. 19**).

Similarly, trends in company numbers offer definitive evidence of the growth in foreign investment in hotels and food services, financial intermediation, and real estate (**Fig. 20**). There have been marked increases in the number and share of

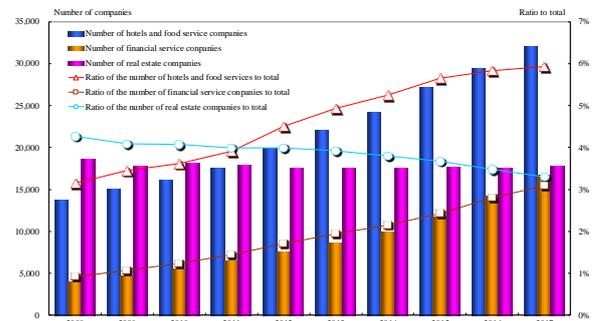
foreign companies being set up in the hotels and catering service and financial intermediation sectors, though the number of new foreign real estate companies appears to have peaked and the ratio to the total is also beginning to decline. On the evidence of the above, it would seem that there has been a major shift in the sectoral distribution of FDI inflows into China away from manufacturing and towards services. Moreover, the steady expansion in FDI inflows into sectors such as wholesale and retail trade, hotels and food services, and financial intermediation, all of which are seen as growth industries (with strong market potential and good consumer spending forecasts within the domestic market), over investment in real estate, which has long been a target for foreign capital, is becoming a characteristic of the sectoral distribution of FDI inflows into China.

Figure 19: Trends in numbers of newly incorporated foreign-invested enterprises in the manufacturing and wholesale and retail trade sectors



Source: Compiled from the National Bureau of Statistics' "National Data" website. Ratios are theoretical values.

Figure 20: Trends in numbers of newly incorporated foreign-invested enterprises in the hotels and food services, financial intermediation and real estate sectors



Source: Compiled from the National Bureau of Statistics' "National Data" website. Ratios are theoretical values.

## 6. Investment in China's strategic emerging industries<sup>4</sup> on the increase

One of the most conspicuous trends in the sectoral distribution of FDI inflows into China in recent years has been the growing investment in new industries and so-called strategic emerging industries.

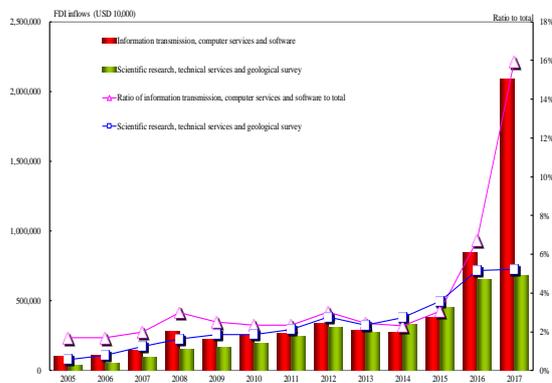
Figure 21 shows trends in FDI inflows (by value and ratio to total) into the three most rapidly growing sectors in China, namely, information transmission, computer services and software, scientific research, technical services and geological survey. FDI into the strategic sectors identified in the "Made in China 2025" initiative has been increasing rapidly since the strategic plan was launched in 2015. Inflows into the ICT-related information transmission, computer services and software sector has been particularly marked, with China recording a 2.2-fold increase in FDI inflows into this sector in 2016 and a 2.5-fold increase the following year, when foreign investment into this sector reached a massive US\$ 20.92 billion. Its ratio to total foreign investment has also surged, rising from 3 percent in 2015 to 7 percent in 2016 and to a remarkable 16 percent in 2017. Whilst investment in scientific research, technical services and geological prospecting has not been as dramatic, there has been an unmistakable increase in FDI inflows since 2016, and the share of foreign investment in these sectors has also increased from around 3 percent to around 5 percent.

<sup>4</sup> The term "strategic emerging industries" as referred to herein is not a strict categorization, but is used for the sake of convenience as a broad new industry concept so as to reflect the addition of industries such as cloud computing, big data services, artificial intelligence, digital innovation (creation), robotics and equipment manufacture, smart manufacturing services, and charging, repair and maintenance services for new energy vehicles to the latest edition of China's "Strategic Emerging Industries Catalogue 2018", which amends the 2012 Catalogue and includes a total 485 sectors and was published by the government in November last year.

A comparison with leasing and business services, a sector that has seen conspicuous growth in the number of newly incorporated enterprises, reveals virtually parallel increases in the number and ratio of newly incorporated enterprises in the scientific research, technical services and geological prospecting sector (Fig. 22). This points to a clear increase in the number of scientific research facilities, technical development centers and technical service bases being established in China and argues that foreign investors are looking to China not only as a market for such services but also as a base for research and development and technical innovation as well.

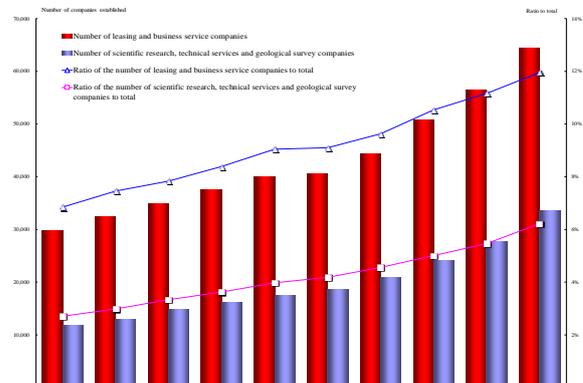
Given that the vector of government measures to attract FDI is also slanted towards electronics and telecommunications, modern services, scientific and technical research, and the promotion of innovation by cooperative ties between foreign and domestic enterprises, these measures can be seen to have yielded some results.

Figure 21: Trends in FDI inflows telecommunications and scientific research and technical services (utilized)



Source: Compiled from the National Bureau of Statistics’ “National Data” website. Ratios are theoretical values.

Figure 22: Trends in numbers of newly incorporated foreign-invested enterprises in the leasing and business services, scientific research and technical services sectors



Source: Compiled from the National Bureau of Statistics’ “National Data” website. Ratios are theoretical values.

**7. Growing foreign expansion into industries being targeted for deregulation and policy reinforcement**

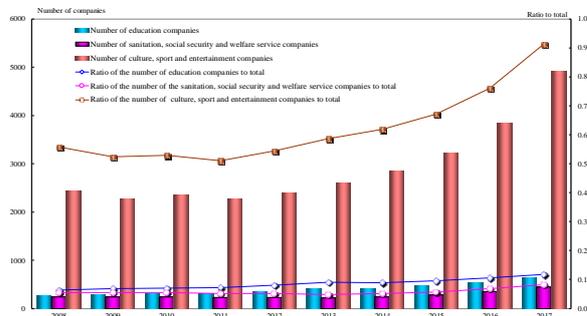
In addition to the strategic emerging industries discussed above, gradual moves by the Chinese government to deregulate foreign investment in sectors that were previously subject to comparatively severe restrictions have led to a clear increase in the number of newly incorporated foreign invested enterprises in these sectors.

Figure 23 shows trends in the numbers of newly incorporated foreign-invested enterprises in the education, sanitation, social security and welfare services, and culture, sports and entertainment sectors, all of which have witnessed marked growth since 2015, with the increase in numbers of new foreign-invested enterprises in the culture, sports and entertainment sector being particularly conspicuous.

Simultaneously, the past three years have seen a sharp increase in the number of newly incorporated foreign-invested enterprises in the management of management of water conservation and environment and public facilities industry, which is part of the environmental protection sector and has been the target of economic and industrial policy in recent years, with

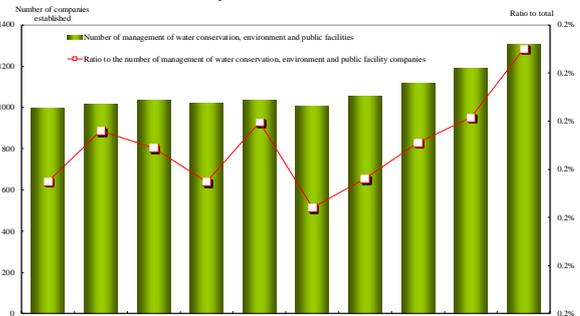
the number reaching 1,308 companies in 2017 (Fig. 24).

Figure 23: Trends in FDI inflows into education, sanitation, social security and welfare services



Source: Compiled from the National Bureau of Statistics' "National Data" website. Ratios are theoretical values.

Figure 24: Trends in numbers of newly incorporated foreign-invested enterprises in the management of water conservation and environment and public facilities industry



Source: Compiled from the National Bureau of Statistics' "National Data" website. Ratios are theoretical values.

The above paragraphs have primarily deal with the increase in numbers of newly incorporated foreign-invested enterprises in China's service sector, however, certain sectors of the manufacturing industry have also witnessed marked growth in new foreign-invested enterprise numbers, specifically those that are categorized as strategic emerging industries, such as pharmaceuticals, telecommunications equipment, computers and business machinery, and medical equipment and instruments (many of which overlap with the hi-tech industry classifications previously employed by China's government.) In 2017, for example, numbers of newly incorporated foreign-invested enterprises rose by 57.5 percent over the previous year in the pharmaceutical manufacturing industry (with FDI inflows increasing by 21.4%), by 27.9 percent in the telecommunications manufacturing industry (with FDI inflows increasing by 4.5%), and by 36.7 percent in the medical equipment and instrument manufacturing industry (with FDI inflows increasing by 23.1%), with these figures on the hi-tech manufacturing sector being highlighted in the "2018 Report on Foreign Investment in China" that was released by the Ministry of Commerce in October last year. Moreover, **Table 4** reveals an unmistakable increase in both YOY-based the number of newly incorporated foreign-invested enterprises and FDI inflows into high-end services, a sector that has not been much discussed to date.

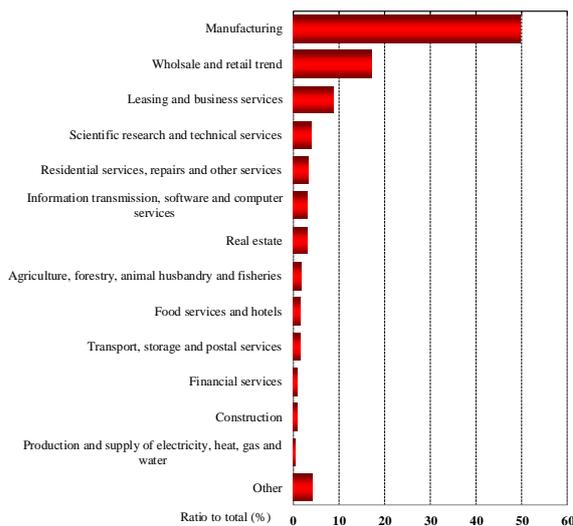
Table 4: Statistics on foreign capital utilization in high-end services, 2017

High-end service industries	No. of companies	YoY (%)	Utilized investment (USD 100 million)	YoY (%)
<b>Total</b>	<b>5990</b>	<b>81.9</b>	<b>260.7</b>	<b>106.4</b>
Information services	3392	102.6	209.7	146.5
E-commerce services	32	-17.9	1.7	88.8
Inspection and measurement services	31	6.9	0.2	-7.1
High-end technical services for the professional service industry	82	110.3	0.5	-63.2
R&D and design services	417	-17.1	14.5	3.2
Scientific research results transfer services	1991	102.1	32.9	37.3
Intellectual property rights protection and related legal services	16	23.1	0.1	-80.3
Environmental monitoring and countermeasures services	29	163.6	1.4	189.4

Source: Compiled from the “2018 Report on Foreign Investment in China”, MOFCOM

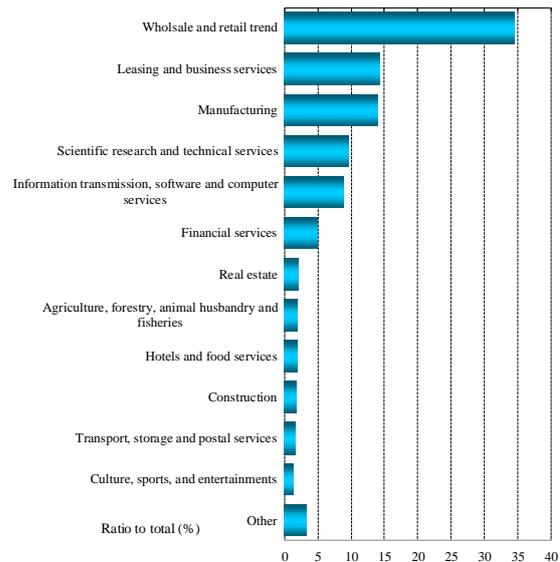
Figure 25 and Figure 26 show the sectoral distribution numbers of newly incorporated foreign-invested enterprises in cumulative (1998- 2017) and single-year terms (for 2017), respectively. On a cumulative basis, newly incorporated foreign manufacturing enterprises account for more than half the total, but the sector ranked in third place in 2017, behind wholesale and retail trade and leasing and business services, with its share dropping to just 14 percent of the total. Furthermore, there is a similarly large gap between the single-year and cumulative figures for the three sectors that rank below manufacturing in terms of their share of total newly incorporated foreign-invested enterprise numbers, namely, scientific research and technical services, information transmission, software and computer services and financial intermediation, all of which accounted for around 5 percent of the total number in 2017.

Figure 25: Sectoral distribution of newly incorporated foreign-invested enterprises for the years 1998 through 2017



Source: Compiled from the “2018 Report on Foreign Investment in China”, MOFCOM

Figure 26: Sectoral distribution of newly incorporated foreign-invested enterprises in 2017



Source: Compiled from the “2018 Report on Foreign Investment in China”, MOFCOM

## 8. Structural shifts in foreign capital assimilation, major challenges and future prospects

As the above paragraphs demonstrate, facilitative measures introduced by the government, the growth of the domestic market and industrial development have not only led to substantial increases in both FDI inflows into China and the number of foreign-invested enterprises being established, but have also produced major shifts in the sectoral distribution of FDI and in the fields being targeted for business development, which represents an important improvement in the quality of FDI coming into China. This has come about as the result of active shifts in the China-bound investment strategies of foreign businesses, which are increasingly making China a focus for investment in response to Chinese economic growth and the sophistication of its industries, but Chinese policy aimed at facilitating the assimilation of foreign capital have also yielded significant results. The role that has been played by foreign investment in China, both in quantitative and qualitative terms, in promoting the growth of the Chinese economy and industry and social progress has been highly praised in a special report published by the Ministry of Commerce.

The recent growth in inbound FDI in the form of foreign acquisitions of Chinese companies (M&As) that has come with industry development and market change also constitutes a key shift in circumstances. **Table 5** offers an overview of the number and value of foreign acquisitions of Chinese companies in 2017 for respective regions of the country. Chinese acquisitions of foreign companies have been much touted, but the number of foreign (primarily from developed nations) led M&A deals involving domestic enterprises (though the target industries are unspecified) is much higher than expected, suggesting that these foreign buyers are looking to make active use of the management resources of local enterprises so as to improve and expand these operations in the local market. Also, these deals would appear to be being driven by investors who see China as a key location for sales market and business expansion and restructuring rather than for the establishment of production bases (i.e. greenfield investment).

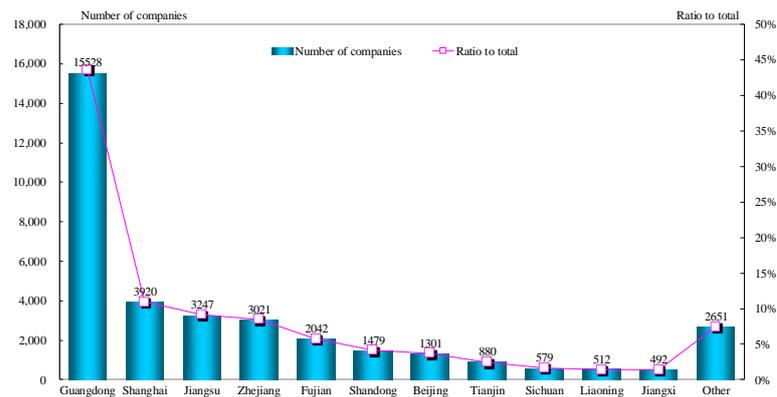
Table 5: Statistics on foreign acquisitions of Chinese enterprises in 2017 (by region)

Category	Number of M&A investment transaction deals			Actual investment amount		
Region	No. of deals (companies)	YoY (%)	Ratio to total (%)	Amount (USD 100 million)	YoY (%)	Ratio to total (%)
Beijing	190	38.7	9.2	42.2	-32.8	28.9
Tianjin	20	0.0	1.0	1.4	-81.1	1.0
Hebei	13	-18.8	0.6	3.2	499.6	2.2
Shanxi	8	166.7	0.4	0	-100	0.0
Inner Mongolia	5	-16.7	0.2	0.1	-96.8	0.1
Liaoning	30	-26.8	1.5	0.9	-76.3	0.6
Jilin	9	350.0	0.4	0.4	116.1	0.3
Heilongjiang	10	66.7	0.5	0	-100	0.0
Shanghai	302	51.8	14.6	8.8	-44.6	6.0
Jiangsu	250	13.6	12.1	18.8	12.2	12.9
Zhejiang	123	15.0	6.0	6.9	-36.9	4.7
Anhui	23	9.5	1.1	0.7	-56	0.5
Fujian	85	-1.2	4.1	5.7	154.6	3.9
Jiangxi	22	83.3	1.1	0.8	301.6	0.6
Shandong	82	6.5	4.0	10.2	14.4	7.0
Henan	30	130.8	1.5	0.5	-76.5	0.3
Hubei	30	0.0	1.5	2.8	51.8	1.9
Hunan	13	85.7	0.6	1.1	96.1	0.8
Guangdong	684	86.9	33.1	23.7	-31.8	16.3
Guangxi	15	0.0	0.7	0.7	-49.2	0.5
Hainan	1	-50.0	0.1	0.2	-40.8	0.1
Chongqing	24	20.0	1.2	0.7	-65.9	0.5
Sichuan	50	28.2	2.4	9.4	444.8	6.5
Guizhou	2	0.0	0.1	0	-100	0.0
Yunnan	15	25.0	0.7	3.5	227.3	2.4
Shaanxi	10	42.9	0.5	0.8	-69.2	0.6
Gansu	2	-60.0	0.1	0.3	-40.2	0.2
Qinghai	6	-25.0	0.3	1.8	18	1.3
Ningxia	12	140.0	0.6	0	-95.6	0.0
Xinjiang	15	0.0	0.7	0.7	-49.2	0.5
Total	2066	39.2	100	145.7	-22.9	100

Source: Compiled from the “2018 Report on Foreign Investment in China”, MOFCOM. Discrepancies between number of companies and the value of their investments given in the totals row and the actual figures are as cited in the original document.

It is worth noting, however, that the regional distribution of newly incorporated foreign-invested enterprises in 2017 (**Fig. 27**) demonstrates a similar bias. In other words, the abiding preference among foreign investors for the eastern coastal region, where markets and industries are large in scale and technical capabilities and human resources are abundant is essentially deadlocked. What this means is that foreign investment, acquisitions included, is concentrating excessively in the Pearl and Yangtze River Deltas and the Beijing area, thereby contributing to interregional growth imbalances and the overconcentration of industries and making it more difficult for China to resolve these major challenges it faces. China has established numerous industry parks and free-trade zones (FTZ) in all its regions with a view to attracting foreign investment, and given the abundant catalogue of industries in which foreign investment is encouraged, but the significant gap between the policy ideal and the amounts of foreign capital that are being assimilated in China’s various regions is a major issue. Moreover, it goes without saying that the sectors and industries that remain off limits to foreign investment and the regulations that impose restrictions thereon (particularly those restriction full foreign ownership) are areas of policy that still need to be addressed.

Figure 27: Trends in location choice for newly incorporated foreign-invested enterprises in 2017



Source: Compiled from the “2018 Report on Foreign Investment in China”, MOFCOM.

As China looks to respond to the growing trade friction with the United States, it has made huge strides with its policy on the utilization of foreign capital at this milestone marking the fortieth anniversary of reform and opening up. Specifically, the release of its first nationwide negative list for market access at the end of last year attracted major attention.

In fact, the State Council issued two documents in 2017 prior to the onset of the trade war with the United States: the **Notice on Several Measures on Promoting Further Openness and Active Utilization of Foreign Investment (Guofa [2017] No. 5; the “20 facilitative measures for foreign investment” hereunder)**, and **Several Measures for Promoting Foreign Investment Growth (Guofa [2017] No. 39; the “22 facilitative measures for foreign investment” hereunder)**, with a view to “easing the restrictions on foreign market access, optimizing the environment for foreign business operation in China, and making China an attractive destination for foreign investment”. On June 10, 2018, the State Council then issued the **Circular on Several Measures Concerning the Active and Effective Use of Foreign Investment in Order to Boost High-quality Economic Growth (Guofa [2018] No. 19)**, which together with the “20 facilitative measures for foreign investment” and “22 facilitative measures for foreign investment”, attracted attention as a third policy document addressing the rules on foreign investment administration.

The *Negative List for Market Access (2018 edition)* that was issued by the National Development and Reform Commission and the Ministry of Commerce on December 25, 2018, clearly states that this negative list for market access is to be implemented on a nationwide basis. In a press conference in certain them held the same day, Xu Shanchang, Director-General of the Economic System Reform Department of the NDRC, said: “The nationwide implementation of the market entry negative list represents a major innovation of the system. It establishes a unified and fair system of rules on market entry, giving all market entities the ability to make a decision on whether or not to enter the industries, sectors, and operations, etc. enumerated in the list under equal terms and independently in accordance with the law, prevents related organizations and local governments from arbitrarily imposing examination and approval measures at the market entry stage, thus realizing “open access unless explicitly prohibited” in the true sense of the word.” (People’s Daily, January 27, 2018).

According to the official briefing, China published a Draft Negative List for Market Access (for pilot implementation) in March 2016, which was initially implemented on a pilot basis in Tianjin, Shanghai, Fujian and Guangdong. The pilot approach was later extended to cover a further fifteen provinces and cities in 2017. The 2018 negative list that was compiled as a careful summary of experiences with the pilot comprises three sections: an explanation of the list, the list itself and supplementary notes.

The list is divided into two broad categories: “access prohibited” and “access permitted” and consists of 151 items and 581 specific rules, down by 177 and 288 items, respectively, on the draft version. The four prohibited industries are: industries in which market access is explicitly prohibited by laws or regulations; projects involving investment and construction that are explicitly banned under the “Catalogue for Guiding Industry Restructuring”; “financial business activities that are undertaken in breach of regulations” (i.e. illegal financing) and “online business activities that are undertaken in breach of regulations” (i.e. unlawful internet activities). Market entities are not permitted to enter these prohibited industries and no official examination and approval procedures have been put into place.

It lists 147 permitted access areas, including 128 items in 18 of the 20 industries that relate to the national economy, 10 items on the “List of investments approved by government”, six items on the “List prohibiting internet market access”, and a further three items that are punishable, etc.

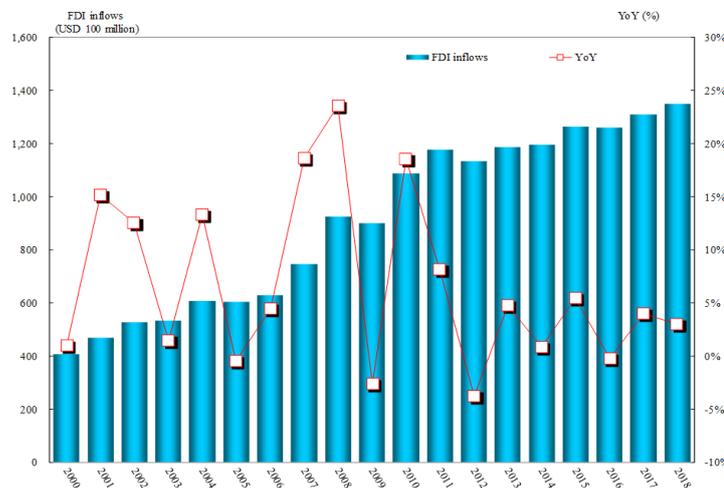
Director-General Xu went on to explain that: “Following the nationwide implementation of the Negative List on Market Access, the review and approval of access to China’s markets will be administered by ‘listing’. Further improvements will be made to the review and approval process for entry into areas that are currently unlisted. Unreasonable or discriminatory access conditions must not be imposed on private enterprises seeking market access, and the adoption of administrative restraints other than the list will not be permitted; all market entities will be treated fairly and on an equal footing, discretionary powers will be reduced, the various unreasonable restrictions and hidden barriers to market entry, examination and approval, permission, investment management and so forth must be removed so as to facilitate the creation of a business environment that is stable, fair, transparent and predictable.” (ibid)

The development and implementation of this series of proactive measures to ease the regulations on foreign investment by the government has its roots in the results and issues of forty years of foreign capital assimilation and is a proactive move to address the new developments both at home and abroad, the trade friction with the United States included. It is being seen as a proactive stance towards attracting foreign investment, and the further opening of China’s system of foreign capital administration, alongside dynamic and highly efficient reforms are expected, which should improve fairness, transparency and convenience and create a more attractive business environment for foreign investors. Foreign investors, meanwhile, will be able to make independent choices on their target region and industry, which should lead to improvements in the inordinate bias in location choice for foreign-invested enterprises.

On January 14, 2019, the Ministry of Commerce released data on global foreign direct investment in China. The figures show a 0.9-percent increase in FDI inflows into China, which reached 885.6 billion yuan (or approximately 14.15 trillion

yen or US\$ 135 billion, an increase of 3% year on year. **Fig. 28.** The number of newly incorporated foreign-invested enterprises increased by 69.8% to over 60,000, with a 7.7 percent increase in investment from the United States, a nation with which trade friction is increasing. Its growth rate is slower than Japan (13.6%), South Korea (24.1%), the United Kingdom (150.1%), Germany (79.3%) and other major trade partners, but it was still higher than the overall rate of increase. Investment from the developed world, including Japan, the United States and Europe, continues to grow steadily. FDI in manufacturing increased by 20.1 percent over the previous year, with the growth in investment in advanced technology (hi-tech manufacturing) being particularly favorable at 35.1 percent. With first half of 2018 witnessing a big drop in FDI worldwide, China’s acceptance of the largest amount of FDI in history is a major achievement, and further regulatory easing and improvements in the investment environment at the central and regional level are expected to facilitate a higher quality of foreign investment and stable business operations and to contribute to sustainable economic growth and further industry sophistication in China.

Figure 28: Trends in China’s acceptance of FDI



Source: Compiled from National Bureau of Statistics and MOFCOM statistics and press releases.

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