



China Economic Monitor

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Note: Unless otherwise stated, data used in this report are from Chinese government agencies such as the National Bureau of Statistics (NBS), the People's Bank of China (PBOC), the Ministry of Commerce (MOFCOM) and the General administration of Customs (GACC).

Executive summary

China's economic growth remained solid in 2017, with GDP growing by 6.8% in Q4 and 6.9% for the whole year. The growth rate was 0.2 percentage points higher than in 2016, marking the first pick-up in growth since 2010.

The service sector was the main driver behind the rebound in GDP growth. In Q4, the tertiary industry (service sector) grew by 8.3% and annual growth hit 8%, outperforming the primary and secondary industries for the fifth consecutive year. The service sector contributed to 58.8% of overall economic growth, marking a record high.

From the demand perspective, recovering external demand was the main driving force for China's GDP growth in 2017. Net exports contributed 0.6 percentage points to the overall growth in 2017, a sharp increase compared to 2016 (when it subtracted 0.4 percentage points from overall growth). Meanwhile, consumption and investment contributed 4.1 percentage points and 2.2 percentage points to GDP growth, respectively, both lower than their shares in 2016. This indicates that excluding the contribution of exports, domestic growth momentum actually slowed in 2017 from the previous year. This is mostly due to China's continuous push of supply-side structural reform, which has affected short-term growth. However, if implemented successfully, these reforms should pave the way for China's sustainable growth in the long run.

Looking ahead, we believe China's economy will be supported by several factors in 2018:

- Retail sales have been growing at a double digit rate for 14 years, and the growth of average national income per capita also surpassed that of GDP in 2017. Rising income provides solid support for continuous consumption growth.
- The profitability of industrial enterprises has been improving since 2016, helping push a recovery in investment. Manufacturing investment has started to pick up since Q4 2017, and we expect this trend to continue in 2018.
- The global economy is seeing a synchronised recovery for the first time in recent years. Greater external demand should help China's exports.

At the same time, we think China's economy is also facing considerable downside pressures:

- Regulations on local government financing will be further strengthened, which will increase local fiscal pressure in the short term. Infrastructure investment grew by 15% in 2017, and we expect a slower rate of growth this year.

- Real estate market policies will continue to be tightened, and property investment and sales are expected to soften. That being said, we do not expect the property market to experience a sharp correction in 2018. On the one hand, housing inventory has reached relatively low levels. On the other hand, shanty town renovations and rental housing construction should support construction activity and real estate investment in 2018.
- The central government will continue to focus on reducing financial risks, and has been releasing a series of regulatory policies. This implies that the credit market will remain relatively tight in 2018, and interest rates will likely see upward pressure.

Looking at China's economic growth over the next few years, we believe there are three major themes that should be closely monitored.

First, preventing and mitigating major risks – especially financial risks. Over the past three years, the Central Economic Work Conference (CEWC), a major annual policy meeting that sets the economic development priorities for the following year, has repeatedly stressed the bottom line of “no systemic financial risks”. Strengthening financial supervision will remain a central policy goal of the government in the near future.

Second, high quality development. China's growth model is transitioning from one of high speed to high-quality development, and its R&D investment has been rising continuously. This change has a far-reaching impact on China's consumption, production, investment, trade and R&D, and companies need to rethink their strategies to respond to the shifting demand.

Finally, building a green economy. The 19th China Communist Party (CPC) National Congress emphasises that building a green ecosystem is a long-term strategy for China's sustainable development. We believe the impact of higher environmental standards will be twofold. On the one hand, it will raise the operating cost of polluting industries, which – along with supply side structural reform – will speed up the elimination of backward and excess capacities. On the other hand, green development will also generate significant new demand in environmental management and provide new business opportunities for environmental protection industries and low energy-consumption enterprises.



Special topic: Fintech

Financial technology (fintech) is changing the landscape of the global financial industry and has penetrated many fields, including payments, credit, insurance, crowd funding, wealth management and supply chain finance. Fintech has seen particularly strong growth in China in recent years. According to *2017 Fintech 100*, a joint report by KPMG and H2 Ventures, five of the top 10 global leading fintech companies are from China.

Compared to other countries such as the US, China's fintech companies place a stronger focus on big data analysis – 94 percent of China's leading fintech companies regard big data as the core technology driving their growth. In addition, China's fintech sector is particularly strong in credit and payments. The relative underdevelopment of China's traditional financial industry, especially in consumer loans and credit card payment, offers significant room for growth for fintech companies. Meanwhile, China's major internet companies such as Alibaba, Tencent, Baidu and JD.com have made extensive efforts to create an ecosystem throughout the entire financial services chain, leveraging their advantages in large user bases, traffic, technology and funding.

China's future fintech development is expected to see three major trends:

- Fintech companies are increasingly working closer with traditional financial institutions.
- Fintech companies are placing a greater focus on their technology roots, empowering financial services with new technology tools.
- As the Chinese government continues to increase its scrutiny on financial risks, regulatory technology (regtech) is expected to see particularly strong growth.

1

Economic environment



Macroeconomic trends

► Economic activity

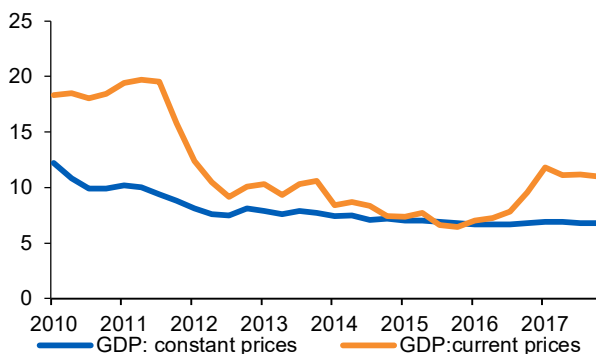
In 2017, China's GDP grew by 6.9%, up 0.2 percentage points compared with 2016, marking the first recovery of the growth rate since 2010. The rapid growth of China's tertiary industry (the services sector) is the main driving force for this rebound. Nominal GDP continued its double-digit growth – increasing by 11.2% year-over-year (YOY), reflecting an improvement in corporate revenue and profitability. In 2017, industrial production grew by 6.6%, an increase of 0.6 percentage points over 2016. However, the growth of industrial production eased somewhat in H2 and slowed to 6.2% in Q4, a lower rate than in the previous two quarters (Q2: 6.9%; Q3: 6.3%).

Retail sales growth in 2017 remained at a relatively high level of 10.2%, but slightly decreased by 0.2 percentage points compared to 2016. The rapid growth of disposable income provided strong support for consumption.

In 2017, per capita disposable income in real terms increased by 7.3%, 1 percentage point higher than in 2016, and 0.4 percentage points above the real GDP growth rate. We expect consumption to maintain double-digit growth in 2018.

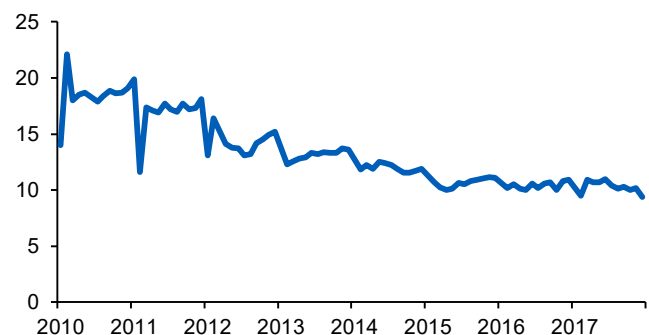
In addition to continued growth, the structure of consumption is also changing and online sales are experiencing fast growth. Since 2015, the growth rate of online spending has exceeded offline spending by at least 15 percentage points every month. As of the end of 2017, online retail sales of physical goods accounted for 15% of total retail sales. China's fast e-commerce growth is partly due to its underdeveloped retail network – especially in the third and fourth-tier cities and rural areas. Online retail is helping to save costs and provide consumers with more choices, creating greater potential demand and overall consumption growth.

Fig. 1: GDP: YOY (%)



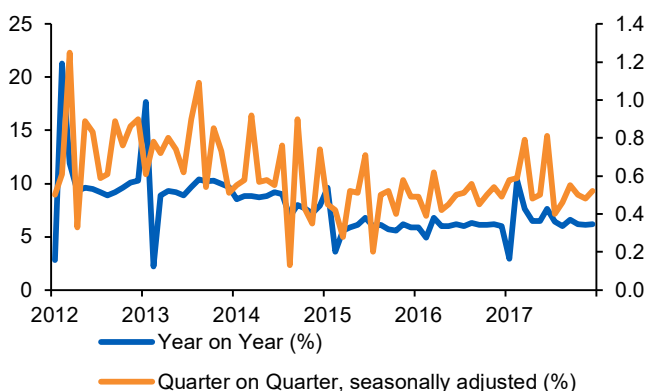
Source: Wind, KPMG analysis

Fig. 3: Nominal retail sales: YOY (%)



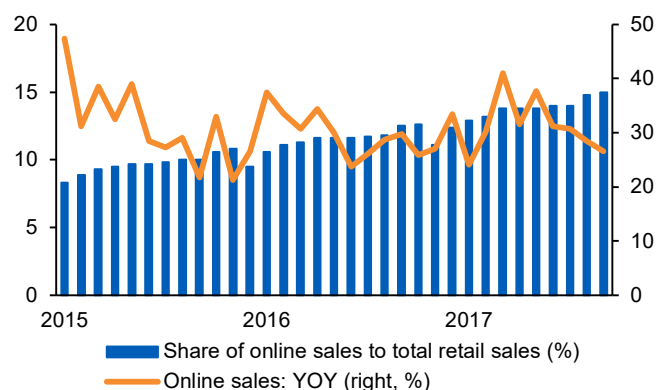
Source: Wind, KPMG analysis

Fig. 2: Industrial production: YOY (%)



Source: Wind, KPMG analysis

Fig. 4: Online retail sales



Source: Wind, KPMG analysis

Investment growth started on a strong note in 2017, but slowed slightly towards the end of the year, with fixed assets investment (FAI) increasing by 7.2%, a drop of 0.9 percentage points compared with 2016. However, with improving industrial enterprise profitability, manufacturing investment started to pick up in Q4, increasing by 4.8%. This partly offset the slowdown of investment in real estate and infrastructure. We expect the recovery in manufacturing investment to continue in 2018.

Infrastructure investment increased by 14.9% in 2017, a slight decrease of 0.8 percentage points compared with 2016. Between April and June 2017, the Ministry of Finance (together with five other ministries and commissions) issued the *Notice on Further Regulation of the Debt Financing of Local Governments* and the *Notice on Strictly Prohibiting Illegal Financing by Local Governments in the Name of Government Purchase of Services*. The measures aim to tighten regulations on public-private partnership (PPP) projects, industrial funds, government purchases of services and other irregularities. With these measures likely to increase the difficulty of local government financing, investment in the infrastructure sector should continue to ease in 2018.

Real estate investment rose by 7% in 2017, at a similar rate to the previous year. In the short term, regulations and controls in the real estate sector will remain tight, which will affect real estate investment in 2018. On the other hand, the central government has put an emphasis on “establishing a housing system that ensures supply through multiple sources, provides housing support through multiple channels, and encourages both housing purchase and renting”.¹ This indicates that this round of regulation will focus more on increasing supply, instead of containing demand.²

The rental housing market is expected to see accelerated growth, especially in the long-term rental market. In 2017, more than 50 cities across the country issued policies encouraging rental housing; more than one-third of the top 30 real estate developers in terms of sales have set up long-term apartment brands or set foot in the leasing market.³ It will be important to monitor the extent to which the construction of rental housing will have an impact on real estate sales and investment in the future.

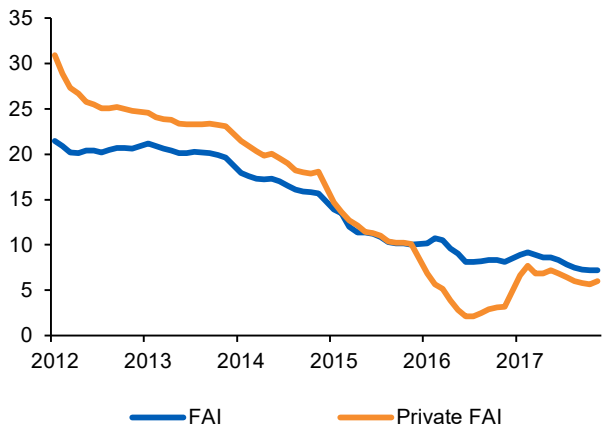
¹ Report of the 19th Communist Party of China National Congress.

² Recently, the Ministry of Housing and Urban-Rural Development announced that 5.8 million units of shantytown housing will be renovated, faster than the previous expectation.

³ ‘A revolution of rental in the Chinese style’, wallstreetcn.com, January 2018

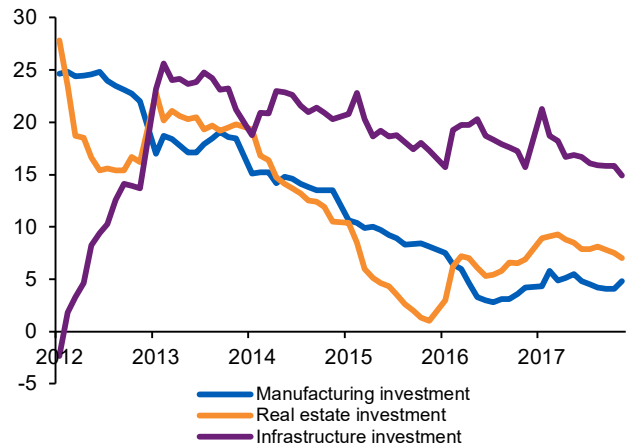


Fig. 5: FAI: YTD YOY (%)



Source: Wind, KPMG analysis

Fig. 6: FAI by sector: YTD YOY (%)



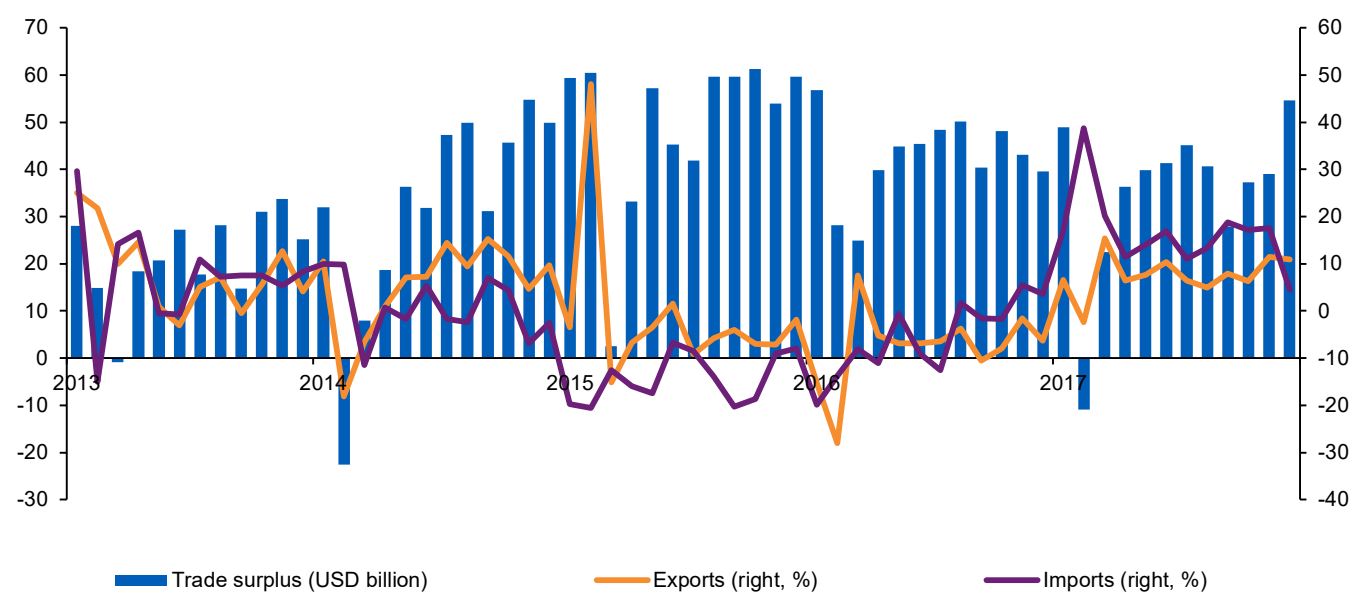
Source: Wind, KPMG analysis



In addition, the recovery of exports was the major driver for the economic rebound in 2017. Exports grew by 7.9% in 2017, reversing the downward trend over the last two years, and reaching its highest level since 2013. The global

economic recovery and resulting improving external demand are expected to promote the steady growth of China's exports in 2018.⁴

Fig. 7: International trade



Source: Wind, KPMG analysis



⁴ IMF raised its global economic forecast in its January 2018 World Economic Outlook Update to 3.9% for both 2018 and 2019, 0.2 percentage points higher than the previous forecasts (October 2017).

► Inflation and monetary policy

The consumer price index (CPI) was 1.6% in 2017, and its growth rate was 0.4 percentage points lower than that of 2016, far below the government's inflation target of 3%.

Helped by reduced supply as a result of cutting overcapacity and greater environmental protection, the producer price index (PPI) rose by 6.3% in 2017, marking a notable rebound from 2016 (down by 1.4%), and a new high since 2009.

The low base of food prices and the improving economy are expected to lead to a slight rebound of the CPI in 2018. We expect moderate PPI growth due to both a high base and weakening demand caused by the slowdown in real estate and infrastructure investment. However, environmental protection measures will continue to limit production and provide support to prices. Overall, we expect the PPI to continue to grow in 2018, but at a slower rate.

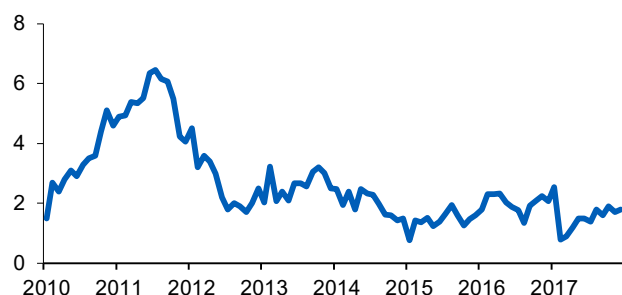
The growth rate of money supply (M2) continued to fall since the beginning of 2017, reaching a record low of

8.2% in December. The growth rate of both total social financing (TSF) and local-debt-adjusted TSF stock⁵ continued to decline. By the end of 2017, they were up 12% and 13.7%, respectively, their lowest levels since June 2015, indicating a tightening of monetary policy.

With increasing regulatory supervision, a large share of off-balance-sheet financing was brought back to the balance sheet in the form of expanding bank loans. New RMB bank loans increased by 13.5 trillion in 2017, RMB 0.88 trillion more than the previous year. However, only about 40% of the new loans went to companies in the second half of 2017, while the remaining 60%, mainly driven by real estate mortgage loans, flowed to households.

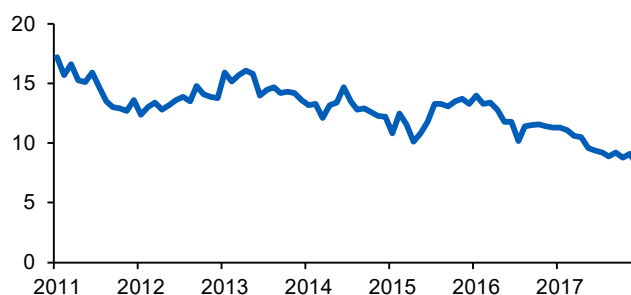
A series of regulatory policies on asset management, trusts and entrusted loans were introduced recently,⁶ suggesting that non-standard debt financing activities will be subject to stricter controls. It is expected that the overall financing environment will be further tightened in 2018.

Fig. 8: CPI: YOY (%)



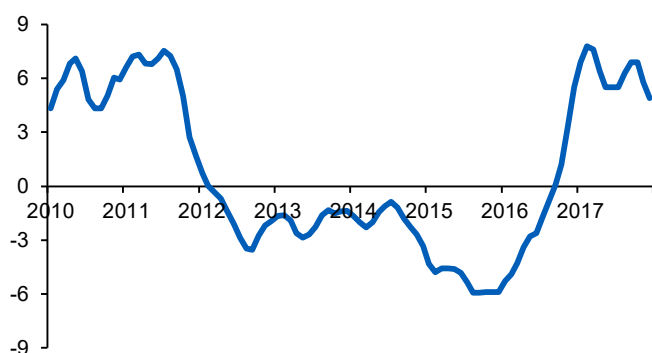
Source: Wind, KPMG analysis

Fig. 10: M2: YOY (%)



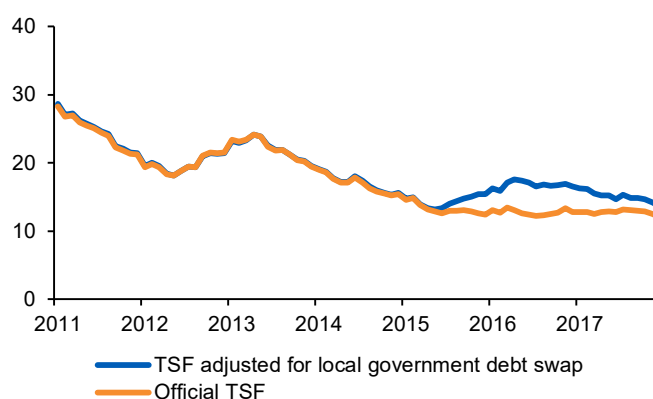
Source: Wind, KPMG analysis

Fig. 9: PPI: YOY (%)



Source: Wind, KPMG analysis

Fig. 11: TSF stock: YOY (%)

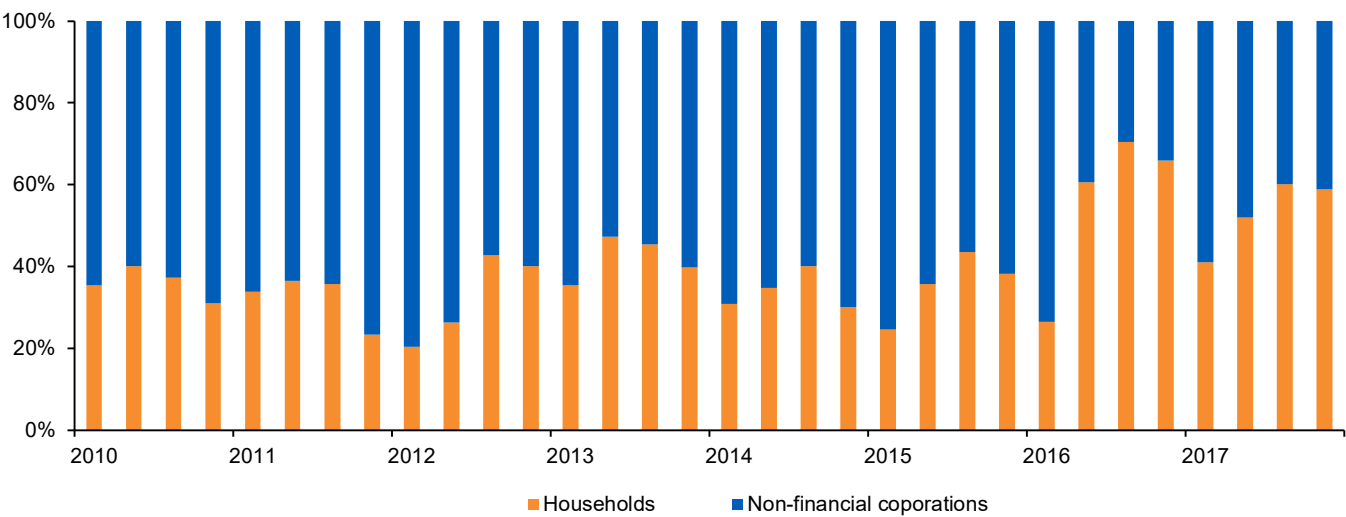


Source: Wind, KPMG analysis

⁵ The Chinese government has started to issue local government bonds to swap existing local government debt since 2015. We have included local government bond issuances in our calculation of total social financing to make the data more comparable over time.

⁶ See Table 2 (Page 15) on 'Key regulatory policies carried out since the beginning of Q4 2017'.

Fig. 12: Share of bank loans by sector (%)



Source: Wind, KPMG analysis



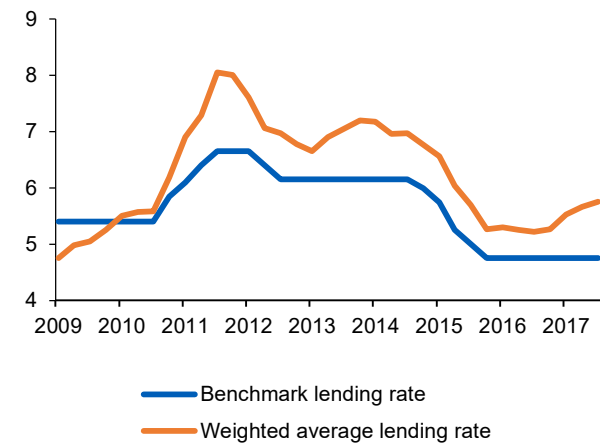
► Interest and exchange rates

Although the benchmark interest rates have remained unchanged since October 2015, the weighted average interest rate of loans by financial institutions has been gradually rising since Q3 2016 due to financial deleveraging.⁷ As of the end of September 2017, the rate increased to 5.76%, 0.54 percentage points higher than the same period a year ago.

Key market interest rates have also been edging up. For example, as of 26 January, 2018, the 7-day repo rates

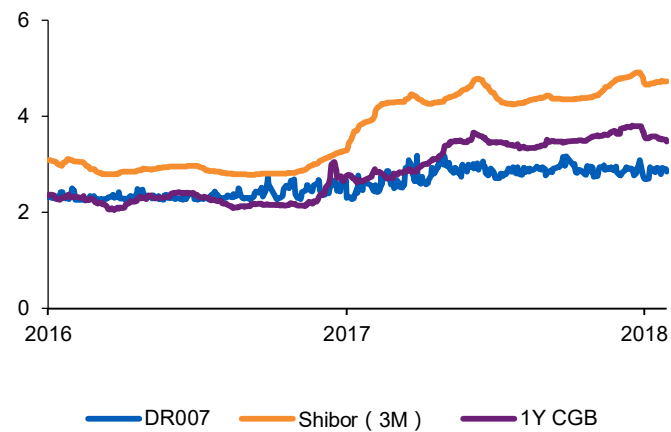
of depository institutions (DR007), the 3-month Shanghai Interbank Offered Rate (Shibor 3M) and the one-year bond yield recorded 2.92%, 4.73% and 3.52%, respectively. This corresponds to a rise of 0.2 percentage points, 1.4 percentage points and 0.8 percentage points, respectively, from the beginning of the year, reflecting tightened liquidity.

Fig. 13: Lending rate (%)



Source: Wind, KPMG analysis

Fig. 14: Major market interest rates (%)



Source: Wind, KPMG analysis



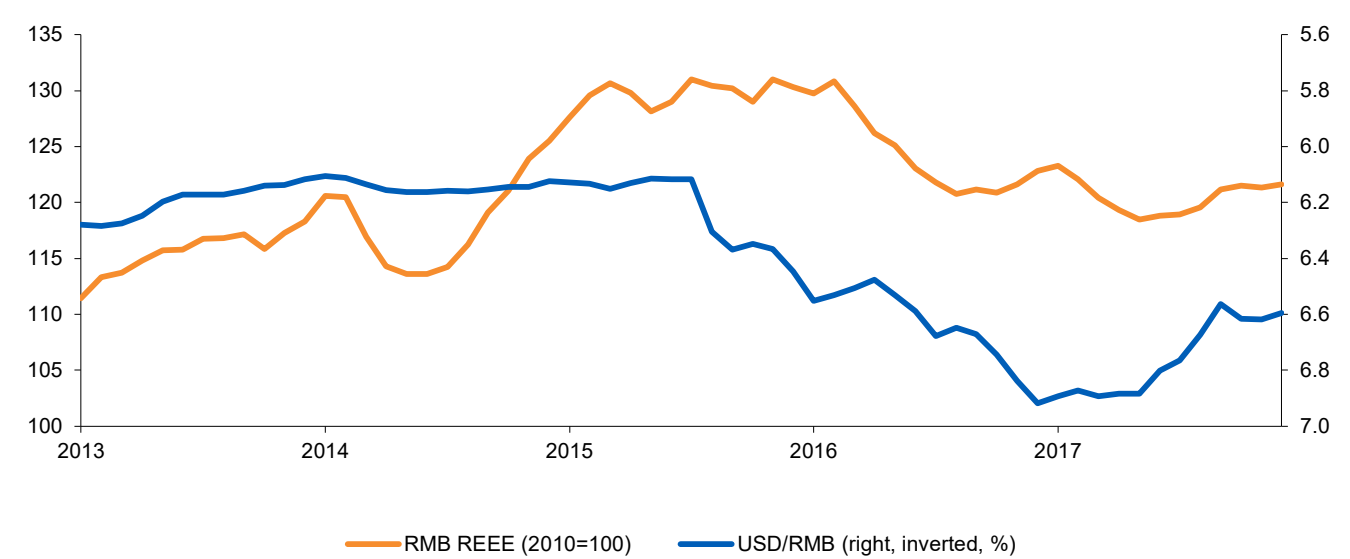
⁷ Weighted average interest rate of loans refers to RMB loans to non-financial enterprises and other sectors excluding interbank deposits. They include short, medium, and long-term loans, bill financing, financial leasing and other advance payments.



Benefiting from a weakening USD, the exchange rate of RMB against USD has appreciated by 6.7% since the start of 2017. In December 2017, the average rate of USD against RMB rose to 6.69 and reached 6.3 at the end of January 2018. After a dip in H1, the RMB real effective exchange rate index (REER)⁸ started to pick up gradually from May 2017. As of the end of 2017, the index recorded 121.6, recovering all the losses seen in the first half of the year.

Meanwhile, capital outflows eased in 2017 due to heightened controls on overseas investment. Foreign exchange reserves have continued to increase since February 2017 and reached USD 3.14 trillion by the year end, an increase of USD 129.43 billion from the end of 2016. The CEWC has said to “keep the RMB exchange rate relatively stable at a reasonable equilibrium level”, and we expect to see the RMB fluctuate in both directions in 2018.

Fig. 15: RMB exchange rate



Source: Wind, KPMG analysis

⁸ RMB real effective exchange rate (REER) index was calculated by the Bank for International Settlements (BIS). It is the weighted average exchange rate of RMB against its major trading partners (including 61 economies). Compared with the RMB exchange rate against the US dollar, the REER index can better reflect the international price of the RMB. A higher reading of REER represents the appreciation of the RMB.

Three themes of China's future development

► Preventing risks

The latest annual CEWC held in December 2017 explicitly ranked “preventing and resolving major risks” as the top priority for the next three years. It also noted that financial risk is the key risk to watch, and emphasised that “prudent monetary policy should be kept neutral, and the gate of monetary supply should be under control”. This indicates that China should keep a relatively tight monetary policy in 2018.

Table 1: The changes related to monetary policy, risk prevention and deleveraging from the past three Central Economic Work Conferences

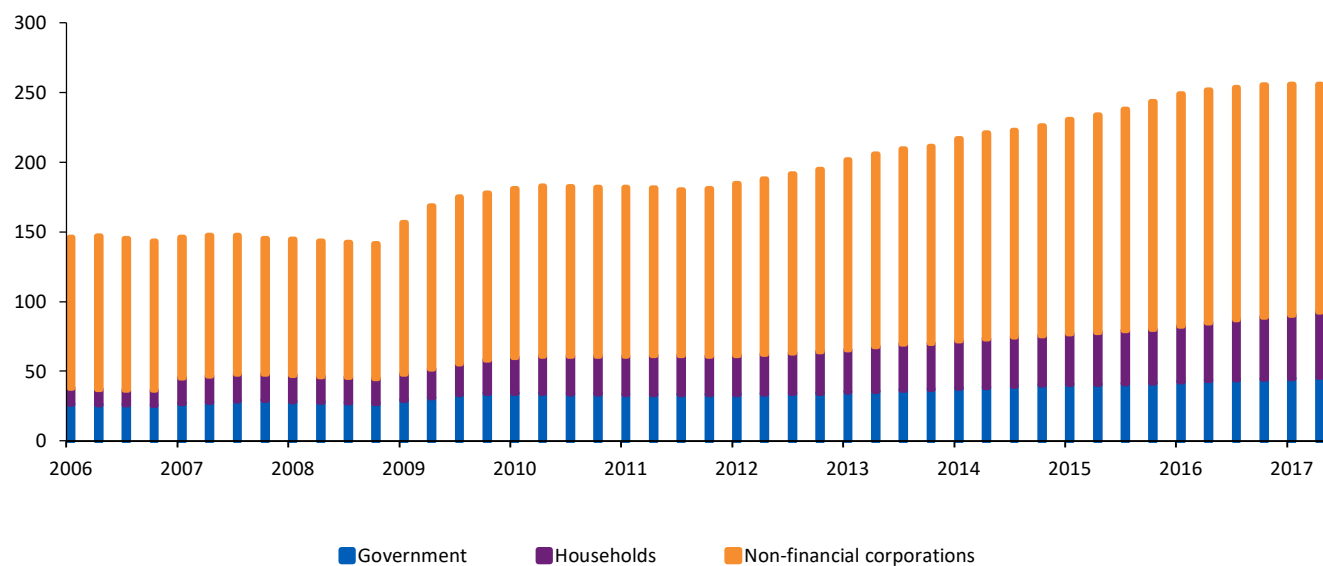
	2016	2017	2018
Monetary policy	<ul style="list-style-type: none"> Prudent monetary policy should be flexible and moderate Maintain proper and sufficient liquidity and modest increase of TSF 	<ul style="list-style-type: none"> Monetary policy should be prudent and neutral Properly regulate the gate of monetary supply, and maintain stable liquidity 	<ul style="list-style-type: none"> Prudent monetary policy should be kept neutral, the gate of monetary supply should be controlled, and credit and social financing should see reasonable growth
Risk prevention	<ul style="list-style-type: none"> Prevent and resolve financial risks Resolve debt risks of local governments Curb the spread of illegal fundraising Safeguard the bottom line of no systemic and regional risks 	<ul style="list-style-type: none"> Prioritise the prevention and control of financial risks, and tackle a number of risk areas Ensure that there are no systemic financial risks 	<ul style="list-style-type: none"> Prevent and resolve major risks, with a focus on financial risks Properly prevent and tackle risks in key areas, and strengthen the supervision system in weak areas Safeguard the bottom line of preventing systemic financial risks
Deleveraging	<ul style="list-style-type: none"> Focus on five tasks: cutting overcapacity, destocking, deleveraging, reducing corporate costs and shoring up weak spots 	<ul style="list-style-type: none"> Prioritise corporate deleveraging Regulate government borrowing behaviour 	<ul style="list-style-type: none"> Continue to cut overcapacity, destock, deleverage, reduce corporate costs and shore up weak spots

Source: KPMG analysis



Financial deleveraging has made significant progress in the past two years. According to data released by the Bank for International Settlements (BIS),⁹ the rapid increase of China's debt ratio has slowed. As of the end of June 2017, the ratio of non-financial sectors' debt to GDP stabilised at around 256%, a level similar to Q1 2017. In particular, the debt ratio of non-financial corporates decreased for four consecutive quarters, dropping from 167% in Q2 2016 to 163% in Q2 2017.

Fig. 16: Debt to GDP by sector (%)



Source: BIS, KPMG analysis

⁹ The Bank for International Settlements, <https://www.bis.org>

Meanwhile, the leverage ratio within the financial system is also being controlled. The growth of interbank assets has slowed and channelling transactions, capital circulating within various entities of the financial system, has reduced. Interbank claims have dropped YOY for seven consecutive months and decreased by 6.3% YOY by the end of 2017. Growth of bank claims on non-bank financial institutions (NBFIs) fell to 5.8% YOY, a record low since February 2009. In addition, existing interbank certificates of deposit (CDs) have shown a clear downward trend since H2 2017, dropping to RMB 8.02 trillion by the end of December 2017, RMB 446.1 billion lower than in July.

Financial deleveraging has exerted some downward pressure on the growth of the real economy. For example, the TSF, which reflects the funding support for the real economy by financial institutions, has dropped to its lowest level since mid-2015. The government has released a series of regulations on asset management, trusts, and entrusted loans since Q4 2017 (see Table 2), reflecting continued scrutiny on financial risks. We expect that the government will further strengthen financial supervision and build a long-term mechanism to prevent financial risks.

Table 2: Key regulatory policies carried out since the beginning of Q4 2017

	Policy	Issue Date	Issuing Agency
1	Guiding Opinions on Regulating the Asset Management Business of Financial Institutions (Draft for Comment)	7 November, 2017	PBoC
2	Notice on Regulating the Cooperation of Banks and Trusts	22 November, 2017	CBRC
3	Commercial Bank Liquidity Risk Management Measures (Revised Draft)	6 December, 2017	CBRC
4	Capital Management Measures for Financial Asset Management Companies (Trial)	26 December, 2017	CBRC
5	Large-Amount Risk Exposure Management Measures for Commercial Banks (Draft for Comment)	5 January, 2018	CBRC
6	Interim Equity Management Measures for Commercial Banks	5 January, 2018	CBRC
7	Entrusted Loans Management Measures for Commercial Banks	5 January, 2018	CBRC
8	Notice on Further Regulation of Chaos in the Banking Market	12 January, 2018	CBRC

Source: KPMG analysis

Note: PBoC: the People's Bank of China; CBRC: China Banking Regulatory Commission

► High quality development

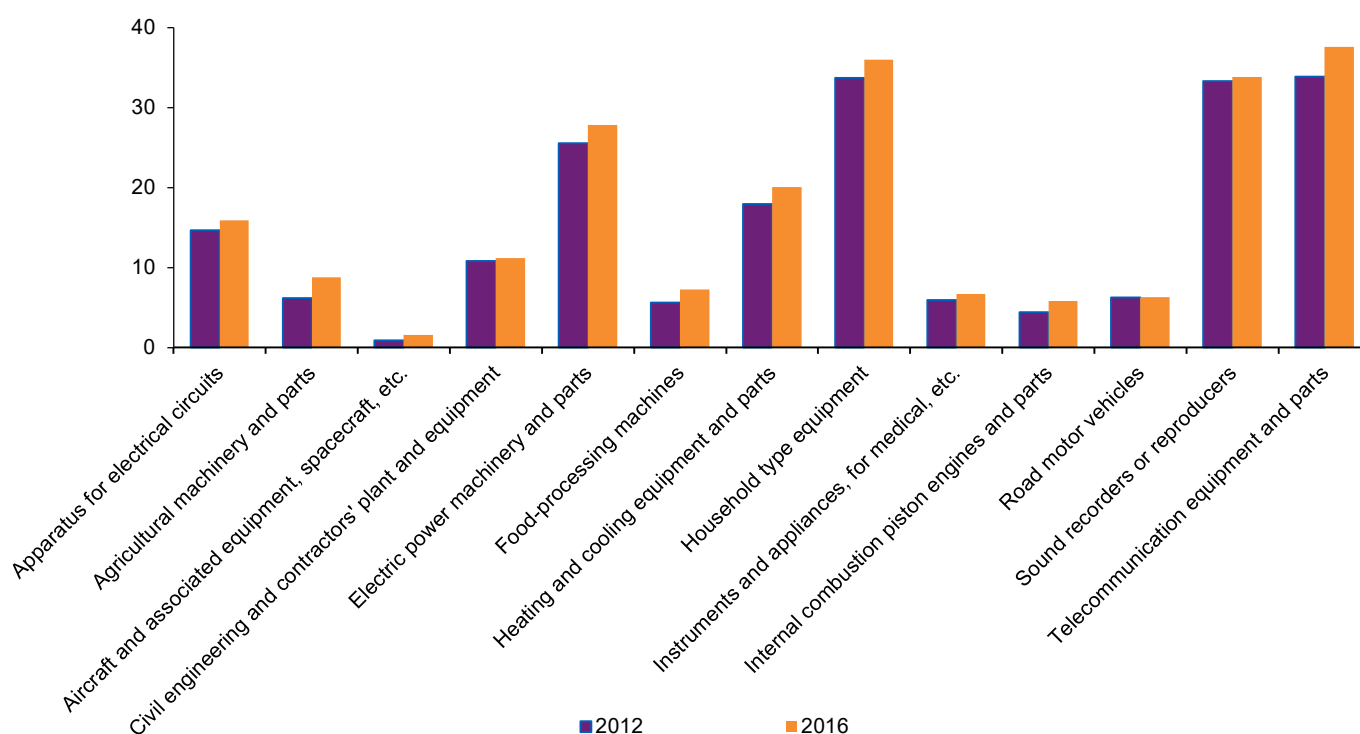
The “high-quality development stage” is an important concept put forward at the 19th CPC National Congress and the CEWC, as well as an essential requirement for economic development in the “new era”. According to the World Bank,¹⁰ the working age population (15-64 years) in China peaked in 2014, and the labour supply will continue to decline in the future.

In the meantime, China’s national incremental capital output rate (ICOR) has dropped to around 10% in recent years. In other words, every RMB 100 invested only creates around RMB 10 of new GDP. This shows that the periods of “demographic dividend” and “capital-driven growth” are over. Maintaining steady economic development requires higher production efficiency and better quality development. The 19th CPC National Congress report has clearly pointed out that China’s economy has shifted from “rapid growth” to “high-quality” development. The policy aims to change from “high speed” to “high quality”, which means that the government will gradually reduce its overt emphasis on GDP growth, while future investment opportunities will be more structural in nature.

China’s economic development has been gradually shifting to “high quality” in recent years, reflected in improved investment and output structure and greater investment in innovation. Since 2016, investment in overcapacity industries such as coal and ferrous metals has been shrinking. In contrast, investment in key equipment manufacturing such as IT equipment, as well as the modern services industry such as environmental protection and healthcare, is gaining momentum. From 2012 to 2016, the global market share of China’s high-tech equipment exports has shown continuous growth.

Corporate R&D and innovation activities are also increasing, and China’s R&D investment as a share of GDP rose to 2.11% as of the end of 2016. In the latest Global Innovation Index¹¹ released by the World Intellectual Property Organization (WIPO), China ascended to No. 22, becoming the first middle-income country to feature in the top 25.

Fig.17 Share of China’s high-end equipment product exports in global markets (%)



Source: UNCTAD, KPMG analysis

¹⁰ World Development Indicators, the World Bank

¹¹ World Intellectual Property Organization, <http://www.wipo.int/portal/en/>

► Green economy

The 19th China Communist Party (CPC) National Congress emphasised that building a green ecosystem is a long-term strategy for China's sustainable development.¹² Also, the CEWC stated that "efforts must be made on pollution prevention and control to reduce the emissions of major pollutants and improve the overall ecological environment. The keys are to protect clear skies, adjust industrial structure, eliminate outdated capacity, regulate energy structure, enhance energy-saving efforts and assessment, and modify transport structure". In the future, the closure and restricted production of outdated enterprises in industries such as steel and coal may become the "new normal" for green development.

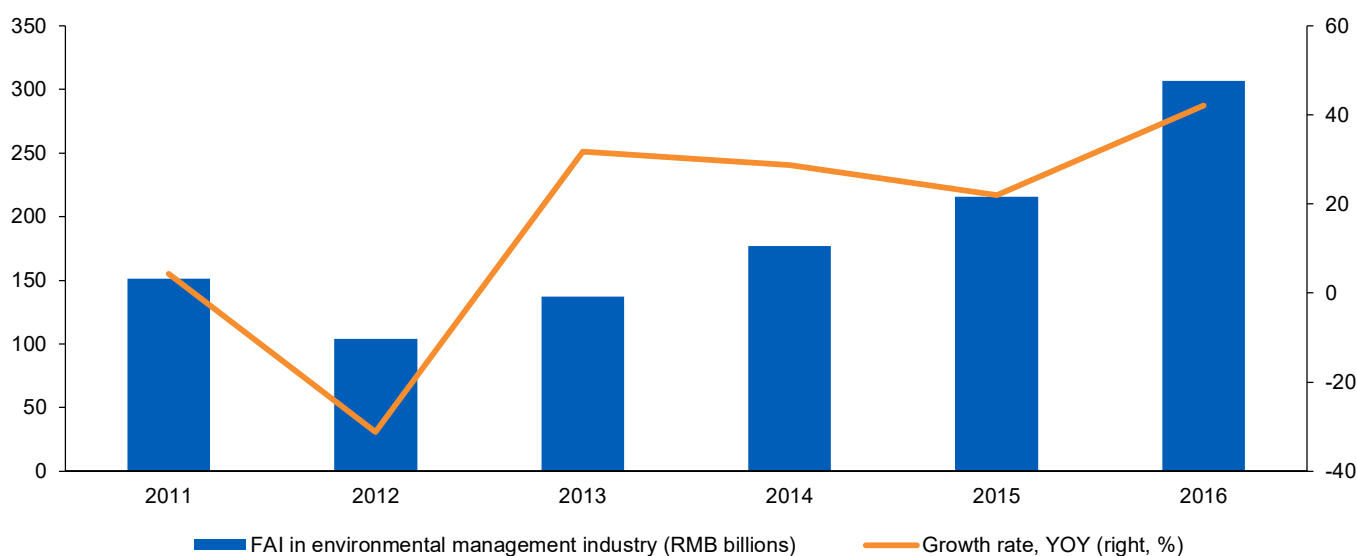
The introduction of environmental protection policies¹³ since 2017 has increased operating costs in high-polluting industries, and at the same time, stimulated demand and created significant investment opportunities in the environmental governance sector.

The environmental pollution problem is closely related to the investment-driven development model that China has

long relied on, which caused both overcapacity and serious environmental issues. For example, the steel, coal, non-ferrous metals and chemical industries are not only facing problems of excess capacity, but also high pollution and high energy consumption. Enhancing environmental supervision and strengthening environmental "compulsory constraints" will directly increase the operating costs of high-polluting industries, restrict enterprises that fail to comply with environmental regulation, help protect high-quality capacity and boost overall profitability.

At the same time, rising environmental costs will also stimulate more demand for emerging industries such as environmental governance and new energy, and inject more momentum into China's economy during the transition. For example, according to the National Bureau of Statistics, investment in the environmental management industry has risen rapidly since 2012, with an average annual compound rate of nearly 31%. Also, new-energy vehicle production in China in 2017 increased by 57.4% YOY, far greater than the 6.2% growth of total auto output.

Fig. 18: FAI in environmental management industry



Source: Wind, KPMG analysis

¹² The 19th CPC National Congress stated that "building an ecological civilisation is vital to sustain the Chinese nation's development" and specified to "strive to build China into a great modern socialist country that is prosperous, strong, democratic, culturally advanced, harmonious, and beautiful".

¹³ For example, in January 2017, the State Council issued the '13th Five-Year Plan for Energy Conservation and Emission Reduction'. The Ministry of Industry and Information Technology (MIIT) issued 'Key Work Plans for Industrial Energy Saving Monitoring in 2017' and 'Industrial Energy Saving and Green-Standardised action plan' in March and May 2017, respectively.

2

Review of key government policies



► The 19th CPC National Congress

The 19th CPC National Congress was held in Beijing from 18 to 24 October, 2017. An important outcome of the meeting was the revision of the judgment on the "major contradictions" in Chinese society. The previous formulation was "the ever-growing material and cultural needs of the people versus backward social production", put forward at the 6th Plenary Session of the 11th Party Central Committee in 1981. This judgment had remained unchanged since then. However, the 19th National Congress revised it to "the contradiction between unbalanced and inadequate development and the people's ever-growing needs for a better life".

This seemingly minor change reflects the adjustment of China's future development priorities, and has important policy implications. After nearly 40 years of reform and opening up, the level of China's economic development has markedly improved. In many respects, the manufacturing capability of Chinese industry is foremost in the world – yet problems have arisen around the structure of economic development, inclusive development and environmental governance. The adjustment of judgments on the major contradictions in Chinese society means that solving unbalanced and inadequate development will become the basic starting point for policymaking in the future. This will bring new opportunities for businesses in various fields such as consumption, technological innovation, high-end manufacturing, environmental protection, ecology, infrastructure, construction and agriculture.

The report of the 19th CPC National Congress also pointed out that China's economy has shifted from a period of rapid growth to one of high-quality development. China's economy has maintained an average annual growth rate of over 9% for almost four decades. However, since the Global Financial Crisis, China's domestic conditions and the global environment have both undergone significant changes, and the Chinese economy has entered a stage known as the "new normal".

As growth slows, it is necessary to establish a new development model and achieve higher-quality economic growth. This requires the optimisation and upgrading of China's economic structure. It needs to shift from the resource and labour-intensive industries to technology and knowledge-intensive industries; from low-tech, low-value-added products to high-tech, high value-added products; from energy-intensive and high-pollution production to clean energy, energy-saving and emissions-reducing

production; from investment-driven to consumer-driven economic growth; and from merely focusing on new capacity expansion to both improving existing capacity and optimising incremental changes.

► The Central Economic Work Conference sets three key goals

From 18 to 20 December, the annual CEWC was held in Beijing. This annual meeting reviews the economic development of the past year and sets the direction and focus of economic work in the coming year, which has important policy implications. The latest conference was the first one held after the 19th CPC National Congress and provides more policy clarity related to the change from high-speed to high-quality development.

The meeting stated that China will maintain a "stable and neutral" monetary policy in 2018. Against the backdrop of interest rate hikes in the US and domestic deleveraging, we expect monetary policy to lean towards tightening in 2018. For instance, the CEWC proposed "controlling the master valve of money supply", in contrast with the "proper regulation of the currency valve" proposed last year. It displayed a clearer and firmer attitude towards maintaining prudence in monetary policy.

The conference proposed to continue to maintain a proactive fiscal policy while also emphasising optimisation of expenditure. It is estimated that in 2018, more financial support will be given to key areas such as targeted poverty alleviation and pollution prevention and controls. At the same time, in order to promote high quality development, there will be no reduction in fiscal expenditure in technological innovation, emerging industries and social welfare.

The conference identified three major economic tasks for the next three years: prevention and mitigation of major risks, targeted poverty alleviation, and pollution control.

- The focus of risk prevention is on financial risks, controlling leverage, improving the real economy, and strengthening the management of off-balance sheet businesses and regulatory arbitrage. Although the overall rate of debt growth in China has slowed, its absolute level remains high. As a result, ensuring that there is no systemic financial risk remains a key task for the financial sector.
- As of the end of 2016, there were still 43.35 million rural people living in poverty in China. Lifting people out of poverty is very significant to building a prosperous society. The work of poverty alleviation in China has entered a crucial stage, and targeted poverty reduction can be integrated with local industrial policies.

- The focus on environmental protection is to prevent and control air pollution, which is an area of public concern. Policies on environmental protection and curtailing production are likely to become more prevalent. Environmental requirements for enterprises are likely to become more rigorous, while investment in environmental protection equipment will increase.

Regarding the real estate market, following the policy tone that "property should be used for housing rather than for speculation" set in the 2016 CEWC, the latest meeting emphasised the need to accelerate housing reform and the construction of long-term mechanisms. In 2017, a series of real estate policies were introduced to encourage reform and balance supply and demand. For example, the government implemented land supply policies, promoted the construction of public housing, and prevented consumer loans from entering the real estate market. This shows that the policy focus is to set up a long-term equilibrium in the real estate market to reduce the risk of bubbles.

► First revisions to the Anti-Unfair Competition Law in 24 years

On 4 November, 2017, the 12th NPC Standing Committee passed an amendment to the Anti-Unfair Competition Law that came into force on 1 January, 2018. China's first Anti-Unfair Competition Law was promulgated and implemented in 1993, making this its first revision in 24 years. During this period, the Chinese economy has experienced rapid development, and some new economic phenomena – particularly the rise of the internet economy – have placed new requirements on legislation against unfair competition. The focus of the amendment includes the following six points:¹⁴

- Perfected the definition of "operator" and expanded the applicable object of "Anti-Unfair Competition Law"
- Added new clauses for the use of technological means to achieve unfair competition in the internet field
- Increased prohibitions on "fraudulent transactions"
- Amended and perfected provisions on counterfeiting and fraudulent behaviour, realising a proper connection with the Trademark Law
- Offered a clearer and more rational definition of commercial bribery
- Improved provisions on legal liability provisions and increased penalties for unfair competition

The amendment to the bill helps to better protect the rights and interests of consumers, maintains order in the market, and promotes the healthy development of the market. In particular, the added clause on unfair competition in the internet domain helps clarify the boundaries between counterfeiting, confusion, commercial bribery and normal market competition, and promotes healthy market competition.

► New policy to promote private manufacturing investment

On 20 November, 16 ministries and commissions – including the Ministry of Industry and Information Technology, the National Development and Reform Commission (NDRC), the Ministry of Science and Technology, the Ministry of Finance, the Ministry of Commerce and the PBoC – jointly issued the *Guiding Opinions for the Role of Non-Governmental Investors in Helping Implement the Manufacturing Superpower Strategy* (the Opinions). The Opinions systematically sort through relevant policies for promoting private investment in the manufacturing industry and making China a manufacturing powerhouse. It puts forward eight major tasks: enhancing China's innovative development capabilities; enhancing the integration of information technology with industry; upgrading the capacity of the country's industrial base and enhancing the quality of its brands; promoting upgrades to green manufacturing; optimising China's industrial structure and layout; promoting the shift to service-oriented industries; and encouraging international growth.

Recent years have seen a slowdown in private manufacturing's investment in fixed assets, with cumulative YOY growth dropping to a record low of 2.1% in August 2016. The deepening of supply side structural reforms in the second half of 2016 led to a rise in the profitability of manufacturing enterprises and a rebound in investment. However, improvements have been slow to materialise, and growth in private manufacturing investment once again weakened in the second half of 2017, hitting 4.1% in November (compared to 5.6% growth in the first half of the year). The release of the Opinions is expected to improve the private investment environment and boost private enterprise financing. It is also expected to speed up and guide the upgrade and transformation of China's manufacturing industry into a high-end, smart, green and service-driven sector.

► New measures for outbound investment released

On 26 December, the NDRC released *Administrative Measures for the Outbound Investment by Enterprises* (the Measures), effective on 1 March, 2018. The previous regulation of *Administrative Measures on Approval and Filing for Outbound Investment Projects* will expire at the same time. In recent years, an increasing number of Chinese enterprises have invested abroad. The number of transactions boomed in 2016, and China has been the world's second largest outbound investor for two consecutive years. Many new issues have emerged during this process, calling for amendments to the original overseas investment management system in order to better serve enterprises investing overseas, and strengthening supervision to reduce potential risks.

¹⁴ 'Interview with the Director General of The Anti-Monopoly and Anti-Unfair Competition Enforcement Bureau of the SAIC on the new Anti-Unfair Competition Law', China Business Times, 13 November, 2017.

China's regulatory policies on foreign investment have undergone several adjustments in the past. China first released the *Interim Measures for the Approval of Overseas Investment Projects* in 2004 and revised it with *Administrative Measures on Approval and Filing for Outbound Investment Projects* in 2014. The 2014 regulation changed the regulation for overseas investment from one which required approval for every transaction to one which focused on record filing and required approval only for sensitive investments. The newly-announced Measures introduce eight actions (see Table 3) in three main areas to further simplify overseas investment procedures, improve supervisions, and encourage the sustained and healthy development of outbound investment.

Table 3: Eight actions introduced in the Measures for the Administration of Overseas Investment in Enterprises

Aim	Content	Key changes
Streamlining and decentralisation to make it easier for enterprises to invest overseas	Removal of the project reporting system	The original provisions stipulated that in overseas acquisitions or bids involving Chinese investment of USD 300 million or more, the investors should submit a Project Information Report to the NDRC prior to engaging in any substantial work abroad. The new Measures dispense with these provisions.
	Removal of provincial preliminary approval and transferal	The original provisions stipulated that local enterprises must submit the necessary materials for approval or record-keeping to the NDRC via the Provincial Development and Reform Commission. The new Measures remove the provincial-level preliminary approval and transferal stage. Local enterprises can now submit relevant application materials to the NDRC directly via an online system.
	Relaxing the deadline for approval and record-keeping procedures for investors	The new Measures relax the deadline for approval and record-keeping procedures for investors from prior to signing the agreement (or prior to the agreement coming into effect) to prior to execution.
Strengthening regulation and increasing standardisation of overseas investment by enterprises	Addressing management shortcomings	The new Measures incorporate the management framework of domestic enterprises and natural persons engaging in overseas investment through foreign enterprises that they control, and adopt a targeted management approach.
	Innovation of regulatory tools to improve coordinated and overall supervision	The new Measures will monitor and examine overseas investment through online monitoring, interviews and written correspondence, and spot checks. The Measures also introduce systems for project completion reports, and major issue inquiries and reports.
	Improvement of disciplinary measures, record-keeping of criminality in overseas investment	For malfeasance, false declarations and other criminal acts, the new Measures clarify disciplinary measures and increase disciplinary efforts. The Measures also propose keeping records of overseas investment violations and the introduction of a collaborative disciplinary system.
Optimising services and further serving overseas investment	Enriching services	Investors can enquire about policies and other information from the agency in charge of managing overseas investment, and provide comments and feedback on their circumstances and any issues. The agency can also issue risk warnings to investors or stakeholders for their reference.
	Implementation of online processing	Once the new Measures have been introduced, the majority of stages for managing overseas investment (including macro-guidance, information services, approval and record-keeping, full monitoring, joint disciplinary action) will be carried out through the online system.

Source: China Government Website, KPMG analysis

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Regional development

► Developing the middle Yangtze River market

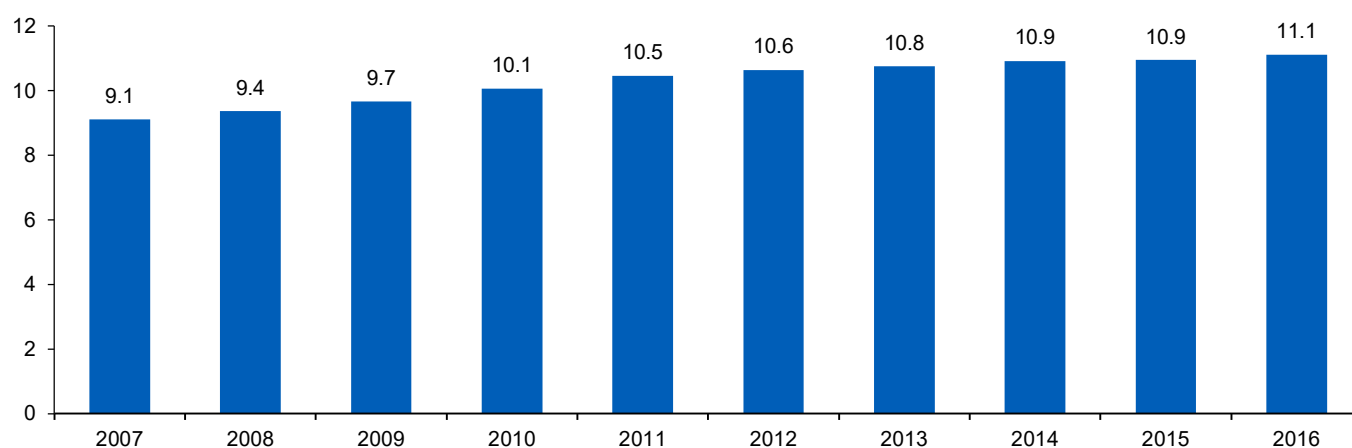
On 12 October, the General Office of the Ministry of Commerce issued the *Yangtze River Middle Reaches Regional Market Development Plan (2016-2020)* (the Plan). It is expected to boost the development of urban clusters in the Yangtze River's middle reaches – which primarily consist of the Hubei, Hunan and Jiangxi provinces – and the Yangtze River Economic Belt, and promote the integration of regional markets in the Yangtze River's middle reaches.

The Plan is the first time for the Ministry of Commerce to issue an inter-regional transport development plan. Using Hubei, Hunan and Jiangxi's advantages in transport, it will seize the strategic opportunities created by the Belt and Road Initiative and the development of the Yangtze River Economic Belt to transform the middle reaches of the Yangtze River into an important national trade and logistics hub. The Plan proposes optimising the layout of

commercial functions and dividing the functional regions of the Yangtze River's middle reaches into "Three Cores and Eight Regions". This includes the three core functional areas of the Wuhan-Ezhou-Huangshi metropolitan ring, the Changzhou-Zhuzhou-Xiangtan urban cluster, and the combination of Nanchang and Jiujiang. It also includes robust logistics systems, the development of smart transportation, and encouragement of the creation of a unified market.

The middle reaches of the Yangtze River is an important hub in the Yangtze River Economic Belt. The total population of Hubei, Hunan and Jiangxi is 173 million, accounting for 13% of China's total population. In 2016, the GDP of the three provinces totalled RMB 8.3 trillion, accounting for 11.1% of China's GDP – up from 9.1% in 2007.

Fig. 19: Share of GDP in Hubei, Hunan and Jiangxi provinces as percentage of national GDP (%)



Source: Wind, KPMG analysis



► Hong Kong's role in the Belt and Road Initiative

On 14 December, the NDRC and Hong Kong signed the *Arrangement between the National Development and Reform Commission and the Government of the Hong Kong Special Administrative Region for Advancing Hong Kong's Full Participation in and Contribution to the Belt and Road Initiative* (the HK-NDRC Arrangement). The HK-NDRC Arrangement focuses on various areas such as finance and investment, infrastructure and shipping, economic and trade exchanges and cooperation, people-to-people bonds, promoting the development of the Guangdong-Hong Kong-Macao Bay Area, and strengthening mutual cooperation and dispute resolution services.

Hong Kong plays a prominent role in the Belt and Road Initiative as an international centre for finance, shipping and trade. It is also the largest asset management centre in Asia and the largest offshore RMB hub in the world. In addition, Hong Kong's low tax rate, pool of professional talent and extensive network of contacts offers a competitive platform for Belt and Road investment and financing. The China Development Bank and the Hong Kong Monetary Authority (HKMA) recently established the Belt and Road Infrastructure Financing Promotion Office and issued a Belt and Road bond to leverage Hong Kong's strengths in finance.

In addition, Hong Kong can also provide a full range of services for all countries along the Belt and Road in accounting, law, consulting, tourism, infrastructure and construction. In her first Policy Address on 11 October, Hong Kong's Chief Executive Carrie Lam said that the Special Administrative Region Government will actively seek to promote free trade, investment protection and double tax treaties between other economies, including those along the Belt and Road.

► SAIC issues measures to support the Shaanxi Free Trade Zone

On 25 November, the State Administration for Industry and Commerce (SAIC) issued *Several Opinions by the State Administration for Industry and Commerce for Supporting the Construction of a Free Trade Zone in China (Shaanxi Province)* (the Opinions). The Opinions provide policy support for the Shaanxi Free Trade Zone in five areas: market access, streamlining and delegating administrations, ex ante and ex post supervision, trademark and advertisement management, and consumer protection. The SAIC supports the pilot reform of "separation of permits and licenses"¹⁵ in the Shaanxi Free Trade Zone. The SAIC also encourages enterprises in Shaanxi Province to expand trademark brands abroad, the establishment of a platform for long-term international cooperation for countries along the Silk Road, and the creation of a good consumer environment.

The Shaanxi Free Trade Zone was approved by the State Council in March 2017 and is one of the third batch of seven free trade zones that were launched. As the only free trade zone located in China's Northwest, it is strategically positioned as a place for China's reform and opening up to reach "new heights" inland, as well as an important point for economic cooperation and cultural exchange. It will play an important role in promoting the development of the Belt and Road Initiative, boosting the overall development of Western China, and bolstering gateway cities in Western China.

Shaanxi is a core region for the Belt and Road Initiative and is at the centre of the Guanzhong Plain urban cluster of state-level urban clusters (planning for which was recently approved in principle by the State Council). Shaanxi Province is accelerating construction of a high-speed rail network with Xi'an City at its centre, and is set to create a comprehensive high-speed rail network that connects surrounding regions, which will play a leading role in driving the development of Northwest China.

Xi'an City, the capital of Shaanxi Province, is also the starting point for the ancient Silk Road. As an important "node city" of the new Eurasian Continental Bridge, Xi'an has strong advantages in terms of its location, resources, industry, culture and technology. It also has great potential in investment, commerce and trade, and is an important base for advanced manufacturing and technological innovation. The city offers comparative advantages in aerospace, electronic information, automobile manufacturing and biomedicine.

¹⁵ Under the previous regulation, enterprises needed to obtain operating permits from governing agencies before they could apply for business licences from the SAIC. In the new system, enterprises conducting regular business can apply for business licences directly, and apply for operating permits only when necessary.

► Release of the *Three-Year Action Plan for Promoting Artificial Intelligence*

On 14 December, the Ministry of Industry and Information Technology (MIIT) released the *Three-year Action Plan for Promoting the Development of a New Generation of Artificial Intelligence Industry (2018-2020)* (the Action Plan) to promote the "Made in China 2025" initiative and encourage the growth of the country's artificial intelligence (AI) industry. Following the State Council's release of the *Plan for the Development of a New Generation of Artificial Intelligence* in July 2017, the Action Plan provides a more detailed and applicable interpretation of its content, and lists specific, three-year targets for a number of tasks. AI creates significant spill-over effects, and its growth will drive the progress of related technologies and improve the level of smart technology across a number of industries.

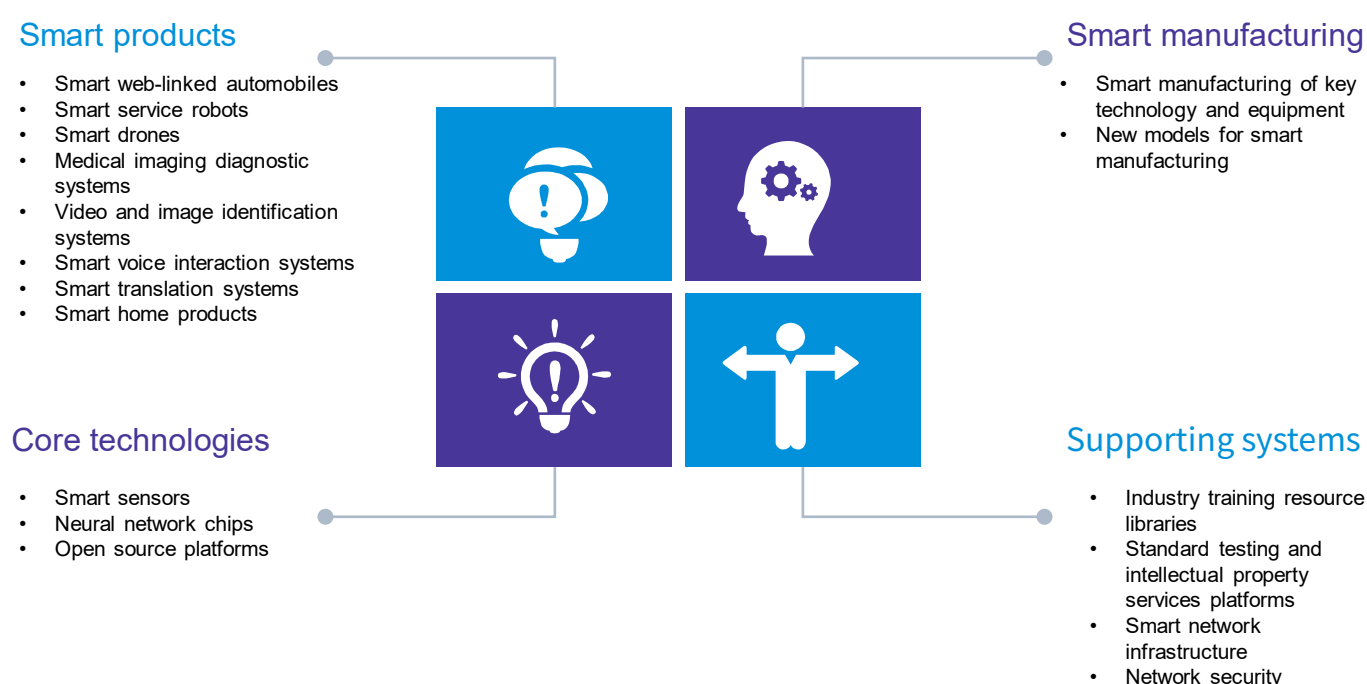
The Action Plan states that China will focus on the development of AI in four areas (see Table 4). This growth will involve 17 fields. China's AI industry has seen rapid growth in recent years and these fields are expected to receive further support from the government, which should bring in substantial investment and growth opportunities.

► China's National Big Data Strategy

On 8 December, the Political Bureau of the CPC Central Committee conducted a second round of collective study on the implementation of the National Big Data Strategy. The focus was on encouraging the implementation of the National Big Data Strategy and the building of a "digital China". Particular attention was paid to the following five areas: innovation in the big data technology industry; building a digital economy that uses data as a key element; using big data to improve the level of state governance; leveraging big data to boost security and improve people's livelihood; and ensuring national data security.

China first put forward the idea of a National Big Data Strategy in 2015, and proposed the construction of integrated national big data centres in 2016. The collective study re-emphasises the importance of the National Big Data Strategy, which will help accelerate the development of China's big data industry. In addition, the implementation of the strategy will accelerate the use of big data in reducing enterprise costs, minimising risk, and assisting decision-making.

Table 4: Fields related to the growth of AI



Source: Ministry of Industry and Information Technology, KPMG analysis

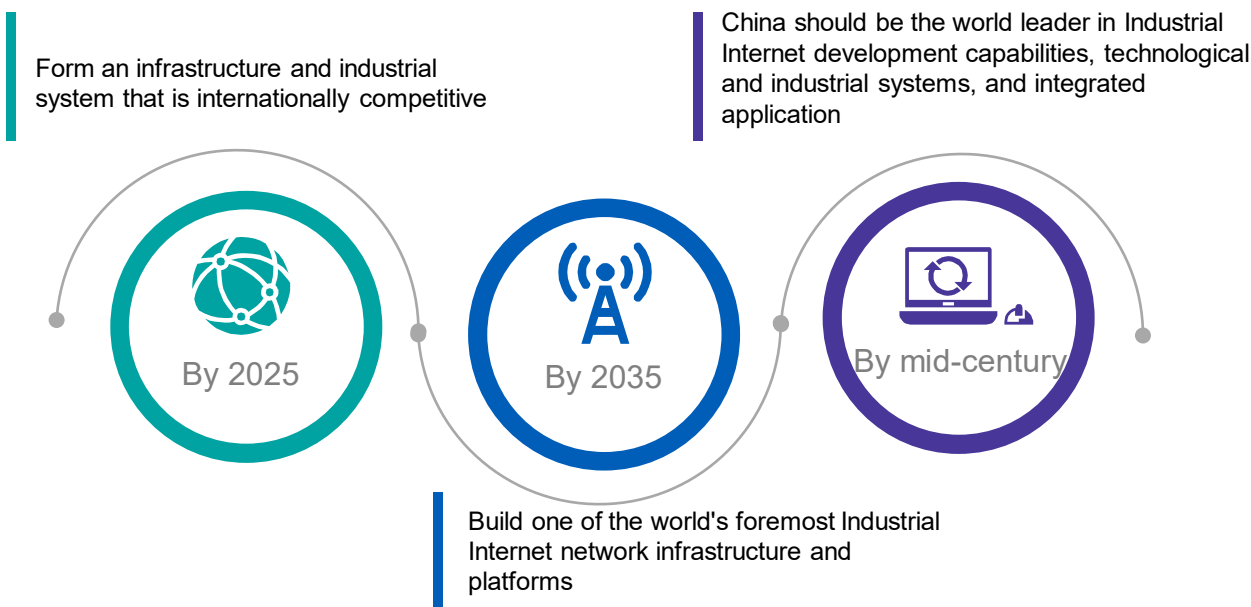
► Developing the Industrial Internet

On 27 November, the State Council released *Guiding Opinions on Deepening the Internet + Advanced Manufacturing and Developing Industrial Internet* (the Opinions). The world economy is in the midst of a new technological and industrial revolution. As an integration of a new generation of information technology and manufacturing, the Industrial Internet is a key infrastructure for the industrial revolution in digitalisation, networking and machine intelligence.

The Industrial Internet is an important cornerstone for deepening the "Internet + Advanced Manufacturing Industry", and its development will help advance China's strategic goal of transforming into a powerhouse in both manufacturing and the internet. Developing the Industrial Internet is beneficial to accelerating the growth of smart manufacturing, and will help allocate production and service resources more extensively, efficiently and accurately. It will also encourage the transformation and upgrade of traditional industries, and will generate new technologies, business types and models.

Currently, there is still a gap in the development of the Industrial Internet between China and developed economies. For example, supporting industries for the Industrial Internet are still underdeveloped, competitiveness in core technologies and key platforms is lacking, and the level of digitalisation among enterprises is low. With the structure of the global Industrial Internet yet to be established and with significant room for fast growth, China is striving to capitalise on this opportunity. The Opinions set out development goals divided into three phases (Table 5).

Table 5: Industrial Internet development goals



Source: China Government Website, KPMG analysis

¹⁶ 'IPv6 creates a new area of internet of everything', www.china.gov, 27 November, 2017

► Promoting Internet Protocol Version 6 (IPv6)

On 26 November, the General Office of the CPC Central Committee and the General Office of the State Council released the *Action Plan for Promoting the Deployment of the Sixth Edition of the Internet Protocol (IPv6)* (the Action Plan). The main goal of the Action Plan is "in the next five to ten years, to form the next generation of internet proprietary technology systems and industrial ecology, and build the largest IPv6 commercial application network in the world to achieve the major aim of integrating and applying next generation internet in all fields of the economy and society".

With the rapid growth of the internet industry, global demand for IP addresses is also booming. Global internet network addresses based on Internet Protocol version 4 (IPv4) have nearly run out and strain the service quality. However, IPv6 can provide plenty of network addresses and vast space for innovation. It significantly enhances the load-bearing capacity and service level of the internet, and effectively supports the rapid development of emerging fields such as mobile internet, the Internet of Things, the Industrial Internet, cloud computing, big data and AI.

Compared to IPv4, which consists of 32 bits and yields approximately 4.3 billion addresses, IPv6 uses a 128-bit address and expands the address space to 2 to the power of 128th.¹⁶ This is large enough to allocate on average 4.86×10^{28} addresses to every single person in the world. The abundance of network address space through IPv6 is of great significance because it offers a better solution to the problems of network real-name systems and user identity traceability, allowing accurate network management and precise positioning. The real-name system is also protected from privacy leaks, greatly reducing network fraud and substantially enhancing the safety of data resources and personal information. This will further enhance the security and credibility of the internet, and its overall governability.

► Another rate hike by the US Fed

On 14 December, the Federal Reserve (the Fed) decided – in a 7-2 vote – to increase interest rates. It raised the federal funds rate by 25 basis points from 1% -1.25% to 1.25% -1.50%, in line with market expectations. This was the third rate hike by the Fed in 2017, and the fifth increase in the current cycle. According to a survey of the Federal Open Market Commission (FOMC), the Fed expects to raise interest rates three times in 2018. At the same time, the Fed is more optimistic about US economic growth and raised its 2018 GDP forecast from 2.1% to 2.5%. It also expects the unemployment rate to drop to 3.9% and inflation to remain at 1.9%.

Continued rate hikes by the US have affected the monetary policy of many countries around the world. The European Central Bank (ECB) announced in October that it will begin to reduce its quantitative easing policy in 2018 and the Bank of England increased its policy rate by 25 basis points to 0.5% in November. At the end of November, the Bank of Korea also announced a rate hike of 25 basis points to 1.5%, marking its first interest rate increase in more than six years. Hong Kong raised its policy rate by 25 basis points after the Fed announcement. The Fed's continuous rate hikes will likely lead to a further tightening of monetary policy in some economies.



► US tax reform

On 22 December, President Trump signed the Tax Cuts and Jobs Act, which will come into effect in 2018. It is the largest tax reform in the US since 1986, and will have wide-ranging impacts. Key reform measures related to business taxes include:¹⁷

- Reducing the federal corporate income tax rate: The maximum federal corporate income tax rate was reduced from 35% to 21%. With state tax/local tax included, the average US corporate income tax rate is about 25.75%, similar to the average tax rate in OECD member countries (23.5%) and in China (25%).
- Encouraging investment: The new tax system allows investment to be expensed – investment can be deducted in full in the first year, rather than through depreciation. The implementation period is five years.
- Encouraging the repatriation of overseas profits: Prior to the tax reform, untaxed overseas profits were subject to a 35% corporate income tax upon repatriation to the US. Following the reform, dividends from overseas enterprises paid to qualified US companies are now tax-exempt. A one-time remittance tax will be levied on the cumulative profits previously retained abroad, which is 15.5% for cash or cash equivalents, and 8% for non-cash assets.
- Encouraging export and intellectual property income: Following the tax reform, a low tax rate of 13.125% will be applied to the portion of the excess return (return over 10% of the tangible assets) for the overseas income from sales or services of US companies, as well as to the portion of the excess return for their overseas subsidiaries.
- Enforcing Base Erosion Anti-Avoidance Tax: By stipulating a minimum tax, US companies are restricted from eroding the US domestic tax base by paying certain expenses such as service fees, royalties and interests to their overseas affiliates to reduce their taxable income in the US.

¹⁷ For more information on US tax reform, please refer to 'Conference Agreement for H.R.1 – Initial Observations', released by KPMG US on 20 December, 2017, <https://home.kpmg.com/content/dam/kpmg/us/pdf/2017/12/tnf-conference-agreement-dec18-2017.pdf>.

The wide-ranging tax relief bill will have a number of effects on US economic growth, fiscal deficit and government debt. Tax cuts could drive business investment and household consumption, boosting economic growth. According to estimates by the US Tax Policy Center and the US Congress, tax cuts may raise average nominal GDP growth by about 0.4% between 2018 and 2020. On the other hand, the US Congressional Budget Office predicted that the tax cuts would increase the federal government deficit by USD 1.5 trillion over the next 10 years, during which time the federal debt-to-GDP ratio will also increase from 91.2% to 97.5%.¹⁸

In addition to the US, many other countries have also introduced tax cuts in recent years to enhance the competitiveness of their companies. In January 2017, Germany announced annual tax cuts of 15 billion euros for businesses and economic development, and the UK lowered its corporate income tax and capital gains tax through a series of cuts in April 2017. In 2018, France's mandatory tax amount will be reduced by about 7 billion euros. Meanwhile, the Japanese government is also considering lowering the corporate income tax rate to approximately 25%.

China has also made significant efforts to reduce taxes and fees. Over the last five years, the replacement of sales tax with value-added tax (VAT) is estimated to have created nearly RMB 2 trillion in tax savings. In 2017 alone, various measures decreased corporate tax and fee burdens by more than RMB 1 trillion. In addition, hi-tech enterprises and R&D expenditure are already receiving preferential tax treatment.

Regarding US-China investment, on the one hand, President Trump's tax reform has drastically reduced the tax costs for US companies repatriating their profits from overseas, and some US companies investing in China may need to re-evaluate their capital arrangements. On the other hand, the tax reform will also reduce the costs of investing in the US, and will encourage Chinese enterprises to increase their investment in the US. At the same time, it is important to note that tax is just one of many factors that investors consider. China is still attractive to global investors in terms of its supply chain network, costs and market size.

Also, over the past 20 years, the cumulative US foreign direct investment (FDI) into China accounted for about 4%¹⁹ of total FDI in the country. We expect the impact of the US tax reform on China's overall FDI to be limited.

¹⁸ 'Estimated Deficits and Debt under the Conference Agreement of HR 1', US Congressional Budget Office, 2 January, 2018. The forecast does not take into account the tax cuts' macroeconomic impact in areas such as employment and investment.

¹⁹ Excluding Hong Kong, the US accounts for 8.4% of China's foreign investment.



3

Special topic: Fintech



The concept of fintech

Fintech, a combination of "financial" and "technology", does not have a definitive definition. The Financial Stability Board (FSB) believes that fintech refers to "technologically-enabled financial innovation that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services". The International Organization of Securities Commissions (IOSCO) defines fintech as "a variety of innovative business models and emerging technologies that have the potential to transform the financial services industry". In essence, fintech refers to the innovative technologies that

can reduce transaction costs, increase efficiency and create new service models and processes in the financial sector.

Currently, fintech encompasses a number of cutting-edge technologies such as big data, cloud computing, AI and blockchain, and covers a wide range of financial sectors including credit, payments, asset trading, wealth management, insurance, crowdfunding, digital currency and regtech.

Box: Differences between fintech and internet finance

Internet finance and fintech share some similarities, but are different in nature. While the core of internet finance is still finance, technology is at the heart of fintech. Internet finance refers to the "internetisation" of traditional financial services. The internet has expanded the channels and ways for financial institutions to connect with and provide more timely and convenient services to customers.

Meanwhile, the emphasis for fintech is on the use of emerging technologies such as big data, cloud computing, blockchain and AI to improve or even disrupt the existing financial industry services and models. Fintech companies include not only competitors looking to use their technological prowess to break into traditional financial markets, but also technology companies that seek to provide technical services to financial institutions.

In essence, both internet finance and fintech are the result of the convergence of information technology and financial services. Internet finance places a greater emphasis on the financial industry's use of the internet as a new channel, while fintech focuses on using technology to disrupt or empower financial services in order to improve efficiency and innovate in new services.



The development of fintech in China



The early stage (before 2004):

IT-driven

The term "fintech" originated in the US and was used on Wall Street as early as the beginning of the 1980s. It started with the establishment of IT departments within financial institutions and the use of IT to reduce operating costs and enhance service efficiency. Some of the most well-known products of this were ATM machines, POS (point-of-sale) machines, and the digitalisation and automation of banks' transaction and clearing systems. China entered this stage at the beginning of this century. In order to improve efficiency and better align with international financial institutions, Chinese financial institutions started to build up and expand their own IT systems, utilising modern communication networks and database technologies to optimise service processes and enhance operational efficiency.



The online stage (2004 – 2016):

Internet-driven

In 2004, China's first third-party online payment platform – Alipay – was officially launched and began stand-alone operations.²⁰ At this time, internet companies started to widely penetrate the financial sector. On the one hand, internet companies used their success in e-commerce to push into the fields of payments, credit²¹ and wealth management.²² On the other hand, financial enterprises accelerated the set-up of online service platforms and gathered user information to connect transactions, payments and assets, which greatly extended the coverage of China's financial services and enhanced the convenience of service. Typical lines of this business included third-party payment, peer-to-peer (P2P) loans, online wealth management, internet insurance and internet securities, and many other new types of service.



The deepening stage (post-2016):

Data-driven

With increasing market competition and regulation, internet companies that rely on duplicating business models and lack technological innovation are losing their competitive edge. Technological progress has gradually become the fundamental driving force behind growth in the industry. Meanwhile, the internet is also moving from the era of Information Technology to the era of Digital Technology. The combination of cutting-edge technologies – such as big data, cloud computing, AI and blockchain – with financial services has greatly changed how information is collected and decisions are made, greatly enhancing the efficiency of the traditional financial industry. Typical products include credit ratings based on big data, AI-enabled investment advisory and supply chain finance.

²⁰ Taobao.com launched Alipay on 18 October, 2003, but it was not until 8 December, 2004 that Zhejiang Alipay Network Technology Co., Ltd. was established. The Alipay website only went online and began operating independently on 30 December.

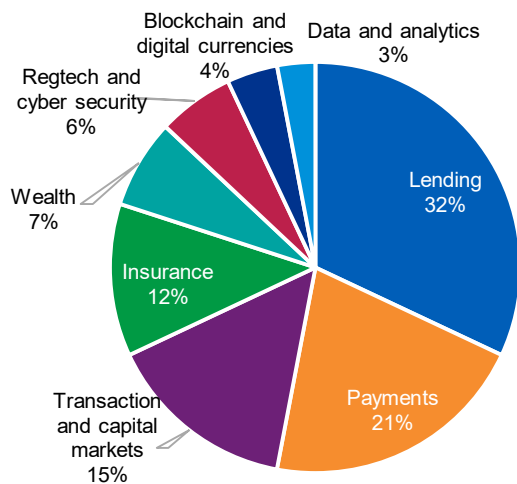
²¹ June 2007 saw the launch of ppdai.com, China's first P2P loans platform, marking the entry of China's fintech companies into the credit business.

²² In June 2013, Alipay and Tianhong Fund formally launched their "Yu'E Bao" (a money-market fund) wealth management product, after which various other online wealth management products were launched. In July 2013, Sina released its "micro-bank" and officially entered the wealth management market; in October, Baidu Financial's Baifa Wealth Management plan went online; in December, Netease launched its wealth management tool; and Tencent released its Licitong platform in January 2014.

A comparison of fintech in China and the world

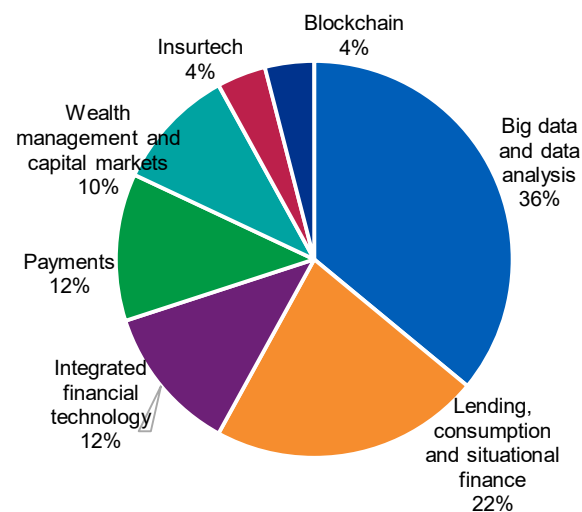
Fintech is changing the landscape of the financial industry across financial sectors. The 2017 *FinTech 100*,²³ a joint report by KPMG and H2 Ventures, finds that fintech companies are predominantly operating in the credit, payments, transaction and capital markets, insurance and wealth management industries. More than half of the companies (53) in the list are credit and payment companies, and there are 15 and 12 companies in transaction and capital markets, and insurance, respectively. Although only one-fifth of the companies on the list are engaged in wealth management, regtech, blockchain, and data analysis, it is a reflection of the diversification trend of fintech and presents significant growth prospects.²⁴

Fig. 20: Global Fintech 100 sector distribution



Source: '2017 Fintech 100', KPMG and H2 Ventures

Fig. 21: China Leading Fintech 50 sector distribution



Source: '2017 China Leading Fintech 50', KPMG

²³ '2017 Fintech 100', KPMG and H2 Ventures, <https://h2.vc/reports/FinTechinnovators/2017>

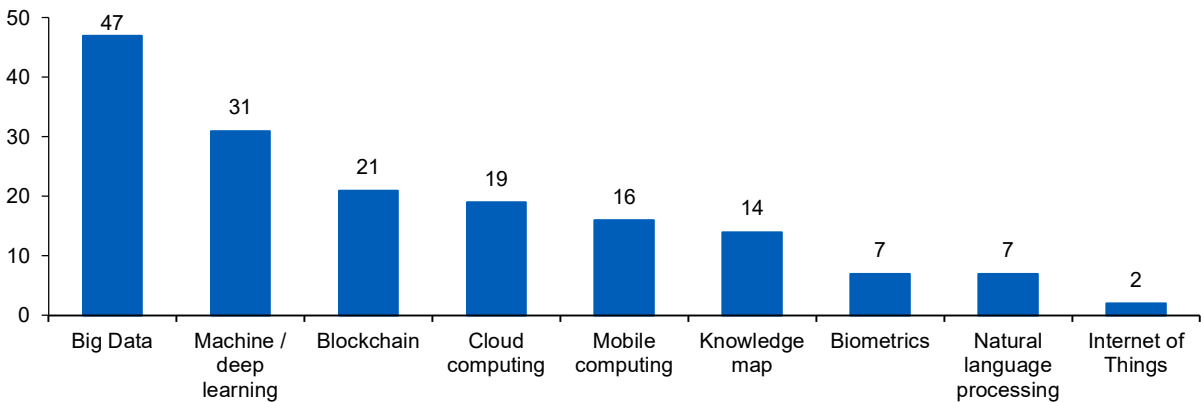
²⁴ In 2017, nine Chinese enterprises ranked in the *Fintech 100*. Six of these companies operate in the field of credit, and the other three are involved in payments, capital markets and insurance, respectively.



In comparison, Chinese fintech companies focus more on big data analysis. According to KPMG's recently-released *2017 China Leading Fintech 50*²⁵ – which ranks leading and emerging fintech companies in China – more than one-third (18) of the listed companies come from the "big data and data analytics" sector, while 11 are focused on "lending, consumption and scenario finance". Only four companies in the blockchain and insurance technology sectors feature in the list, suggesting that there is still room for further development in the sector.

Data is the foundation of all fintech companies' efforts in driving innovation. Forty-seven out of 50 of China's leading fintech companies regard big data as the core technology that drives their growth. This highlights the importance that fintech companies attach to data resources, and reflects the fundamental role that big data technology plays in supporting fintech.

Fig. 22: Key tech element distribution of the China Leading Fintech 50



Source: '2017 China Leading Fintech 50', KPMG

²⁵ '2017 China Leading Fintech 50', KPMG China, December 2017, <https://home.kpmg.com/cn/zh/home/campaigns/2017/12/china-FinTech-50.html>

► Comparison between China and the US

China and the US are fast becoming the leaders of the global digital economy, and both countries have also enjoyed rapid growth in the fintech sector. *The 2017 Fintech 100* features 19 US companies and nine Chinese companies, putting the two countries in first and third place, respectively. The growth of fintech is also attracting the attention of investors. According to KPMG's *The Pulse of Fintech* report, Chinese fintech companies attracted a total of USD 6.4 billion in venture capital in 2016. This accounted for 47.1% of the world's total investment and made it the largest recipient of venture capital worldwide.²⁶

In terms of industry distribution, China's fintech companies are largely concentrated in the areas of credit and payments (see Figure 23). In the US, their distribution is more diverse (see Figure 24). The difference is partly due to the different development stage of the financial systems in these two countries. The US financial market has a long history and its financial services system is more mature. The focus of many fintech companies is on helping the existing financial institutions to enhance efficiency and provide richer and more personalised financial products. As a result, US fintech companies are involved in a broad spectrum of financial sectors.

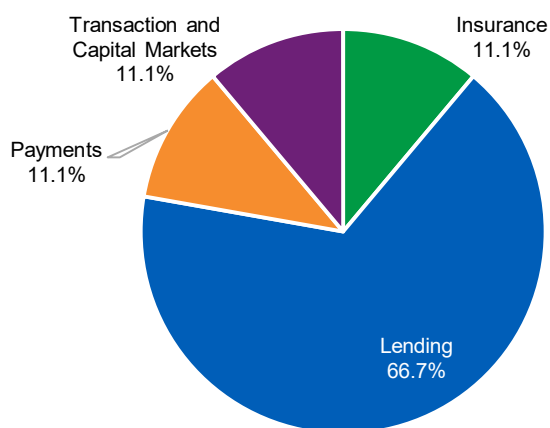
China's financial industry has a relatively shorter history. In particular, services in the consumer-oriented credit and payment sectors had a relatively late start, and have low

penetration rates. For example, as of 2016, China had an average of 0.3 credit cards per person – well below the US average of 3.2 credit cards per capita.²⁷ At the same time, the rapid growth of China's economy and household incomes, as well as soaring demand in the credit and payment fields, have created a huge market for Chinese fintech companies to enter.

China is already a world leader in payments and credit fintech. For example, data shows that China's third-party mobile payment reached RMB 38 trillion (about USD 5.5 trillion) in 2016, nearly 50 times the amount for the US during the same period (USD 112 billion).²⁸

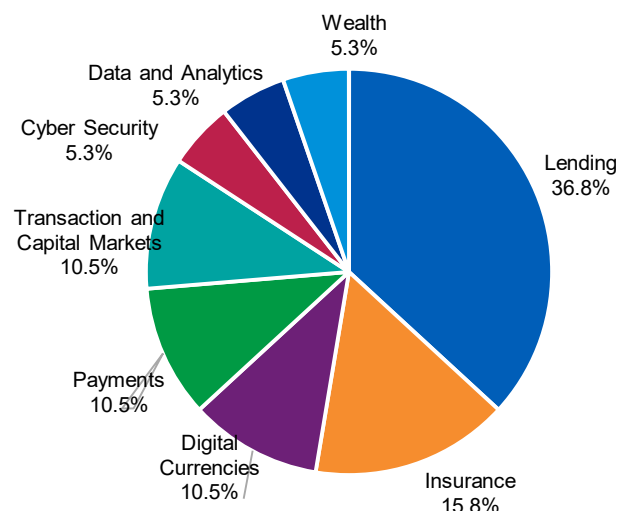
When it comes to innovators, China's major internet companies – Alibaba, Tencent, Baidu and JD.com – have played an important role in developing the country's fintech sector. With their advantages in user base, traffic, technology and funding, they have created a broad distribution of business lines and ecosystems stretching across the entire financial services chain. At present, their business lines have achieved wide-scale penetration into many fields such as payments, credit, wealth management and insurance. In comparison, US fintech companies tend to focus on just a single or small number of core technologies. The companies are also relatively small in scale, but they are large in number and highly innovative.

Figure 23: Chinese company sectors in the Fintech 100



Source: '2017 Fintech 100', KPMG and H2 Ventures

Figure 24: US company sectors in the Fintech 100



Source: '2017 Fintech 100', KPMG and H2 Ventures

²⁶ 'The Pulse of Fintech Q4 2016', KPMG

²⁷ Bank for International Settlements, KPMG analysis

²⁸ 'China mobile payments dwarf those in US as FinTech booms, research shows', Financial Times, 14 February, 2017

01

Closer cooperation between fintech companies and financial institutions

The technical strengths of fintech companies will complement traditional financial institutions' advantages in capital and professional services. The closer cooperation between fintech companies and financial institutions will continue to strengthen in 2018. Following an announcement in November 2015 that China CITIC would team up with Baidu to launch Aibank, China's first direct bank with an independent legal entity, an increasing number of traditional financial institutions have begun seeking out partnerships with fintech companies. In 2017, for example, China's four major state-owned banks collaborated with Baidu, Alibaba, Tencent and JD.com on a number of initiatives (see Table 6).

Table 6: Cooperation between the four state-owned commercial banks and internet companies

Date	Partnership	Content
28 March, 2017	China Construction Bank and Alibaba	Promotion of China Construction Bank's online credit card business; collaboration across online and offline channels; collaboration in electronic payments; and the connection of credit systems.
16 June, 2017	ICBC and JD.com	Wide-ranging collaboration in fields including financial science and technology, retail banking, consumer finance, corporate credit, "campus ecology", asset management and personal joint accounts.
20 June, 2017	Agricultural Bank of China and Baidu	Creation of a joint Fintech Laboratory; wide-ranging collaboration around specific applications such as the "Financial Brain" and "Customer Profile"; precision marketing; credit assessments; risk monitoring; smart investment consulting; and smart services.
22 June, 2017	Bank of China and Tencent	Creation of a joint Fintech Laboratory and in-depth collaboration in cloud computing; big data; blockchain and AI to jointly create inclusive finance, cloud finance, smart finance and technology finance.

Source: Open Source, KPMG Analysis

Cooperating with fintech companies will continue to help traditional financial institutions to improve their technology capabilities and transform their growth models. For fintech enterprises, leveraging their technology and closer interdisciplinary collaboration will help them break through capital and industry constraints and integrate with the broader financial services ecosystem.

02

Return of fintech to its technology roots

The development of China's economy has led to an increasing demand for high-quality and convenient financial services in the market. Only continued technological progress can help the financial industry to overcome pain points and continue to grow. At present, issues such as insufficient support for the real economy, a low degree of financial product customisation, and financial fraud have constrained further growth in the industry.

However, breakthroughs and innovative uses of fintech such as big data, cloud computing, AI, blockchain, IoT and biometrics have created opportunities to address these issues. For example, more scenarios can be seamlessly connected with financial services by building more efficient online and offline platforms. The use of big data technology allows the multidimensional and multi-angle identification of users' needs, encouraging the development of customised financial products. Financial institutions can also cross-validate the authenticity of user information by incorporating biometrics, and identify unusual transactions in complex data environments by analysing similar behaviours through deep learning algorithms.

With more than 750 million domestic netizens and a mobile internet user penetration of more than 96 percent,²⁹ it has become increasingly difficult for fintech companies to solely rely on capturing new users to grow. Fintech is returning to its technology roots, and the use of technology to serve the financial industry has become an industry consensus. Going forward, the companies that will succeed amid fierce competition will be the ones that are highly innovative and possess unique technical strengths.

03

Regtech is expected to become a "blue ocean" for fintech growth

Fintech has had revolutionary implications for improving financial service capabilities and reducing transaction costs. At the same time, this kind of "disruptive innovation" also makes the connection and aggregation of financial risks more complicated. Risk accumulation becomes less visible and spreads faster, and effective regulation is vital to the healthy and sustainable development of fintech. However, strengthening supervision will also increase compliance costs for financial institutions.

'Regtech' is the application of technological innovation to help address compliance and regulatory requirements. Regtech can help financial institutions seamlessly and systematically monitor regulatory compliance, and identify and control risks in order to simplify compliance processes and reduce compliance costs. From a regulatory perspective, regtech helps detect financial risks, accurately tracks violations and reduces regulatory costs, while improving the accuracy and effectiveness of risk prevention.

In May 2017, the PBoC established a Fintech Committee to strengthen the use of regtech. It aims to actively leverage technologies such as big data, AI and cloud computing to enhance financial regulatory measures and improve screening, prevention and resolution capabilities for financial risks across sectors and markets.

At present, regtech in China is still relatively underdeveloped (there were no Chinese regtech companies in the *2017 Fintech 100*). However, with China's tightening financial regulations and increasing risk awareness among institutions, we expect regtech to see faster growth³⁰ and become a central force in future fintech innovation.

²⁹ According to data released by the China Internet Network Information Centre, as of the first half of 2017, there were 751 million internet users in the country and 724 million mobile internet users. Mobile netizens accounted for 96.3% of total netizens.

³⁰ 'The Pulse of FinTech Q2 2017', published by KPMG, showed that in the first half of 2017, global regtech attracted over USD 590 million of venture capital – higher than the amount of venture capital invested during the whole of 2015. It is estimated that in 2017, venture capital investment in regtech would exceed the USD 990 million spent in 2016 and hit a record high.

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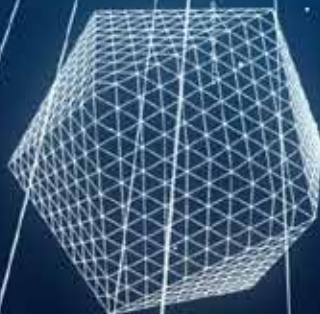
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Table: Key indicators

			2016	2017	2017					
	Indicator	Unit	Annual	Annual	Jul	Aug	Sep	Oct	Nov	Dec
Economic activity	GDP	Trillion RMB	74.4	82.7	21.2			23.5		
		% YOY	6.7	6.9	6.8			6.8		
	Industrial production	% YOY	6.0	6.6	6.4	6.0	6.6	6.2	6.1	6.2
	Industrial profit	% YOY	8.5	21.0	16.5	24.0	27.7	25.1	14.9	10.8
	Retail sales	% YOY	10.4	10.2	10.4	10.1	10.3	10.0	10.2	9.4
	Fixed asset investment	% YOY YTD	8.1	7.2	8.3	7.8	7.5	7.3	7.2	7.2
	Property starts	% YOY YTD	8.1	7.0	8.0	7.6	6.8	5.6	6.9	7.0
	Property sales	% YOY YTD	22.5	7.7	14.0	12.7	10.3	8.2	7.9	7.7
	Land purchases	% YOY YTD	-3.4	15.8	11.1	10.1	12.2	12.9	16.3	15.8
	Manufacturing PMI	Index	50.3	51.6	51.4	51.7	52.4	51.6	51.8	51.6
International trade and investment	Exports	% YOY	-7.7	7.9	6.4	4.9	7.9	6.3	11.5	10.9
	Imports	% YOY	-5.5	15.9	11.1	13.4	18.8	17.1	17.6	4.5
	Trade surplus	Billion USD	509.7	422.5	45.1	40.7	27.9	37.2	39.0	54.7
	Foreign direct investment (FDI)	Billion USD	126.0	131.0	6.5	9.4	10.6	9.0	18.8	11.1
	Outbound direct investment (ODI)	Billion USD	170.1	120.1	9.0	11.5	9.3	8.3	21.2	12.5
Financial market	RMB exchange rate	USD/CNY	6.64	6.75	6.8	6.7	6.6	6.6	6.6	6.6
	RMB real effective exchange rate	Index	124.4	120.5	119.0	119.6	121.2	121.5	121.3	121.6
	Shanghai composite index (Period end)	Index	3104	3307	3273	3361	3349	3393	3317	3307
	Money supply (M2)	% YOY	11.3	8.2	9.2	8.9	9.2	8.8	9.1	8.2
	Stock of total social financing (TSF)	% YOY	12.8	12.0	13.2	13.1	13.0	12.9	12.5	12.0
	New TSF	RMB billion	17802	19440	1196	1489	1834	1036	1620	1140
	New bank loans	RMB billion	12646	13523	826	1090	1270	663	1120	584
	Shibor (overnight)	%	2.07	2.63	2.68	2.82	2.75	2.66	2.73	2.67
Price	Consumer price index (CPI)	% YOY	2.0	1.6	1.4	1.8	1.6	1.9	1.7	1.8
	Producer price index (PPI)	% YOY	-1.4	6.3	5.5	6.3	6.9	6.9	5.8	4.9
	Crude oil	USD/barrel	43.5	50.9	46.7	48.1	49.9	51.6	56.7	57.9
	Steel (rebar)	RMB/ton	2476	3878	3823	4071	4105	4030	4186	4663
	Housing price index (70 cities)	% YOY	6.4	8.5	9.3	8.2	6.5	5.7	5.5	5.8

Source: Wind, KPMG analysis

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