Business Review of Premier Li Keqiang's Government Work Report

March 2017

The annual Government Work Report, delivered by Chinese premier Li Keqiang at the Fifth Session of the 12th National People's Congress on 5th March, 2017, sent out many important messages. Besides reviewing the achievements of 2016 and rolling out the government's goals and priorities for 2017, the Report discusses major investment opportunities that foreign companies should be mindful of and the kind of business environment they will operate in, in the coming year.

Premier Li announced a wide array of policy goals, ranging from economic opening to reform measures, creating over 11 million new urban jobs, keeping CPI at around 3% to seeking a steady rise in import and export volumes and reducing at least 3.4% in energy consumption per unit of GDP.

Noticeably, GDP growth rate for the coming year has been set at "around 6.5%, or higher if possible in practice," relative to the range of 6.5-7% for 2016. The targeted GDP growth rate is lower than the actual GDP growth of 6.7% in 2016. This is a realistic goal, given the uncertainties at home and abroad, along with the squeezing effect of the supply-side structural reforms which will be accelerated this year.

In order to pave the way and create an amicable climate for the all-important 19th National Congress of the Communist Party of China to be held in autumn this year, the government has adopted "seeking progress while maintaining stability" as the core theme for 2017. Focused on improving quality and effectiveness of growth, the government has set the goals of "stabilising growth, deepening reform, making structural adjustments, improving living standards and guarding against risks."

Investment leading the way

Fixed asset investment will remain a key driver of China's economic growth, though there is an emphasis on "effective investment" for 2017. The government will invest 800 billion yuan in railway construction and 1.8 trillion yuan in highway and waterway projects in 2017. Construction on another 15 major water conservancy projects will begin; and work on major rail transport, civil aviation, and telecommunications infrastructure projects will be speeded up.

The government is expected to continue its massive investment in major state projects in the areas of clean energy, transport, communication, oil and gas, environmental protection, modern logistics, city rail, emerging industries and upgrading of manufacturing, as included in the 13th Five-Year Plan (2016-2020).

Given the lukewarm growth of 3.2% for private investments relative to robust growth of 18.7% for state sector in 2016, Premier Li promised that the government would improve policies and measures to encourage private investment, and continue to promote public-private partnerships (PPPs).

In terms of regional development, the government will continue to pursue its "Three Grand Investment Strategies." These are the Belt and Road Initiative, Beijing-Tianjin-Hebei city cluster, and the Yangtze River Economic Belt, in addition to international industrial capacity cooperation scheme.

Emerging industries and investment hot-spots

China's Development Plan for Strategic Emerging Industries will be implemented fully this year. The government will accelerate the R&D and commercialisation of new materials, artificial intelligence, integrated circuits, bio-pharmacy and 5-G mobile communications.

The government will also step up efforts to implement the *Made in China 2025* initiative, promote application of big data, cloud computing, and the Internet of Things. It will also encourage use of new technologies, new forms of business, and new models to bring about transformation in the production, management, and marketing models of traditional industries. National smart manufacturing demonstration zones and manufacturing innovation centres will be built.

Environmental protection will be another sector of interest to foreign investors. The government has set aggressive targets of cutting sulphur dioxide and nitrogen oxide emissions by 3%, drastically reducing fine particulate matter (PM2.5) density, strengthening the prevention and control of water and soil pollution, and improving control over exhaust emitted by motor vehicles.

State-owned enterprise (SOE) reform could also provide some new opportunities as the government vows to make substantive progress this year on joint ownership in industries such as electricity, petroleum, natural gas, railways, civil aviation, telecommunications, and defence. Further, the government plans to advance structural reform in the power, and oil and gas sectors to open their competitive operations to the private sector.

As the standards of living improve, people's demand for high-quality services has soared. Premier Li pledged to step up efforts to ensure people's access to equitable and quality education, make progress in building a healthy China, develop new types of think tanks with distinctive Chinese features, work to develop cultural industries and launch extensive 'Fitness-for-All' initiatives so that more people can enjoy sports and stay fit and healthy. This will create enormous business opportunities in areas such as education, elderly care, healthcare, tourism, e-commerce and creative services for foreign companies.

Pro-business reform actions

A prominent feature of this year's action plan is the government's renewed commitment to deepening structural reform to create a business-friendly environment.

Specifically, the government pledges to streamline administration, delegate more powers, and improve regulation and services to enable the market to play the decisive role in resource allocation. It will also expand the piloting of granting market access to foreign companies on the basis of a negative list[1], and reduce the discretionary powers of the government while giving the market more freedom to take its course.

To improve private investors' confidence in China's judicial system, the government has vowed to improve the property rights and protection system for the rights of economic entities under all forms of ownership and the property rights of citizens. In addition to addressing infringement on the property rights of businesses, the government will provide equal rights and opportunities and fair rules for all market entities. All industries and sectors, for which entry is not explicitly prohibited by laws or regulations, "will be open to all types of market entities," in Premier Li's words.

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[1] The negative list refers to sectors and businesses that are off-limits to foreign investment, and is an extension to the existing investment-approval method of specifying categories that are "encouraged", "prohibited" or "restricted". The negative list method was first adopted in the China (Shanghai) Pilot Free Trade Zone after it opened in 2013. The term negative list first emerged during international investment treaty negotiations, and is now common practice globally, with many countries outlining sectors that are key to national security or sensitive to increased foreign competition.

Source: http://usa.chinadaily.com.cn/epaper/2015-11/03/content_22359380.htm

More importantly, following the set of new measures on attracting foreign investment released in January 2017, Premier Li offered further commitments to foreign investors. These include revisiting the catalogue of industries open to foreign-invested firms (FIEs) and making service sector industries, manufacturing, and mining more open to FIEs; encouraging FIEs to be listed and issue bonds in China; treating FIEs the same as domestic firms on applications, standards-setting and government procurement; and allowing FIEs to enjoy the same preferential policies under the *Made in China 2025* initiative.

As part of the supply-side structural reform efforts to cut cost for business, the government has promised to overhaul government-managed funds, abolish municipal public utility surcharges and 35 administrative charges, reduce government imposed transaction costs and lower energy and logistics costs. In addition, the government will also investigate and punish the production and sale of counterfeit and substandard goods, false advertising, and price fraud to better protect consumer rights.

It needs to be noted that all these liberal measures are set against the background of dwindling foreign investment in China in recent years, particularly in manufacturing. With rising cost of production and depreciating RMB, more Chinese companies are relocating to lower cost neighbouring countries and even to America. Bold tax cut plans by the US and the UK for strengthening their competitiveness will only encourage this trend. They also resonate with the calls of President Xi Jinping at the World Economic Forum in Davos in January 2017 to oppose protectionism and promote further globalisation and opening-up.

Another real estate boom?

China's real estate sector experienced a surprisingly high growth in 2016. Sales of commercial properties rose 22.4% year-on-year, and real estate investment jumped by 6.9% over the previous year to RMB 10.3 trillion, which is 17% of total fixed investment. However, due to the rapid rise of property prices in many cities, the governments at different levels have recently laid new regulations to restrict further investment and "speculative" purchases by residents and investors. Credits for speculative house purchasing will be prohibited, as "houses are built to be inhabited, not for speculation," in President Xi's words.

In 2017, the government will establish not only a robust long-term mechanism for promoting steady and sound development of the real estate sector, with multiple levels of demand being met primarily by the market, they will also provide basic housing support. Cities that are under big pressure from rising housing prices need to increase appropriate supply of land for residential use.

Thus, the housing boom of 2016 is unlikely to continue in 2017.

RMB exchange rate and bad debt

The RMB has been under great pressure for devaluation recently as the interest rate of the US dollar has gone up and the M2 money supply is projected to grow by another 12% this year. It reached a record 155 trillion yuan by the end of 2016, making China's stock of currency in circulation equivalent to that of the US, the EU and Japan combined.

Given the changed situation, it is interesting to note that in the Government Work Report, Premier Li used a new expression of "maintaining the currency's stable position in the global monetary system." This indicates that the government is more tolerant in accepting a weaker yuan this year.

Preventing systemic financial risk is one of the key priorities for 2017. China's five biggest banks reported a combined loss of 274 billion yuan (around US$40 billion) from writing off bad debts for the first nine months of 2016. At the end of September 2016, the average ratio of non-performing loans (NPL) had risen to 1.72% from 1.69% at the end of June 2016, according to China's Banking Regulatory Commission. The real NPL rate, however, could be a few times higher, according to international rating agencies.

To address this rising concern, Premier Li pledged to reform the financial regulatory system and work systematically to defuse major potential risks. He insisted that the fundamentals of the Chinese economy have remained sound, with high capital adequacy ratio and provision coverage of commercial banks. And the government has many financial tools and instruments that can be used to fight off financial risks.

This is largely true, as most of China's debts are domestic in nature, with limited international debt (which is below the threshold of safety). The government still has the power and will to keep things at bay. Finally, the Chinese economy will continue to grow, albeit at a slower rate. So many NPLs could be diluted and resolved along with economic expansions.

Besides, Chinese banks have already taken various steps to mitigate the NPL risks. These include exploring new market-oriented and innovative methods such as transfer of bad assets, securitisation of bad assets, debt-equity swap, and credit default swap (CDS). Some banks are taking pre-emptive actions to raise capital from the market while pricing remains favourable in order to prepare for higher loan impairments. Given the factors above, a financial crisis is unlikely.

Conclusion

Maintaining stable and sound economic development as well as social harmony and stability are the key objectives for 2017, as the country gears up for the 19th Party Congress where the top leadership team will be significantly reshuffled. The government has demonstrated its commitment to deepening reform and opening-up, and set difficult tasks for itself.

Foreign companies are poised to benefit from the new round of trade and investment liberalisation, while contributing to China's economic advancement. If these liberal policies could be successfully implemented, it will be a win-win situation for both sides.

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