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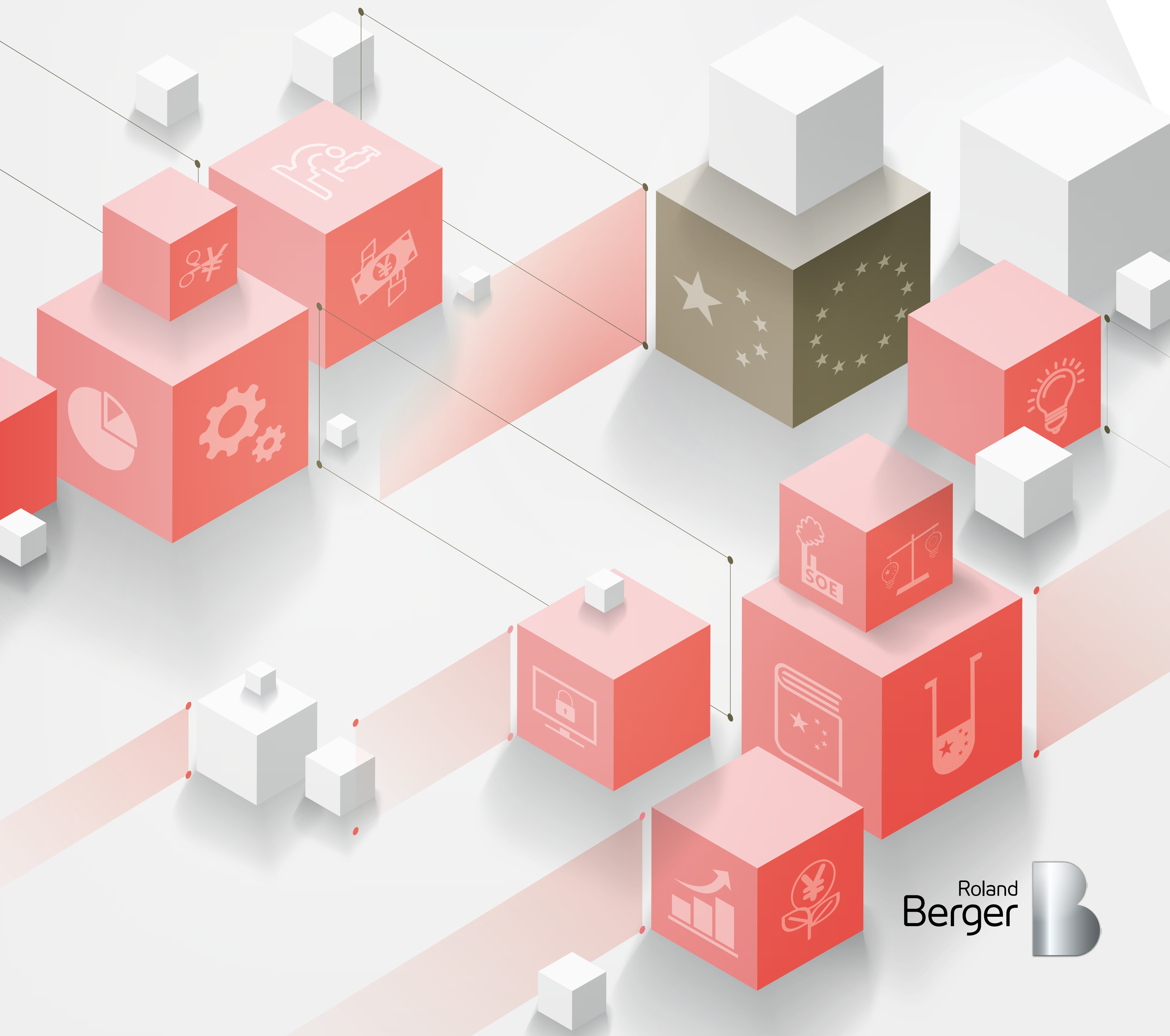
European Business in China

Business Confidence Survey 2019



Roland Berger

European Union Chamber of Commerce in China

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TABLE OF CONTENTS

TABLE OF FIGURES

EXECUTIVE SUMMARY

China's significant market opening announcements made in 2018 were received with mixed feelings by the European business community. Despite bringing some improvements, positive impacts have been diluted by stagnation, or even backsliding, in other areas. Scepticism remains as to whether reform promises will become a reality, as there has been a lack of consistency in the signals coming from the Chinese leadership. While European businesses have heard that China's door will continue to open wider and wider, they have also witnessed sustained support for state-owned enterprises, higher incidences of unfair technology transfers and the strengthening of the Communist Party's role in business.

Added to this, pressure caused by macroeconomic challenges—with the global and Chinese economies continuing to slow—coupled with the slow pace of regulatory reform, mean that many European firms are facing increasingly difficult times while tied up in red tape that should have been cut years ago.

Increased market access in their respective industries was reported by 40% of respondents to the *Business Confidence Survey* (BCS) *2019*. This is largely due to the June 2018 revision of the negative list for foreign investment, in which the number of sectors previously restricted or prohibited to foreign investors was reduced, and timelines were published for the gradual lifting of ownership caps in the financial services and automotive sectors.[1] As a result, a quarter of members reported feeling more welcome than when they first entered the Chinese market, citing increased market access as the most significant reason.

This is certainly progress but it is far from universal or complete. While meaningful change was seen in cosmetics, for example, which had the largest share of respondents (82%) report opening up in the past twelve months,[2] other industries reported market closing. It is highly concerning that closing was seen in legal services (23%), and information and communications technology (ICT) (26%), as these industries provide services to companies operating in multiple sectors of the economy, thereby amplifying the negative impacts.

In addition to market opening, the international business community is increasingly focussing its attention on other issues in need of improvement, such as regulation, equal treatment and SOE reform. Nearly half of survey respondents report that they believe regulatory obstacles will continue to increase over the next five years, with the top three being ambiguous rules and regulations (48%), the unpredictable legislative environment (33%) and administrative issues (29%). These challenges translate directly into unnecessary financial costs, with 39% of member companies reporting that regulatory factors had negatively impacted their net profit margins in 2018. Internet restrictions are but one example: they had a negative economic impact on half of respondents, of whom 74% said the cost represented 1% to 5% of their annual revenue.

Unequal treatment is reported by 45% of respondents, with the most frequently cited areas of discrimination being market access (43%), administrative issues (28%) and communication with the government (26%). Chinese firms operating in the EU are afforded equal treatment and have clear mechanisms for seeking recourse under the rule of law if they feel they are discriminated against. As China enters its fifth decade of reform and opening up, it is high time that European companies are afforded reciprocal treatment in this respect.

The shadow of the state-owned economy continues to loom over the Chinese market, with 70% of European enterprises reporting that SOEs are present in their industries and hold advantages in most areas of doing business, including public procurement, the ability to influence policy, and access to financing and licences. Despite official government

1 *Special Administrative Measures on Access to Foreign Investment 2018*, National Development and Reform Commission (NDRC) and Ministry of Commerce (MOFCOM), 28th June 2018, viewed 6th March 2019, <http://www.mofcom.gov.cn/article/b/f/201806/20180602760432.shtml>

2 This was in large part the result of simplified administrative approvals for imported non-special cosmetics, which made it considerably easier for international brands to enter the market: *Notice on the Nationwide Implementation of Notification Management of Imported Non-special Cosmetics*, National Medical Products Administration, 9th November 2018, viewed 25th March 2019, <http://www.nmpa.gov.cn/WS04/CL2193/331915.html>

announcements that competitive neutrality[3] will be implemented,[4] European firms have a mixed outlook: a third believe it will be realised in the next two to five years, while another third expect it will never happen.

The persistence of widespread indirect barriers in the regulatory environment—which affect a third of respondents to the BCS 2019—also serve to highlight the incomplete nature of China's market opening. For example, European companies still face burdensome administrative procedures, regulations are often implemented unevenly throughout China, and those in industries that have been technically 'opened' still face opaque licensing practices and struggle to gain the permission they need to operate.

It is imperative that the Chinese Government focusses on improving market access and its regulatory environment, so as to mitigate the economic factors that are more outside its control. The top three current concerns are the Chinese economic slowdown (13 percentage points higher than 2018), the global economic slowdown and rising labour costs. These have led some members to revise their outlook: only 45% of respondents said they are optimistic about growth in their sector over the next two years, down 17% from 2018.

The US-China trade war emerged as the fourth largest challenge to future business. While it has not yet negatively impacted European companies as much as anticipated, it has clearly taken a heavy toll on business sentiment. When the situation first began to unfold, international expectations were raised that China may be compelled to accelerate systemic reforms to deal with the underlying causes of the dispute. At its root is the 'reform deficit'—the widening gap between the pace of China's reform agenda and the rate at which its economy is growing and maturing—and the lack of reciprocity in its trade and investment relationships. That these have not been satisfactorily dealt with has increased the impatience felt by the international business community.

One of the more significant shortcomings of China's reform agenda is that certain high-level promises to improve its business environment for international companies have failed to translate into concrete action. For example, European firms report that unfair technology transfers have continued to take place, despite official assurances that this practice would be stopped:[5] 20% of BCS respondents said they have felt compelled to transfer technology in order to maintain market access, up from 10% in 2017. This trend is particularly evident in high-value, cutting-edge industries such as chemicals and petroleum (30%), medical devices (28%), pharmaceuticals (27%) and automotive (21%). Worryingly, 63% of respondents that have felt compelled to transfer technology said it happened within the last two years, and a quarter said the transfer was still taking place at the time of the survey period in January 2019.

Yet in spite of these substantial challenges, the Chinese market remains a top-three destination for current and future investment for 62% of respondents, a reminder of just how heavily committed European companies are, and the integral role that China plays in international supply chains. European firms are dedicated to developing in China, with 56% of respondents looking to expand their current operations in 2019. These findings signal that the business community is not inclined towards decoupling between Europe and China.

Members continued to manage macroeconomic challenges and rising costs confidently. While revenue growth in 2018 dropped 7% y-o-y (although it should be noted that 2017 was a record year for many), positive earnings before interest and tax (EBIT) were reported by 75% of respondents, down just two percentage points from 2017, and remaining the second highest level in the last decade.

At the same time, there remains vast untapped potential in the EU-China investment relationship, with 65% of members reporting that they would be likely to increase their investment if they were granted greater access to the Chinese market. Overall EU investment into China was only euro (EUR) 6.1 billion in 2018, a fraction of EU investment in markets such as the US, which reached EUR 149 billion in 2017.[6]

3 Fair competition between SOEs and the private sector, in line with market principles.
4 *China to Further Improve Business Climate Focusing on Weak Links,* State Council, 26th March 2019, viewed 28th March 2019, <http://english.gov.cn/premier/news/2019/03/26/content_281476580878408.htm>
5 *Circular of The State Council on Measures To Actively and Effectively Utilise Foreign Capital To Promote High-Quality Economic Development,* State Council, 15th June 2018, viewed 7th March 2019, <http://baijiahao.baidu.com/s?id=1603332637134972498&wfr=spider&for=pc>
6 *Key Metrics EU-China Investment Relationship,* Delegation of the European Union to China, 2019, viewed 21st March 2019; Hamilton, David and Quinlan, Joseph, *The Transatlantic Economy 2018: Annual Survey of Jobs, Trade and Investment Between the United States and Europe*, Center for Transatlantic Relations at Johns Hopkins University and the American Chamber of Commerce to the European Union, 2017, p. viii, viewed 21st March 2019, <https://transatlanticrelations.org/wp-content/uploads/2018/03/TA2018_FullStudy.pdf>

China's market is also increasingly important for European companies because of the ideas and technology being created in the country. In 2018, a majority of respondents said for the first time that Chinese firms were equally or more innovative than European firms, and in 2019, 62% of respondents report this to be the case. The vast majority (81%) of European enterprises see opportunity in domestic Chinese innovation, likely because they expect to benefit from both better suppliers and stronger competition, which can spur them on to deliver higher quality goods and services at the best possible prices.

China would do well to capitalise on this situation, and foster a more competitive economy. This will necessitate continued market opening in conjunction with complementary reforms to the regulatory environment to eliminate direct and indirect investment barriers, and a commitment to ensure that the rules are properly implemented. By doing so, China can deliver on its promises to create an open, fair and well-regulated economy, thereby increasing foreign investment and achieving its goal of successfully transitioning to an economic model based on sustainable development.

1 EUROPEAN BUSINESS SEES PROGRESS IN CERTAIN AREAS

Over the past 12 months, new opportunities have emerged for European companies operating in China. Some were granted greater access to the Chinese market, with the *Special Administrative Measures on Access to Foreign Investment* (negative list), introduced in June 2018, reducing the number of sectors restricted to foreign investment.

In the financial services sector, foreign ownership caps were raised from 49% to 51%, and will be fully eliminated in 2021.[7] Similarly, in the automotive sector, ownership caps for new energy vehicles (NEVs) were removed, and will also be lifted by 2020 at the latest for commercial vehicles, and by 2022 for passenger cars.[8] Companies in these sectors can now, or in the future, take a controlling stake in joint ventures (JVs) with Chinese partners, or even set up a wholly foreign-owned enterprise (WFOE) for the first time.

For many members of the European business community, however, the opening-up announcements fell short of expectations. Some felt the measures lacked ambition, as a significant 48 sectors remain closed or restricted to foreign investment, with more featuring on the separate negative list for market access. Others believe that because some domestic Chinese companies have been protected from international competition for so long, it will now be difficult to challenge their hold on the market. Many are in agreement that existing indirect barriers undermine the significance of the market opening altogether, such as European banks that have struggled to obtain the regulatory approvals necessary to operate in China.

In 2019, respondents have continued to recognise the progress made in China's research and development (R&D) and innovation environment. For the second year running, a majority of European firms said that Chinese companies are equally or more innovative. Some members with R&D centres in China have also benefitted from high productivity and in some cases lower costs, enabling them to bring better products and services to Chinese consumers and their home markets.

The continued reduction of pollution levels has meant more blue skies across the country, improving the quality of life.

1.1 Market opening: good for some, too late for others

On 28th June 2018, China announced greater market access for international investors with the *Special Administrative Measures on Access to Foreign Investment 2018*, or the new foreign investment negative list.[9] The list reduced the number of sectors restricted or prohibited to foreign investors at the national level from 63 to 48, and put into writing the previous announcements that the banking, automative, agriculture, mining and infrastructure sectors would see investment restrictions relaxed or removed.

At the same time, the authorities updated the foreign investment negative list for free trade zones (FTZs), which reduced the number of special administrative measures from 95 to 45, opening up areas such as agriculture and energy.[10] The relevance of FTZs to European companies remains limited, however, as businesses prefer their operations to be determined by market factors, such as pricing, costs and proximity to suppliers and customers, rather than gaining access to preferential policies restricted to a certain zone.

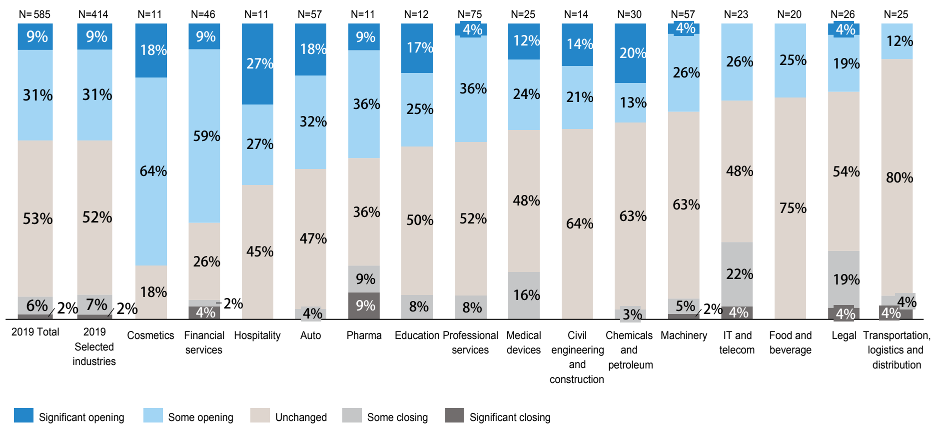
7 *China Further Eases Foreign Investment Curbs, Reuters*, 28th June 2018, viewed 19th March 2019, <https://www.reuters.com/article/us-china-economy-foreign-investment/china-further-eases-foreign-investment-curbs-idUSKBN1JO23M>
8 Ibid.
9 *Special Administrative Measures on Access to Foreign Investment 2018*, NDRC and MOFCOM, 28th June 2018, viewed 6th March 2019, <http://www.mofcom.gov.cn/article/b/f/201806/20180602760432.shtml>
10 *Special Regulations for Free Trade Zone Foreign Investment Access (Negative List) (2018 Version)*, NDRC and MOFCOM, 30th June 2018, viewed 19th March 2019, <http://www.mofcom.gov.cn/article/b/f/201806/20180602760435.shtml>

Members were more interested in the national foreign investment negative list, which wrote market-opening measures into legislation after a long period of waiting for high-level promises to be realised, such as those made at the 19th Party Congress in October 2017[11] and the Boao Forum for Asia in April 2018.

The cosmetics industry saw the highest share of members report market opening in 2018. This was due to simplification of administrative approvals for imported non-special cosmetics. While cosmetics was technically already open to international firms according to the negative list, complicated procedures for importing non-special cosmetics meant that it had taken an especially long time for international brands to get some of their products onto the Chinese market.[12]

Figure 1: Greater market access for cosmetics, financial services and hospitality

Has there been any market opening in your industry in Mainland China for foreign companies (year-on-year)?



11 *Xi Jinping's Report to the 19th National Party Congress, People's Daily*, 28th October 2017, viewed 1st April 2019, <http://cpc.people.com.cn/n1/2017/1028/c64094-29613660.html>

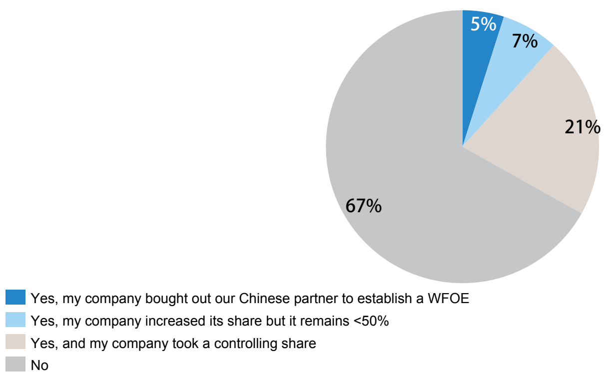
12 *Notice on the Nationwide Implementation of Notification Management of Imported Non-special Cosmetics*, National Medical Products Administration, 9th November 2018, viewed 25th March 2019, <http://www.nmpa.gov.cn/WS04/CL2193/331915.html>

The relaxation or removal of equity caps for foreign investors meant that some European companies with JVs decided to increase their share in the partnership. A notable one fifth of respondents took a controlling share.

Figure 2: Raised equity caps drive some to increase JV shares

In light of market opening announcements and lifting of equity caps in 2018, has your company increased your share in a JV?[1)]

N=163



1) *Only asked if answer to the question 'Does your company have a Joint Venture (JV) with a Chinese company (including SOEs and POEs)?' was 'Yes'*

In 2019, 26% of members said they felt more welcome than when they first entered the Chinese market, an increase of four percentage points year-on-year (y-o-y). When these companies were asked the most significant reasons they felt more welcome, greater market access was the most frequently cited.

Figure 3: European businesses feel more accepted

As a foreign investor in China, do you feel:

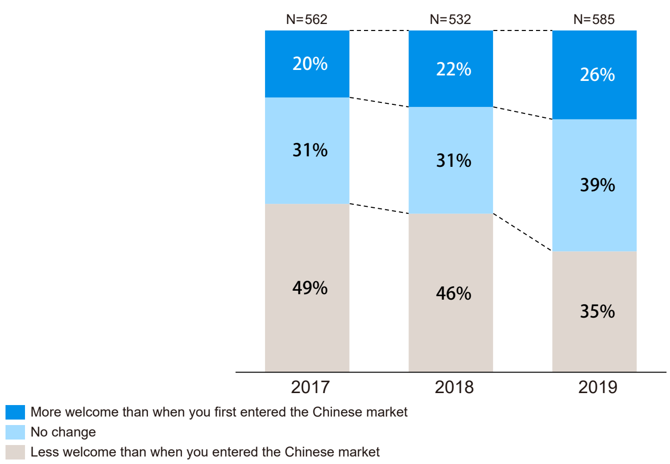
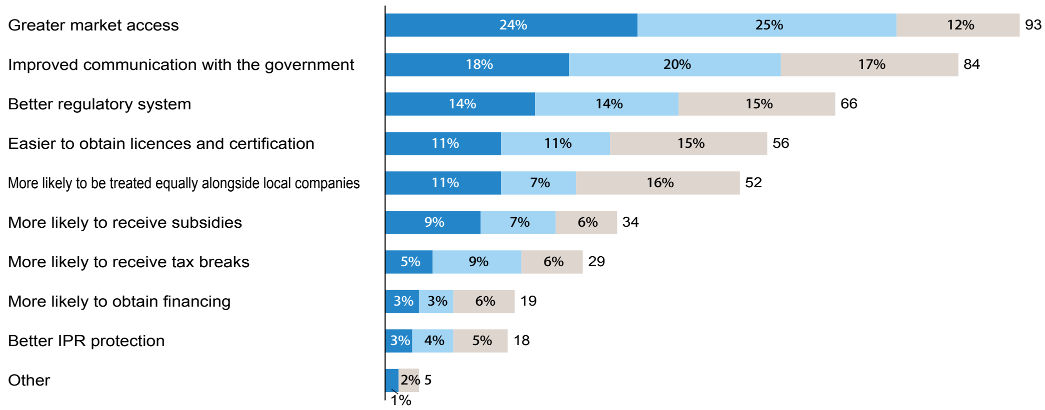


Figure 4: Increased market access provides warmer welcome

What are the most significant reasons that you feel more welcome?1) 2)

N=152



1) Only asked if answer to the question 'As a foreign investor in China, do you feel: a) More welcome than when you first entered the Chinese market, b) Less welcome than when you entered the Chinese market, c) No change' was 'More welcome than when first entered China'

2) Multiple answers possible, percentage calculated on the total number of respondents

It is concerning, however, that only a small proportion (9%) of respondents saw the opening as ‘significant’.

The impact of market opening has been diminished partly because several sectors removed from the negative list for foreign investment remain on the *Negative List for Market Access* (2018 Version). This list defines market access for all businesses, including state-owned enterprises (SOEs), private companies, joint-ownership and foreign firms.[13] What this means in practice is that while certain restrictions were relaxed in the foreign investment negative list—for example in electric grid construction and management—further restrictions in that sector can still be found on the *Negative List for Market Access*, leaving more than just the 48 items on the *Negative List for Foreign Investment* blocked to European businesses.[14]

Beyond the negative lists, European businesses are also often blocked from accessing certain markets by regulatory barriers. For example, looking at foreign construction service providers (CSPs), which include architects, surveyors, project managers and contractors, it is possible to see just how restrictive this is. They are only allowed to take part in four kinds of projects in niche industries.[15] These projects account for a tiny share of the construction industry, reflected by the fact that WFOEs accounted for just 0.05% of the total value of CSP output in China in 2017.[16]

In the banking sector, state-owned banks have been protected from international competition for so long that they already have a well-established foothold, making it difficult for foreign banks to expand their market share of 1.32% (as of late 2017).[17] While it may be difficult for European banks to provide regular services, they do hold a competitive advantage in cross-border services and niche products such as green financing. In these areas, European financial services firms are concerned about the lack of transparency when applying for licences, and the underdeveloped regulatory framework. There

13 *China’s New Negative List Targets Unified Market Access, China Briefing,* 9th January 2019, viewed 19th March 2019, <https://www.china-briefing.com/news/chinas-new-negative-list-targets-unified-market-access/>

14 *Notice on the Release of the ‘Negative List for Market Access (2018 Version), National Development* and Reform Commission (NDRC), 21st December 2018, viewed 19th March 2019, <http://www.ndrc.gov.cn/zcfb/zcfbtz/201812/t20181228_924067.html>

15 *Regulations on the Administration of Foreign-Invested Construction Enterprises*, Ministry of Construction and Ministry of Foreign Economic Relations and Trade, 2002, viewed 8th March 2019, <http://www.mofcom.gov.cn/article/bh/200301/20030100064300.shtml>

16 *Statistical Data for the Total Revenue of Construction Enterprises in 2017 Classified According to Type of Registration*, National Bureau of Statistics, 2017, viewed 26th March 2019, <http://data.stats.gov.cn/easyquery.htm?cn=C01>

17 *China’s Financial Opening Isn’t Quite What it Seems, Bloomberg*, 4th April 2018, viewed 19th March 2019, <https://www.bloomberg.com/opinion/articles/2018-04-03/china-s-financial-opening-isn-t-quite-what-it-seems>; *China: Foreign Banks Fumble over their Expansion Strategies, Euromoney*, 29th June 2018, viewed 26th March 2019, <https://www.euromoney.com/article/b18vjw1pb6dykl/china-foreign-banks-fumble-over-their-expansion-strategies>

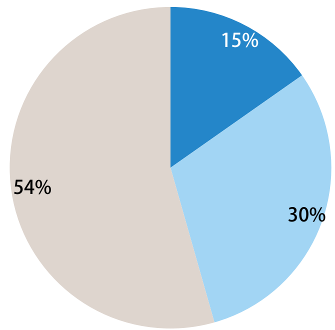
have been several cases where foreign financial services firms' applications to enter the Chinese market have been refused without clear reasons being given, although members report some improvements to the application process in early 2019.

While continued market opening is still a priority for members, the authorities also need to address back-end barriers by: making regulatory approvals predictable; granting international businesses greater access to financing; creating a clear and comprehensive regulatory framework; and delivering a level playing field for all companies.

Figure 5: Doors open for some, but high thresholds await

Does your company face market access restrictions in China?

N=585

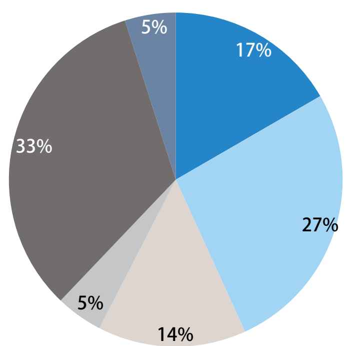


European businesses have a mixed outlook on what the future holds for market access, with around one third of respondents expecting to see meaningful opening in the next two to five years, but another third not expecting to ever see it. With new market opening announcements in the 2019 government work report, the release of the new Foreign Investment Law (FIL), and revisions to the negative list for foreign investment planned before June 2019, next year's results may be more positive if the announcements translate into tangible opportunities.[18]

Figure 6: Mixed outlook on future market opening

When do you expect to see meaningful opening in your industry? 1)

N=264



1) *Answered if answer to previous question, 'Does your company face market access restrictions in China?', was not 'No'*

18 *Government Work Report (Transcript)*, Central People's Government, 5th March 2019, viewed 6th March 2019, <http://www.gov.cn/premier/2019-03/05/content_5370734.htm?mc_cid=7210bcfc5e&mc_eid=d6411c087e>; *Foreign Investment Law*, National People's Congress, 15th March 2019, viewed 19th March 2019, <http://www.npc.gov.cn/npc/xinwen/2019-03/15/content_2083532.htm>; *Li Keqiang: China Will Further Relax Market Access for Foreign Investment*, State Council, 28th March 2019, viewed 28th March 2019, <http://www.gov.cn/guowuyuan/2019-03/28/content_5377696.htm>

1.2 European firms see opportunity in increasingly innovative China

Over the past three years, there has been a significant jump in European companies' perceptions of the innovation ecosystem in China. In 2019, 38% of respondents rate China's innovation and research and development (R&D) environment as more favourable than the worldwide average, compared to just 15% in 2016.

One of the main drivers of Chinese innovation is the significant sums spent on R&D. In 2015, China surpassed the EU for the first time in gross domestic expenditures on R&D, making it the second largest spender after the US.[19] The gap between China and the US is also narrowing: in 2017, China spent a record Chinese yuan (CNY) 1.76 trillion, representing a y-o-y increase of 12.3%, while the US spent CNY 3.6 trillion (United States dollars (USD) 538 billion).[20] If China continues along this trend, it is likely to overtake the US within the next five to 10 years.[21]

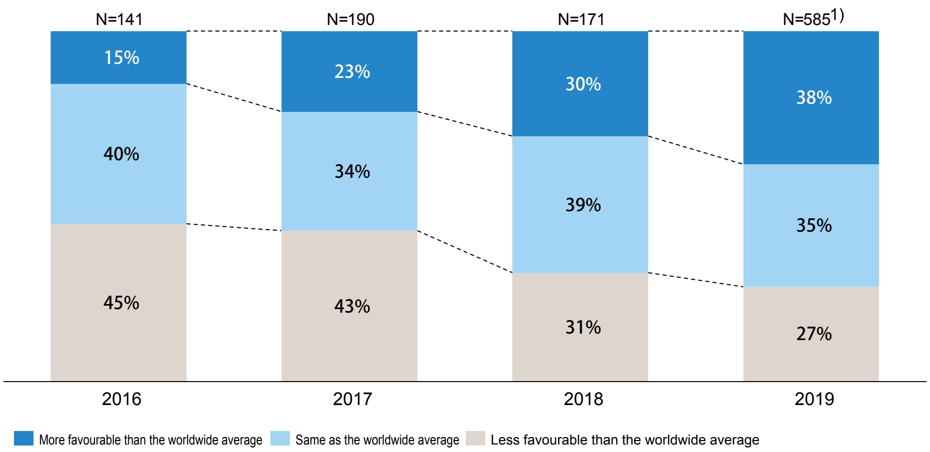
In addition to government incentives, domestic companies have benefitted from the size of the Chinese retail market, which is expected to overtake the US and reach more than CNY 37.6 trillion in 2019.[22] Chinese companies are reaping the rewards of being able to test their products on a large consumer base and scale up quickly.

A larger share of the Chinese population has also been freed up to engage in innovation as the economy becomes more productive, while at the same time more Chinese students are studying abroad, bringing knowledge and skills back to China.[23]

Government incentives, low research costs and R&D teams' productivity are all areas in which European businesses feel China compares favourably to other countries. In other areas, such as Internet access and intellectual property rights (IPR) protection, China still has a long way to go.

Figure 7: China's R&D and innovation ecosystem continues to improve

How do you consider China's innovation and R&D environment compared to the worldwide average?



1) *Up until 2018, this was only asked if the answer to 'Does your company has a R&D centre in Mainland China' was 'Yes', which explains the surge in the number of respondents*

19 Normile, Dennis, *Surging R&D Spending in China Narrows Gap with United States, Sciencemag*, 10th October 2018, viewed 19th March 2019, <https://www.sciencemag.org/news/2018/10/surging-rd-spending-china-narrows-gap-united-states>

20 Radu, Sintia, *The Big Spenders in Research and Development, US News*, 9th November 2018, viewed 19th March 2019, <https://www.usnews.com/news/best-countries/articles/2018-11-09/these-countries-are-the-top-spenders-on-research-and-development>

21 Harris, Briony, *China is an Innovation Superpower. This is Why*, World Economic Forum, 7th February 2018, viewed 19th March 2019, <https://www.weforum.org/agenda/2018/02/these-charts-show-how-china-is-becoming-an-innovation-superpower/>

22 Stern, Neil, *China to Become the World's Largest Retail Market, Even with a Slowdown, Forbes*, 5th February 2019, viewed 26th March 2019, <https://www.forbes.com/sites/neilstern/2019/02/05/china-to-become-the-worlds-largest-retail-market-even-with-a-slowdown/>

23 *Overseas Returnees to China Have Bright Prospects for Employment and Entrepreneurship, Report by Zhaopin and CCG Finds, PR Newswire*, 21st August 2018, viewed 26th March 2019, <https://www.prnewswire.com/news-releases/overseas-returnees-to-china-have-bright-prospects-for-employment-and-entrepreneurship-report-by-zhaopin-and-ccg-finds-300699890.html>

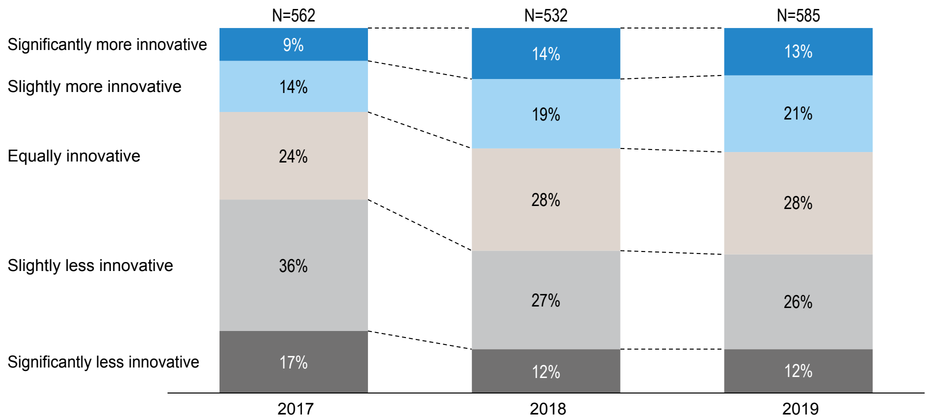
While the government's main goal in R&D is to make science and technology a driver of high-quality, sustainable economic growth, the private sector sees innovation as a means to enhance their competitive advantage, both domestically and in international markets. In 2017, private sector R&D spending, including that of international businesses in China, increased by 12.5% y-o-y to CNY 1.36 trillion.[24]

European firms recognise that Chinese companies are becoming more innovative: 2018 was the first year that a majority of European firms said Chinese firms were equally or more innovative, and in 2019, 62% of respondents continue to see this as being the case.

In the aviation industry, for example, European airlines feel that Chinese online travel agents like Ctrip and Qunar are leading the way in ticket purchasing interfaces and marketing. Ctrip, which is expanding overseas with its international brand trip.com and recently acquired Skyscanner in Europe, was ranked among the top 30 of Forbes' *World's Most Innovative Companies 2018*.[25]

Figure 8: Majority still see Chinese firms as equally or more innovative

Within your industry, how innovative do you feel Chinese firms are compared to European firms?



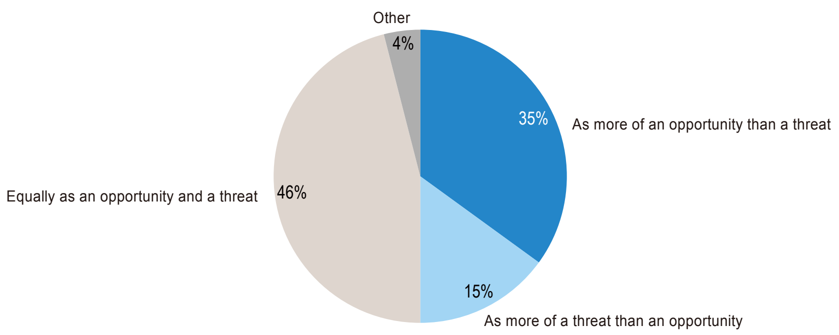
24 *Overseas Returnees to China Have Bright Prospects for Employment and Entrepreneurship, Report by Zhaopin and CCG Finds, PR Newswire*, 21st August 2018, viewed 26th March 2019, <https://www.prnewswire.com/news-releases/overseas-returnees-to-china-have-bright-prospects-for-employment-and-entrepreneurship-report-by-zhaopin-and-ccgfinds-300699890.html>

25 *CEO Interview: Ctrip's Strategic Threat to Expedia, Priceline and Everyone Else, Skift*, 13th March 2017, viewed 19th March 2019, <https://skift.com/2017/03/13/ceo-interview-ctrips-strategic-threat-to-expedia-priceline-and-everyone-else/>; *Ctrip International on the Forbes Growth Champions List, Forbes*, 6th June 2018, viewed 19th March 2019, <https://www.forbes.com/companies/ctrip-international/#6e5ef6c9595d>

Rather than feeling threatened, the majority of European firms see opportunity in China's strength in innovation. European businesses welcome healthy competition, as it spurs them to deliver high quality goods and services to consumers, while maintaining the best possible prices.[26] Another reason is that European businesses are benefitting from having more and more innovative Chinese firms in their supply chains.

Figure 9: European firms react positively to competition

How does your company see domestic Chinese innovation?

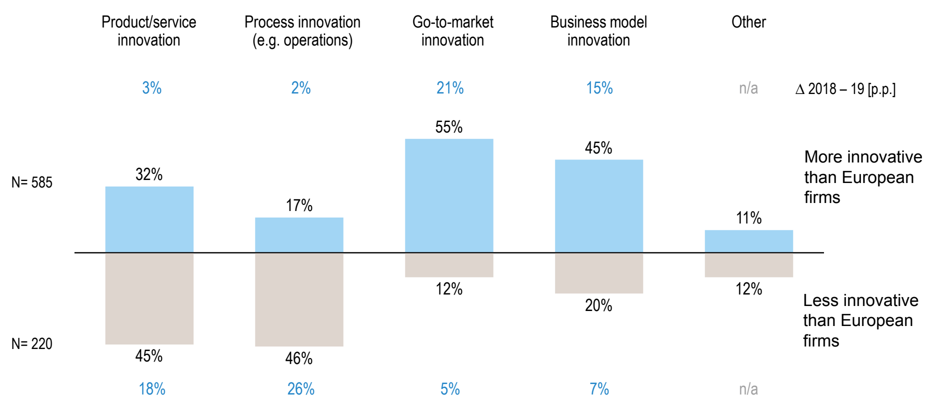


26 *Why is Competition Policy Important for Consumers?*, European Commission, 16th April 2012, viewed 19th March 2019, <http://ec.europa.eu/competition/consumers/why_en.html>

Chinese companies continue to do well in go-to-market and business model innovation, where they have developed new ways to market and operate existing products and services. When it comes to product/service and process innovation, however, European firms still hold the advantage.

Figure 10: European companies maintain edge in key areas

In which areas are Chinese firms more innovative than European firms?1)
In which areas are Chinese firms less innovative than European firms?1)



1) Multiple answers possible; percentage represents the total share of all respondents who agreed with a statement

1.3 Blue skies ahead

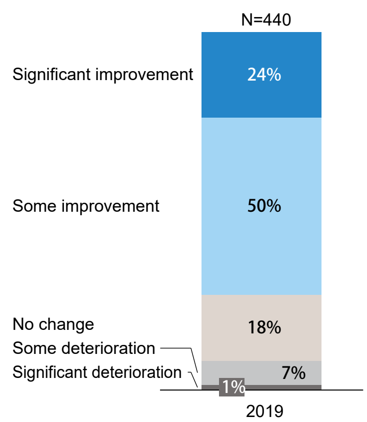
Across the country, members report noticeable improvements in air quality between 2018 and 2019. The reduction in pollution levels can largely be attributed to the State Council's *Air Pollution Action Plan*, released in 2013, which set particulate matter (PM) 2.5 targets for every province.[27] The State Council then released the *2018–2020 Three-year Action Plan for Winning the Blue Sky War* as a follow-up strategy in July 2018.[28] The new plan sets the same PM2.5 target published in 2016 as part of the 13th Five-year Plan for environmental protection, which mandates a reduction by at least 18% in PM2.5 levels on a 2015 baseline in cities of prefectural or higher level, and where standards have not already been met.

The three biggest city clusters (Beijing-Tianjin-Hebei, and the Pearl and Yangtze deltas) all beat their targets in 2018.[29] It is worth noting, however, that no city yet has managed to reach the World Health Organization's recommended annual mean PM2.5 level of 10µg/m³ (milligrams per cubic metre).[30] Furthermore, local governments' implementation of the clean air campaign has sometimes been heavy-handed and erratic, such as its shutting down of some compliant manufacturers without warning in order to meet targets at the last minute, which created uncertainty in the business environment.[31]

27 *Air Pollution Action Plan*, State Council, 10th September 2013, viewed 9th March 2019, <http://www.gov.cn/zwgk/2013-09/12/content_2486773.htm>
28 *2018–2020 Three-year Action Plan for Winning the Blue Sky War*, State Council, 3rd July 2018, viewed 9th March 2019, <http://www.gov.cn/zhengce/content/2018-07/03/content_5303158.htm>
29 *'Airpocalypse' Over? Beijing Breathes Easier as Clean Air Drive Pays Off, US Embassy Smog Readings Suggest, South China Morning Post*, 20th August 2018, viewed 9th March 2019, <https://www.scmp.com/news/china/policies-politics/article/2160444/beijings-clean-air-drive-paying-swift-recovery>
30 *China Releases 2020 Action Plan for Air Pollution, China Dialogue*, 6th July 2018, viewed 9th March 2019, <https://www.chinadialogue.net/article/show/single/en/10711-China-releases-2-2-action-plan-for-air-pollution>
31 *The Power of Central Environmental Protection Inspections: All 31 Provinces Were Covered in Two Years From 2016 to 2017, Xinhua*, 7th November 2017, viewed 19th March 2019, <http://www.xinhuanet.com/2017-11/07/c_1121916536.htm>

Figure 11: Air quality improves across the board

How has the air quality of your region evolved over the last year?[1)]



1) Question only asked to the respondents based in the Beijing, Shanghai, Tianjin, Southwest China and Shenyang chapters

Air quality issues remain European companies' top challenge to attract international talent (see Figure 66), suggesting that it will take longer for international perceptions of China's air quality to catch up with the improvements that have actually taken place on the ground.

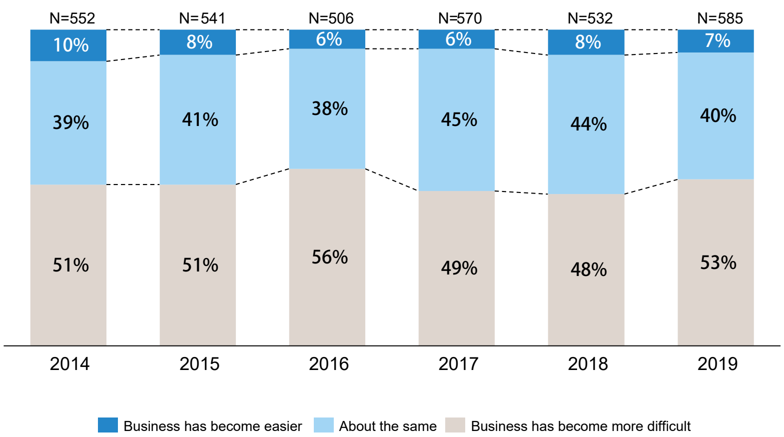
2 BUSINESS OUTLOOK NEGATIVELY IMPACTED AMIDST ECONOMIC SLOWDOWN

2.1 European companies revise outlook

In 2019, over half of respondents report encountering more obstacles to doing business.

Figure 12: Business becomes more difficult for majority of respondents

How has doing business in China for your company developed in the last year?



The economic slowdown is now ranked by 27% of member companies as the top challenge to future business in China, up eight percentage points compared to the previous year. Economic growth has decelerated as the government's campaign to control financial risks by reducing reliance on debt-fuelled stimulus has contributed to a significant tightening of fixed-asset investment.[32] The de-risking campaign has also reduced access to credit for privately-owned companies.

Businesses are concerned that this potential long-term slowdown in growth will negatively impact revenues, making it increasingly difficult for them to improve their bottom lines, access financing and manage costs.

The slowdown was somewhat mitigated in the last quarter of 2018, with exporters rushing to ship their goods out of China before a new round of US tariffs on Chinese goods was introduced.[33] In the first quarter of 2019, however, the deceleration became increasingly apparent, as industrial output rose by the weakest degree in 17 years.[34]

32 *World Economic Outlook Update, January 2019*, International Monetary Fund, January 2019, viewed 20th March 2019, <https://www.imf.org/en/Publications/WEO/Issues/2019/01/11/weo-update-january-2019>; *China's Economy Grows at Slowest Annual Rate Since 1990, Financial Times*, 22nd January 2019, viewed 19th March 2019, <https://www.ft.com/content/9706b890-1ad7-11e9-9e64-d150b3105d21>

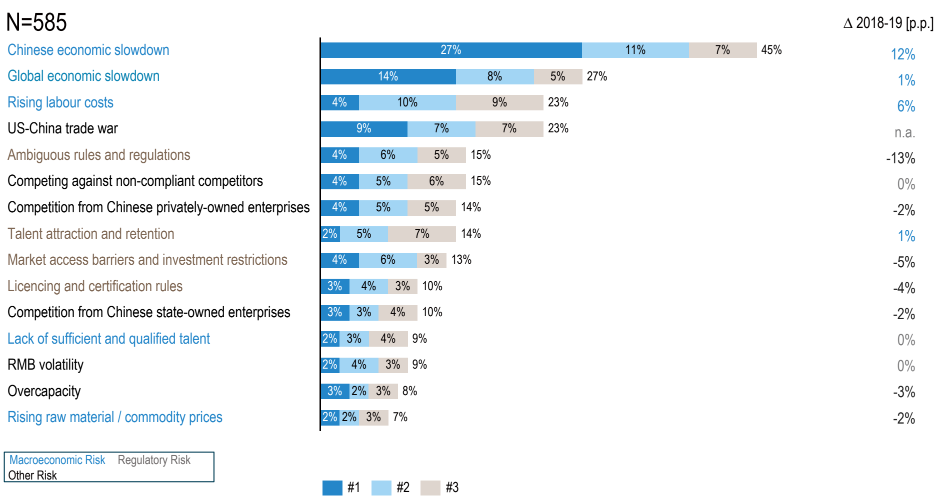
33 *Trump's Trade War Spurs Chinese Export Rush to Beat Tariffs, Bloomberg*, 8th November 2018, viewed 19th March 2019, <https://www.bloomberg.com/news/articles/2018-11-08/chinese-exports-top-estimates-amid-rush-to-skirt-higher-tariffs>

34 *China Growth to Remain Under Pressure Until mid-2019: Analysts, Financial Times*, 14th March 2019, viewed 19th March 2019, <https://www.ft.com/content/25689366-461f-11e9-b168-96a37d002cd3>

After the Chinese and global economic slowdown, respondents ranked labour costs as the third greatest challenge to future business, followed by an emerging issue: the US-China trade war.[35] An escalation of current tensions would take a heavy toll on business sentiment, leading to a tightening of investments.

Figure 13: Macroeconomic challenges lie ahead

Please rank the top three business challenges your company perceives as having the greatest impact on future business in Mainland China



In its annual review of the global economy, the International Monetary Fund (IMF) predicted the Chinese economy would continue to slow further in 2019, forecasting 6.2% growth.[36] To manage the impact of the slowdown, the Chinese Government has introduced measures to lower operational burdens by reducing businesses' tax and social insurance contributions, increasing the central government budget deficit target and cutting value-added tax (VAT) rates.[37] While these policies represent a positive step away from stimulus measures used in the past, it will take time for them to take effect. In the long term, however, they should unlock more sustainable, high-quality growth.

The economic slowdown has led companies to revise their outlook. In 2019, only 45% of respondents said they are optimistic about growth in their sector over the next two years, down 17% y-o-y.

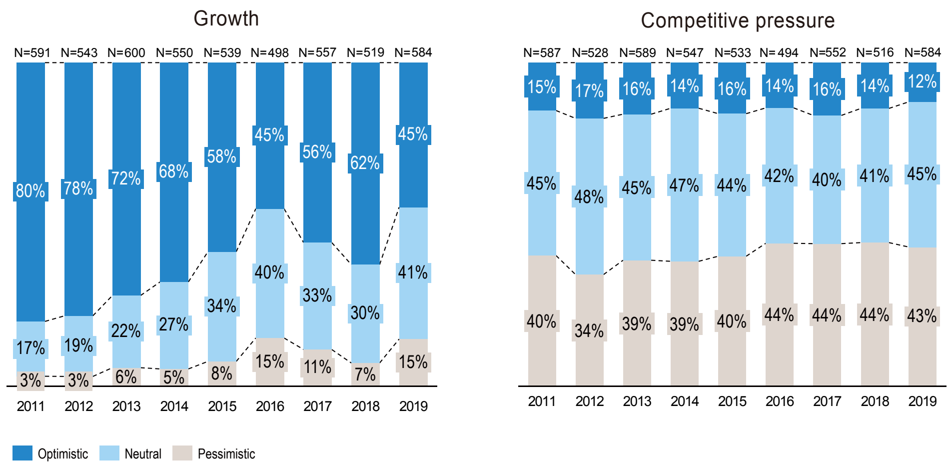
35 2019 was the first year the US-China trade war was added to the list of choices in the BCS for greatest future business challenges. The addition meant that other challenges were not selected by as high a share of respondents as they would have without the change. This does not mean that these challenges are not a priority.

36 *World Economic Outlook, April 2019: Growth Slowdown, Precarious Recovery*, IMF, 2nd April 2019, P. 47, viewed 8th May 2019, <https://www.imf.org/en/Publications/WEO/Issues/2019/03/28/world-economic-outlook-april-019#Statistical%20Appendix>

37 *Government Work Report (Transcript)*, Central People's Government, 5th March 2019, viewed 6th March 2019, <http://www.gov.cn/premier/2019-03/05/content_5370734.htm?mc_cid=7210bcfc5e&mc_eid=d6411c087e>

Figure 14: Optimism drops over future growth

How would you describe the business outlook for your sector in China over the next two years?



2.2 China's 'reform deficit' creates new challenges

Over the past two years, China's reform and opening up agenda has progressed more rapidly than during any other period since the country's accession to the World Trade Organization (WTO) in 2001. In addition to greater market access for international investors, there has also been significant improvement in R&D and innovation, environmental protection and local business environments.

Compared to the rapid growth of China's economy, however, it is clear that reform and opening up has failed to keep pace, resulting in a 'reform deficit'. This deficit is a source of discontent not only for the European business community, but also for China's other major trading partners, including the US. The US-China trade war is a direct manifestation of frustrations over the lack of reciprocity in China's trade and investment relationships.

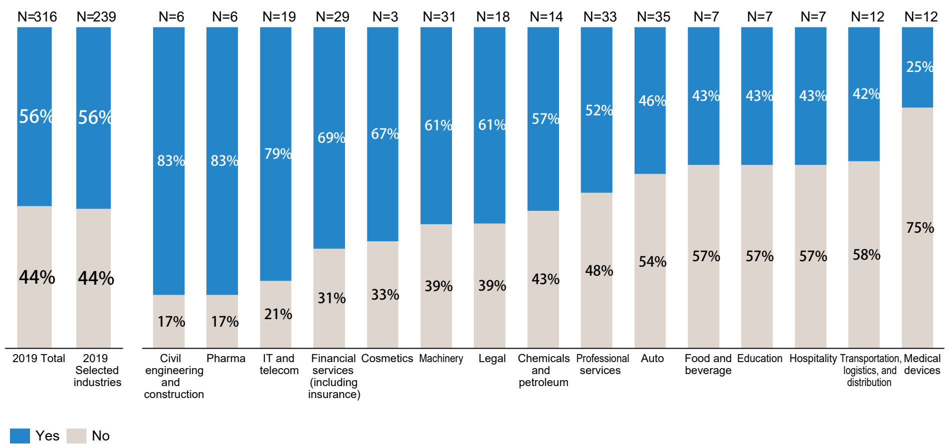
Global tensions have been exacerbated by massive flows of Chinese outbound investments into other markets. In 2018, worldwide Chinese investments totalled USD 179.1 billion, with the top destinations being the US, Australia and the UK.[38] Seeing the huge opportunities Chinese companies have gained abroad, other countries cannot help but make comparisons with the restrictions their businesses face in China.[39]

38 Scissors, Derek, *Chinese Investment: State-owned Enterprises Stop Globalising, for the Moment*, AEI, January 2019, viewed 29th March 2019, <http://www.aei.org/china-global-investment-tracker/>

39 *A New Era in EU-China Relations, More Wide-Ranging Strategic Cooperation*?, European Parliament Directorate-General for External Policies Policy Department, July 2018, viewed 20th March 2019, p.12, <http://www.europarl.europa.eu/RegData/etudes/STUD/2018/570493/EXPO_STU(2018)570493_EN.pdf>

Figure 15: Reciprocity still lacking in EU-China relationship

Do you feel that Chinese companies in your sector enjoy better market access in Europe than European companies enjoy in China?1) 2)



1) *Excludes answer 'Do not know'*

2) *Industries selected are those for which there were at least 6 responses*

3 REGULATORY REFORM NOW IMPERATIVE

Ambiguous rules and regulations are now ranked the greatest future challenge to business after macroeconomic risks, rising labour costs and the US-China trade war. In the current climate it is therefore imperative for China to address the issues within its control, which include tackling the various structural issues in its regulatory environment and delivering mature, stable and transparent institutions that align with international norms.

Better regulation will make businesses more confident and productive, while opening up new areas of the economy will help to balance against the effects of the slowdown and foster greater choice and better outcomes for consumers.

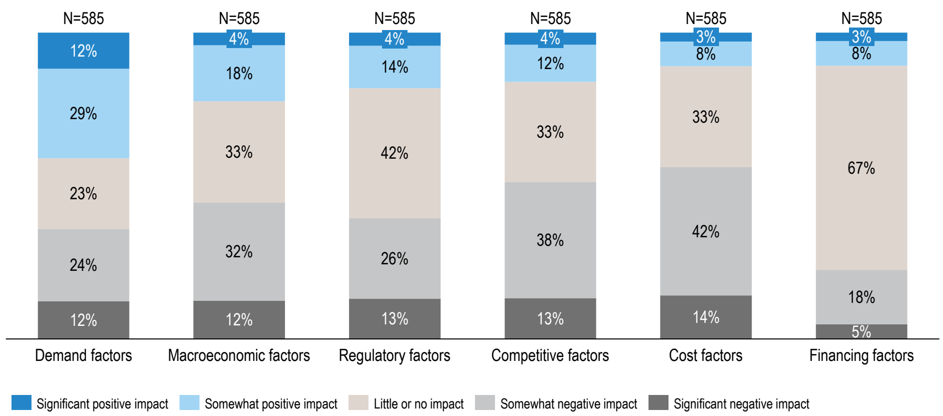
3.1 Regulatory burdens harder to bear

Among respondents that face market access restrictions in China, 67% say they are a result of indirect barriers, including certification and policy issues, and difficulties obtaining licences. In particular, the vague nature of much of China's legal and regulatory system means that businesses shoulder huge operational burdens and uncertainty, which makes long-term planning, risk prevention and communication with headquarters extremely challenging.

These indirect barriers translate directly into financial costs, with 39% of member companies reporting that regulatory factors had negatively impacted their net profit margins in 2018.

Figure 16: Regulatory issues hit bottom lines

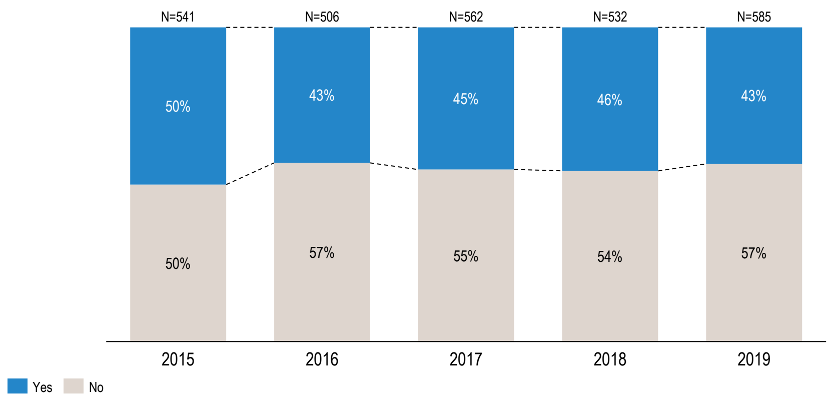
Please indicate the significance of the following factors affecting your company's net profit margin in 2018



The slow pace of regulatory reform is evidenced by the fact that in 2019, 43% of respondents report missing out on business opportunities due to market access restrictions or regulatory barriers, an improvement of just seven percentage points over the past five years. More than 10% of those affected said the opportunities were worth more than a quarter of their annual revenue in China.

Figure 17: Slow pace of reform deprives European companies of opportunities

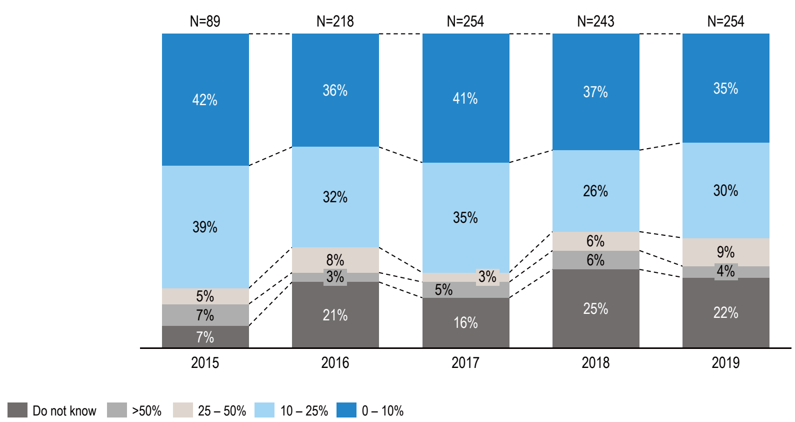
Has your company missed out on business opportunities in China as a result of market access restrictions or regulatory barriers?1)



1) Asked only if answer to previous question, 'How does your company perceive foreign-invested enterprises' treatment by the Chinese Government in your industry compared to that of domestic Chinese companies?' was not 'Foreign-invested enterprises are treated equally'

Figure 18: Missed opportunities translate into high costs

What percentage of your company's annual revenue in China do these missed opportunities represent?1)

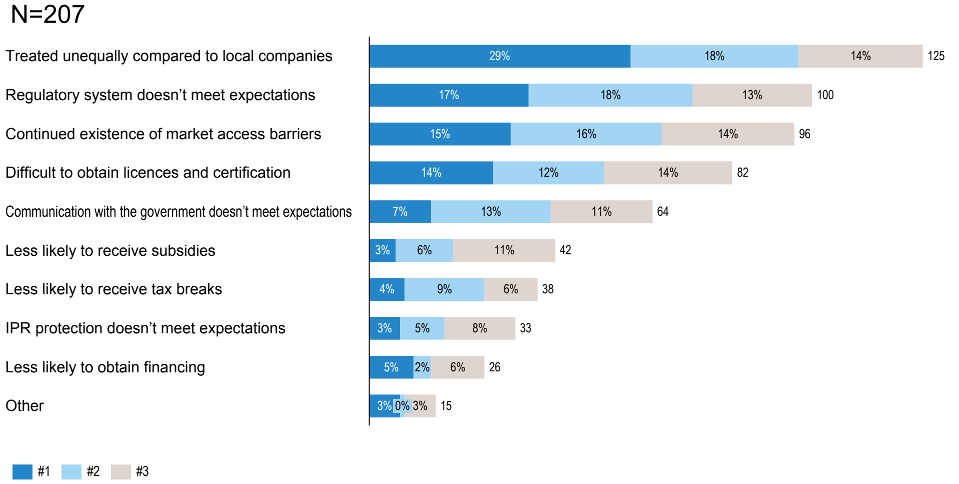


1) Asked only if answer to previous question, 'Has your company missed business opportunities in Mainland China as a result of market access restrictions or regulatory barriers?' was 'Yes'

The regulatory system not meeting expectations was ranked second highest among the reasons respondents felt less welcome than when they first entered the Chinese market, after unequal treatment compared to local companies.

Figure 19: Unequal treatment is the biggest source of discontent

What are the most significant reasons that you feel less welcome?



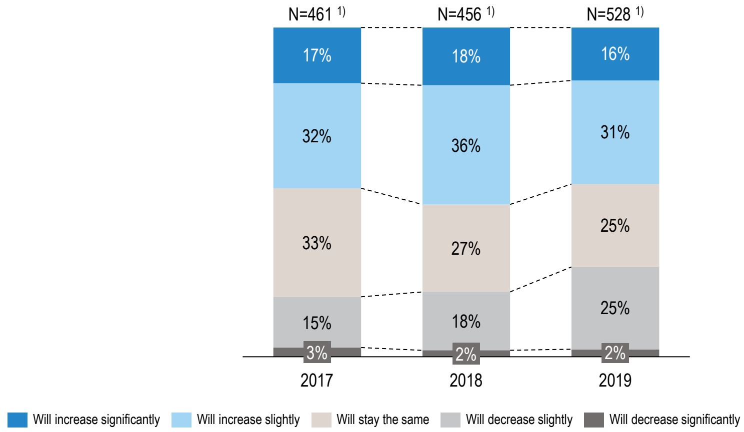
1) *Only asked if answer to the question 'As a foreign investor in China, do you feel: a) More welcome than when you first entered the Chinese market, b) Less welcome than when you entered the Chinese market, c) No change' was 'Less welcome than when first entered China'*

2) *Multiple answers possible, percentage calculated on the total number of respondents*

While it is concerning that regulatory reform has stagnated, it is more worrying that nearly half of respondents believe regulatory obstacles will increase in the next five years, while another 25% expect them to remain as challenging as they are now.

Figure 20: Bleak outlook for regulatory environment

How do you expect the number of regulatory obstacles facing your company in Mainland China to change over the next five years?



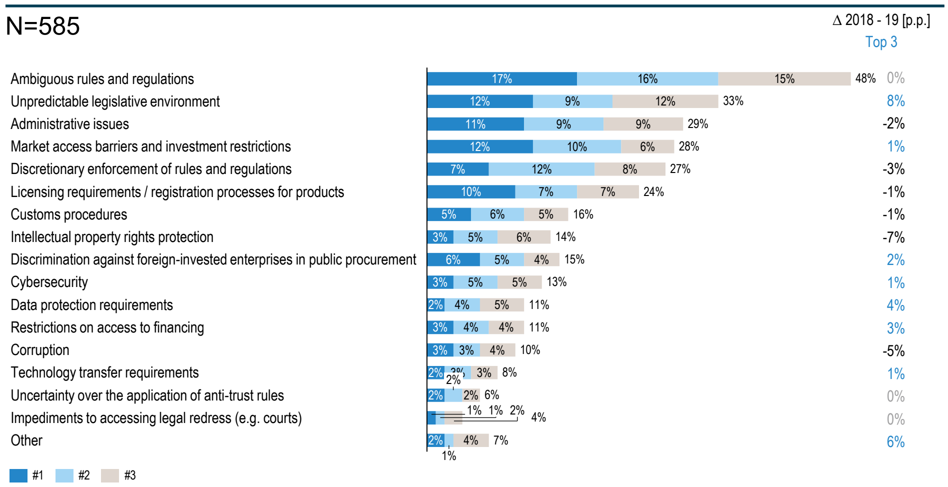
1) *Excludes answer 'Do not know'*

3.2 Ambiguous rules hinder progress

Ambiguous rules and regulations are ranked as the top regulatory obstacle, followed by the unpredictable legislative environment.

Figure 21: Ambiguity main regulatory obstacle

Which are the top three most significant regulatory obstacles for your company when doing business in Mainland China?1) 2)



1) Figures represent the proportion of respondents who rated each issue their #1 – 3 most significant regulatory obstacle

2) Percentages calculated on the total number of respondents

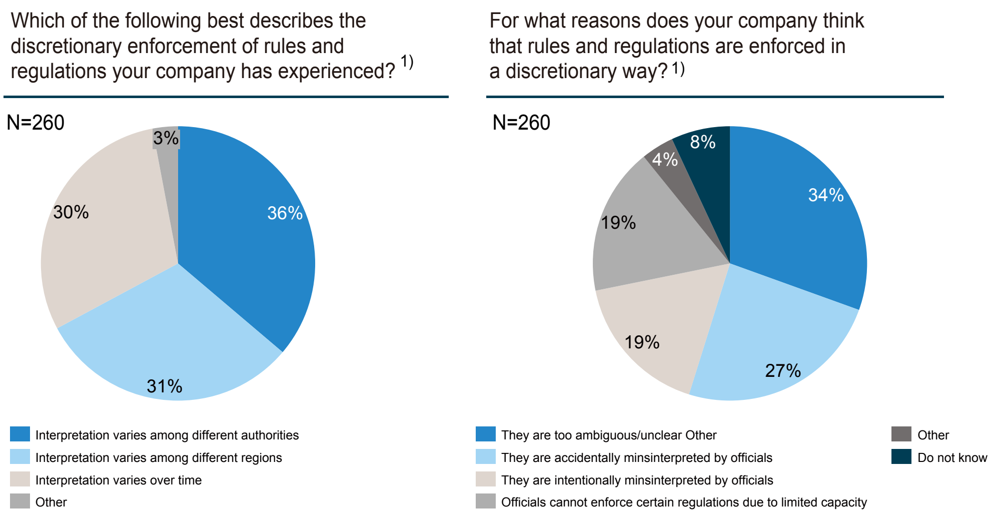
One of the principle sources of ambiguity in laws is the 'opening clause' of most normative documents, which concludes with, "[…] and others, as provided by other/relevant laws and regulations."[40] This adds a sense of vagueness and gives government officials leeway to enforce the law in different ways, which in turn makes it difficult for businesses to ensure they are fully compliant.

Another example of ambiguous legislation can be found in the Foreign Investment Law (FIL), passed by the National People's Congress (NPC) on 15th March 2019, which contains broad terms and vague language throughout.[41] For example, "needs of national economic and social development" (Article 14) lacks proper definition, creating uncertainty that damages business confidence.

40 For example: *Regulations on Investment in the Automotive Industry*, NDRC, 10th December 2018, viewed 21st March 2019, <http://www.chinalaw.gov.cn/Department/content/2018-12/10/594_230928.html>; *Regulations on Foreign-invested Futures Companies*, China Securities Regulatory Commission, 24th August 2018, viewed 21st March 2019, <http://www.chinalaw.gov.cn/Department/content/2018-10/16/594_205105.html>; *Regulations on the Food Safety Supervision of Online Food Services*, China Food and Drug Administration, 16th August 2018, viewed 21st March 2019, <http://www.chinalaw.gov.cn/Department/content/2018-08/16/594_206154.html>

41 *Foreign Investment Law*, NPC, 15th March 2019, viewed 21st March 2019, <http://www.chinalaw.gov.cn/Department/content/2019-03/18/592_230773.html>

Figure 22: Ambiguous regulations leave room for discretionary enforcement



1) *Asked if the answer to previous question, 'Which are the most significant regulatory obstacles for your company when doing business in Mainland China?' was 'Discretionary enforcement of rules and regulations'*

Another example is the Product Quality Law, which uses the term "unqualified products" without specifying a mandatory national standard that should be applied.[42] Interpretations will therefore differ in implementation, giving rise to conflict between enterprises, consumers and local law enforcement authorities.

3.3 Improvements to business environment mainly benefit Chinese firms

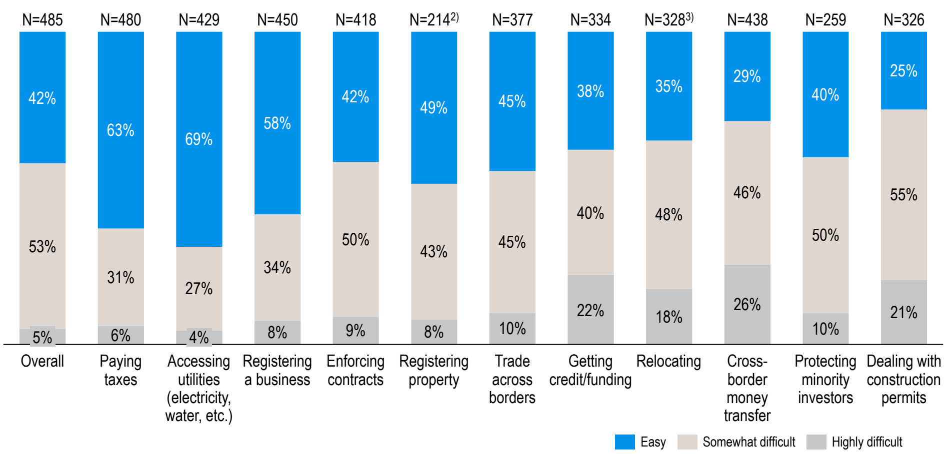
The World Bank's *Doing Business* report measures how conducive a country's regulatory environment is to the starting and operation of a local business. In the 2018 report, China advanced to a global ranking of 46, up from 78 the previous year, thanks to new measures designed to ease businesses' burdens.[43] However, European companies' ratings of doing business in response to questions in the BCS 2019 suggest that they have not seen as many improvements as local firms have.

Noticeably, cross-border money transfers were deemed challenging by a significant 72% of respondents. Enforcing contracts, dealing with construction permits and relocating—which are all integral to daily operations—were also seen as particularly problematic.

42 *Product Quality Law*, NPC, 17th January 2019, viewed 21st March 2019, <http://www.chinalaw.gov.cn/Department/content/2019-01/17/592_227082.html>
43 *Doing Business Report: China Carries Out Record Business Reforms, Edges into Top 50 Economies*, The World Bank, 31st October 2018, viewed 13th March 2019, <https://www.worldbank.org/en/news/press-release/2018/10/31/doing-business-report-china-carries-out-record-business-reforms-edges-into-top-50-economies>

Figure 23: European firms report many difficulties in doing business

Please rate the ease of doing business in your region, in the following areas[1)]



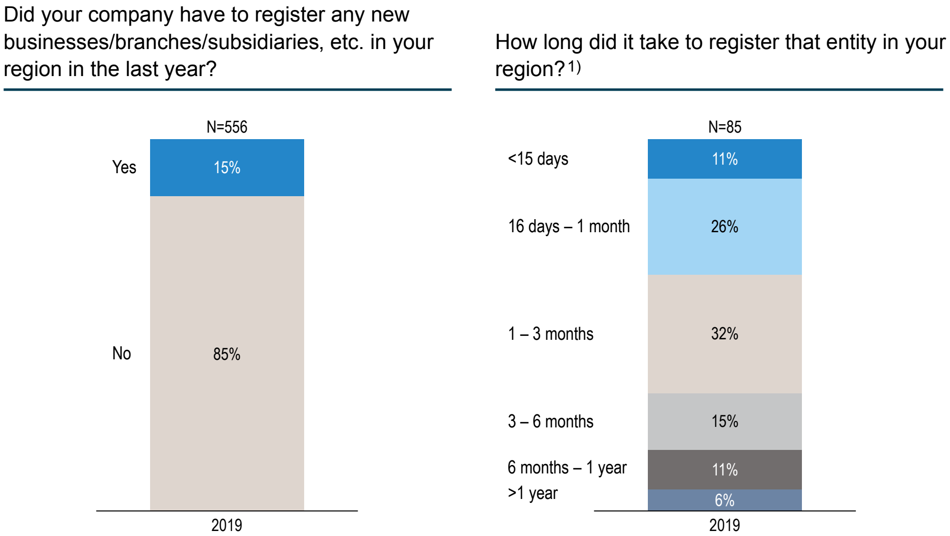
1) Excludes answer 'Not applicable/Do not know'

2) Answer not available for Shanghai respondents

3) Answer not available for Southwest China respondents

The stark difference in treatment of local and international companies is particularly apparent when examining the average time needed to set up a business. According to the 2018 *Doing Business* report, it takes nine days on average for a local firm.[44] Yet, 89% of European companies that set up an entity in the last year said it took longer than 15 days. In fact, it took three months or longer for a third of respondents.

Figure 24: Setting up a business took over three months for a third of respondents



1) Only asked if the answer to the previous question was 'Yes'

44 *Ease of Doing Business in China*, The World Bank, 2019, viewed 13th March 2019, <http://www.doingbusiness.org/en/data/exploreeconomies/china#DB_dwcp>

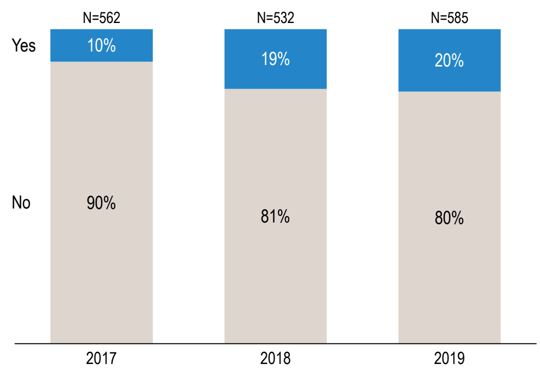
3.4 Compelled tech transfers continue despite government pledges

In 2019, 20% of respondents report having felt compelled to transfer technology in order to maintain market access, up from 10% in 2017. European companies often choose to voluntarily transfer technology to local firms, for such reasons as making their suppliers more reliable or to produce higher-quality products. Compelled transfers take place when firms unwillingly hand over technology through a JV agreement or regulations in order to gain access to the Chinese market.[45]

Not all companies—for example, many in service industries—have technology to transfer, so the percentage of companies that are in high-value, cutting edge industries have felt compelled to transfer technology at higher than average rates: 30% of chemicals and petroleum companies, 28% of medical device companies, 27% of pharmaceutical companies and 21% of automotive companies report this to be the case.

Figure 25: Reported cases of compelled tech transfers doubles in two years

Has your company felt compelled to transfer technology and/or trade secrets in order to maintain market access?1)



1) Prior to 2019, this question did not cover trade secrets

Although *State Council Document 19*, published in June 2018, prohibits government officials from forcing technology transfers through administrative means, the phrasing used has left plenty of scope for transfers to be forced through alternative methods.[46]

In many industries that are still closed to foreign investors, European firms' only choice is to operate through JVs with domestic companies, where the European partner cannot hold a controlling stake.[47] Some companies have been forced to hand over sensitive technology to partners that later compete with them in China and other markets. SOEs also play a prominent role, as they may demand technology transfers from foreign companies to their local suppliers in exchange for the SOE purchasing products from them.[48]

It is highly concerning that 63% of respondents that have felt compelled to transfer technology said it happened within the last two years, and a quarter say the transfer is currently taking place.[49]

45 *Is the US Right to Cry Foul About Forced Technology Transfer to do Business in China – and What is Beijing's Position?, South China Morning Post*, 10th January 2019, viewed 19th March 2019, <https://www.scmp.com/news/china/diplomacy/article/2181528/us-right-cry-foul-about-forced-technology-transfer-do-business>

46 *Circular of The State Council On Measures To Actively And Effectively Utilise Foreign Capital To Promote High-Quality Economic Development*, State Council, 15th June 2018, viewed 7th March 2019, <http://baijiahao.baidu.com/s?id=1603332637134972498&wfr=spider&for=pc>

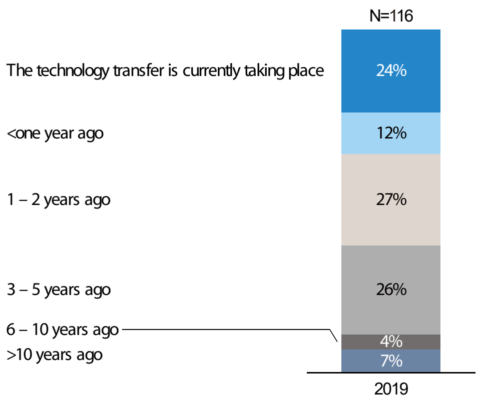
47 Branstetter, Lee, *What is the Problem of Forced Technology Transfer in China*?, *Econofact*, 3rd August 2018, viewed 21st March 2019, <https://econofact.org/what-is-the-problem-of-forced-technology-transfer-in-china>

48 Ibid.

49 *China Rejects US Accusations on Technology Transfer as Baseless at WTO, Xinhua*, 29th May 2018, viewed 21st March 2019, <http://www.xinhuanet.com/english/2018-05/29/c_137213238.htm>

Figure 26: Quarter of tech transfers taking place right now

How long ago did the compelled transfer take place?[1)]



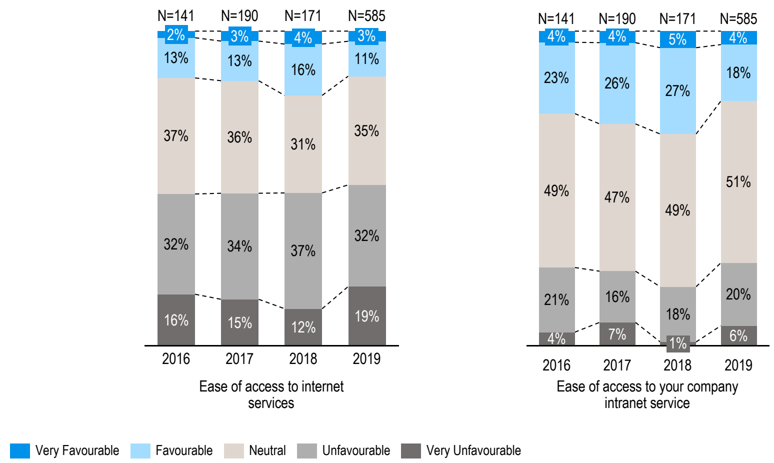
1) *Asked only if the answer to the question 'Has your company felt compelled to transfer technology and/or trade secrets in order to maintain market access?' was 'Yes'*

3.5 Restrictive internet and Cybersecurity Law impede business

Although China has stated its ambition to become an international hub for innovation and R&D, this goal is not very realistic while it continues to impose restrictions on internet access. Over half of European companies evaluate internet access for R&D purposes as unfavourable. Another quarter rate their ability to access their company's intranet negatively.

Figure 27: Internet restrictions cast doubt over China's ambitions to become global R&D centre

How does your company evaluate the following factors regarding R&D in China?[1)]

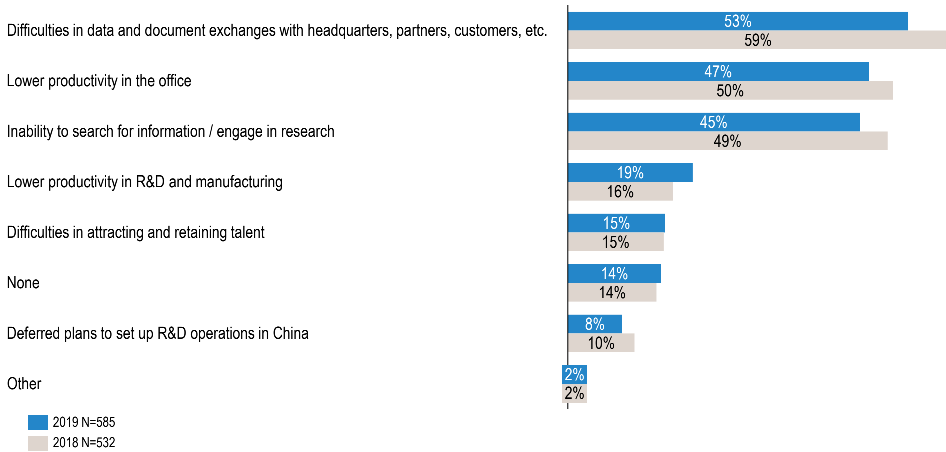


1) *Up until 2018, only asked if the answer to the question 'Does your company has a R&D centre in Mainland China' was 'Yes', which explains the surge in the number of respondents*

Blocked websites, slow connections and instability mean that over half of member companies struggle to exchange data and documents with the outside world, including their headquarters, partners and customers. Almost half of respondents also say they experience lower productivity and the inability to search for information and engage in research.

Figure 28: China's internet restrictions isolate its market from rest of the world

What is the impact on your company due to internet instability, slowness or access restrictions in China?1)

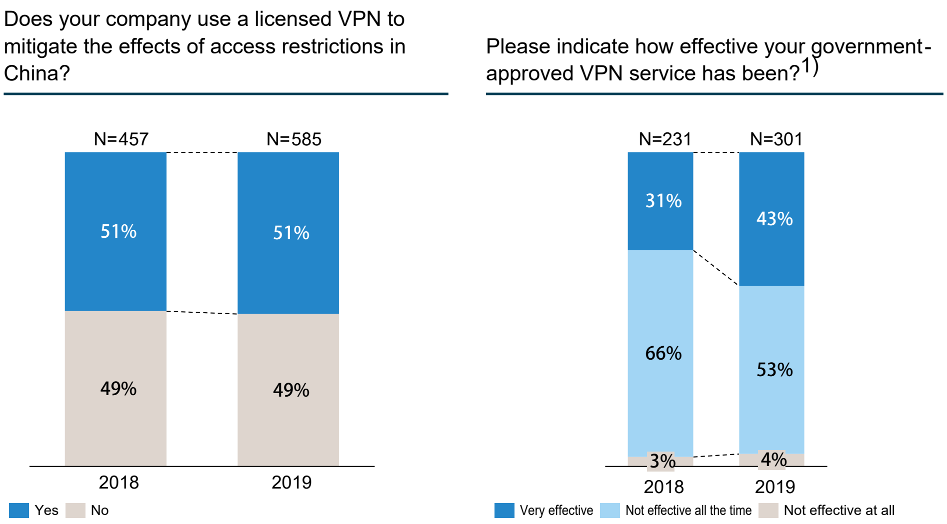


1) Multiple answers possible; percentage divided by number of respondents

Virtual private networks (VPNs) are a key mechanism to ensure the safety and confidentiality of data flows, as well as to mitigate internet restrictions. Although businesses in China are required to use a VPN system supplied by a government-licensed provider, many have chosen not to over security concerns. Among companies that do use a licensed VPN, there has been a 13 percentage point decrease y-o-y in those that say the service is unreliable, yet the figure still stands at a significant 53%. Furthermore, small and medium-sized enterprises (SMEs), which have limited resources, struggle to cover the high costs of using these services.[50]

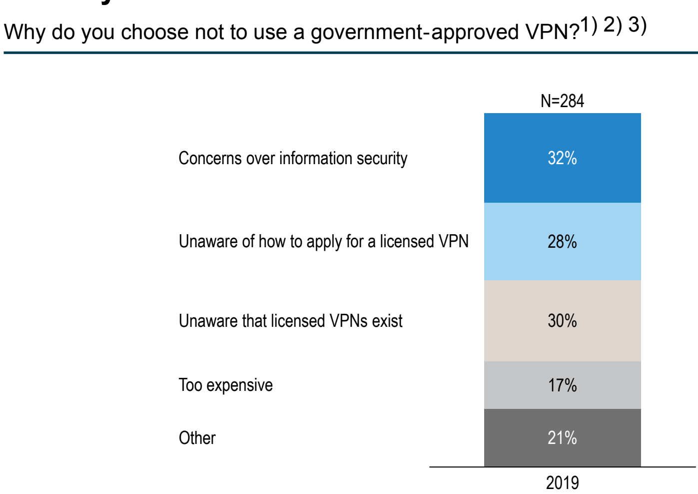
50 According to the European Chamber's methodology for this survey, an SME is an enterprise that employs less than 250 people.

Figure 29: Official VPN solutions unreliable for more than half of respondents



1) *Asked only if the answer to the previous question, 'Does your company use a government-approved VPN to mitigate the effects of access restrictions in China?', was 'Yes'*

Figure 30: Licensed VPNs raise significant concerns over information security

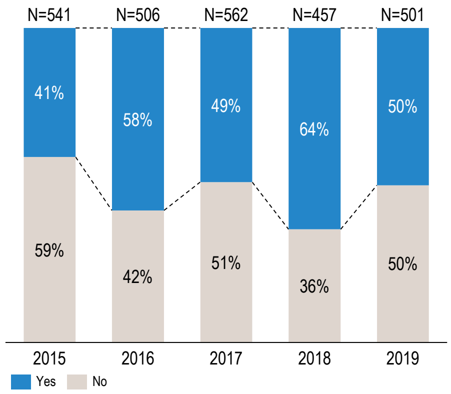


1) *Asked only if the answer to the previous question, 'Does your company use a government-approved VPN to mitigate the effects of access restrictions in China?' was 'No'*
2) *Multiple answers possible*
3) *Percentage divided by number of respondents*

Internet restrictions have a negative economic impact on half of respondents, 74% of whom say the cost represents 1% to 5% of their annual revenue – a significant unnecessary cost that companies should not have to cover.

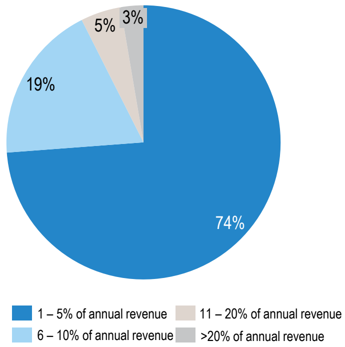
Figure 31: Internet restrictions carry significant costs

Do internet restrictions have a negative economic impact on your company?1) 2)



Please estimate the cost of internet restrictions on your company3)

N=250

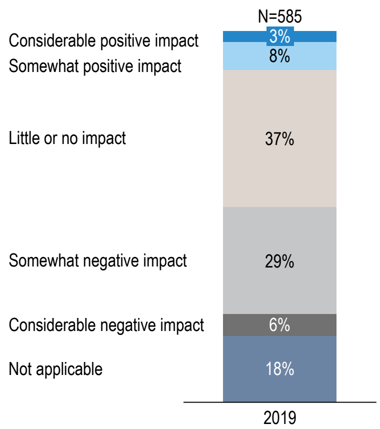


1) *Asked only if the answer to the previous question, 'What is the impact of Internet instability, slowness and/or access restrictions on your company in China?' was not h) 'None'*
2) *In 2017, the question was 'Has the continued strengthening in measures to tighten Internet control and access restrictions in China been having an even bigger negative impact on your company?'*
3) *Asked ony if the answer to the previous question, 'Do internet restrictions have a negative economic impact on your company?', was 'Yes'*

China's Cybersecurity Law (CSL) was passed on 7th November 2016, and came into force on 1st June 2017. As the nation's first comprehensive privacy and security regulation for cyberspace, the CSL imposes unprecedented requirements on the use of data and the internet. While many of the supporting measures that will define how the law works in practice have not been released, 35% of European firms believe it will have a negative impact on their business.

Figure 32: Concerns building over new data regulations

How do you expect China's new data regulations to impact your company?



The CSL requires important data and personal information collected or generated in China to be stored within China's borders.[51] If cross-border data transfers are warranted by business needs, a security assessment should be conducted (Article 37).[52]

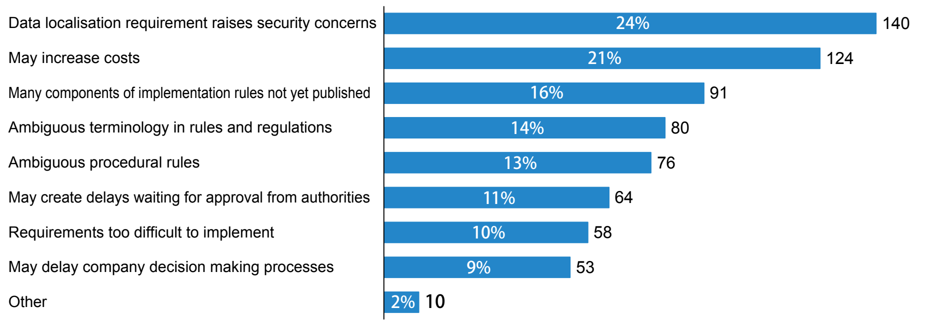
51 *China's Cybersecurity Law*, Reed Smith, 2018, viewed 9th March 2019, <https://www.reedsmith.com/-/media/files/perspectives/2018/chinas-cybersecurity-law-002.pdf>
52 *Cybersecurity Law*, NPC, 7th November 2016, viewed 1st April 2019, <http://www.miit.gov.cn/n1146295/n1146557/n1146614/c5345009/content.html>; *Overview of China's Cybersecurity Law*, KPMG, February 2017, viewed 20th March 2019, <https://assets.kpmg/content/dam/kpmg/cn/pdf/en/2017/02/overview-of-cybersecurity-law.pdf>

A quarter of respondents across a diverse range of industries—including IT and telecoms, healthcare and airlines—are worried that the data localisation requirements raise security concerns.

Figure 33: Data localisation requirement creates most unease in European business community

Which aspects does your company find most concerning about China's data regulations?[1)]

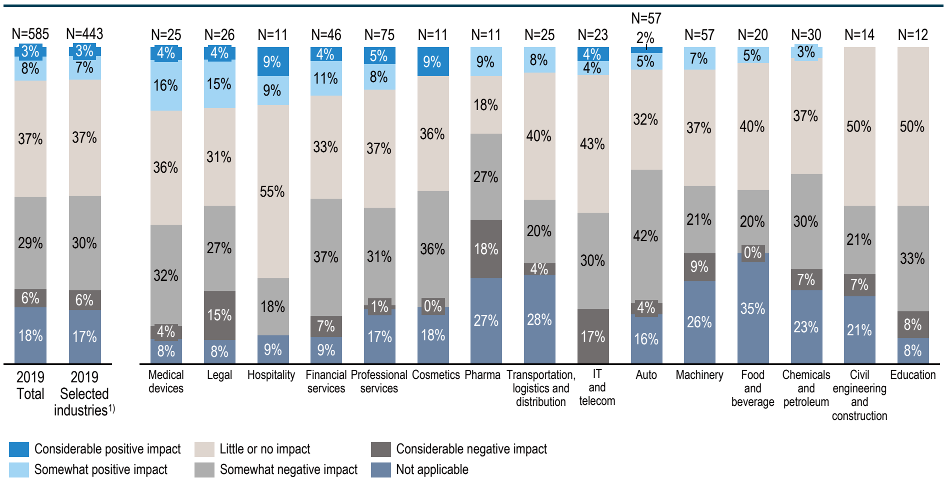
N=585



1) *Multiple answers possible; percentage divided by number of respondents*

Figure 34: All industries anticipate new data rules will lead to negative outcomes

How do you expect China's new data regulations to impact your company?



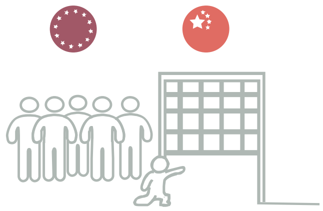
1) *Selected industries are those with more than 10 respondents*

BUSINESS CONFIDENCE SURVEY 2019 FINDINGS

EUROPEAN BUSINESSES SEE PROGRESS IN SOME AREAS

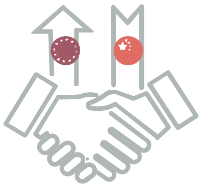
40%
of respondentssaw market opening for foreign companies in 2018

… but only **9%** of those said it was significant

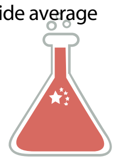


26%
feel more welcome than when they first entered the Chinese market (+4% y-o-y)

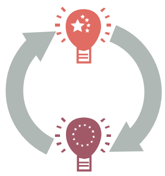
33%
of respondents increased their share in a JV



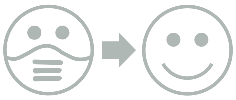
38%
of respondents see China's R&D and innovation environment as more favourable than the worldwide average



81%
of respondents see opportunities in Chinese innovation

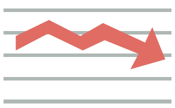


74%
of respondents said they saw improvement in air quality in 2018

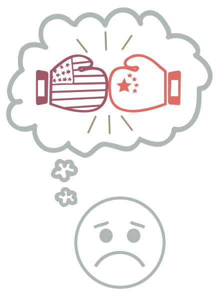


BUSINESS OUTLOOK REMAINS MIXED

27%
of respondents said the Chinese economic slowdown is the number one challenge to future business



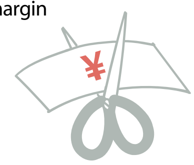
The US-China trade war is now the **4th** major challenge to future business



56%
of respondents say Chinese firms enjoy better market access in Europe than European firms enjoy in China

REGULATORY REFORM NEEDED NOW MORE THAN EVER

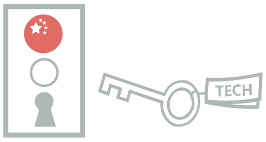
40%
of respondents say regulation had a negative impact on their net profit margin



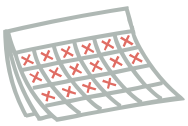
30%
of respondents say they face indirect market access barriers (e.g. access to licences)

41%
of respondents believe regulatory obstacles will worsen over next five years

20%
of respondents have been compelled to transfer technology (up 10 percentage points from 2016)



32%
of respondents said it took them over six months to set up a business



50%
of respondents rate the ease of doing business as difficult

…and **63%** said the transfer happened within the last two years

Internet access

51%

of respondents say ease of access to internet services is unfavourable compared to worldwide average

Data regulations

24%

of respondents say data localisation requirements raise security concerns

..and **21%**

say it may increase costs

Cybersecurity Law

67%

of respondents believe the Cybersecurity Law will lead to increased operational burdens

..and **29%**

believe it will lead to market access restrictions

UNEQUAL TREATMENT

45%

of respondents say they are still treated unfavourably compared to domestic Chinese companies

SOEs are present in

70%

of respondents' sectors

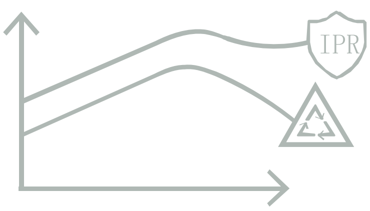
Top three areas where SOEs hold the advantage over private firms

- Access to government contacts
- Access to cheap financing
- Ability to influence policy

SOME PROGRESS STALLS

35% rate IPR enforcement as adequate or excellent (+1% y-o-y, vs +5% the previous year)

69% of respondents that suffered IPR infringement said it happened in the past two years



65%

rate environmental enforcement as adequate or strong (-7% y-o-y)

SME WAKEUP CALL

40%

of SMEs' EBIT margins increased y-o-y, vs 50% for large firms

SME MNC

26%

of SMEs' net profit margins negatively affected by access to financing, vs 14% for large firms

50%

of SMEs said they are treated unequally compared with domestic firms

39%

of SMEs do not expect to ever see meaningful opening in their sector

34%

of SMEs do not expect to ever see a level playing field through national treatment

EUROPEAN FIRMS REMAIN DEDICATED TO CHINESE MARKET

65%

of respondents would increase their investment in China if given greater market access

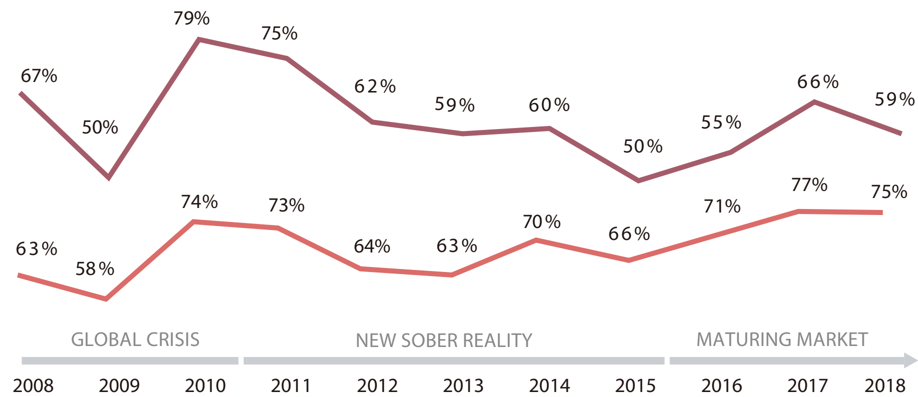
BUSINESS CONFIDENCE SURVEY 2019 FINDINGS

FINANCIAL PERFORMANCE

(Financial year)

Increased revenues

Profitable companies

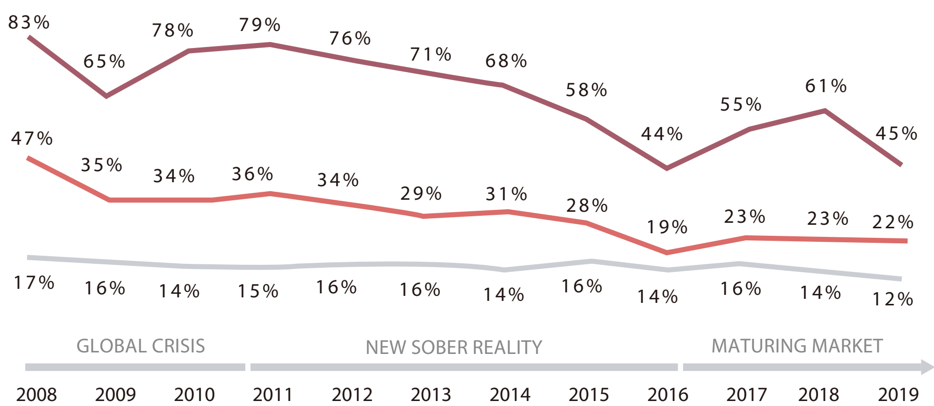


OPTIMISM

Optimistic about growth

Optimistic about profitability

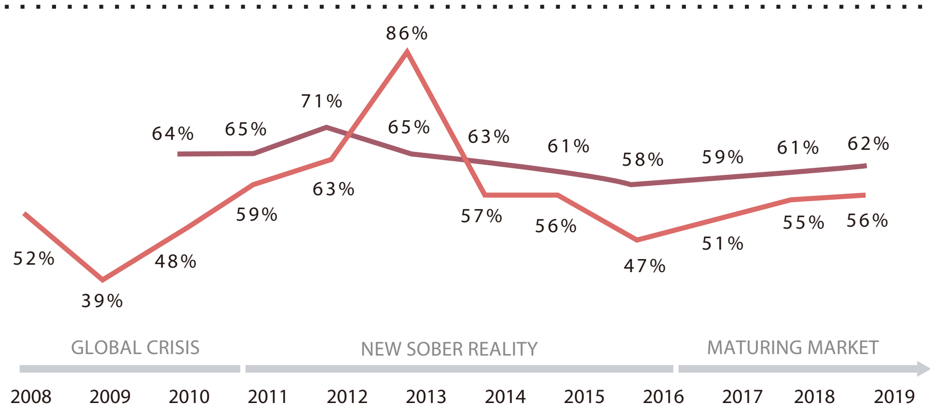
Optimistic about competitive pressure



IN CHINA TO STAY

Rank China among the top three destinations for new investments

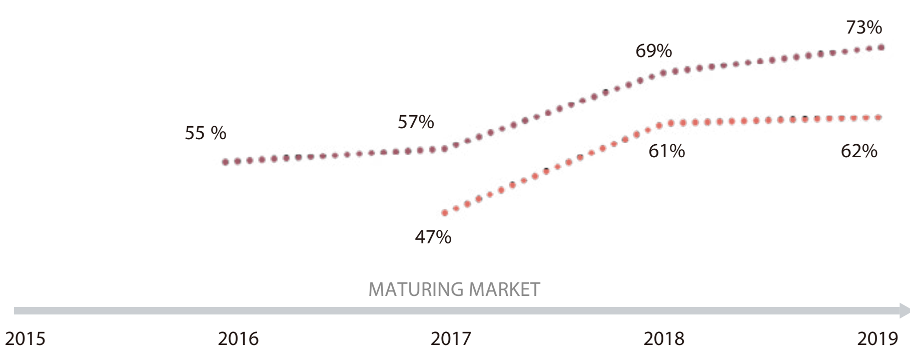
Consider expanding their China operations



R&D IN CHINA

Consider China R&D environment equally or more favourable than worldwide average

Consider Chinese firms equally or more innovative than European firms



TOP-RATED REGULATORY OBSTACLES

The reform process has stalled and regulatory obstacles persist

	# 1	# 2	#3
2019	Ambiguous rules and regulations	Unpredictable legislative environment	Administrative issues
2018	Ambiguous rules and regulations	Administrative issues	Discretionary law enforcement
2017	Ambiguous rules and regulations	Administrative issues	Unpredictable legislative environment
2016	Unpredictable legislative environment	Administrative issues	Discretionary law enforcement
2015	Unpredictable legislative environment	Administrative issues	Discretionary law enforcement
2014	Unpredictable legislative environment	Discretionary law enforcement	Administrative issues
2013	Discretionary law enforcement	Administrative issues	Corruption

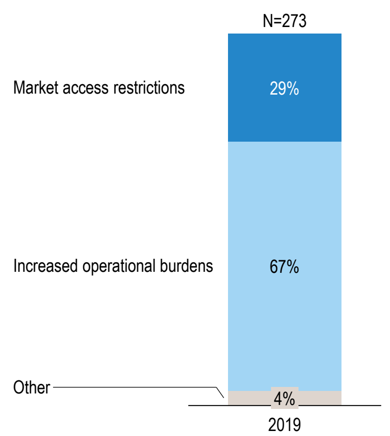
The draft *Security Assessment Measures,* issued by the Cyberspace Administration of China (CAC) in 2017, stipulate that network operators will need to conduct a cross-border data transfer security assessment under a variety of different conditions.[53] Depending on the conditions, the security assessment can be a self-assessment and/or a regulatory assessment. It is an additional administrative burden that may create operational delays and make communication with headquarters more difficult than it already is, given existing internet access restrictions.

In total, 67% of respondents believe that the CSL will increase their operational burdens, and not simply due to the data-related requirements. For example, the CSL includes requirements for critical information infrastructure protection, classified cybersecurity protection, critical network equipment and specialised network security products testing and certification and a general requirement for network products and services to be secure and trustworthy.

Some of the aforementioned cybersecurity schemes, which may build on one another, magnify the concerns of the European business community that the CSL may create very tangible market access barriers.

Figure 35: Companies expect additional burdens under the Cybersecurity Law

What form does your company believe this impact will take? 1)



1) *Only asked if the answer to the previous question 'What impact do you expect China's Cybersecurity Law to have on your company?' shows an impact*

53 *Where are We Now With Data Protection Law in China*?, Freshfields, 13th September 2018, viewed 9th March 2019, <http://knowledge.freshfields.com/m/Global/r/3824/where_are_we_now_with_data_protection_law_in_china_>

4 LEVEL PLAYING FIELD REMAINS OUT OF REACH

The presence of international companies is important for China's economic development. They bring products and services that benefit local consumers and enterprises, and contribute significantly to tax payments, job creation and innovation. In Shanghai, for instance, international companies created 20% of employment in 2016, even though they only made up 2% of total enterprises.[54] In 2018, international companies applied for 148,000 patents, up 9.2% y-o-y.[55]

Despite this, the government continues to protect local enterprises to promote the development of domestic industry. In the long term, exposing domestic business to healthy competition from international firms is actually more conducive to achieving the government's ambitions of becoming a global leader in innovation, as it pushes Chinese businesses to become more creative and resourceful.

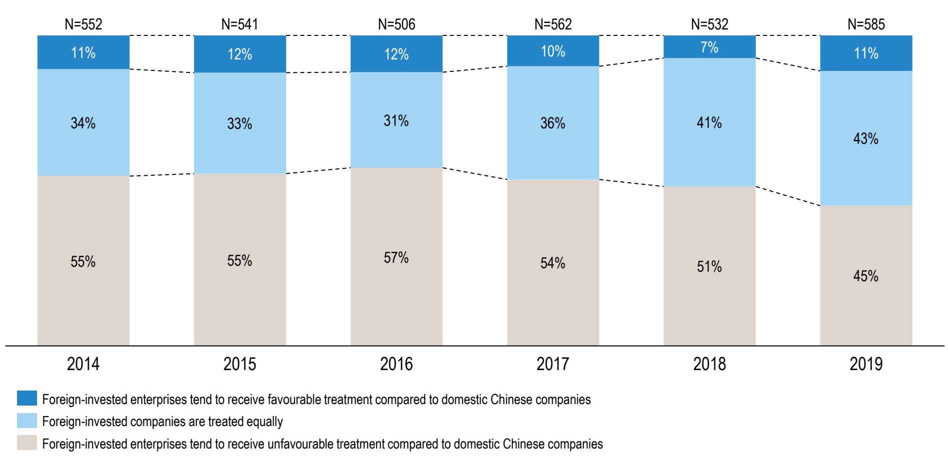
The finding that most European companies see their Chinese counterparts as equally or more innovative, as well as the fact that many Chinese enterprises have expanded successfully overseas, indicates that domestic firms are already strong enough to thrive without government support. It is time for China to remove the training wheels for domestic business and deliver a level-playing field for all.

4.1 Equal treatment improves, but almost half still report discrimination

Although the proportion of European firms that say they tend to receive unfavourable treatment compared to domestic Chinese companies has gradually reduced over the past three years, it still stands at a significant 45%.

Figure 36: 45% of respondents report unfavourable treatment

How does your company perceive foreign-invested companies' treatment by the Chinese Government in your industry compared to that of domestic Chinese companies?



54 *Foreign-funded Enterprises Account for Around 2% of the Total Number of Enterprises in Shanghai and 20% of the Total Number of Employees*, Special Representative Office of the Ministry of Commerce in Shanghai, 2nd May 2017, viewed 21st March 2019, <http://shtb.mofcom.gov.cn/article/shangwxw/liywz/201705/20170502567630.shtml>

55 *Foreign Media: Foreign Enterprises' Patent Applications Broke New Record Last Year with 148,000 Submissions, Sina*, 15th January 2019, viewed 21st March 2019, <http://finance.sina.com.cn/world/gjcj/2019-01-15/doc-ihqfskcn7296483.shtml>

Market access restrictions are the main reason foreign companies believe they cannot operate on equal terms with their domestic counterparts. European companies also find themselves at a disadvantage when it comes to administrative issues, communication with the government and environmental enforcement. This means they have to bear higher costs and often do not have adequate representation in policy-making processes.

Unequal treatment compared to local companies is also the most significant reason European firms feel less welcome than when they first entered the Chinese market.

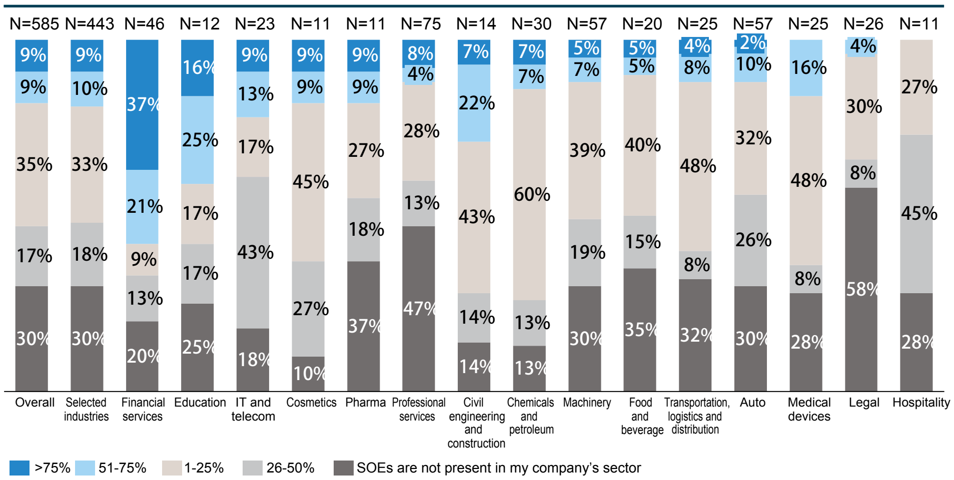
4.2 SOEs dominate in many industries

After China's accession to the WTO in 2001, the body's protocol required China to terminate subsidies and other financial support to state-owned enterprises (SOEs).[56] The subsequent restructuring of the state sector led to the closure of thousands of loss-making SOEs and the write-off of non-performing loans by state-owned banks. These measures resulted in growth of private investment that was almost two and a half times that of state investment in the early 2000s.[57] Since 2011, however, there has been a reversal – the pace of private investment has slowed dramatically, while that of state investment has become several times faster.[58]

Although the absolute number of SOEs has decreased, the number of enterprises in which the state has a controlling stake has increased.[59] At the same time, the value of state assets has risen from around CNY 10 trillion in 2003 to over CNY 43 trillion by 2019.[60] It is apparent that the state-owned sector has been concentrated into a group of larger entities with combined assets that are greater than ever. Indeed, 70% of European companies said SOEs were present in their sector, highlighting the broad influence of the state throughout the economy.

Figure 37: SOEs hold over 50% market share in financial services

How much market share do SOEs hold in your sector?1)

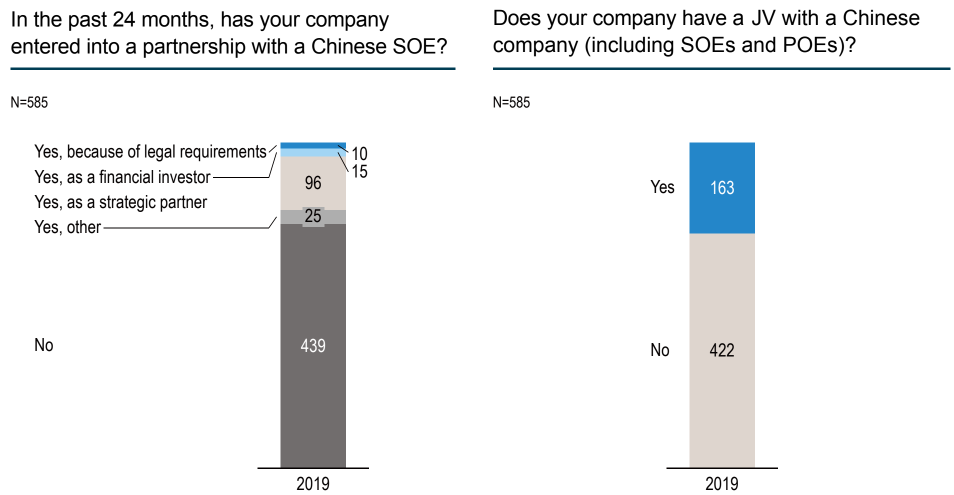


1) Selected industries are those with at least 11 responses

56 *Protocol of the Accession (WT/L/432)*, *'Accessions: China'*, WTO, 11th December 2001, viewed 21st March 2019, <https://www.wto.org/english/thewto_e/acc_e/a1_chine_e.htm>
57 Lardy, Nicholas, 'Private Sector Development', in: Garnaut, Ross; Song, Ligang; Fang, Cai (eds), *China's 40 Years of Reform and Development 1978-2018*, Australian National University Press, July 2018, viewed 21st March 2019, <https://press.anu.edu.au/publications/series/china-update-series/chinas-40-years-reform-and-development-1978-2018>
58 *China Statistical Yearbook 2012*, National Bureau of Statistics of China, 2012, viewed 21st March 2019, <http://www.stats.gov.cn/tjsj/ndsj/2012/indexch.htm>; *China Statistical Yearbook 2018*, National Bureau of Statistics of China, 2018, viewed 21st March 2019, <http://www.stats.gov.cn/tjsj/ndsj/2018/indexch.htm>
59 *China Premium Database*, CEIC, 2019, viewed 21st March 2019, <https://www.ceicdata.com/en/products/china-economic-database>
60 Ibid.

The government has, at various points, encouraged the privatisation of SOEs, with mixed-ownership reforms and through opening competition with the private sector in non-sensitive sectors such as retail, automotive and hospitality.[61] The government's introduction of mixed-ownership reforms encourage SOEs to seek private investment, as well as state investment in the private sector, thereby increasing the competitiveness of the state sector and its influence throughout the economy.[62] Partly in response to these measures, one quarter of European companies have entered into a partnership with an SOE in the past 24 months.

Figure 38: Some European companies take part in SOE mixed-ownership reforms



However, in strategic industries the government believes are important to national security and the economy, Beijing has sought to consolidate the influence of state assets.[63] In industries with a strong SOE presence, such as financial services, European firms struggle to expand their market share despite the recent lifting of equity caps, as the state-owned sector has already established a dominant position in the industry. Because many financial services firms' local JV partners are SOEs, allowing majority foreign ownership would equate to surrendering state assets, making it highly unlikely or impossible for foreign firms to obtain a majority stake.

SOEs hold advantages in most areas of doing business, including public procurement, the ability to influence policy, and gaining access to financing and licences.

61 Song, Ligang, 'State-owned enterprise reform in China: Past, present and prospects', in: Garnaut, Ross; Song, Ligang; Fang, Cai (eds), *China's 40 Years of Reform and Development 1978-2018*, Australian National University Press, July 2018, viewed 21st March 2019, <https://press.anu.edu.au/publications/series/china-update-series/chinas-40-years-reform-and-development-1978-2018>

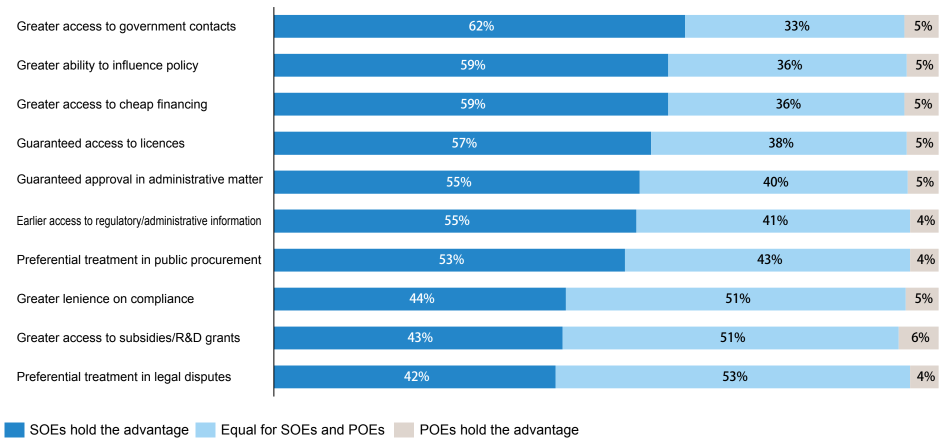
62 *China to Expand Mixed Ownership Reform of SOEs, Xinhua*, 21st November 2018, viewed 21st March 2019, <http://www.xinhuanet.com/english/2018-11/21/c_137622062.htm>

63 Ibid.

Figure 39: SOEs have the upper hand in most areas of doing business

Which type of firm holds the advantage in the following areas in your sector?

N=585



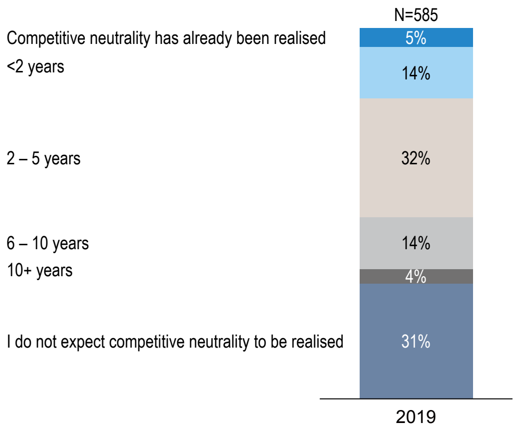
In 2018, Yi Gang, governor of the People's Bank of China (PBoC), said China is considering treating SOEs in line with the principles of competitive neutrality.[64] According to the Organisation for Economic Co-operation and Development (OECD), competitive neutrality can be understood as a regulatory framework within which public and private enterprises face the same set of rules, and where contact with the state does not bring a competitive advantage to any market participant.[65] On 26th March 2019, during a meeting of the State Council, it was announced that the government will implement the principle of competitive neutrality and overhaul the policies and measures that both hamper the growth of private businesses and fail to treat domestic and foreign investors as equals.[66]

Despite these comments, European Chamber members are mixed in their outlook on competitive neutrality being realised. While one third expect it will happen in the next two to five years, another third believe it will never take place. Currently, the government does not have any formal legislation that sets a timeline or specific measures to achieve competitive neutrality, and it remains unclear how the government would measure its progress towards meeting this goal.

64 *Can Chinese State Firms Compete Fairly? Beijing Claims 'Competitive Neutrality', South China Morning Post*, 15th October 2018, viewed 13th March 2019, <https://www.scmp.com/economy/china-economy/article/2168676/can-chinese-state-firms-compete-fairly-beijing-claims>
65 *Achieving Competitive Neutrality*, OECD, 2019, viewed 13th March 2019, <http://www.oecd.org/competition/achievingcompetitiveneutrality.htm>
66 *China to Further Improve Business Climate Focusing on Weak Links*, State Council, 26th March 2019, viewed 2nd April 2019, <http://english.gov.cn/premier/news/2019/03/26/content_281476580878408.htm?mc_cid=6a7adfb8f0&mc_eid=d6411c087e>

Figure 40: European business has mixed outlook on competitive neutrality

When do you expect competitive neutrality between SOEs, JVs, POEs (incl. FIEs) to be fully realised?

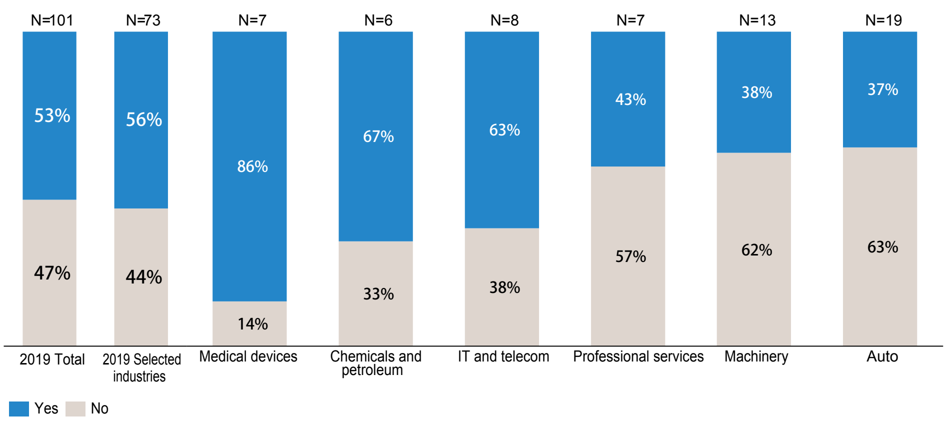


4.3 CM2025 still seen to unfairly promote Chinese industry

In industries covered by the China Manufacturing 2025 (CM2025) initiative, European firms report a noticeable improvement in their ability to participate, with the percentage of companies that can take part in the initiative rising to 53% in 2019 from 42% in 2018.

Figure 41: CM2025 sees European participation rise in industries covered by the initiative

Are you able to participate in China Manufacturing 2025?1) 2) 3)



1) Excludes answer 'Do not know'

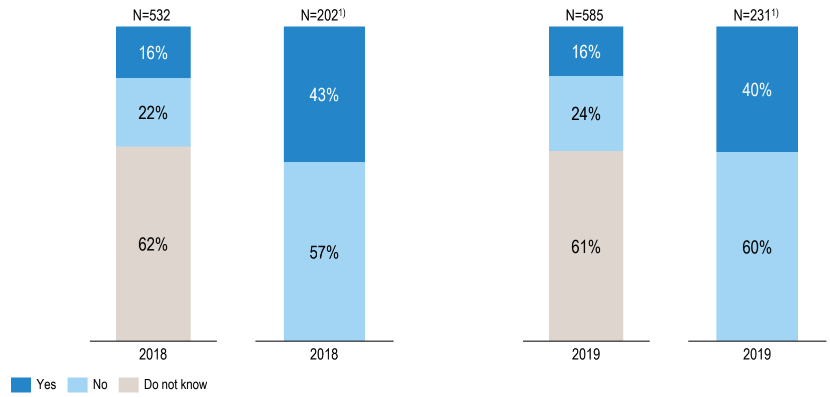
2) Industries selected are those for which there were at least 6 responses

3) Only asked the question if the answer was 'Yes' to the previous question, 'Are you in an industry covered by China Manufacturing 2025?'

Yet CM2025 is still seen to promote domestic companies at the expense of foreign firms, with 40% of companies seeing increased discrimination under the initiative.

Figure 42: CM2025 still discriminates against some foreign firms

Are you seeing increased discrimination against foreign companies compared to Chinese companies under China Manufacturing 2025?



1) Excludes answer 'Do not know'

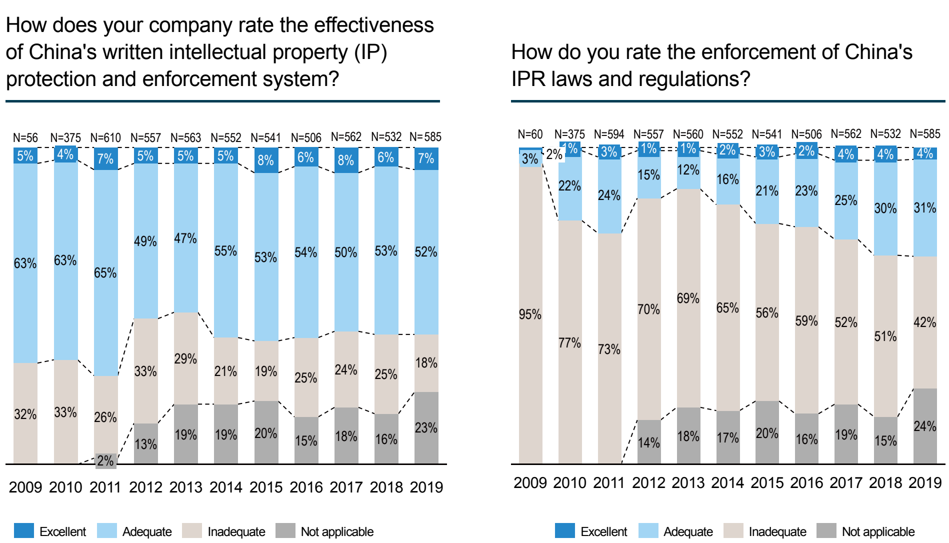
5 ALARM BELLS SOUND AS PROGRESS SLOWS IN SOME AREAS

In 2018, China proved that it was fully capable of making progress in areas it had prioritised for future development. Huge improvements were recorded in European businesses' ratings of IPR enforcement and environmental protection measures. Disappointingly, the momentum has not continued. It is imperative that China does not take its foot off the pedal when it comes to protecting IPR and the environment even in the face of short-term macroeconomic challenges, as these areas will help drive more sustainable development over the long term.

5.1 IPR improvements stall

While 2018 saw a significant jump in European companies' ratings of IPR enforcement, progress has slowed, with positive ratings only increasing 1% y-o-y in this year's report.

Figure 43: Enforcement of IPR laws and regulations stagnates

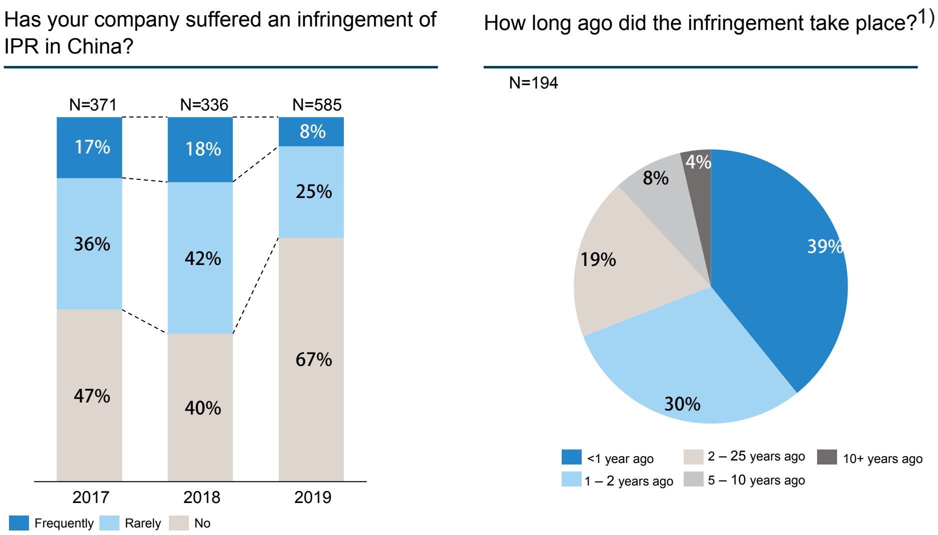


There is also a dire need for the government to improve preventative measures, as IPR infringements continue to take place, albeit to a lesser extent than in the past. Among companies that have been affected, 69% said the IPR infringement took place within the past two years. Preventative measures could include raising punitive compensation caps and increasing the number of years that infringers are barred from the industry.

E-commerce companies note that although there has been a reduction in the number of fake goods found on Taobao and JD—China's two largest e-commerce platforms—a number of copyright infringers have simply moved to alternative platforms like WeChat, which remain comparatively unregulated.[67]

67 Zhou, Wenting, *E-commerce Firms Make Headway in Stamping Out Counterfeits, China Daily*, 11th January 2018, viewed 19th March 2019, <http://www.chinadaily.com.cn/a/201801/11/WS5a56a447a3102e5b1737410a.html>

Figure 44: IPR infringements continue but to a lesser extent

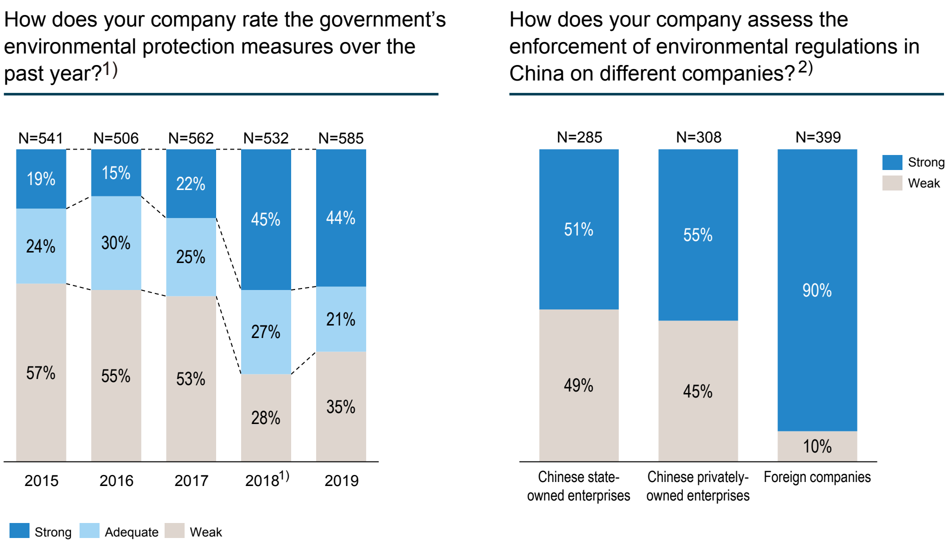


1) *Only asked if the answer to the previous question, 'Has your company suffered an infringement of IPR in China?', was not 'No'*

5.2 Setback in environmental enforcement

Last year's BCS also reported huge progress in European companies' evaluation of environmental protection measures. In 2019, however, this trend has not continued. The share of respondents that rated environmental protection as 'strong or adequate' dropped by 7% y-o-y to 65%.

Figure 45: Government takes foot off the pedal on environmental enforcement



1) *Answers 'Weak' and 'Poor' added for 2018*

2) *Excludes answer 'Do not know'*

6 EUROPEAN BUSINESS REMAINS COMMITTED TO CHINA, DESPITE CHALLENGES

In spite of the volume and complexity of the issues that European companies face when doing business, the Chinese market remains integral to their future plans and they are dedicated to finding ways to expand their operations in the country. European companies have also continued to perform well, with strong profits recorded for 2018, as they are used to operating in challenging conditions against strong competition.

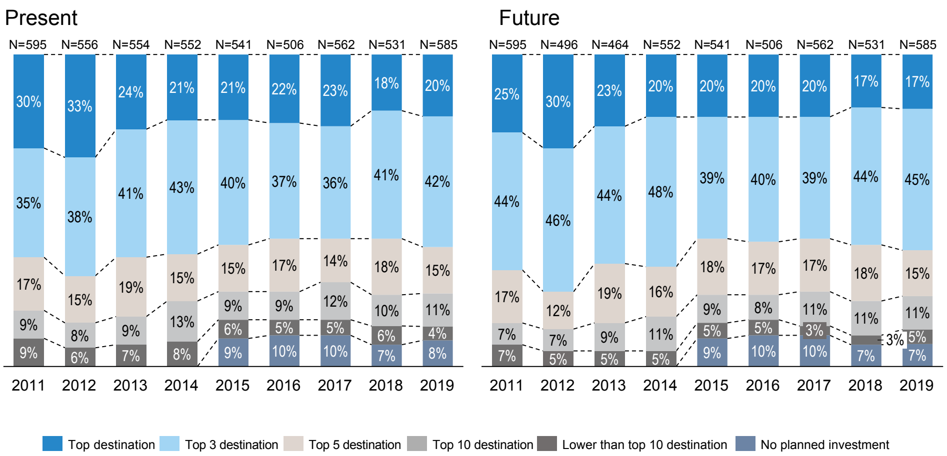
At the same time, European companies could contribute a lot more to the Chinese economy if they were not burdened by regulatory obstacles, unequal treatment and restricted market access. EU investment flows into China only reached EUR 6.1 billion in 2018, significantly less than EU investment in the US, which was EUR 149 billion in 2017.[68] If China fulfilled its reform commitments, it would unlock a huge stream of investment that could help it better manage the effects of the economic slowdown.

6.1 Here for the Chinese market

The size of the Chinese market and untapped growth potential still outweigh the considerable costs of operating here that arise from difficult operating conditions, and therefore European companies remain dedicated to doing business in China. The country remains among the top-three current and future investment destinations for 62% of respondents.

Figure 46: China remains a top investment destination for many

On a global scale, where does China rank as a destination for present and future investments for your company?

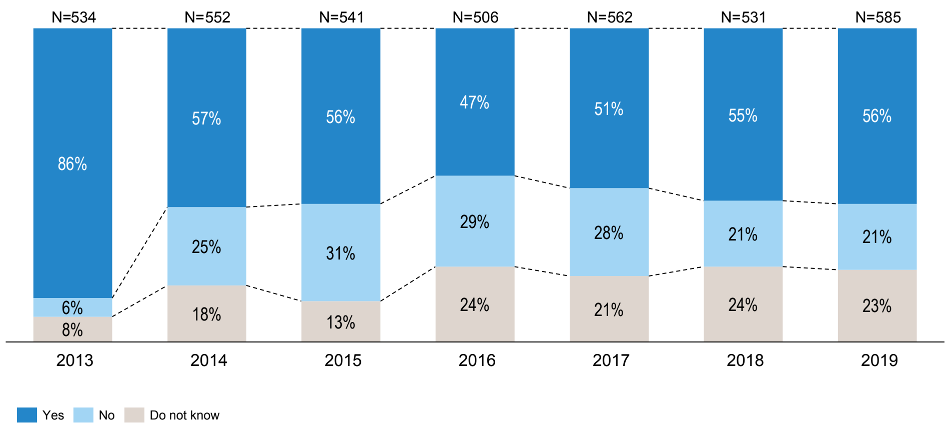


68 *Key Metrics EU-China Investment Relationship*, Delegation of the European Union to China, 2019, viewed 21st March 2019; Hamilton, David and Quinlan, Joseph, *The Transatlantic Economy 2018: Annual Survey of Jobs, Trade and Investment Between the United States and Europe*, Center for Transatlantic Relations at Johns Hopkins University and the American Chamber of Commerce to the European Union, p. viii, 2017, viewed 21st March 2019, <https://transatlanticrelations.org/wp-content/uploads/2018/03/TA2018_FullStudy.pdf>

It is also encouraging that 56% of respondents are looking to expand their China operations in 2019.

Figure 47: European companies plan to expand in China in 2019

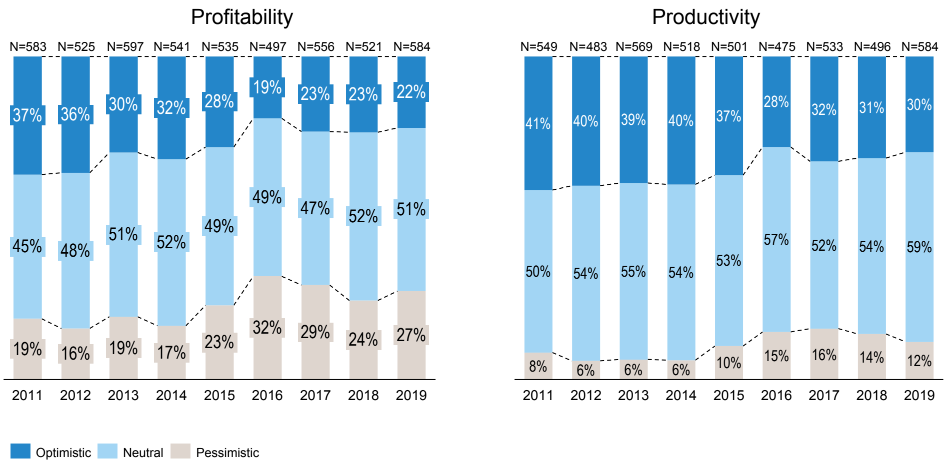
Is your company considering expanding current China operations in 2019?



European firms remain confident in their ability to remain profitable, with 22% of respondents optimistic about their profitability outlook for the next two years, down just 1% y-o-y.

Figure 48: Members report stable outlook on profitability and productivity

How would you describe the business outlook for your sector in China over the next two years?

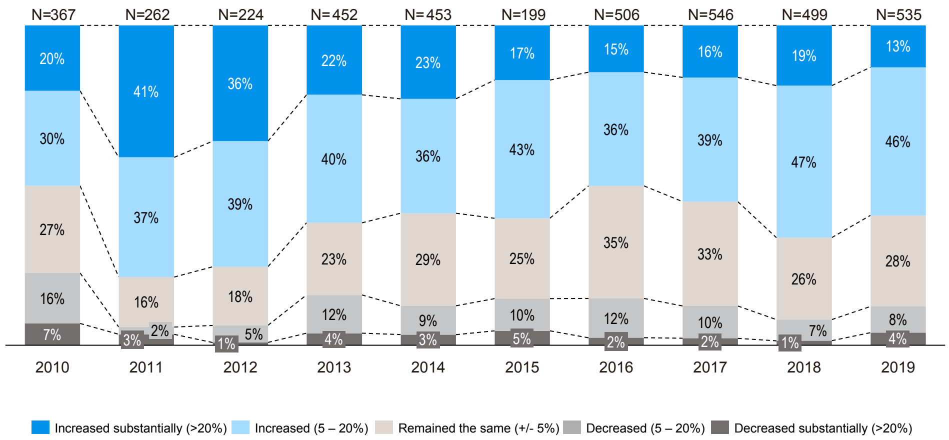


6.2 Successful European firms ready to invest more under right conditions

In spite of concerns about the economic slowdown, there was only a 7% y-o-y drop in the share of respondents that reported increased revenues. If we take into account the fact that 2017 was a record revenue year for many respondents, the significance of this drop perhaps diminishes further.

Figure 49: Revenue growth dips slightly

How did your company's total 2018 revenue in Mainland China evolve compared to 2017?1)



1) Excludes answer 'Not Applicable'

Professional services and legal firms saw greater demand in 2018, as other industries sought their services to help cut costs, navigate the US-China trade war and deal with factory closures resulting from the government's crackdown on polluting entities.

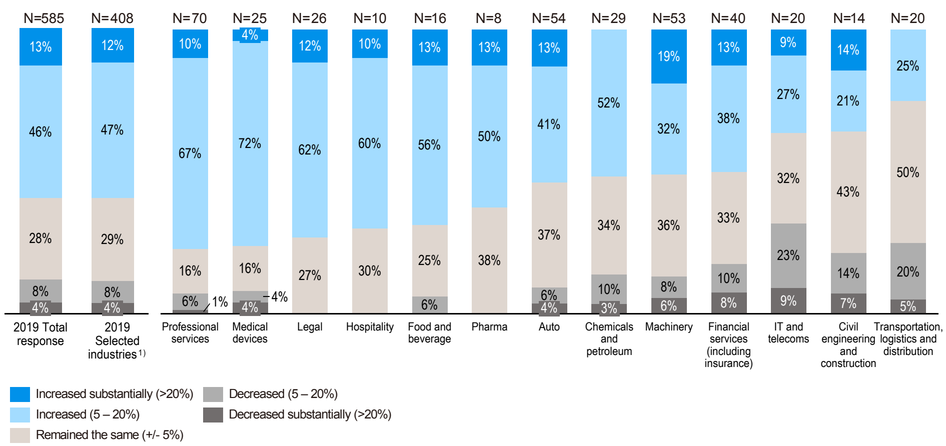
The medical devices industry also performed well, the top reasons being increased demand as a result of China's rapidly ageing population and a general improvement in citizens' access to advanced medical treatment. The rise in chronic diseases caused by unhealthy lifestyles also resulted in greater demand.

The transportation, logistics and distribution industries were least likely to see a rise in revenues. As service providers to manufacturing firms, companies in these sectors are reconfiguring their supply chains to address the challenges of manufacturing upgrading, the economic slowdown and the US-China trade war. Furthermore, the government's destocking of the unsold property inventory means storage and transportation orders from manufacturers have decreased, while costs such as raw materials have gone up.[69]

69 *China's Supply-side Structural Reforms: Progress and Outlook*, Economist Intelligence Unit, 2017, pp. 11-14, viewed 2nd April 2019, <http://www.eiu.com/Handlers/WhitepaperHandler.ashx?fi=China_SSSR_EN.pdf&mode=wp&campaignid=ChinaSSSR2017>

Figure 50: Professional services, medical devices and legal firms see high revenue increase

How did your company's total 2018 revenue in Mainland China evolve compared to 2017? 2)

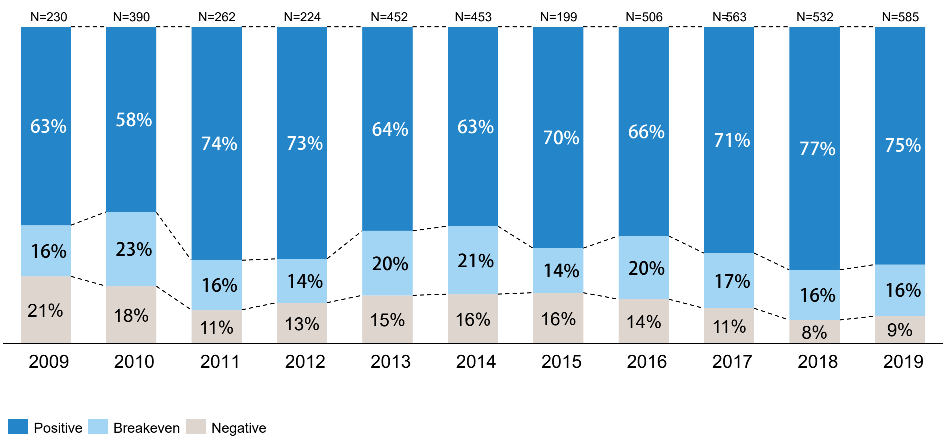


1) *Industries selected are those for which there were at least 8 responses*
2) *Excludes answer 'Not Applicable'*

Despite facing declining revenue growth, 75% of respondents reported positive earnings before interest and tax (EBIT) for 2018, down just two percentage points from 2017, and still the second highest level in the last decade. This indicates that European firms remain agile in a more challenging market. Profits were strong across all sectors as businesses continued to manage their costs effectively.

Figure 51: European companies remain profitable in China

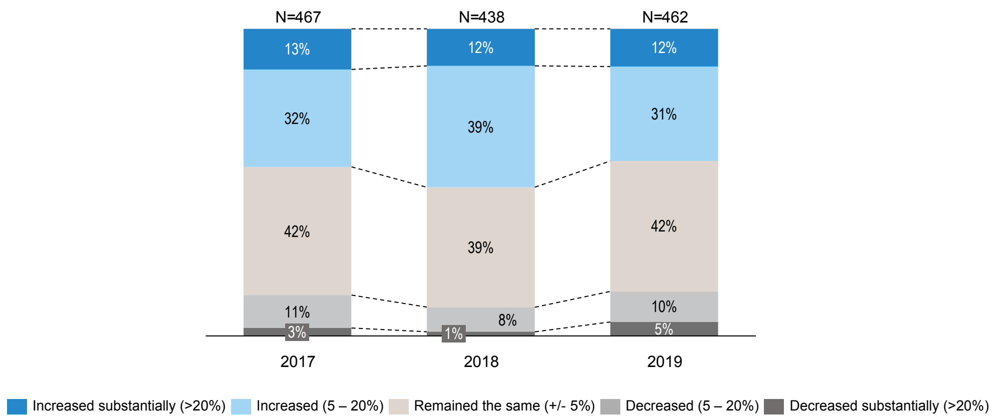
Please describe your company's earnings before interest and tax (EBIT) in Mainland China in 2018



Although the proportion of respondents that increased their EBIT margin in 2018 declined by eight percentage points compared to the previous year, 39% said the margin was still higher than their worldwide average – the highest percentage since 2012.

Figure 52: Healthy EBIT margins endure

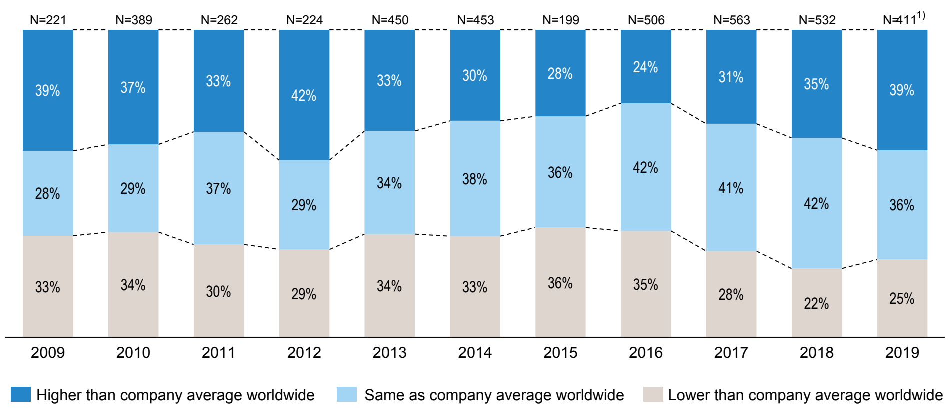
How did your company's 2018 EBIT margin in Mainland China evolve compared to 2017?[1)]



1) Excludes respondents who were unable to answer

Figure 53: China profits compare favourably to rest of the world

How does the EBIT margin of your company's Mainland China operations evolve compared to your company's worldwide average EBIT margin in 2018?



1) Excludes answer 'Not applicable'

If the government granted international businesses greater market access, 65% of members would be likely to increase investment, with almost half of those willing to invest an additional 5% to 10% of their annual revenue.

Figure 54: Greater market opening likely to release untapped European investment

If greater market access were granted to foreign companies in your industry, how would this impact your company's investment decisions in China?

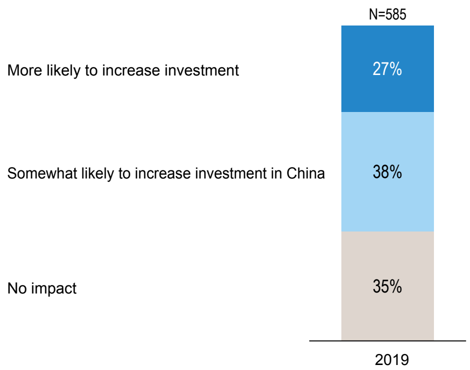
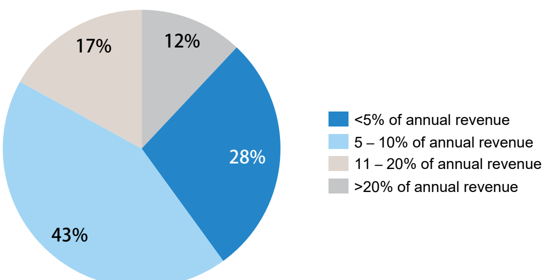


Figure 55: Considerable European capital waiting to be let in

By how much would you be likely to increase your company's investments into China? 1)

N=381



1) *Asked only if the answer to the previous question, 'If greater market access was granted to foreign companies in your industry, how would this impact your company's investments decisions in Mainland China?', was not 'No impact'*

7 SMES CALL FOR BETTER POLICY IMPLEMENTATION

Small and medium-sized enterprises (SMEs) represent 99.6% of businesses in China and contribute 60% of the national GDP.[70] They also create more than 80% of jobs, hold more than 70% of patents and contribute more than 50% of taxes.[71] Multinational corporations (MNCs) depend on SMEs in their supply chains and supporting industries, and SMEs are the seeds from which the MNCs of the future can grow. Smaller companies also tend to invest a lot of time and effort in training their staff, and therefore make an important contribution to the development of the local workforce.

At the same time, SMEs are at a natural disadvantage because they lack scale and resources, which means they are hit harder by unfair treatment and operational barriers. SME sentiment can be considered the most telling metric when measuring the overall state of the business environment because they do not have the same buffers as larger enterprises to protect them from external pressures.

Beijing has recognised and acted upon the need to deliver more policy and financial support for SMEs. The State Council and State Administration of Taxation have, for example, introduced policies in recent years that exempt SMEs from value-added tax (VAT).[72] In the 2019 government work report, the authorities also pledged to effectively improve financing and introduce tax cuts for SMEs.[73] Significantly, the report said that loans to SMEs from commercial state-owned banks would increase by at least 30%. Preferential measures to support innovative and high-tech enterprises have also been introduced as part of the wider push to encourage innovation.

In 2018, governments at the central and local levels also made significant efforts to improve the business environment, such as reducing and simplifying administrative approvals, developing online portals and establishing a government service evaluation system, all of which helped China climb the rankings in the World Bank's *Doing Business* report.[74] However, many supportive policies are unclear as to how in implementation they will apply to international SMEs, which means this group continues to face unnecessary administrative burdens.

As long as structural issues remain in the market, no amount of policy directives will allow banks to identify strong private companies, or the market to efficiently allocate resources. As a result, the government is facing difficulties in persuading banks to increase their lending to the private sector, and smaller firms in particular.

70 Guo, Linmao, and Ma, Xianghui, *People's Republic of China Small and Medium-sized Enterprises Promotion Law: Guidebook*, China Democracy and Legal System Publishing House, Beijing, 2017. pp. 15–19.

71 Ibid.

72 *Notice on Further Expanding the Scope of Preferential Income Tax Policies for Small and Low-profit Enterprises*, Ministry of Finance (MOF) and the State Administration of Taxation (SAT), 2nd September 2015, viewed 3rd April 2019, <http://www.chinatax.gov.cn/n810341/n810765/n1465977/n1466027/c1886544/content.html>; *State Council Press Office Holds Press Conference on Specific Measures to Implement the Spirit of the Central Economic Work Conference, Xinhua*, 15th January 2019, viewed 3rd April 2019, <http://www.xinhuanet.com/talking/20190115z/index.htm>

73 *Government Work Report (Transcript)*, Central People's Government, 5th March 2019, viewed 6th March 2019, <http://www.gov.cn/premier/2019-03/05/content_5370734.htm?mc_cid=7210bcfc5e&mc_eid=d6411c087e>

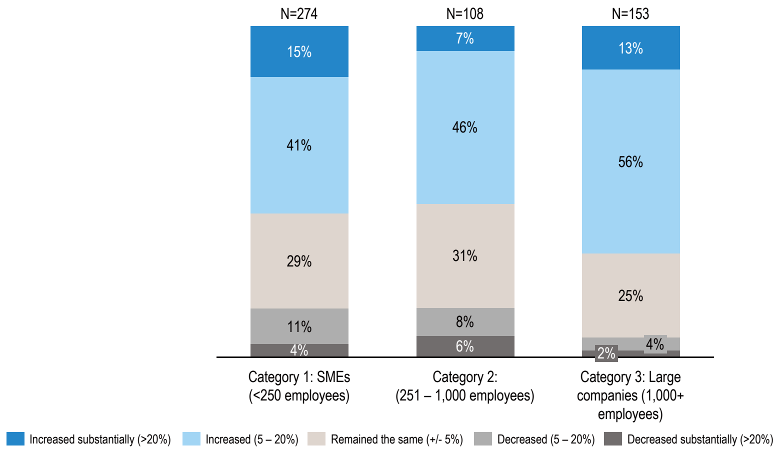
74 *China Vows to Further Improve Business Environment, Xinhua*, 18th July 2018, viewed 3rd April 2019, <http://www.xinhuanet.com/english/2018-07/18/c_137333578.htm>

7.1 SMEs hit harder by slowing economy

In 2019, 15% of SMEs reported decreasing revenues, compared to 6% of large companies.

Figure 56: Twice as many SMEs have seen revenues decrease compared to large companies

How did your company's total 2018 revenue in Mainland China evolve compared to 2017?[1)]



1) Excludes answer 'Not applicable'

With limited resources to deal with operational burdens, and limited financing options, SMEs also have to work harder to remain profitable. The proportion of SMEs that said their EBIT margin declined y-o-y was 10% higher than large companies, while the proportion whose net profit margin was negatively affected by financing was 12% higher.

Figure 57: Smaller firms have to work harder to stay profitable

How did your company's 2018 EBIT in Mainland China evolve compared to 2017?

How did your company's 2018 EBIT margin in Mainland China evolve compared to 2017?

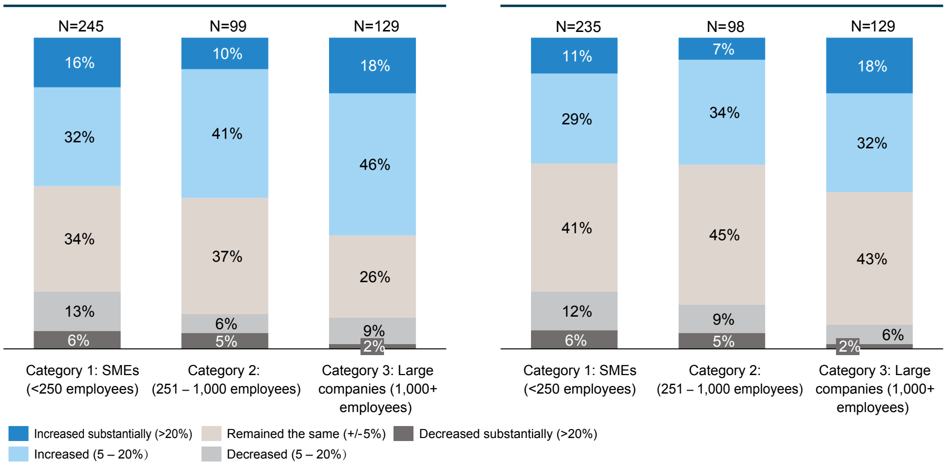
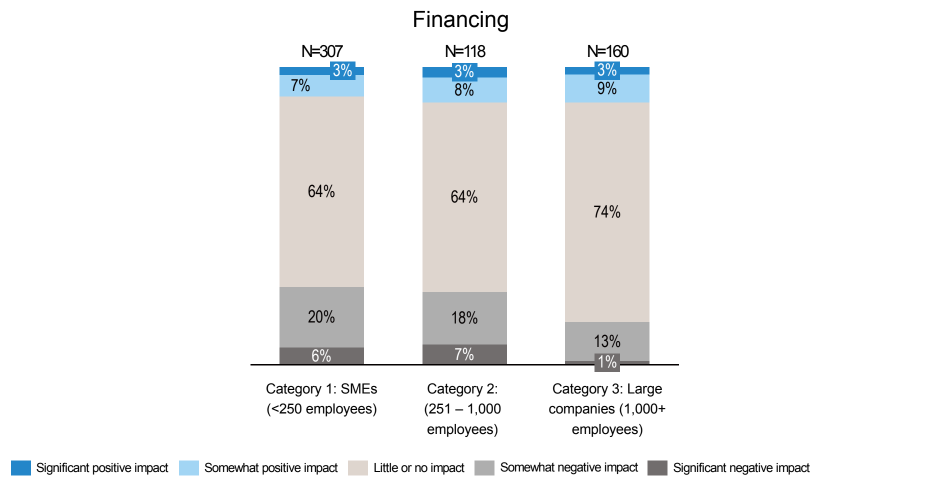


Figure 58: Lack of financing particularly troubling for SMEs

Please indicate the significance of the following factors affecting your company's net profit margin in 2018…



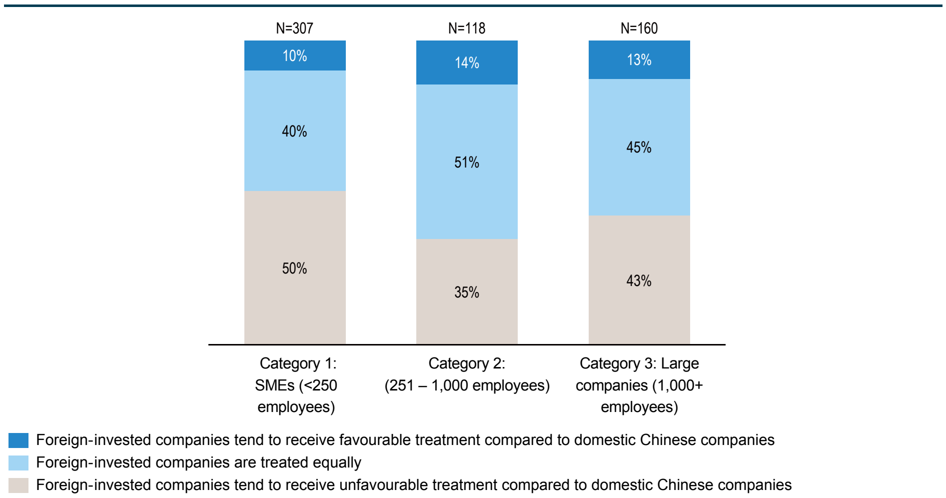
7.2 Undervalued and overlooked

Half of SMEs said they have encountered unfavourable treatment by the government compared to local firms, 15% higher than companies with 251 – 1,000 employees.

Local governments' foreign direct investment (FDI) schemes provide a window of understanding into the preference authorities show for larger foreign firms. Hainan Province, for example, released its *100-Day Campaign to Attract Business* outline in May 2018, as part of its goal to become one of the world's biggest FTZs.[75] The document stated that Hainan would specifically target Fortune 500 companies, global industry leaders and well-known brands to undertake projects in the province, but made no mention of SMEs.

Figure 59: SMEs more likely to feel unfavourably treated

How does your company perceive foreign-invested companies' treatment by the Chinese Government in your industry compared to that of domestic Chinese companies?

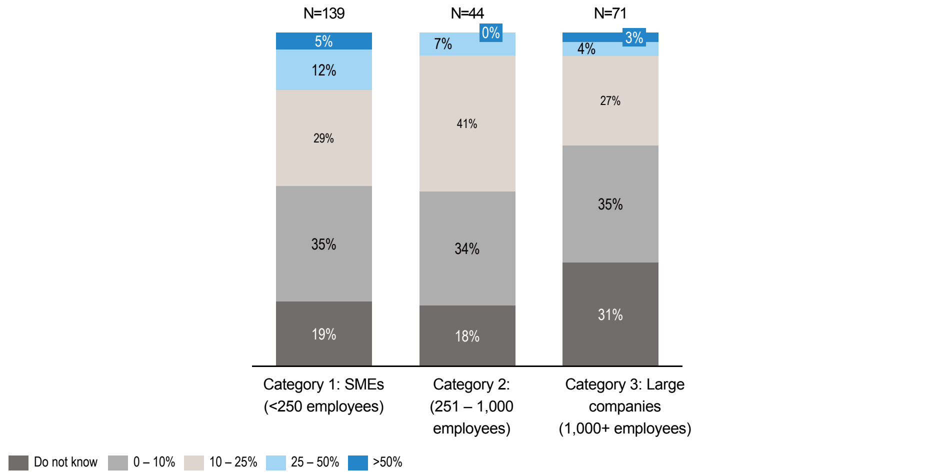


75 *China's Hainan Wants Big Names like Warren Buffett to Come and Invest, South China Morning Post*, 23rd May 2018, viewed 21st March 2019, <https://www.scmp.com/business/article/2147398/sun-sea-sand-and-warren-buffett-chinas-tropical-hainan-wants-big-names-come>

Meanwhile, the costs resulting from regulatory and market access barriers represent a larger share of SMEs' annual revenue, and cut further into their bottom lines.

Figure 60: Market access and regulatory barriers cost SMEs more

What percentage of your company's annual revenue in China do these missed opportunities represent? 1)



1) *Asked only if the answer to the previous question, 'Has your company missed business opportunities in Mainland China as a result of market access restrictions or regulatory barriers?', was 'Yes'*

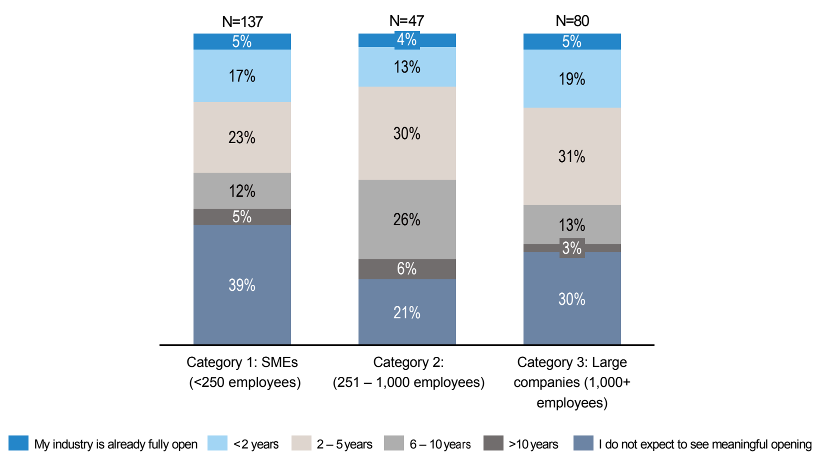
7.3 SMEs feel less optimistic about market opening

SMEs are less optimistic about market opening announcements, with 39% never expecting to see meaningful opening in their sector, compared with 30% for large companies.

Figure 61: SMEs more pessimistic about future market opening

When do you expect to see meaningful opening in your industry?

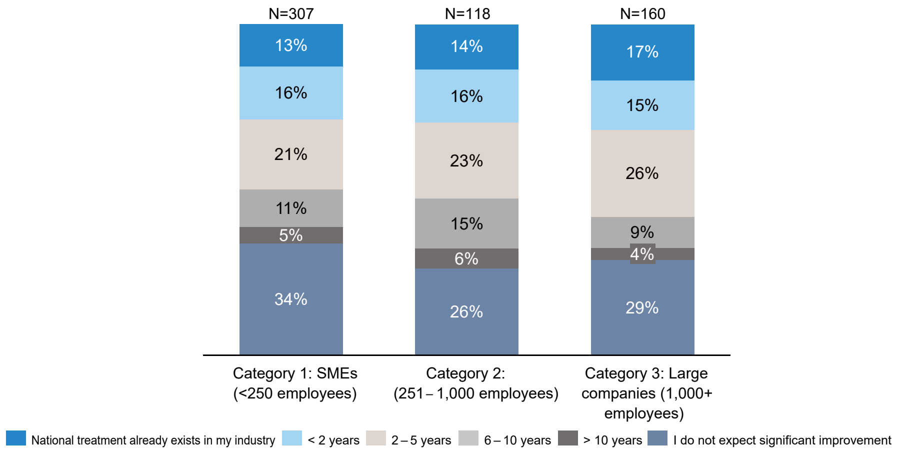
N=264



More than a third of SMEs also never expect to see a level playing field for foreign enterprises in their sector.

Figure 62: SMEs least likely to expect a level playing field

When do you expect to see a level playing field through national treatment for foreign enterprises in your industry?



This year's results show that smaller firms are not just struggling, they are also more pessimistic about the future. As SMEs are an indicator of the overall health of the business environment, their sentiments should serve to motivate the authorities to step up their efforts and address the issues raised by all European businesses in this report.

A good place to start would be ensuring that any measures aimed at increasing market access are matched with commensurate regulatory reforms, and for China to engage with its global partners on trade and investment issues in a more substantial way. This can best be achieved by focusing on the following:

- Releasing unambiguous timelines and roadmaps for the implementation of the FIL that detail when specific consultation periods will take place—with reasonable lead time for providing feedback—to give European stakeholders the opportunity to voice concerns and to clarify vague clauses in the law; as well as stating which leading ministries are responsible for drafting the various implementing guidelines—as happened with State Council Documents numbers 5 and 39—to increase the efficiency of engagement on this important issue.
- Creating more favourable operating conditions—with a focus on strengthening institutions and implementing the rule of law, to create a transparent and predictable legislative environment—eradicating unequal treatment, improving the overall regulatory environment for all businesses and reforming SOEs.
- Working closely with the EU, and within the framework of the WTO when necessary, to positively address intellectual property concerns, in particular the issue of unfair technology transfers.
- Engaging with the EU more deeply to successfully complete a meaningful *Comprehensive Agreement on Investment* (CAI) by 2020, as agreed in the joint statement released during the 21st EU-China Summit on 9th April 2019.[76]

The European business community is ready and willing to support China on all of these issues.

76 *Joint Statement of the 21st EU-China Summit*, Delegation of the European Union to China, 20th February 2019, viewed 21st March 2019, <https://eeas.europa.eu/delegations/china_fi/60836/Joint%20statement%20of%20the%2021st%20EU-China%20summit>

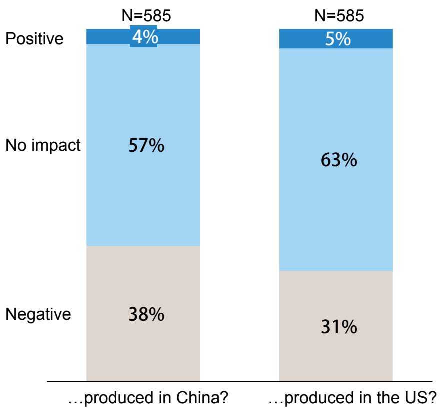
8 ANNEX

8.1 US-China trade war: limited impact, uncertainty abounds

In early July 2018, the US imposed a range of tariffs on Chinese imports in response to what it termed China's continued unfair trade practices. When the BCS was conducted in January 2019, the US had placed tariffs on USD 250 billion worth of Chinese products, and threatened tariffs on USD 267 billion more.[77] China had set tariffs on USD 110 billion worth of US goods. In an increasingly interconnected world, European companies with international supply chains have also found themselves affected: over one third of respondents said they were negatively affected by tariffs from both sides, contrary to expectations that European companies would benefit.

Figure 63: Few European companies report any positive impact from US-China trade war

What kind of impact is your company experiencing as a result of tariffs on goods …



However, the majority are unaffected by tariffs on goods produced in the US and other markets – a reminder that many European companies are in China to serve the domestic market rather than for export.

Most European companies have not changed their business strategy as a result of the US-China trade war, but continue to monitor the situation closely. The conflict is likely to continue having minimal direct impact on members. The most damaging consequence will be the effect on sentiment, which will increasingly hamper business decisions.[78] In the future, this is likely to have an increasingly negative impact on economic growth.

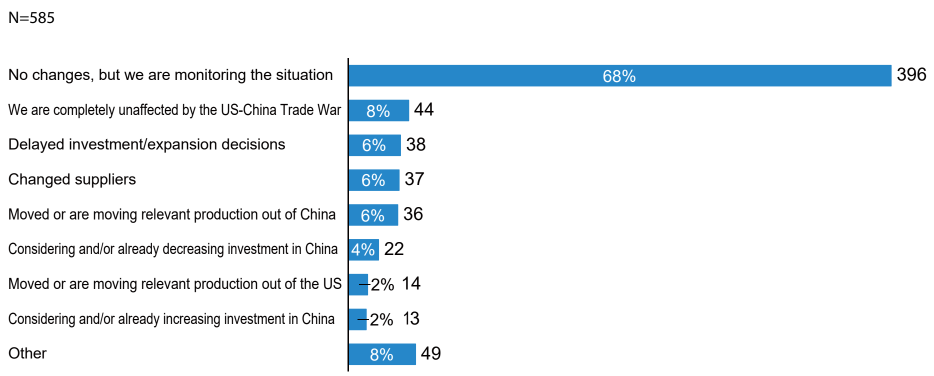
Only 6% of companies have moved or are considering moving relevant production out of China. The top destination choice for these firms is Asia-Pacific countries other than ASEAN member countries (26%), followed by Europe (24%).

A quarter of survey respondents export products from China to the US that are affected by the US tariffs. The industries impacted the most are machinery (49%), civil engineering and construction (43%), and hospitality (45%).

77 *The US-China Trade War: A Timeline,* China Briefing, 25th February 2019, viewed 21st March 2019, <https://www.china-briefing.com/news/the-us-china-trade-war-a-timeline/>
78 *US-China Trade Talks Hit a Bump, The Wall Street Journal*, 8th March 2019, viewed 8th March 2019, <https://www.wsj.com/articles/u-s-china-trade-deal-isnt-imminent-ambassador-branstad-says-11552031163>

Figure 64: Majority of European firms' business strategies remain unchanged

How has your company's business strategy changed as a result of the US-China trade war?[1)]



1) *Multiple answers possible; percentage divided by number of respondents*

In response to US tariffs, 49% of the respondents impacted have covered the costs themselves and kept their prices the same, with another 16% of companies responding by transhipping their goods through other countries.

The main importers of supplies from the US to China that are impacted by Chinese tariffs are chemicals and petroleum (57%), pharmaceuticals (54%) and medical devices (48%) companies. In these industries, 62% of respondents say prices have increased, and the remaining 38% say prices have remained stable.

In response to higher prices on US supplies, 38% of respondents impacted have raised prices on affected products, 34% have swallowed the costs and kept prices the same, and 28% have changed suppliers to avoid the tariffs entirely.

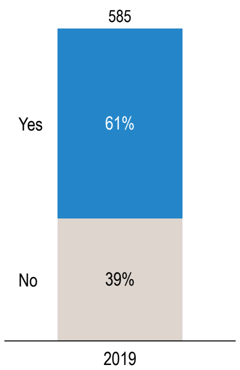
8.2 The struggle to attract and retain talent intensifies

China's working age population peaked in 2010, and the contraction in the workforce is now starting to become apparent as companies struggle to attract the right staff.[79]

79 *China Working-age Population Shrinks, Presenting Pitfall for Pension Plans, Reuters*, 28th February 2018, viewed 10th March 2019, <https://www.reuters.com/article/us-china-economy-population/china-working-age-population-shrinks-presenting-pitfall-for-pension-plans-idUSKCN1GC18C>

Figure 65: Talent tough to come by for most respondents

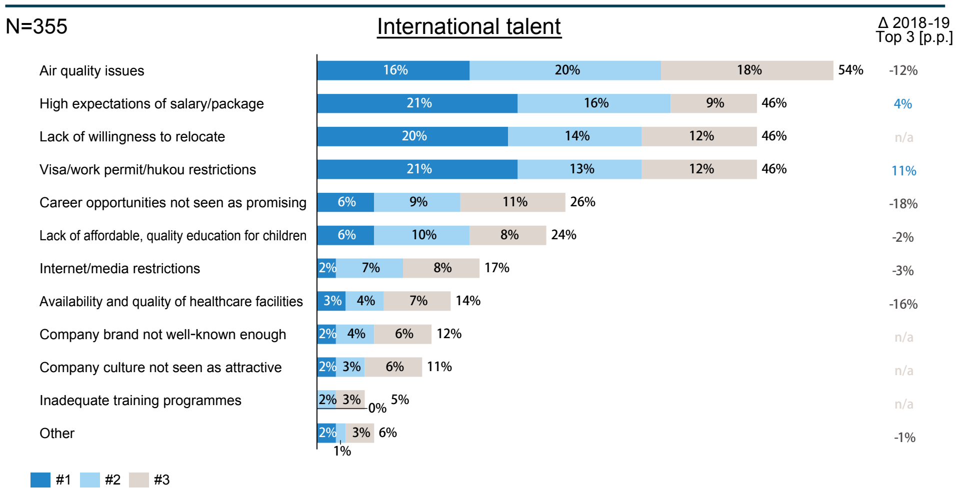
Is your company currently facing any challenges in attracting the right talent in China?



When attracting international talent, air quality issues, high salary expectations, a lack of willingness to relocate, and visa and work permit restrictions are the top challenges. For attracting Chinese talent, high salary expectations outstrips all other issues.

Figure 66: Air quality still main barrier to attracting overseas talent

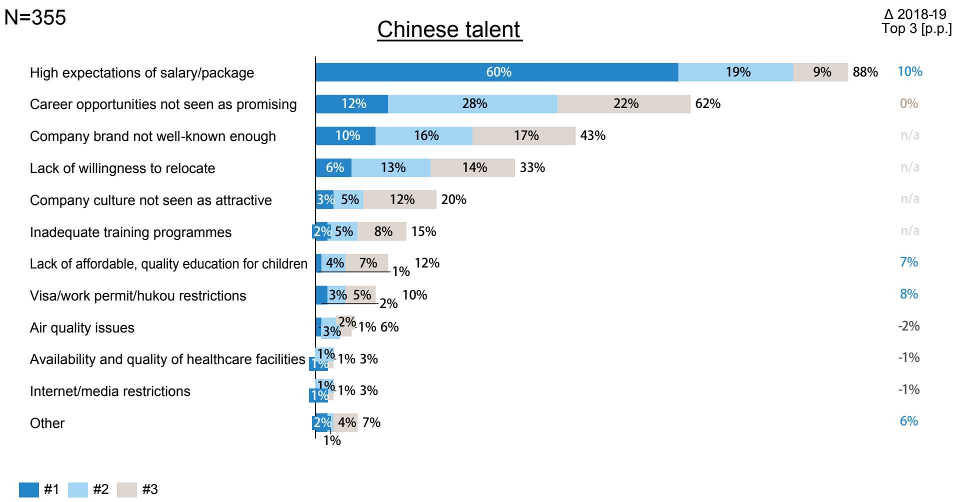
Please list the top 3 challenges in attracting the right talent in China[1)]



1) Asked only if the answer to the previous question, 'Is your company currently facing any challenges in attracting the right talent in China?', was 'Yes'

Figure 67: High salary expectations biggest challenge to attracting local staff

Please list the top 3 challenges in attracting the right talent in China[1)]



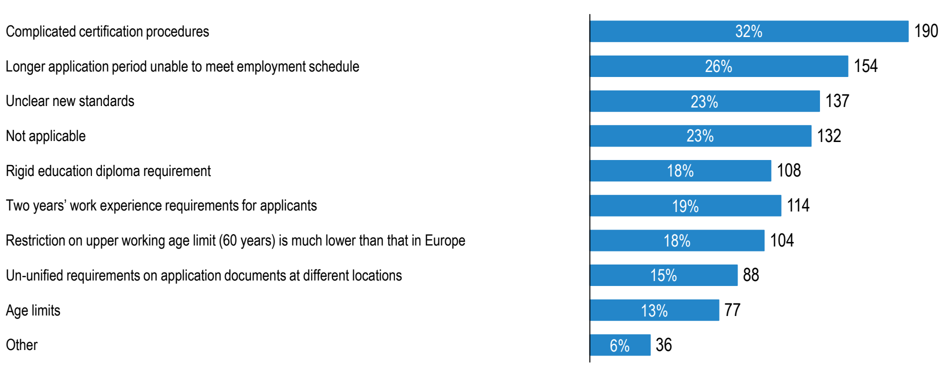
1) *Asked only if the answer to the previous question, 'Is your company currently facing any challenges in attracting the right talent in China?', was 'Yes'*

The new foreigners' work permit (FWP) system was implemented nationwide on 1st April 2017. While it lowers requirements and simplifies administrative processes for high-level talent, for the majority of foreigners—including those most needed by European companies—the process has become significantly more burdensome.

For example, those who have acquired a work visa still need to wait another three weeks to complete the health check required to obtain a residence permit, during which period they cannot work. The visa process can take so long that some candidates may simply give up and take employment elsewhere.

Figure 68: Considerable administrative burdens under work permit system

What are the challenges faced by your company when applying for work permits for foreigners?[1)]



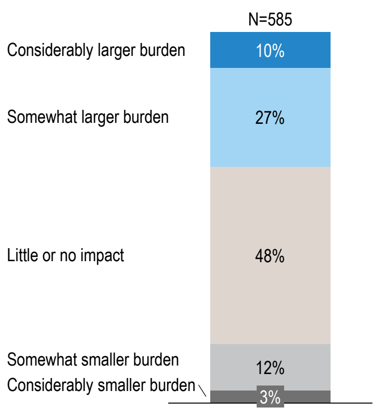
1) *Multiple answers possible; percentage divided by number of respondents*

80 *Individual Income Tax Law*, National People's Congress, 5th September 2018, viewed 10th March 2019, <http://www.npc.gov.cn/npc/xinwen/2018-09/05/content_2060671.htm>

On 5th September 2018, the National People's Congress annonced the new Individual Income Tax (IIT) Law,[80] and 37% of respondents expect increased operational burdens as a result.

Figure 69: New IIT regulations may lead to greater administrative burdens

How do you expect the new Individual Income Tax (IIT) regulations will impact your company's administrative burden?

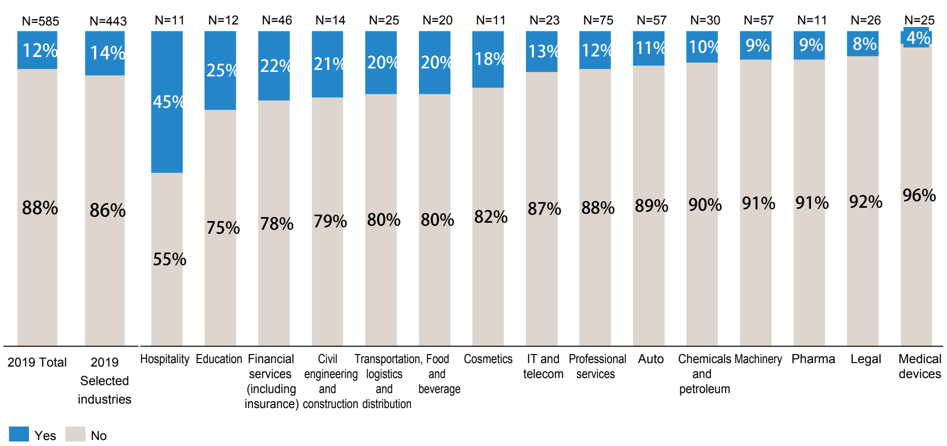


8.3 BRI lacks relevance

While many businesses believe the Belt and Road Initiative (BRI) could bring about new opportunities, the majority (88%) of survey respondents are unable to participate due to a lack of suitable projects and information.

Figure 70: European firms still struggle to participate in BRI

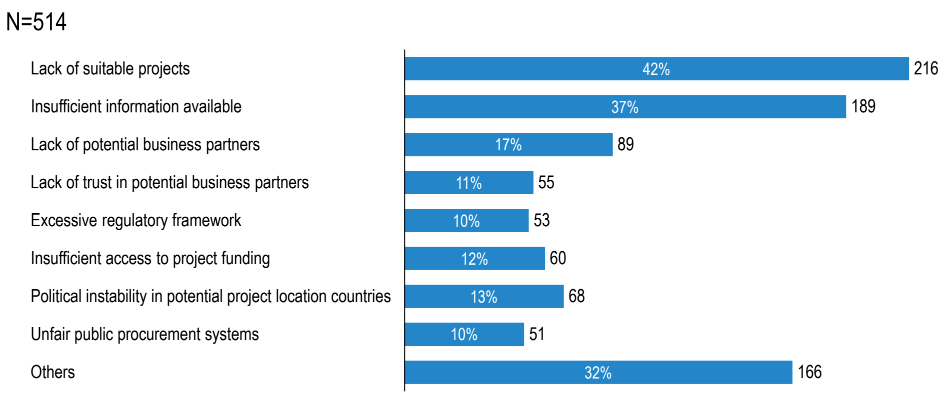
Is your company able to access funding, including subsidies, for Belt and Road Initiative (BRI) projects?[1]



1) Industries selected are those for which there were at least 11 responses

Figure 71: BRI projects unsuitable and illusive for European firms

What are the main challenges experienced by your sector when it comes to BRI projects?[1] [2]



1) *Asked only if the answer to the previous question, 'Is your company able to access funding, including subsidies, for Belt and Road Initiative (BRI) projects?', was 'No'*
2) *Multiple answers possible; percentage divided by number of respondents*

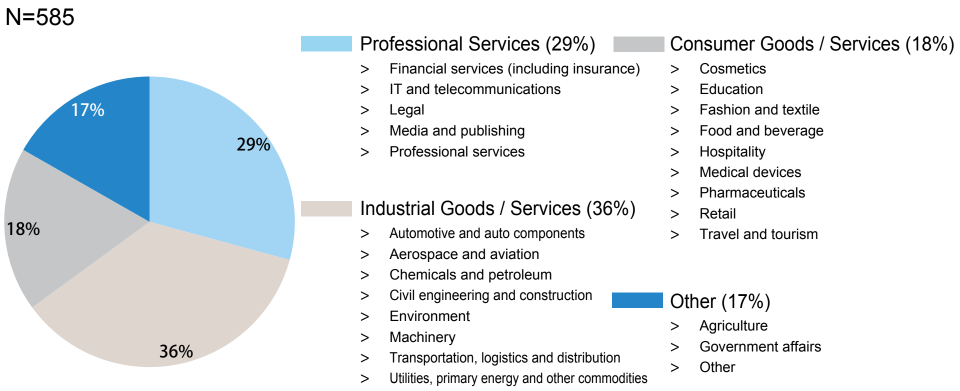
9 PANEL OVERVIEW

9.1 Industry

Companies from a wide cross section of industries were represented in the 2019 survey, with 29% of respondents operating in the professional services sector, 36% in the industrial goods/services sector and 18% in the consumer goods/services sector. Companies in other sectors represented the remaining 17% of respondents. This adds to the quality and representativeness of the data set collected this year. This year's industry breakdown figures are similar to 2018's, which were 31%, 38%, 18% and 13% respectively.

Panel Overview 1

Breakdown of respondents by industry



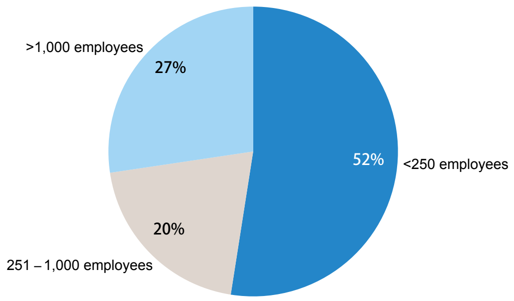
9.2 Size and time in China

In terms of company size, 52% of respondents were SMEs with fewer than 250 employees, 20% were companies with 251–1,000 employees and 27% were large companies with more than 1,000 employees.

Panel Overview 2

Breakdown of respondents by company size

N=585

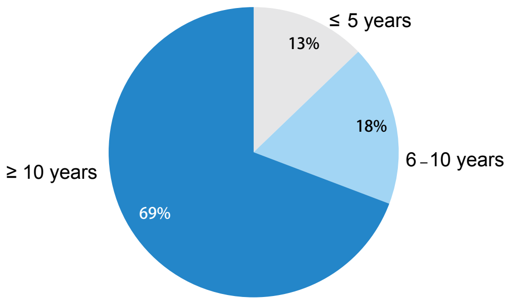


In the 2019 survey, 13% of respondents have operated in China for five years or less; 18% for 6–10 years; and 69% for more than 10 years. These figures are similar to last year's, which were 12%, 28% and 70% respectively.

Panel Overview 3

Breakdown of respondents by time in Mainland China

N=585



10 ABOUT THE SURVEY MOTIVATION AND DESIGN

The purpose of the European Chamber's *European Business in China Business Confidence Survey* is to take an annual snapshot of European companies' successes and challenges in China. Published annually since 2004, the survey has enabled the European Chamber to build a rich data set that serves as a broad indicator of how European companies judge the business environment in China.

The European Chamber invited its members to take part in the 2019 survey over a four-week period during January and February 2019. The survey was conducted in cooperation with Roland Berger and was published in May 2019. There were 1,326 eligible entities. With 585 respondents completing the survey, the 2019 survey achieved a response rate of 44.1%.

In order to obtain a high response rate, which is an essential feature for high-quality results, the survey was condensed as much as possible, while keeping the appropriate questions to make comparisons over time. An online and password-required survey platform was set up for European Chamber members. The survey comprised 67 questions, grouped under three key themes:

- Company Profile and Financial Performance;
- Outlook on the Chinese Business Environment; and
- Outlook on Company Strategy.

A European Chamber chapter-specific section was also added as of 2015, but these questions are not included in this report.

Consistency was one of the key factors that guided the design of the questionnaire and data analysis. We gathered similar data from previous years so that we could trace and understand the development of company strategies and perceptions. We focused on capturing the key issues for European companies operating in China and designed up-to-date questions that are in line with typical issues European companies faced in China in 2018 and 2019.

11 ABOUT ROLAND BERGER

Roland Berger is an independent company, solely owned by our partners, who are responsible for overall corporate performance and business success. Founded in 1967, Roland Berger remains the only leading global consultancy firm with non-Anglo-Saxon roots. We are German by origin, European by nature and global by ambition, including a strong footprint in Asia and other geographies where we feel that we can truly make an impact.

We have always strived to provide a different perspective in the field of consulting and business, and today we continue to constructively challenge standard patterns of thought and provide clients with new solutions to manage disruption and transformation.

Our entrepreneurial spirit has shaped our growth and fuelled our outstanding achievements since the early days of the firm. In short, being a game changer is in our DNA. With nearly 50 years of continuous growth behind us and 2,400 employees working in 34 countries, we are one of the leading players in global top-management consulting and have successful operations in all major international markets.

Through mutual trust and sustainable value added for our clients, we have become a longstanding advisor of major international industry and service companies as well as public institutions worldwide.

12 ABOUT THE EUROPEAN UNION CHAMBER OF COMMERCE IN CHINA

The European Union Chamber of Commerce in China (European Chamber) was founded in 2000 by 51 member companies that shared a goal of establishing a common voice for the various business sectors of the EU and European businesses operating in China. It is a member-driven, non-profit, fee-based organisation with a core structure of 31 working groups and fora representing European business in China.

The European Chamber now has more than 1,600 member companies in seven chapters operating in nine cities: Beijing, Nanjing, Shanghai, Shenyang, South China (Guangzhou and Shenzhen), Southwest China (Chengdu and Chongqing) and Tianjin. Each chapter is managed at the local level by local boards reporting directly to the Executive Committee.

The European Chamber is recognised by the European Commission and the Chinese authorities as the official voice of European business in China. It is also recognised as a foreign chamber of commerce by the Ministry of Civil Affairs. The European Chamber is part of the growing network of European Business Organisations (EBO), which connects European business associations and chambers of commerce from 37 non-EU countries around the world.

Principles:
- We are an independent, non-profit organisation governed by our members.
- We work for the benefit of European business as a whole.
- We operate as a single, networked organisation across Mainland China.
- We maintain close, constructive relations with the Chinese and European authorities, while retaining our independence.
- We seek the broadest possible representation of European business in China within our membership: small, medium and large enterprises from all business sectors and European Member States throughout China.
- We operate in accordance with Chinese laws and regulations.
- We treat all of our members, business partners and employees with fairness and integrity.

www.europeanchamber.com.cn

European Chamber
中国欧盟商会

Beijing
Tel: +86 (10) 6462 2066
Fax: +86 (10) 6462 2067
Email: euccc@europeanchamber.com.cn

Nanjing
Tel: +86 (25) 8362 7330 / 8362 7331
Fax: +86 (25) 8362 7332
Email: nanjing@europeanchamber.com.cn

Shanghai
Tel: +86 (21) 6385 2023
Fax: +86 (21) 6385 2381
Email: shanghai@europeanchamber.com.cn

Shenyang
Tel: +86 (24) 6683 4376
Fax: +86 (24) 6683 4376
Email: shenyang@europeanchamber.com.cn

South China - Guangzhou
Tel: +86 (20) 3801 0269
Fax: +86 (20) 3801 0275
Email: southchina@europeanchamber.com.cn

South China - Shenzhen
Tel: +86 (755) 8632 9042
Fax: +86 (755) 8632 9785
Email: southchina@europeanchamber.com.cn

Southwest - Chengdu
Tel: +86 (28) 8527 6517
Fax: +86 (23) 8527 6517
Email: chengdu@europeanchamber.com.cn

Southwest - Chongqing
Tel: +86 (23) 6308 5669
Fax: +86 (23) 6308 5669
Email: chongqing@europeanchamber.com.cn

Tianjin
Tel: +86 (22) 5830 7608
Fax:+86 (22) 5830 7608
Email: tianjin@europeanchamber.com.cn