



Forecast 2008

## Foreign Investment in China

### Summary

- Overall foreign direct investment (FDI) inflows to China rose by nearly 13.8 percent in 2007 over 2006, according to PRC sources, with investment growing strongly in both financial and non-financial sectors.
- Estimates for China's inbound FDI in 2008 vary, but most predict moderate growth in the 4 to 6 percent range, largely due to new tax laws and industrial policies designed to discourage export-oriented investment.
- Hong Kong remained China's largest source of inbound FDI, with 37.1 percent of the total. The United States slipped slightly to become China's sixth-largest source of FDI, with \$2.6 billion.
- Though 2007 statistics for China's outbound FDI were not yet available, strong growth is expected in 2008 following 21.2 percent growth over the first half of 2007 and 73 percent growth in 2006.
- Key issues for foreign investors in China to watch in 2008 include protection of certain industries or companies, political reshuffling, and the implementation of new tax, labor, and competition-related regulations passed in 2007.
- China has FDI opportunities in a variety of sectors, including services.

### 2007: Year in Review

China remained one of the world's premier destinations for foreign direct investment (FDI) in 2007. Statistics from the PRC Ministry of Commerce (MOFCOM) show that overall FDI surged in 2007, rising by 13.8 percent (based on revised 2006 figures). According to MOFCOM statistics from November 2007, foreign-invested enterprises (FIEs) played a major role in China's economy, accounting for nearly 58 percent of imports and exports. Though statistics vary considerably, the National Bureau of Statistics (NBS) estimates that FIEs employ more than 14 million people, a significant figure even in a populous country like China.

A host of new laws and regulations passed in 2007 will influence FIE operations in China in 2008. Several of these laws—including the Enterprise

Income Tax Law, Antimonopoly Law, and the Labor Contract Law—will bring about major changes to tax rates, employer-employee relations and labor costs, and competitive structures within industries. In addition, 2007 saw the revision of the Catalogue Guiding Foreign Investment in Industry, the chief document determining which areas of the Chinese economy are open to foreign investment. Though the new catalogue contains few major changes to the broad mix of industries that are encouraged and discouraged for FDI, it makes important changes in specific sectors and will affect new foreign investments across a variety of fields.

#### By the numbers

In 2007, China's overall FDI inflows totaled \$82.7 billion, a 13.8 percent increase from 2006 (see Table 1). This marks a reversal from 2006, when China's FDI dropped 8 percent, and can be traced to a number of factors, including an accelerating

appreciation of the renminbi and the continued pull of the growing China market. Some of this surge may also have been due to foreign companies seeking to register their investments before implementation of the new Enterprise Income Tax Law, in order to take advantage of a longer tax adjustment calendar. Non-financial FDI inflows also climbed in 2007, hitting \$74.8 billion and rising 13.6 percent from 2006 (see Table 2). China ranks among the top five destinations for FDI globally.

In 2007, China approved 37,888 new FIEs, down 8.7 percent from the 2006 figure of 41,485. This, along with the increase in the value of the FDI, indicates that, as in past years, the size of new investments is rising. Wholly foreign-owned enterprises (WFOEs) remain the most popular investment vehicle, representing 78 percent of all newly approved investment structures, followed by equity joint ventures (EJVs) and contractual joint ventures (CJVs) (see Table 3).

### Top foreign investors

The primary sources of FDI into China have remained largely consistent over the past few years,

and 2007 was no exception. Hong Kong took the top spot, followed by the British Virgin Islands, South Korea, Japan, and Singapore. Rounding out the top 10 were the United States, the Cayman Islands, Western Samoa, Taiwan, and Mauritius (see Table 4). The only change from previous years was the departure from the top 10 of Germany (whose FDI fell 63.4 percent), and its replacement by Mauritius (whose FDI rose 20.5 percent). The top 10 sources combined account for 87.2 percent of China's total inbound FDI flows.

The continued growth of FDI inflows from Hong Kong and offshore tax havens such as the British Virgin Islands and Mauritius remains a concern for PRC authorities, as officials from MOFCOM, the State Administration of Foreign Exchange, and the State Administration of Taxation (SAT) believe that as much as two-thirds of Chinese FDI could be the result of "round-tripping" – a phenomenon where firms and individuals in the PRC channel funds out of China in order to bring them back as "foreign investment" and take advantage of tax and financial incentives. Sizable investment from tax havens may also be in part

**Table 1: China's Foreign Direct Investment (FDI) Inflows\***

	2006	2007	Year-on-Year Growth (%)
Number of projects	41,485	37,888	-8.69
Utilized FDI (\$ billion)	69.47	82.66	13.8

Note: Growth rates for utilized FDI provided by Ministry of Commerce (MOFCOM), based on updated 2006 statistics not provided with 2007 report.

Source: MOFCOM

**Table 2: Non-Financial FDI Inflows\***

Year	2003	2004	2005	2006	2007
Utilized FDI (\$ billion)	53.51	60.63	60.32	63.02	74.77
Growth (%)	1.46	13.31	-0.50	4.47	13.59

Note: Growth rates for utilized FDI provided by MOFCOM, based on updated 2006 statistics not provided with 2007 report.

Source: MOFCOM

**Table 3: Foreign Direct Investment by Vehicle Type**

	Number of Projects			Utilized FDI Value (\$ billion)		
	2006	2007	% Change	2006	2007	% Change
Total FDI	41,473	37,871	-8.69	65.82	74.77	13.59
EJVs	10,223	7,649	-25.18	14.83	15.60	5.13
CJVs	1,036	641	-38.13	1.99	1.42	-28.77
WFOEs	30,164	29,543	-2.06	48.56	57.26	17.92
Foreign-invested shareholding ventures	50	38	-24.00	0.44	0.49	12.95

\*Note: FDI=foreign direct investment; EJVs=equity joint ventures; CJVs=cooperative joint ventures; WFOEs=wholly foreign-owned enterprises.

Source: PRC National Bureau of Statistics

because of investment from third countries. Some policy moves, including the new Enterprise Income Tax Law (see below) and late 2006 regulations targeting the use of offshore special purpose vehicles, are designed to close these loopholes.

China's top FDI destinations continue to lie along its coast. According to MOFCOM statistics, China's eastern region (Beijing, Fujian, Guangdong, Hainan, Hebei, Jiangsu, Liaoning, Shandong, Shanghai, Tianjin, and Zhejiang) captured 81.9 percent of China's overall inbound FDI in 2006, compared with 5.7 percent for central China and 3.1 percent for western China. By total foreign investment, Jiangsu ranked first with \$3.2 billion, followed by Guangdong (\$3.1 billion), Shanghai (\$2.3 billion), Zhejiang (\$1.3 billion) and Liaoning (\$0.9 billion). By sector, 57.7 percent (\$40.1 billion) of Chinese total net inbound FDI flows poured into manufacturing and 11.9 percent (\$8.2 billion) poured into real estate. Other notable sectors included leasing and business services (\$4.2 billion); transport, storage, and post (\$2.0 billion); and wholesale and retailing (\$1.8 billion).

#### FIEs and profitability

Contrary to perceptions, FIEs in China are demonstrating good financial results. According to the US-China Business Council's (USCBC) 2007 Member Priorities Survey, 83 percent of respondents indicated that their China operations had posted a profit, with roughly two-thirds saying their rate of profitability in China was the same or better than their company's global profit margin rate. Some 85 percent indicated that their China revenues had increased from the previous year. A similar survey conducted by the EU Chamber of Commerce in China showed that 61 percent of

respondents had posted a profit in China in the past year, and that 82 percent of the remaining firms expect to be profitable within three years.

USCBC survey respondents also clearly indicate that they view China as a priority: 84 percent state that China is at or near the top of their companies' overall business priorities. Ninety-six percent stated that accessing or serving the China market was the main reason for investing there, while another 46 percent cited using China as an export platform for other markets in Asia or elsewhere as a secondary reason. Only 28 percent answered that they invested in China to serve as an export platform back to the United States.

#### New rules on foreign investment

The PRC government released several key laws and regulations over the course of 2007 that affect foreign investment in China. Many of these new regulations, some of which were in the works for a number of years, took effect either late in 2007 or early in 2008, meaning that FIEs face an adjustment period this year.

- Enterprise Income Tax Law** The Enterprise Income Tax Law, which took effect January 1, 2008, unifies the corporate income tax rate for FIEs and domestic firms at 25 percent. Prior to the new law, the effective income tax rate for FIEs was 11 percent, while domestic firms faced an effective rate of 23 percent. Although the new law and subsequent circulars addressed many outstanding issues, including tax breaks for companies with high- and new-tech status, deductions, corporate restructuring, and transitional tax rates, FIEs remain concerned about the additional tax burden that these changes entail, and should closely monitor

**Table 4: Top 10 Origins of Foreign Direct Investment\***

Country/Region of Origin	Amount Invested 2006 (\$ billion)	Amount Invested 2007 (\$ billion)	Year-on-Year Growth (%)
Hong Kong	21.31	27.70	30.02
British Virgin Islands	11.68	16.55	41.75
South Korea	3.99	3.68	-7.89
Japan	4.76	3.59	-24.59
Singapore	2.46	3.18	29.30
United States	3.00	2.62	-12.79
Cayman Islands	2.13	2.57	20.59
Western Samoa	1.62	2.17	33.96
Taiwan	2.23	1.77	-20.43
Mauritius	1.11	1.33	20.53

\*Note: Does not include financial sector flows  
Source: MOFCOM

## Outbound Foreign Direct Investment

China's outbound FDI received a great deal of attention in 2007 because of the creation of the PRC's sovereign wealth fund, the China Investment Corp. (CIC), and several high-profile investments and acquisitions. In May 2007, CIC announced the purchase of a \$3 billion stake in Blackstone, and in December, purchased a 9.9 percent stake of Morgan Stanley, worth \$5 billion. China's year-end 2007 statistics for outbound FDI have not been released, but MOFCOM statistics released in October 2007 show that outbound non-financial FDI for the first half of 2007 reached \$7.8 billion, up 21.1 percent over the same period in 2006. A report from the Economist Intelligence Unit predicts that China's total outbound FDI (financial and non-financial) will hit \$26 billion in 2007 and \$37 billion in 2008.

Final, full-year statistics from 2006 show that overall outbound FDI (including the financial sector) in that year reached \$21.2 billion, an increase of nearly 73 percent over 2005. Central government sources (presumably state-owned enterprises) provided the majority of China's outbound FDI, providing \$15.2 billion (86 percent), of the net flow of outbound non-financial FDI.

In 2006, China's outbound FDI flowed to more than 172 destinations across the globe. Latin America netted the largest share (\$8.5 billion), followed closely by Asia (\$7.7 billion). By destination, the Cayman Islands and Hong Kong ranked first and second, respectively, together representing 84 percent of all outbound non-financial FDI, underscoring the pattern of round-tripping noted on p.2, in which PRC funds seek to invest in China via these international tax havens to take advantage of incentives offered to FDI.

As in previous years, the top regional sources of China's overseas investment were its coastal and border provinces. The top nine provinces—Guangdong, Shanghai, Heilongjiang, Zhejiang, Shandong, Jiangsu, Liaoning, and Fujian—accounted for 82 percent (\$1.96 billion) of the net flow of outbound non-financial FDI from provinces. By sector, 53.8 percent (\$11.4 billion) of Chinese total net outbound FDI flows poured into services, while mining took 40.3 percent (\$8.5 billion), and manufacturing took 4.3 percent (\$0.9 billion). The financial sector, in particular, received a great deal of China's outbound FDI, with \$3.5 billion. Other notable sectors included leasing and business services (\$4.5 billion), transportation, warehousing and postal service (\$1.4 billion), and wholesale and retailing (\$1.1 billion).

subsequent SAT statements and circulars for further refinements and implementation details.

- **Labor Contract Law (LCL)** The LCL, passed in June 2007, dictates how labor contracts are to be drafted and enforced. The new provisions raise issues regarding hiring, noncompete clauses, part-time employees, layoffs, collective bargaining, labor unions and dispatch agencies, formulation of company policies, termination, and severance. Many FIEs are concerned about the impact of the LCL on labor costs, existing labor contracts, and relations with employees. The Ministry of Labor and Social Security is expected to issue implementing regulations sometime early in 2008. One outstanding issue is collective bargaining, which is mentioned in the LCL. The Shanghai government has issued follow-up regulations on collective bargaining that could serve as a template for future national regulations, though the implementation of these regulations is still in its early stages. FIEs should be mindful that moves

toward allowing collective bargaining are being tested.

- **Antimonopoly Law (AML)** The AML, finally released in June 2007 after a drafting process that lasted more than a decade, sets rules to define monopolies and anti-competitive behavior and procedures for supervision. The law will take effect on August 1 and introduce new guidelines in a number of key areas affecting foreign companies, including definitions and examples of monopolistic practices and administrative monopolies, criteria for market dominance, national security reviews, and filing requirements. A number of areas need clarification, including authority, enforcement, intellectual property (IP) licensing, and a definition of national "economic" security. As with the LCL, China has yet to issue implementing regulations for the AML.

- **Catalogue Guiding Foreign Investment in Industry** The revised catalogue, which took effect

on December 1, 2007, made a number of changes to China's regulation of new foreign investment projects. Released by MOFCOM and NDRC, the revised catalogue continues to categorize industries according to whether foreign investment is encouraged, restricted, or prohibited. Though much of the catalogue remained unchanged, this year's edition places new restrictions on certain sectors, including export-processing industries and heavy or resource-intensive industries, such as chemicals, machinery, and agriculture. At the same time, the catalogue encourages investment in high-end services, high technology and innovative fields, and environmental and energy-saving technologies.

## What to Watch in 2008

### Political reshuffling

The 17th Chinese Communist Party Congress, which took place in October 2007, launched a period of personnel changes at the highest levels of government that will last until the March 2008 meeting of the National People's Congress (NPC) and then filter through to local governments and, to a certain extent, working levels of central government agencies. Though President Hu Jintao and Premier Wen Jiabao will retain their government posts for another five years, other key economic policy leaders will be stepping down or switching positions (see *Chinese Politics*). By the time the dust clears in March, companies should see a new leadership team in place at the State Council and in agencies central to the regulation of foreign investment, such as MOFCOM and NDRC. The composition of this new team could influence the PRC government's attitude towards FDI and its role in the Chinese economy.

### Economic nationalism

China has debated the role of foreign investment in its economy with varying degrees of intensity for many years. A more restrictive view of FDI seems to be gaining traction, a trend that concerned US businesses are watching closely. USCBC members indicated in USCBC's 2007 membership survey that growing signs of protectionism is one of their top 10 concerns.

PRC policy makers continued their push for "indigenous innovation" as seen in major policy documents such as the 11th Five-Year Plan for high-tech industries and MOFCOM's 2007 Guidelines for Attracting Foreign Investment. Both documents emphasize the importance of "quality" foreign

investment and of making the best use of foreign investment to boost domestic innovation.

The Antimonopoly Law also raised worries of protectionism, as it contains provisions that some mergers and acquisitions could be reviewed and halted in the name of national security – echoing earlier PRC government rules calling for review of foreign acquisitions of certain PRC enterprises to judge whether they endanger "national economic security." Statements from some PRC policymakers during the AML drafting process also indicated publicly that FIEs could be targets of AML enforcement efforts. Implementing regulations that would address FIE concerns have yet to be released, though they are expected before the AML takes effect on August 1.

### Food and product safety

Foreign media attention and resulting US and PRC government activity regarding food and product safety has been unprecedented over the past year; this topic will likely remain high on the PRC agenda this year. Foreign companies should expect new regulations and stepped-up supervision and inspection efforts by agencies like the Administration of Quality Supervision, Inspection, and Quarantine (AQSIQ) and the State Food and Drug Administration. The NPC is currently reviewing the final draft of a new Food Safety Law, and AQSIQ pledged in January 2008 to formulate 10,000 national product standards in 2008.

### Sectors of opportunity

Certain sectors seem poised for opportunity under these new guidelines, including services, new- and high-tech industries, energy and the environment, and healthcare.

- **Services** The PRC views services as a key area for development, and is encouraging foreign investment in high-end services. Services currently account for only about 40 percent of China's current GDP, compared with about 80 percent in the United States. In March 2007, the PRC State Council issued a directive that broadly seeks to promote development of the services sector, complete with a services trade target of \$400 billion by 2010 (up from \$157.1 billion in 2005). In addition, MOFCOM has launched a new website and various reports to document the development of the service sector and promote its growth. Of particular interest are new areas like business process outsourcing and logistics.

- **New- and high-technology** As part of China's push for "indigenous innovation," the government has been supporting firms that invest in new- and high-tech areas. The new catalogue extends and expands on the technologies and sectors that are encouraged under the new catalogue. The new Enterprise Income Tax Law also retains certain tax incentives for new and high-tech areas, although implementation of rules for "new and high-tech status" – including provisions for domestic intellectual property ownership included in its definition – remains a concern. The 2008 legislative calendar includes several new laws that relate to innovation and intellectual property, headlined by the Patent Law and Trademark Law.

- **Energy and the environment** China has made clear in statements and reports that energy and environmental matters are a growing concern. The State Council released a national plan for energy development in April 2007 and followed up with a pair of plans in June 2007 on energy efficiency and climate change. The new foreign investment catalogue specifically added a number of new environmental and energy-saving technologies in several industries to the encouraged category, while placing new restrictions on high energy consuming industries. In addition, PRC policymakers have

pledged to tie energy efficiency and environmental protection to a variety of other areas, including job performance reviews for officials and the ability to secure bank loans for enterprises. The NPC and State Council in 2008 may continue work on draft versions of the Circular Economy Law, which calls for greater efficiency in the use of resources, and the Energy Law, which could boost investment in clean energy and renewables.

- **Healthcare** NDRC and the PRC Ministry of Health are preparing new regulations to govern China's healthcare system, after soliciting and receiving nine proposals for the reform of the medical system in 2007. In late 2007, NDRC began discussing a draft plan for healthcare reform that would establish a basic medical and health service system to cover all PRC residents by 2020. Neither details of the plan nor a timeline for passage have been released. NDRC is likely to continue discussing this plan through the first part of 2008, and other government officials have indicated that China is committed to a major round of healthcare reform in the near future. This reform could have major implications for foreign investment in the healthcare service, pharmaceutical, and medical device sectors.