

New progress,
new era,
China 2020



The Second China International Import Expo

EY 安永
Building a better
working world



Foreword

The year 2019 marks the 70th anniversary of the founding of the People's Republic of China. It also leads us toward another significant milestone – the building of a moderately prosperous society in all respects by 2020. Against this backdrop, China has introduced a series of important policies and institutional arrangements in the pursue of high-level opening up. China has also become an advocate for international trade liberalization and economic cooperation.

As China seeks to adapt to domestic consumption upgrade, enable further opening up and promote international economic ties, the second China International Import Expo (CIIE) attracted participation from 181 countries, regions and international organizations. More than 3,800 enterprises joined the event, which concluded with a total value of US\$71.13 billion in intended deals signed¹.



181

countries, regions and international organizations



3,800+

enterprises



US\$71.13

billion

1. http://www.gov.cn/xinwen/2019-11/11/content_5450731.htm

Looking forward, China has laid out an ambitious plan with the “Two Centenaries” goals. To achieve this, China needs to create a favorable environment to support stable domestic development and strive toward building a future-oriented economic system. China is also expediting the development of high-tech and strategic emerging industries in its journey to becoming a leader in the global innovation and technology arena.

EY is privileged to take part in and witness the economic growth of China. We are very confident in the nation's development prospects and strongly believe a more open China will create opportunities for all.

This year, we are honored to continue our participation in the CIIE, to showcase our professional services in assurance, tax, transaction and tax as well as our experience in helping companies capitalize on opportunities presented by the nation's new growth model. This report *New progress, new era, China 2020* provides in-depth insights on global trends and China's growth prospects, as well as explores future development directions and opportunities on both national and market levels. We hope that it will shed new light on topics that are pertinent to your business strategic plan.

Riding on our global network and more than 50 years of experience in Greater China, EY will continue to collaborate with all parties to assist Chinese companies in their expansion of global footprints, offer multinationals the insights on Chinese regulations and industry trends. Together we will drive international economic and trade cooperation as we continue to work toward building a better working world.

Albert Ng
Chairman, China
Managing Partner, Greater China

Global political and economic update – populism and unilateralism

The world in the backdrop of unilateralism and protectionism

Disenfranchisement after the global financial crisis

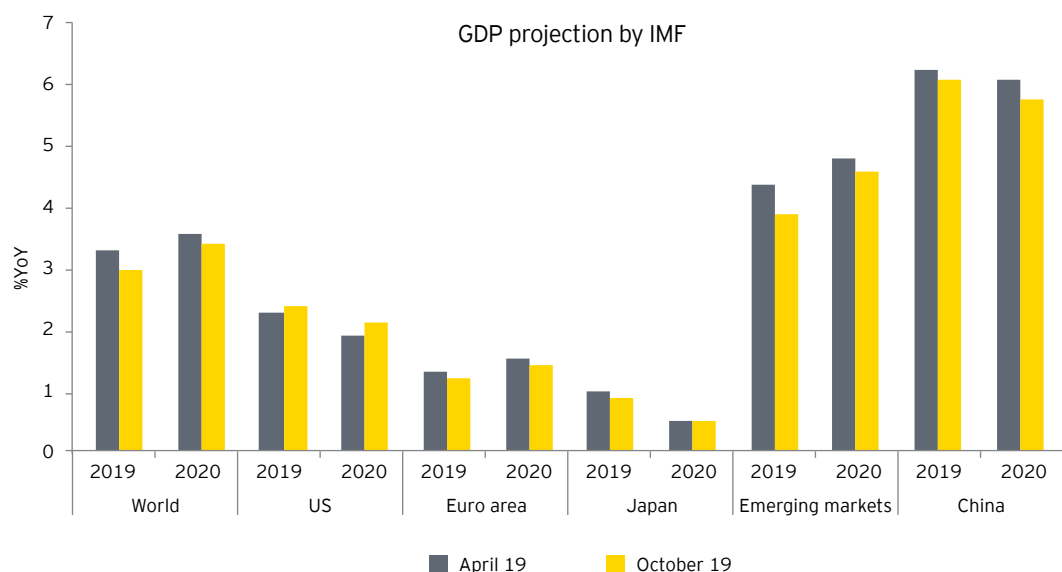
Discontent with globalization and multilateral organizations have led to the return of protectionism and unilateralism around the world, especially in the West, in the aftermath of the global financial crisis. Despite being founded on the principles of openness and cooperation, the world economic order long after World War II is increasingly criticized for being opaque and inefficient, especially in the eyes of some voters in the advanced economies who perceive to have gained little from offshoring or foreign competition.

People believe such background led to the rise of right-winged populism, in countries such as the US, the UK, and many countries in the EU. In the US, for example, President Donald Trump's election was attributed to the success of his campaign "Make America Great Again" and pledges on immigrant exclusion and rhetoric around the US being hurt in trade by other countries. These pledges have also become his main economic policy directions since he was elected in 2016.

Disruption to supply chain dampens the world economic outlook

Amid growing protectionism, the International Monetary Fund (IMF) predicts a bleak global economic outlook as companies have become dependent on widely dispersed supply chains. Disrupted international trade could trigger negative repercussions that reach far beyond the countries directly involved. Together with slowing investment due to technology transfer tensions, the global economy may be getting close to a new recession².

Slowing global growth projections



Source: IMF World Economic Outlook

2. blogs.imf.org/2019/04/09/the-global-economy-a-delicate-moment/



China urges the world to return to the negotiation table

Uncertainty continues to escalate with rising stakes on both sides

The toll on the global economy is rising as the trade dispute between China and the US faces more challenges. The stakes for both economies were up dramatically since 1 August when the US decided to start a 10% tariff on the remaining US\$300b Chinese imports, on top of the US\$250b that was already tariffed at 25%. The US Treasury also officially labeled China as a “currency manipulator” on 5 August, and thus adding new elements of uncertainty to the negotiation. On 23 August, China reacted with rising tariff on US\$75b worth of US products while the US hit back with an additional 5% tariff on US\$550b worth of China imports.

China reiterates its conviction on free trade

Despite being dragged into the epicenter of trade protectionism, China continued to uphold its position as an advocate for multilateralism. In the 2017 World Economic Forum in Davos, President Xi Jinping warned against making globalization a scapegoat for economic problems. China also took steps to strengthen relations with both the developing and developed world, promote regional cooperation to jointly defend the free trade mechanism and make the global governance system fair.

The Belt and Road Initiative (BRI), first proposed in 2013, also aims to deepen South-South integration through connectivity between China and other developing countries. As President Xi later put it, the BRI-driven cooperation among developing countries is facilitating changes in the global governance structure, transforming the development model led by developed countries, and enabling developing countries to play a leading role in exploring development models suitable for their own countries³.

3. www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1658424.shtml



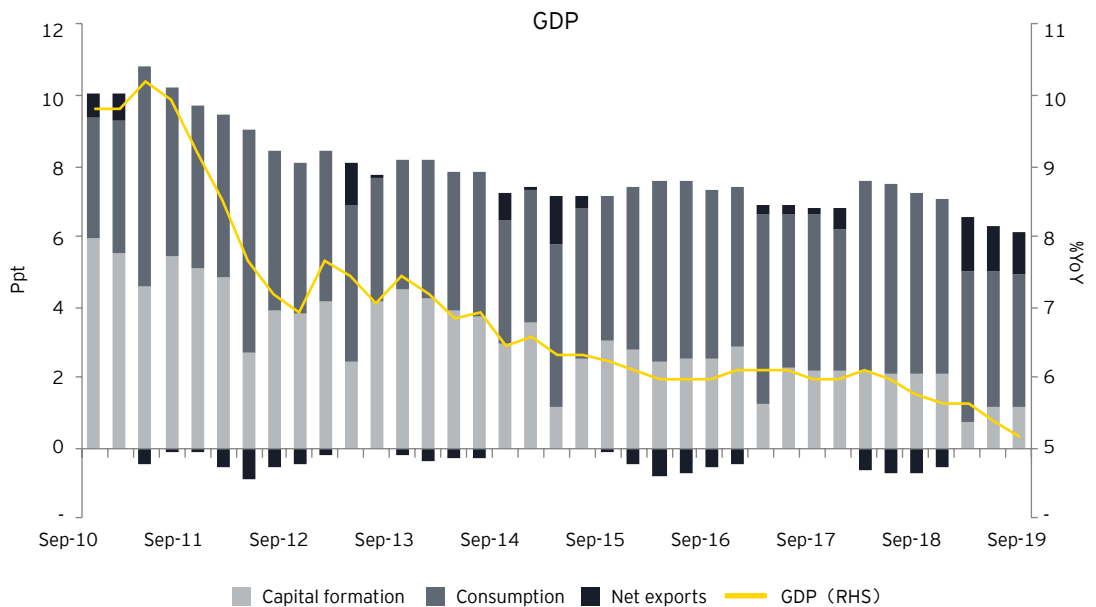
China's growth outlook

Renewing the pledge to maintain "six stabilities"

China's economic outlook remains challenging in the near term. In 3Q 2019 GDP growth slowed to 6.0% YoY, its weakest pace in at least 27 years. It is a change from the relatively upbeat growth earlier in the year, although it still sits in the middle of the official growth target at 6.0-6.5% YoY in 2019. Already in the 2Q Politburo meeting, the leadership has renewed the emphasis on the "six stabilities", namely the policy focus to ensure stability on China's employment, finance, trade, foreign capital flow, investment and expectations. As the State Council's press conference on 3Q GDP emphasized, the stabilizing forces are already taking place.

A closer look at the composition of GDP growth confirms that although global demand is increasingly dampened by the US trade dispute re-escalation, the impact of policy easing has also been limited so far. Most notably, the contribution from capital formation (investment) and total consumption weakened to 19.8% and 60.5% respectively in 3Q 2019, notably below 31.8% and 78.0% in 3Q 2018. All in all, as growth momentum risks decelerating further in 2H, more policy easing is required to keep China's growth momentum from slipping below the official target.

GDP by contribution

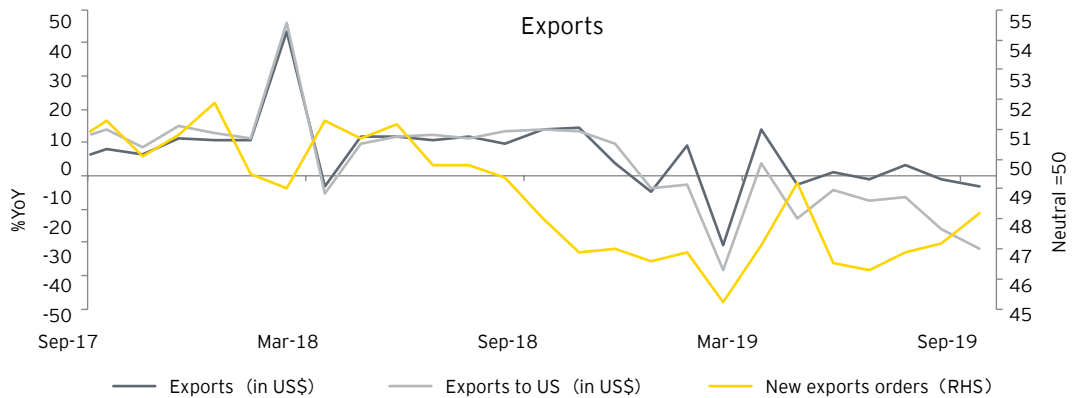


Source: Wind

President Xi urges preparation for a “new long march”

The trade dispute could be highly uncertain in the latter part of the year. As new export orders as a component in Purchasing Manager Index (PMI) remained below contraction threshold for the sixteenth consecutive months, China’s exports growth slowed down further in September as tariff took further toll. Import growth remained lackluster as processing imports (intermediate goods used as inputs for manufacturing goods that are primarily exported) fell further.

Slowing export growth dragged by demand from the US



Source: Wind

It is difficult to see the end of the stalemate between China and the US, while China is prepping up for a protracted conflict with an expanding list of demand. In May, President Xi called for a “new Long March” when China will “start all over again”⁴. This remark alludes to the spirit of endurance and determination amid rising tensions in the trade negotiation.

The 1H Politburo meeting, which ended on 30 July, emphasized the need to “dig deep into China’s consumption potential” as it pledged to strengthen domestic demand through favorable policies, in order to counter the external outlook that may remain challenging in the foreseeable future⁵. It will also have to achieve higher quality of growth through effective market opening, robust innovation, sustainable urbanization, adaptive regulation, and tailored business environment that can stand the test of external headwind.

Businesses remain bullish in economic outlook

Despite the changing external economic and market environment, Chinese businesses remain optimistic about China’s economic growth on the whole, showing that China’s economy stays resilient and a series of policies on deepening reform and opening-up has eased economic and trade pressures.

The report Global Capital Confidence Barometer EY released earlier this year showed that 90% of respondents from Greater China remain positive about China’s economic growth and 68% of Chinese executives expected revenue to grow by 6%-15% in the next 12 months.

68% of Chinese respondents expect revenue to grow by 6%-15% in the next 12 months



4. www.chinadaily.com.cn/a/201905/22/WS5ce43b75a3104842260bcf4a.html

5. Politburo pledges more growth stabilizing measures amid challenging external outlook, EY report

Moreover, market adjustment is inspiring enthusiasm of Chinese companies for mergers and acquisitions. According to EY survey, Global Capital Confidence Barometer, 89% of Chinese executives expected Chinese merger and acquisition (M&A) market to improve in the next 12 months and 42% of Chinese executives expected to pursue M&As in the next 12 months, up from 34% in 2018.

Dig deep into China's potential domestic demand

Swift policy to stabilize employment

The Politburo's emphasis on boosting domestic demand was responded with swift policies from the government. On 31 July, the State Council pledged⁶ to 1) establish an early warning mechanism for large-scale layoffs in the labor market; 2) draw RMB100b from the balance of unemployment insurance on retraining; 3) launch employment assistance programs for fresh graduates, ex-servicemen, and migrant workers; and 4) promote flexible employment and part-time employment markets. In combination with the reduction in social security contribution for employers, which was announced in April, these measures are expected to stabilize the job market as the economy faces pressure to create more jobs.

On 16 August, the National Development and Reform Commission (NDRC) also announced new measures to boost disposable income in order to spur consumption in 2019 and 2020⁷. It will involve 1) removing regulation "blockage" that prevents consumers from upgrading which will likely involve incentives to encourage spending in targeted sectors; 2) expediting reforms in rural development and the residential registration (hukou) system to boost consumer income expectation; 3) shaping a vibrant domestic market by enhancing consumer welfare and improving channels for complaints; and 4) creating a joint-department taskforce to ensure consumption incentives are effectively implemented. The State Council also released 20 new measures on 28 August that aim to promote retail market growth through increasing the size and the attractiveness of retail space and commercial pedestrian streets.

Targeted measures to ease liquidity bottleneck for small businesses

Policy easing on the monetary side has so far been relatively mild as policymakers keep a close eye on debt leverage. The key challenge is to provide adequate liquidity to the small businesses that are the driving force of real economic growth, rather than adding fuel to asset speculation or sustaining zombie companies. These small businesses, compared to the state-owned enterprises (SOEs), have not been able to benefit from credit supplied by leading banks due to their relatively riskier profile and the lack of credit history.

Small businesses have thus turned to the smaller regional banks and the shadow banking system for financing. But as Baoshang Bank and Bank of Jinzhou have both experienced liquidity crunch in 2019, market confidence in these smaller financial institutions has been shaken as well. Together with the consolidation in the shadow banking system, credit supply to smaller businesses has become a gridlock in monetary policy in 2019.

The People's Bank of China (PBoC) elaborated on 2 August that it will make comprehensive use of its multiple monetary tools for counter-cyclical policy adjustment. It suggested that the increasingly targeted tools, such as the targeted medium-term lending facility (TMLF), will be the front-line tools to provide smaller businesses with affordable financing.

On 30 July, the Ministry of Finance (MOF) also announced⁸ that it will set up a special incentive fund of RMB2b annually for local authorities to support financial institutions' services to small and micro businesses. The pilot program will cover 60 cities across the country for three years, and local authorities can use the fund to compensate financial institutions' risk exposure in small and micro business loans or supplement capital for local financial guarantee institutions. The program is part of efforts to encourage local authorities to explore effective solutions for improving private sector funding to support the economy.

6. www.gov.cn/guowuyuan/2019-07/31/content_5417636.htm

7. www.china.com.cn/zhibo/content_75103275.htm

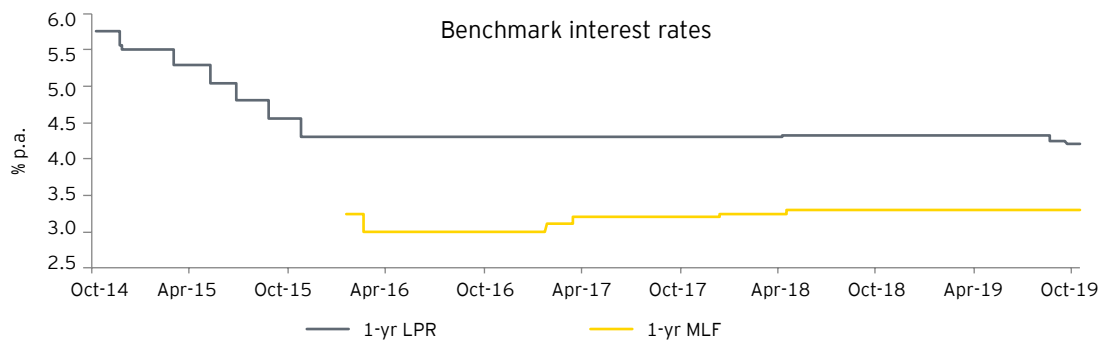
8. www.mof.gov.cn/zhengwuxinxi/caijingshidian/jjrb/201907/t20190730_3318394.html

New interest rate framework allows more broad-stroke easing

On 17 August, the PBoC unveiled a market-oriented interest rate reform which amounted effectively to a moderate general reduction in corporate borrowing costs. The 1-year loan prime rate (LPR) - the new benchmark lending rate - was set at 4.25% on 20 August, below its original level at 4.31%.

The LPR is the average of the rates that 18 designated banks charge their biggest clients. The rate is linked to the medium-term lending facility (MLF) which is the lending cost from the PBOC. It should create a smoother policy transmission mechanism in the financial market compared to the previous 1-year benchmark lending rate, that has been fixed by the PBoC at 4.35% since October 2015. Now with the interest rate framework in place, it would allow more broad-stroke policy adjustment.

China's policy rates

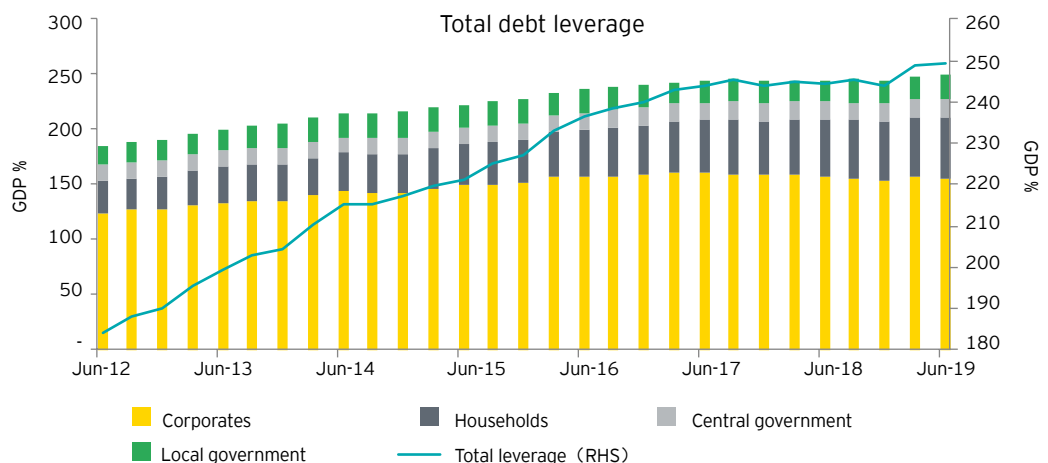


Source: Wind

Massive easing unlikely amid concern for high leverage

Massive easing, nevertheless, is unlikely as the Politburo emphasized that debt deleveraging and risk control remain high priority. The Institute of Economics and the Chinese Academy of Social Sciences (CASS) showed that China's total debt leverage has increased again in 2Q 2019 after a mild decline in 2018 to 249.5% of GDP. While leverage in non-financial departments - household, and the central and local government - has all increased, non-financial corporates leverage jumped significantly to 155.7% in 2Q 2019 from 153.6% in 4Q 2018.

Total debt leverage picked up again in 2019



Source: CASS

On 26 July, the NDRC released a 21-point working plan to cut down the leverage level of the corporate sector. Among them, the NDRC pledged to further reduce excess capacity in the economy and crack down subsidies to failed "zombie companies". It suggests that financial risk control will remain high on the policymakers' agenda in 2H 2019.

China becoming an open and transparent market place

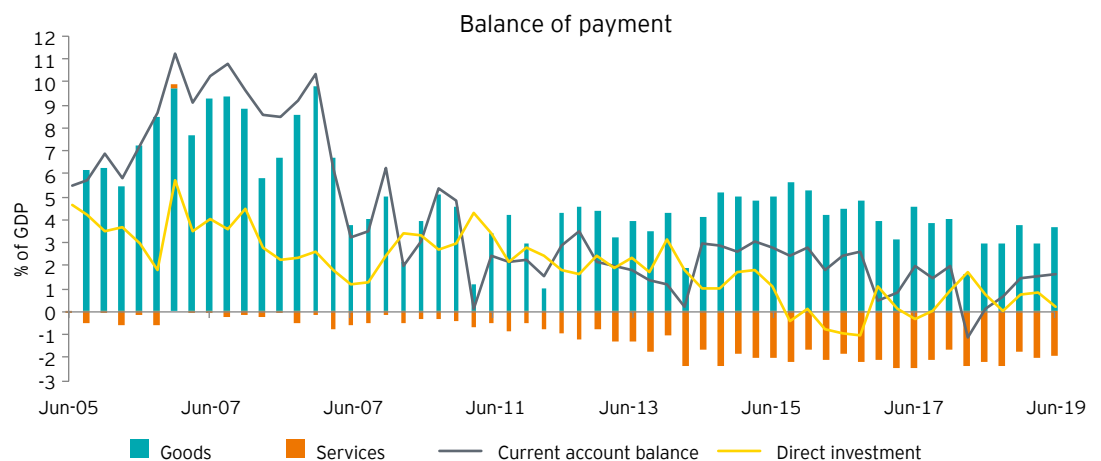
China's balance of payment no longer structurally distorted

Despite the US allegation, the IMF has reaffirmed that China's balance of payment is no longer distorted and the RMB exchange rate is broadly in line with economic fundamentals⁹:

Narrowed current account surplus

First, China's current account surplus has declined substantially compared to its peak of around 10% of GDP in 2007 because 1) China's production cost has increased substantially mainly due to increased labor cost along with the aging population; 2) import growth increased alongside the development of the consumer economy; and 3) the service trade deficit is widening resulted from more overseas travel and shopping.

China's balance of payment is no longer structurally distorted

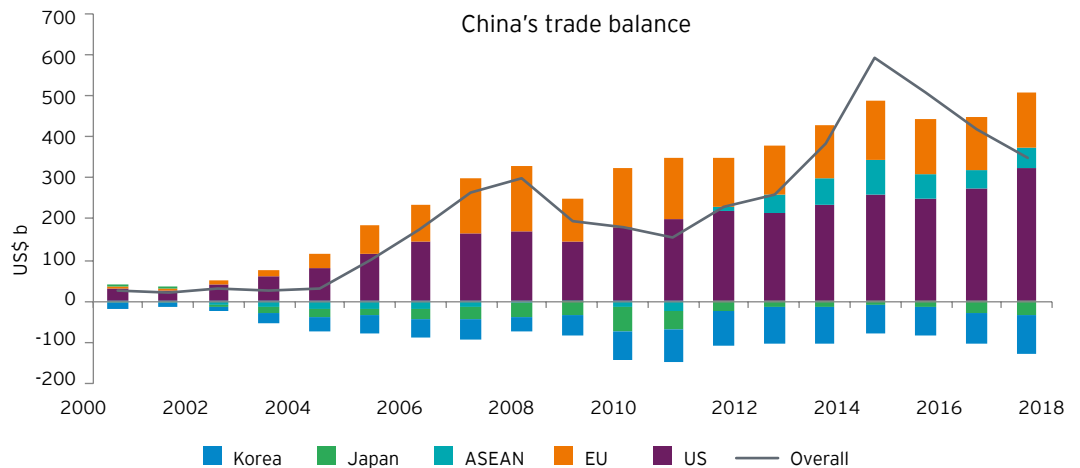


Source: Wind

Contrary to the US's allegation that China is using unfair tactics to boost trade surplus, its trade surplus become remarkably smaller with the rest of the world even before the trade dispute started in 2017. In fact, China's merchandise trade was much smaller or even in deficit with key economies such as the EU (US\$13.5b), ASEAN (US\$8.8b), Japan (-US\$33.5b) and Korea (-US\$95.9b) in 2018, against US\$32.3b with the US. It suggests that China's trade surplus with the US is arguably due to strong demand from the US in a highly globalized supply chain rather than strategic distortion.

9. blogs.imf.org/2019/07/17/rebalancing-the-global-economy-some-progress-but-challenges-ahead/dx

Most of China's trade surplus is with the US



Source: Wind

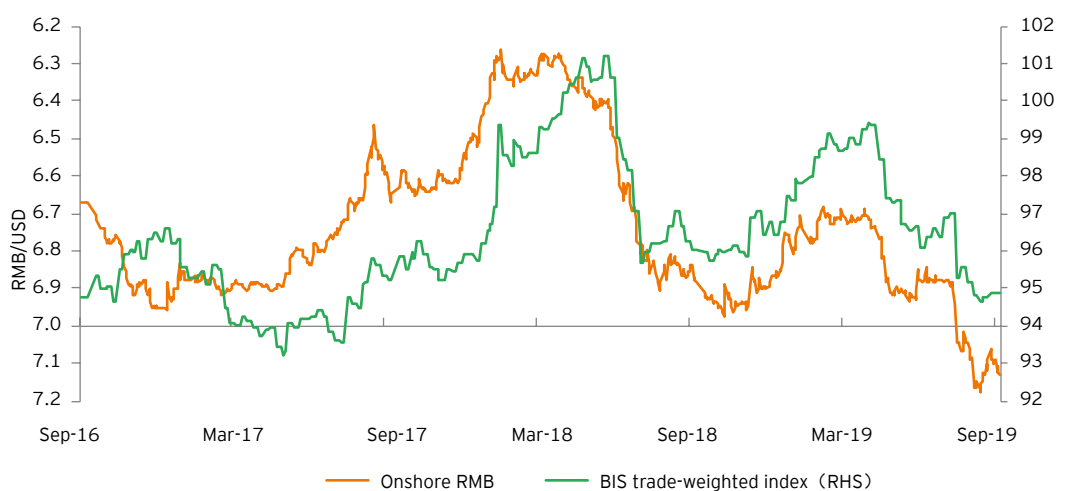
Resilient capital flow as financial market opens

Second, capital inflow has been strong in recent years with support from the inclusion of China A-shares in the MSCI equity indices and the inclusion of local currency government and policy bank bonds into the Bloomberg Barclays Global Aggregate Index. Capital outflow pressure, meanwhile, has been relatively calm since 2017 with government scrutiny on wasteful overseas direct investments and more regulation monitoring illicit capital flow.

Stable RMB against a basket of currencies

Third, the bilateral RMB/USD rate depreciated relatively fast from mid-June to early August 2018 when measures to counter depreciation pressure - the 20% reserve requirement for FX derivatives which is a capital flow management measure (CFM) and the countercyclical adjustment factor (CCAF) in the daily trading band's central parity formation - were reintroduced. IMF estimates suggested there was little intervention from the PBoC. In fact, despite the RMB/USD depreciation, the RMB was broadly stable against the basket publicized by the Bank of International Settlement (BIS).

Trade-weighted RMB exchange rate remained broadly stable



Source: BIS, Wind

The next steps in high-quality opening up

Rather than distorting its balance of payment to its advantage, China plans to launch new reforms to boost further high-quality opening up. It suggests the resolve to go beyond trade dispute negotiation and to achieve a more efficient market with the rest of the world. As President Xi Jinping highlighted in the BRI summit in April 2019¹⁰, the reforms include:

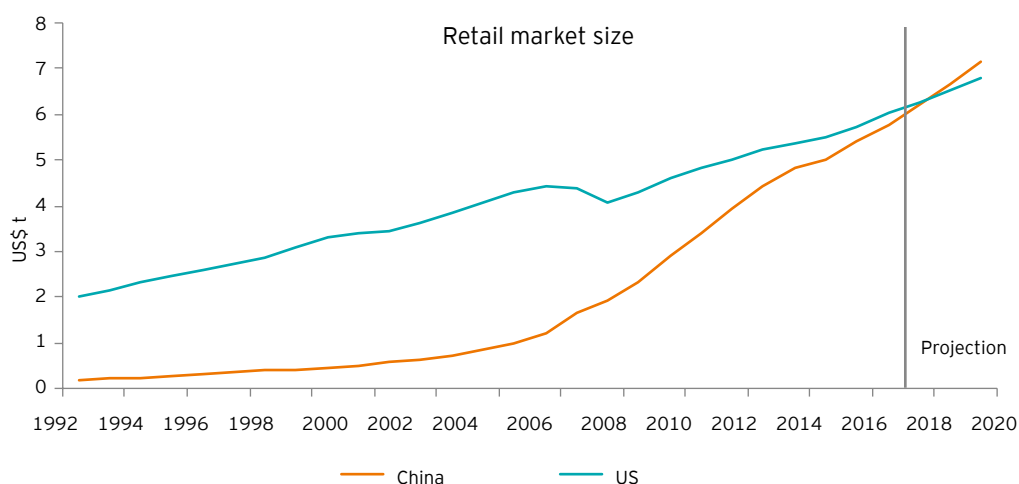
- ▶ Expanding market access for foreign investment in more areas to enable more competition, it will be accompanied with measures to promote fair competition and open cooperation.
- ▶ Enhancing international cooperation in intellectual property protection which includes a legislation framework and elimination of government-driven forced technology transfer.
- ▶ Increasing the import of goods and services on an even larger scale which helps to capture the vast potential appetite of China's consumers by giving them more choices and benefits. It will be accomplished through lower tariffs and the removal of non-tariff barriers.
- ▶ Effectively engaging in international macro-economic policy coordination in which China will strengthen macro policy coordination with other major economies to generate positive spillover and jointly contribute to robust and inclusive growth.
- ▶ Ensuring the implementation of opening-up related policies in which China will strengthen the building of a government based on the rule of law and good faith. A binding mechanism for honoring international agreements will be put in place.

China sets to become the world's largest consumer market

China as the world's largest retail market

China's opening up is attractive to the world as it is expected to overtake the US to become the world's largest retail market. In 2018, China's retail sales (including food services) have reached US\$5.76t, broadly on par with US\$6.02t in the US. As China's economic restructuring takes place, the significance of consumption in the Chinese economy is going to stay on an upward trajectory, making the market more attractive to foreign businesses.

The size of China's retail sale market is about to overtake the US



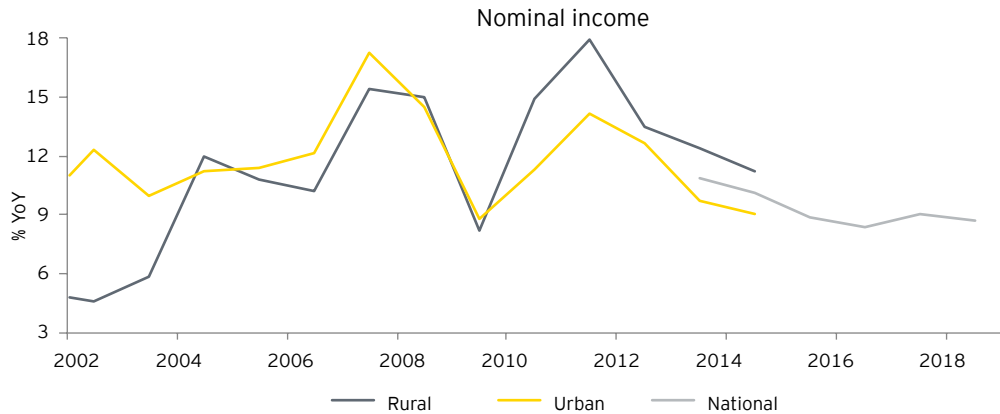
Source: U.S. Census Bureau, Wind

10. www.cpecinfo.com/news/the-complete-text-of-president-xi-jinping-speech-at-the-belt-and-road-forum-for-international-cooperation-2019/NzAwMQ==

Massive income growth in the past decades

It is partly due to further increase in disposable income. The average disposable income of China's urban residents increased by around 623% over the past 20 years, which led to significant increase in welfare in terms of spending ability¹¹. By international standard, China has emerged to become an "upper middle-income economy" according to the World Bank. Government structural reforms such as tax cuts, urbanization, agricultural land reform and improvement in social welfare are all going to further increase willingness to spend.

Income growth reached upper teens between 2007-2013

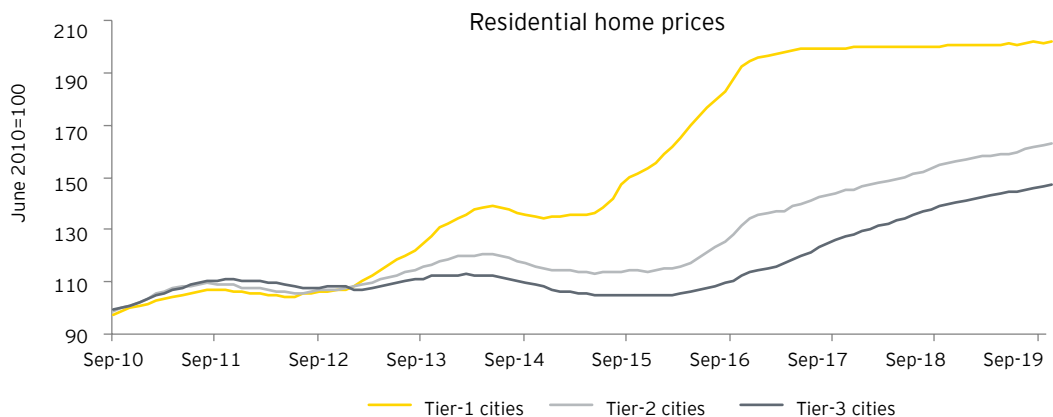


Source: Wind

Asset value appreciation helps contribute to diversified consumer preference

Specifically, the onshore demand for high-quality consumer products is rising. Robust asset value appreciation especially coming from the real estate market has led to wealth effect that dramatically diversified China's consumer spending behavior. Home owners and successful businessmen have been spending more on luxury goods at home, advanced education, advanced medical care and service, and overseas tourism. In fact, despite the downbeat growth in retail sales in 1H 2019, the sales of higher-end consumer products remain broadly resilient.

Despite cooling measures in recent years, home prices have accumulated significant gains in recent years



Source: Wind

11. National Bureau of Statistics, www.stats.gov.cn

Resilient growth of luxury goods consumption



Source: Yaok institute

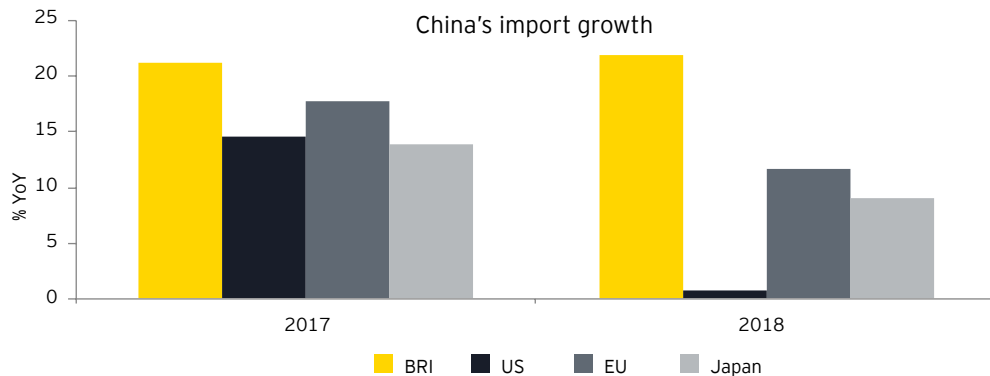
Import substitution in action with benefits for BRI countries

The trade dispute, meanwhile, is already having an impact on China's consumer preference. We have observed that import substitution is in action with consumer preference switching to domestic brands especially for technology products. Meanwhile, consumers are becoming more open to the diverse and novel offering of high-quality imported goods from the rest of the world.

Countries in BRI present attractive alternatives for products from raw industrial materials and agricultural products to machineries and luxury goods. On 23 July, the Ministry of Commerce disclosed that it will update its positive list on imported goods and services. The announcement suggests that lower import tariffs, special credit access, and reduced administration hurdles can be expected to incentivize import trade for targeted products and from targeted origins.

We observed that China's imports from BRI countries have outpaced those from the US, Japan and EU. Meanwhile, companies from BRI regions and countries account for more than 60% of all participants in the import section in the Spring 2019 edition of the China Import and Export Fair in Guangzhou (Canton Fair).

China imports from BRI countries are growing faster than those from the G3



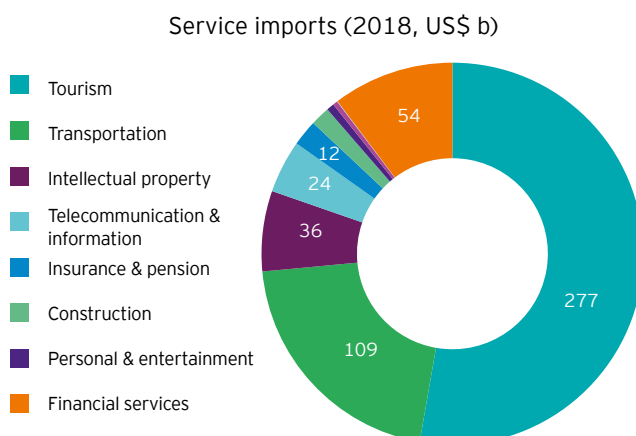
Source: Wind

The final steps in China's balance of payment liberalization

Promoting service imports beyond tourism and education

As China's current merchandise trade has essentially been liberalized, the emphasis in China's opening-up policy is on service trade and capital account. Specifically, as China has achieved significant growth in service imports through overseas tourism and education, the focus is on promoting imports of business service, technology research and development, quality testing and analysis, environment conservation, and consulting services, according to a positive list released by the NDRC on 10 April¹².

China's service imports consist mainly of outbound tourism (including overseas education)



The China International Fair for Trade in Services (CIFTIS) in Beijing has upgraded the level of global service trade development in 2019 to reflect the increased significance of service trade. There were more than 400,000 who came from 137 countries and regions. They also represented more than 8,000 businesses and organizations, and 98 BRI countries.

Regulatory environment conducive for opening-up

Measures aiming to create an environment conducive to encouraging foreign investment have been announced:

First, the Foreign Investment Law (FIL) was announced in March 2019. The objective of the law is to enhance China's business environment through 1) offering foreign enterprises fair and equal treatment as domestic ones; 2) strengthening intellectual property protection; 3) ensuring pre-entry national treatment; and 4) protecting the freedom to remit capital¹³.

Second, the 2019 version of national and free trade zone (FTZ) negative lists is important to the FIL. Released by the NDRC on 30 June, the number of items on the 2019 FI negative lists was reduced from 48 to 40 in the national list, and from 45 to 37 in the FTZ list compared to the 2018 version.

The new negative lists include allowing majority foreign ownership or wholly owned foreign enterprises in various sub-sectors in the services, agriculture, mining, and manufacturing industries. The FTZ negative list further opens up another two industries –fishing (by lifting the ban on investment in fishing products within China's territory) and printing (by removing restrictions on the ownership of press publications).

12. images.mofcom.gov.cn/fms/201904/20190410171604558.pdf

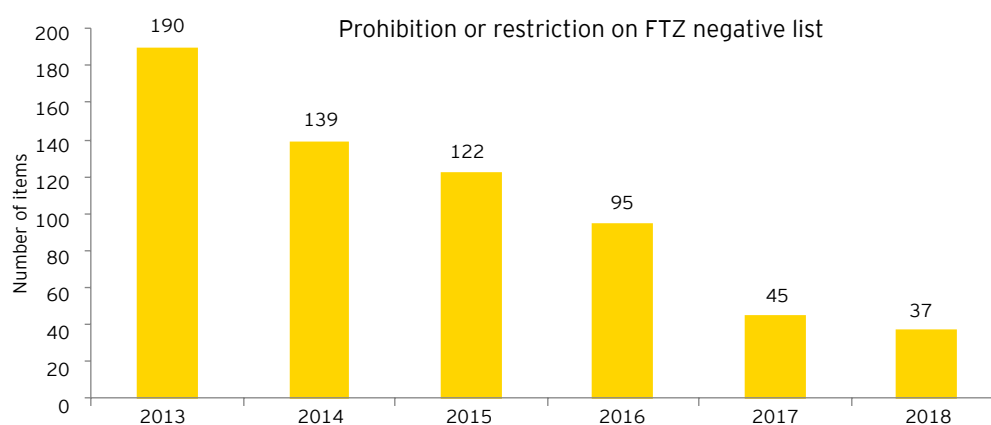
13. *New legislation preps China as an attractive investment destination*, EY report

Latest changes in the negative list of service industries

Sector	2018 national negative list	2019 national negative list
Transportation	<ul style="list-style-type: none"> Domestic shipping agents were controlled by the Chinese side 	Removed
Telecommunication	<ul style="list-style-type: none"> For telecommunication companies: under the telecommunication services opening as per China's WTO commitments, the foreign share of telecommunication services should not exceed 50% (except for e-commerce business), and the basic telecommunication services were controlled by the Chinese side 	<ul style="list-style-type: none"> For telecommunication companies: the foreign share of telecommunication services shall not exceed 50% (except for e-commerce, multi-party communication, store-and-forward, and call center businesses), and the basic telecommunication services shall be controlled by the Chinese side. *The 50% limit on foreign shares in multi-party communication, store-and-forward, and call center businesses have been removed.
Environment and public facilities management	<ul style="list-style-type: none"> Foreign investment in the exploitation of wildlife resources originally produced in China and protected by the country were prohibited 	Removed
Culture, sports and entertainment	<ul style="list-style-type: none"> The construction and operation of cinemas were controlled by the Chinese side Performance brokerage institution were controlled by the Chinese side 	Removed

Source: NDRC

Number of prohibited industries in FTZs



Source: NDRC

Third, an even more decisive step to open up came from the State Council when it announced a new initiative on 6 August to create a competitive business environment for multinational companies in Lingang, a new area in Shanghai FTZ. It is one of the “three strategic measures” for Shanghai put forward by President Xi Jinping in the opening ceremony of the first China International Import Expo (CIIE)¹⁴.

With high hope to nurture the development of the financial industry through capital accounts liberalization, Lingang will encourage multinational companies to set up asset management centers there. New rules that include removing the cap on the proportion of foreign shareholdings in financial institutions, broadening the business scope of foreign financial institutions, supporting qualified foreign investors to establish financial institutions, and ensuring Chinese and foreign financial institutions operate on the same footing¹⁵ will also be piloted in the FTZ.

14. www.xinhuanet.com/english/2018-11/05/c_137583815.htm

15. *Politburo pledges more growth stabilizing measures amid challenging external outlook*, EY report

On technology and innovation, Lingang will offer internationally competitive tax rate (at 15%) for businesses in the field of integrated circuits, artificial intelligence, biomedicine and civil aviation. It will also encourage multi-national companies to set up offshore development and manufacturing center and establish bonded frontier industrial clusters specifically for the development of these four industries. Shanghai government will also create expedited channels for patent applications, along with special mechanisms for those considered as key hi-tech businesses.

Opening up of the capital market

The opening of China's financial sector goes together with its steps to ease capital flow restrictions. To broaden investors' access to its domestic markets and strengthen their appeal, the Shanghai Stock Exchanged launched the Science and Technology Innovation Board (STAR market) in June to encourage unicorn companies to list at home, while it also started the Shanghai-London Stock Connect scheme to facilitate foreign investors in China's stock markets. Also, in the same month, the PBoC announced the abolishment of quota management for the Qualified Foreign Institutional Investors (QFIIs) and offshore RMB QFII (RQFII) to channel more foreign participation in the A-share market.

These measures were followed by an 11-measure plan announced by the Financial Stability and Development Committee (FSDC) on 20 July¹⁶. The measures cover almost all financial sub-sectors with breakthroughs in foreign investors in the interbank market, insurance market, asset management, rating agency, currency brokerage, pension management, and derivative trading¹⁷:

- ▶ Permitting foreign-funded institutions to conduct credit ratings on all types of bonds in China's inter-bank and exchange bond markets
- ▶ Encouraging overseas financial institutions to participate in establishing and investing in wealth and asset management subsidiaries of commercial banks
- ▶ Permitting overseas asset management companies to co-establish foreign-controlled asset management companies with subsidiaries of Chinese banks or insurers
- ▶ Permitting overseas financial institutions to participate in establishing and investing in pension management companies
- ▶ Supporting foreign capital investment in wholly-owned currency brokerage establishment or equity participation in such establishments
- ▶ Bringing forward the transition period for 51% to 100% foreign ownership cap on life insurers, from 2021 to 2020
- ▶ Removing a rule that previously required domestic insurance companies to hold at least 75% of the shares in their asset management business, therefore allowing foreign investors to hold more than the current 25% ownership limit
- ▶ Relaxing entry conditions for foreign insurance companies by removing a requirement that they have at least a 30-year business track record
- ▶ Bringing forward the cancellation of the foreign ownership limit in securities firms, asset management companies and futures companies from 2021 to 2020
- ▶ Allowance to obtain Type-A lead underwriting licenses in the interbank bond market
- ▶ Further facilitating overseas institutional investments in the interbank bond market

In our view, the opening-up will not only inject new blood to China's financial market and reduce the pressure on the RMB, but also increase the competitiveness and maturity of the financial market. For example, the participation of international rating agencies could help to benchmark China's bond market environment against that in the rest of the world. Foreign investors, likewise, would help to optimize China's financial resources allocation in a market-oriented mechanism. The opening-up of the financial market, as such, is going to bring new impetus to China's high-quality growth.

16. www.gov.cn/guowuyuan/2019-07/20/content_5412220.htm

17. [www.ey.com/Publication/vwLUAssets/ey-pov-china-further-opens-up-financial-sector-viii-en/\\$FILE/ey-pov-china-further-opens-up-financial-sector-viii-en.pdf](http://www.ey.com/Publication/vwLUAssets/ey-pov-china-further-opens-up-financial-sector-viii-en/$FILE/ey-pov-china-further-opens-up-financial-sector-viii-en.pdf)

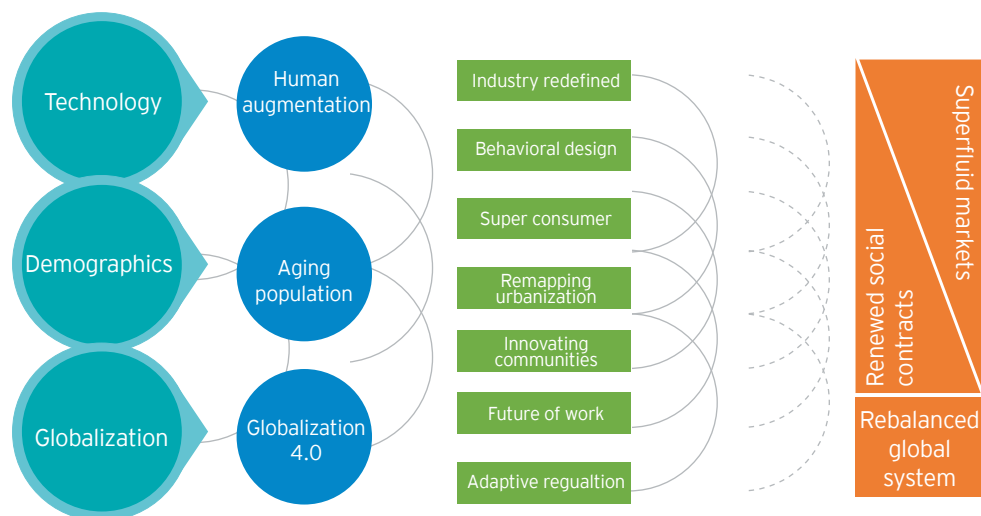
From open market to future-oriented economic system

Three variables of future development

What happens in the next 10-15 years is critical to China's development. President Xi Jinping delivered a report at the 19th National Congress of the Communist Party of China (CPC), clearly pointing out, "In the first stage from 2020 to 2035, we will build on the foundation created by the moderately prosperous society with a further 15 years of hard work to see that socialist modernization is basically realized; with gains in economic strength and overall improvement in science and technology, people are leading more comfortable lives, and the size of the middle-income group has grown considerably. Disparities in urban-rural development, in development between regions, and living standards are significantly reduced; equitable access to basic public services is basically ensured; and solid progress has been made toward prosperity for everyone; a modern social governance system has basically taken shape, and society is full of vitality, harmonious, and orderly; there is a fundamental improvement in the environment and the goal of building a Beautiful China is basically attained."

With the current economy, society and international political environment entering a period of in-depth readjustment, disruptive technologies and innovations are changing economic and social activities in an unprecedented way. This trend is expected to continue in the next 10-15 years while more profound impacts are expected amid increased uncertainties.

EY report *Megatrends shaping 2018 and beyond: the upside of disruption* introduces an analytic framework on understanding future trends, suggesting technological development, demographics and globalization as primary driving forces of future trends and disruptive changes. Interactions among all these forces will impact the future of economics, society and international politics and define what they will look like by shaping the future and driving disruptive changes with emerging technologies, demographics and globalization trends.



Source: *Megatrends shaping 2018 and beyond: the upside of disruption*, EY, 2018.

The report highlights human augmentation, aging population and globalization 4.0 as the most recent dominant drivers. Given China's industrial structure, development goals and demographics as well as its integration into the global system these three drivers are variables to China's future development.

Human augmentation

Human augmentation involves various information technologies, including artificial intelligence (AI), augmented reality (AR), virtual reality (VR), blockchains, sensors and biotechnology and nanotechnology. With these technologies mixed or integrated, solutions are created to make driverless cars, drones, robots and wearables. As technologies enabling innovative products and services have become mature, we are entering a new era when technology will no longer be reactive but proactive, work with human, or even take over some human decisions making.

In the new era of technology, the integration between human intelligence and AI will speed up the exploration of natural sciences while humans will have a deeper understanding and awareness of themselves and refresh their knowledge. As human augmentation takes on more trivial tasks, organizational forms of production, employment and social security systems, and social and legal norms will embrace new frontiers and challenges.

- ▶ **Industry redefined.** Technology and innovation are reinventing and redefining industries, blurring the boundaries between industries and sectors. Through pursuing M&As, exploring new business models, enhancing business and technological competence, companies that are accelerating expansion and cross-industry collaboration through alliance are gaining momentum. Traditional distinctions of industries are breaking down. In turn, long-standing boundaries and constraints are becoming a catalyst for value creation, allowing an industrial ecosystem to flourish enabled by the convergence of industries and sectors.
- ▶ **Work redefined.** Driven by disruptive technologies, such as AI and robotics, driverless cars, iStore and automation are becoming a reality, hitting hard on employment and labor markets. Meanwhile, traditional employer-employee relationship is dissolving, and work will be less permanent but more flexible; organizations are likely to go minimal and recruit freelancers based on specific tasks. Freelancers are able to switch easily between tasks and organizations, creating a more flexible and fluid labor market.
- ▶ **Behavior redefined.** Data generated by humans every day goes beyond the processing capacity of human brains, while AI greatly helps humans to improve their cognitive functions in the digital era. So far, data and algorithm-enabled AI has helped make decisions in some areas such as GPS navigation. In the future, widely adopted human augmentation may take over human decisions making about work and life without human interference, thus blurring boundaries between humans and machines.
- ▶ **Existing social and legal norms challenged.** Technologies are transforming industries and creating new ones. Changes to the job market are inevitable. Even human behavior is impacted by technologies. All these pose new challenges to laws, regulations and company code of conduct.

China is taking measures to support development and the use of key human augmentation technologies. Take AI as an example, China ranks the first by total number of papers published and cited and ranks the second by number of AI companies. In 2017, capital raised in the AI sector accounted for 60% of the world's total amount¹⁸. As for China, its future development will to a large extent, depend on whether or not the country can tackle the challenges of human augmentation development, lead technology standards, strike a balance between technology usage and social value through legal norms and create a sustainable, healthy and vibrant innovation and entrepreneurship ecosystem.

18. *China AI Development Report 2018*, China Institute for Science and Technology Policy at Tsinghua University (CISTP).

Globalization 4.0

Over the last 70 years, social productivity and efficiency in resource allocation have been greatly improved. More than 1 billion people in the world have been lifted out of poverty thanks to international trade and global supply chains. In particular, China has achieved remarkable results in poverty alleviation. People in China living on less than US\$1.9 a day (based on purchasing power parity in 2011) accounted for 0.7% of the country's total population, down from 67% in 1990¹⁹.

However, the wealth gap is growing among countries with different income levels and the outcomes of globalization are not equally allocated among different classes. In developed countries, the manufacturing industry witnessed a loss of jobs due to industrial migration driven by globalization and technology disruption and the middle class is shrinking. According to a report released by the US-based Pew Research Center in 2015, the total income of middle-income households accounted for 43% of national income in 2014, down from 62% in 1970, while the ratio of total income of high-income households rose to 49% at the same period²⁰. Meanwhile, we see a decline of the middle class in most developed countries in Europe and America²¹.

Moreover, immigrants and refugees contributed partially to growing division and opposition in some countries. With all these combined, populist leaders or political parties came to power or generated greater political influence, leading to the return of unilateralism and protectionism around the world. As such, tough challenges faced by economic globalization are lying ahead and the world is seeing a faster pace toward a new era of globalization.

Amid growing populism, scale and cost advantages of the manufacturing sector in developing countries are eroded by the evolution and application of AI, robotics and other technologies. As a result, manufacturers may bring production back to developed countries or moved production to major markets such as China to be closer to consumers. A global market will replace international trade and characterize the future of globalization. In the era of Globalization 4.0, readjustment and restructuring of global industries and value chains are likely to hit employment and the economic foundation in numerous developing countries, which may lead to a rise in economic and social instability.

In 2018, the total value of China's import and export exceeded US\$4.6 trillion, making China the largest goods trader in the world; foreign trade created 180 million jobs²². In the era of Globalization 4.0, certain industries and domestic employment may suffer in China in the short to medium run, nevertheless, the global structure of trade will be of great significance for China's development in the long run.

Aging population

Quite a few countries face challenges on how to manage the aging population, especially in China. At the end of 2018, people aged 60 and above accounted for 17.9% of total population in mainland China, exceeding those under 15 for the first time²³. According to National Health Commission, elderly people are expected to hit 487 million around 2050, representing 34.9% of China's total population²⁴.

Aging population leads to declining labor forces and growing health care and pension burdens. According to the National Bureau of Statistics, in 2012-2018, China's working-age population reported negative growth in both number and proportion for seven consecutive years with a total reduction of 26 million. Moreover, the China Institute for Employment Research at Renmin University expects that China's working-age population will drop sharply after 2030, with an annual decrease of 7.6 million²⁵. According to an estimate by China's Ministry of Human Resources and Social Security in 2016, China's working-age population is expected to drop to 700 million in 2050 from 830 million in 2030²⁶.

19. The World Bank

20. *The American Middle Class Is Losing Ground*, Pew Research Center.

21. *Middle Class Fortunes in Western Europe*, Pew Research Center.

22. <http://www.xinhuanet.com/politics/70zn/fbh7/index.htm>

23. http://www.xinhuanet.com/politics/2019-01/21/c_1210043265.htm

24. http://www.xinhuanet.com/health/2018-07/20/c_1123151851.htm

25. <http://www.nbd.com.cn/articles/2016-11-21/1054573.html>

26. <http://finance.sina.com.cn/money/forex/datafx/2016-07-22/doc-ifyuhukz0781328.shtml>

“Getting old before getting rich” is regarded as one of the most important features of the aging population phenomenon in China. Coping with health care and pension challenges when demographic dividend is disappearing and whether productivity can be improved by advanced technologies add an extra layer of uncertainty to China’s future growth.

Grasp three key opportunities for China’s development

The above three variables constitute a great part of China’s internal and external development environment and direction in the future. The following three key opportunities will be vital to the development direction of China’s future-oriented economic system.

New urbanization

According to the National Bureau of Statistics of China, as of the end of 2018, the urbanization rate of China’s permanent population reached 59.58%, an increase of 48.94% from the end of 1949, an average annual increase of 0.71%²⁷, but there is still a big gap compared with the average urbanization level of 80% in developed countries²⁸. According to the calculation of 80% urbanization rate, China will still have more than 200 million people entering the city to work, live and purchase properties in the future, which makes it a huge market.

Most of China’s wealth is created in cities, and cities have also driven the development of the surrounding areas. The 19th National Congress of the Communist Party of China proposed to build an urban structure in which large, medium and small cities and small towns coordinate development with urban agglomerations, and to establish a more effective new mechanism for regional coordinated development. In 2019, China successively issued “The Development Plan for Guangdong-Hong Kong-Macao Greater Bay Area” and “The Development Plan for Yangtze River Delta Regional Integration” and other regional development guidance documents to guide the coordinated development of regional industries, and the construction of systems and infrastructure. In February 2019, the National Development and Reform Commission of China issued the “Guiding Opinions on Modern Metropolitan Areas Development”, which required the relaxing of urban settlement restrictions excluding some megacities, and proposed to basically eliminate the administrative barriers and systems that hinder the free flow of production factors by 2022, with several modern metropolitan areas to be established gradually. It also required the pattern of the modern metropolitan areas to become more mature in 2035, forming a number of metropolitan areas with global influence.

There are also some problems that cannot be ignored in China’s urbanization process, including population load, aging, traffic congestion, air pollution and inadequate public services. Taking Shenzhen as an example, the resident population of Shenzhen at the end of 2018 reached 13,026,600, an increase of 498,300 from the end of 2017²⁹. However, as for the corresponding urban space, the per capita construction land area of Shenzhen in 2016 was 83.8 square meters, only about half of that of Beijing. Public services in Shenzhen continued to be short. In 2018, the shortage of public school places exceeded 50,000. The number of hospitals in Shenzhen at all levels accounted only for 134, which was 19.1% of that in Beijing, 38.4% in Shanghai and 58.5% in Guangzhou, respectively. The shortage in refuse processing capacity is another issue in public service. In 2018, the average production of kitchen waste per day in Shenzhen in 2018 was 1,800 tons, but the actual processing capacity was only 830 tons, with nearly 1,000 tons of kitchen waste being incinerated and transferred³⁰.

Solving the above problems is crucial in achieving sustainable urbanization and development, and it will also create huge technical space and massive commercial value.

27. http://www.gov.cn/shuju/2019-08/16/content_5421576.htm

28. https://finance.ifeng.com/a/20171013/15721240_0.shtml

29. <http://www.tjcn.org/tjgb/19gd/35973.html>

30. <https://news.sina.com.cn/o/2018-04-23/doc-ifzqvvrz7146346.shtml>



Clean energy and new materials. Global warming has caused a series of meteorological disasters such as rising sea levels, which seriously threaten fragile urban environments and ecosystems. According to statistics, although sea level rise only directly threatens 2% of the global land areas, these areas are home to 13% of the world's urban population³¹. In China, water logging problems also plague many cities. To solve these problems, we need to plan urban areas with fresh perspectives, utilize more clean energy and new materials, improve energy efficiency, and reduce damages to the local environment, geology and ecosystem caused by urban construction. For example, the construction of "sponge cities" implemented in many places in China has reduced the number of water logging disasters in cities through new water-permeable materials and pipe network reconstruction.



Intelligent transportation and infrastructure. Smarter transportation systems and urban infrastructure provide new ideas for solving problems such as urban congestion and air pollution. At present, shared travel services have increased the frequency of vehicle use and urban traffic efficiency to a certain extent, but if unmanned driving becomes a reality, it will completely disrupt the existing transportation system. By building smarter urban management and road systems, unmanned driving can achieve 24/7 transportation with fewer cars, greatly improving traffic efficiency, urban space and environmental governance.



Health care. Driven by data and algorithms, future health care services will be more personalized, prevention, prediction and patient-oriented. AI and gene editing technology will disrupt the existing pharmaceutical research and development model and accelerate the clinical application of new drugs and new therapies. Robotics, unmanned driving and other technologies will greatly facilitate the care of the elderly and improve their quality of life. In the future, the medical service systems will be platform-based, linking government, public service sectors, commercial sectors and patients. Massive health care data will be shared on platforms safely and in real time, promoting continuous breakthroughs in health care services.



Education and training. The concentration of population in cities means greater demands for quality educational resources. Meanwhile, technology and labor market trends will also place new demands on the education system, and upskilling will replace knowledge transfer as the main purpose of education. Driven by the concept of technology empowerment and lifelong learning, the education and training industry will have more new "opportunity windows". Cities with more people and technology-oriented education and training systems will become the source of innovation for a future society.

Energized innovation ecosystem

According to the data released jointly by the National Bureau of Statistics, the Ministry of Science and Technology and the Ministry of Finance, the investment in research and experimental development in China in 2018 was RMB1,967.79 billion, ranking second in the world; the intensity of R&D expenditure (the ratio of R&D expenditure to GDP) was 2.19%, an increase of 0.04% compared with the previous year, a record high³². In 2018, 438 companies in China entered the World Top 2,500 R&D investors, ranking third in the world³³.

China's innovation ecosystem continues to be dynamic and matures gradually. China is one of the most active countries of venture capital activities in the world, accounting for nearly a quarter of the total global venture capital investment in the past three years. As of the end of May 2019, China had 7,055 registered venture capital funds, with the scale exceeding that of the US, reaching RMB1.01 trillion³⁴. In December 2018, the State Council executive meeting decided to implement income tax incentives to promote the development of venture capital, and provide more flexible options for the tax treatment of venture capital fund individual partners to obtain benefits from venture capital funds, which is conducive to further developing the venture capital market in a low tax environment.

31. *2018 and Future Trends: The Opportunities of Disruptions*, EY.

32. *Statistical Communiqué of National Science and Technology Funds Investment, 2018*.

33. http://www.gov.cn/xinwen/2019-09/14/content_5429797.htm

34. *Global Venture Capital Yearly White Paper, 2019*

In July 2019, the science and technology innovation board was launched. It is positioned to be at the forefront of world science and technology, mainly serving science and technology innovation enterprises that conform to national strategies, have core technology breakthroughs, and have high market recognition. It focuses on supporting high-tech industries and strategic emerging industries such as next-generation information technology, high-end equipment, new materials, new energy, energy conservation and environmental protection, and biomedicine. The establishment of the science and technology innovation board is conducive to broadening financing channels for science and technology enterprises and obtaining more forms of financial support.

In terms of ecological distribution of innovation, due to the improvement of regional economic development in various regions and the high operating and living costs in the four first-tier cities of Beijing, Shanghai, Shenzhen and Guangzhou, more innovative capital and talent have flooded into second-tier cities. Many local governments such as Chengdu, Hangzhou and Xi'an have successively issued a series of industrial support and talent introduction policies to promote the development of local innovative industries. Taking Chengdu as an example, the digital economy such as the internet and big data in Chengdu has developed rapidly in recent years. The Chengdu government has successively introduced a number of industrial plans to support the development of mobile internet, big data and AI. In 2018, Chengdu's major internet companies realized operating income of RMB43.74 billion (excluding e-commerce transaction volume and basic telecom business income), a year-on-year increase of 32.0%. Among them, Chengdu's game enterprises ranked first nationally in terms of growth rate and R&D ratio, realizing RMB20.73 billion revenue³⁵.

Personalized consumption era

Consumers nowadays are increasingly pursuing unique and superior product and services experience. In the era of personalized consumption, technologies and devices such as AI, human-computer interaction and ubiquitous wearables will give consumers huge say. In terms of work, entertainment, catering, shopping, education and health, channels for consumers to acquire personalized and rich experience will be mounting.

With advanced technologies, consumer preferences will be recorded, their needs better analyzed, and AI will increasingly make decisions for consumers and complete purchases. Voice recognition will become the main form of human-computer interaction in the future. The Internet of Things, computing and data analysis will seamlessly integrate consumers' daily life, and the cost of obtaining products and services will be greatly reduced.

In the era of personalized consumption, consumer profiling become more accurate, and the provision and acquisition of products and services become more intelligent and automated. Companies need to create richer and deeper emotional interactions with consumers so that their products and services are more personalized to consumer needs. To meet all these, companies need to have the ability to deliver quality services across multiple platforms and channels, and online and offline, which also means they must focus on acquiring, analyzing, and understanding existing and potential customers' data with the right technology portfolio investment. By combining technology and data, companies need to redesign business processes and operations to understand the consumer's brand experience.

Governments and policy makers need to understand that the attitudes and tolerance toward privacy and personal data exchange may vary among generations. At the same time, it should be noted that the adoption of technology-driven personalized consumption is different in different regions and groups. It is more urgent to make proper arrangement in a personalized consumption era to prevent inequality rooted in wealth, infrastructure access and education gaps.

China is about to become the world's largest consumer market with consumption being the main driver of the its economy. In the first half of 2019, domestic consumption expenditure contributed 60.1% to China's economic growth³⁶. The era of personalized consumption will further unleash China's consumption potential, which will not only drive the development of manufacturing, retail, logistics, education, health, entertainment and other industries, but also lead to great economic and commercial value created by the continuous investment in digital infrastructure and information technology by governments and enterprises.

35. *Report on the Development of Internet in Chengdu, 2018*

36. http://www.ce.cn/xwzx/gnsz/gdxw/201907/15/t20190715_32617858.shtml

Adaptive regulation drives the construction of a future-oriented economy

Disruptive technologies and new business models have an impact on the relevant regulatory systems in many ways. As one of the most active innovation markets in the world, China faces particular challenges in this regard. It is vital to consider how to implement reasonable and appropriate regulation without damaging the innovation power and market vitality, taking into account the interests of various market entities, especially the interests of consumers, laborers and SMEs, promoting high-quality development for China in the future and building a future-oriented economy.

The current regulatory challenges are that technology and business innovation either runs ahead of regulation and public awareness or is beyond the scope of existing legislation and regulatory procedures cannot adapt to the rapid evolution of technology and business. In the case of unmanned driving, updated regulation not only needs to ensure road safety of the driverless technology, but also redefines the vehicle's driving rights and obligations. In addition, new road infrastructure standards are needed, as well as clear stipulation on the definition and handling of traffic data.

Given the above challenges, merely adjusting legislation and regulation responding to innovative technologies and market changes is simply not enough. It is more important to establish a modern technology-driven adaptive regulatory system that uses big data and algorithms to plan and monitor complex problems under uncertain conditions, enabling dynamic management. Taking anti-money laundering as an example, adaptive regulation changes the traditional model of "following supervision in advance and investigating and punishing afterward", emphasizes the elimination of data silos, connects "structured data" and "unstructured data", accurately analyzes user behavior and improves risk models, thereby effectively identifying suspicious transactions.

Three main characteristics of adaptive regulation:

- 1 Open.** Public data should be made available to society and improves data transparency and reliability. Third parties are encouraged to use public data to develop products that complement government services. For example, China vigorously promotes the construction of inclusive financial systems through opening up the data of small and medium-sized enterprises and farmers to financial platforms so as to improve credit files, simplify and accelerate credit granting.
- 2 Real-time.** Technology-driven regulatory reporting and compliance have become a reality in financial sector. With data being opened up and shared in a larger scale, technologies such as AI will reduce compliance costs in more areas and promote real-time pre-regulation.
- 3 Dynamic.** The ultimate goal of adaptive regulation is to make predictions on markets and industries through data analysis and identify the mismatch between the existing regulatory system and market development for future planning. Recently, the People's Bank of China revealed that it would conduct pilot projects in financial technology application, known as the "China Regulatory Sandboxes", with relevant ministries and commissions in 10 provinces and cities including Beijing, Shanghai and Guangzhou. This will help establish a suitable regulatory environment for the development of innovative products and achieve a win-win situation for risk management and market vitality.

Adaptive regulation is a fundamental change to the previous linear regulatory system that will be replaced by a diverse one. Adaptive regulation requires close coordination between public and private sectors to improve regulatory efficiency, reduce compliance costs, and increase economic efficiency. At the same time, innovative technologies play an important role in promoting adaptive regulatory processes which are more realistic to the market and technology, contribute to bridging gaps among regulators and market entities, and therefore help promote healthier and sustainable industrial ecology.

China will build a moderately prosperous society in an all-round way in 2020 and has set its development goals for the next 15 years. Implementing adaptive regulation in more industries and sectors will consolidate China's leading position in areas such as AI and big data, help the country seize more opportunities for disruptive technologies, and realize forward-looking layout of cutting-edge technology to promote high-quality development and accelerate the construction of a future-oriented economy.



Conclusion



Amid rising external uncertainties, China's large domestic market underpins sustained growth. As the country continues to promote structural adjustment and financial reform, increase domestic demand and create a new landscape for opening up, a strong domestic market will bolster China's economic growth and create great opportunities for other countries and foreign companies.

China is entering a crucial stage of continued reform and development. As such, decision-makers need to thoroughly consider economic, social and technological trends for the years ahead. In addition, they need to formulate industrial development plans, continue the development of the regulatory regimes, cultivate and retain talent, support innovation with more inclusiveness and high transparency, and manage risks and uncertainties.

Meanwhile, companies need to gain deeper understanding of China's economic and social structure and opportunities in future, enhance communication with decision-makers on industrial planning and regulations. In addition, companies need to expedite adoption of new technologies and foster value-added products and services that increase customers' confidence and tap into their potential needs.

Deepening reform, expanding opening up and building a future-oriented economic system will mark the start of a new journey of China in the new era.



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