



China Economic Monitor

Q1 2019

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Executive summary

The Chinese economy

In 2018, China's GDP grew by 6.6% year-on-year, 0.2 percentage points lower than in 2017. Its growth rate remained within a reasonable range and above the Government's target of approximately 6.5%.

A review of the trends throughout 2018 reveals that the downward pressure on China's economy was mainly due to two factors — the cyclical decline in demand for deleveraging and the impact of the Sino-US trade friction on market sentiment. Specifically, against the backdrop of structural deleveraging and the dual pressures of strong financial supervision and strict regulation of borrowing by local governments, infrastructure investment shrunk rapidly, plummeting from an average annual growth rate of approximately 20% to a historical low of around 3% in Q1. Excessive growth in residents' debt level over the past several years, meanwhile, has also put pressure on consumption growth. Automobile sales have declined for the first time in 18 years; at the same time, escalating Sino-US trade friction has also put negative impact on the economy. For example, after the US officially announced US\$50 billion of tariffs on Chinese exports from June 15, the RMB CFETS exchange rate index fell by 5.2%. In addition, the Shanghai Composite Index fell by more than 20% from March to early December.

In response to the significant changes in the internal and external economic environment, starting from the second half of 2018, China began to adopt counter-cyclical measures including proactive monetary and fiscal policies to mitigate the economic risks.

In terms of monetary policy, in 2018, the People's Bank of China (PBOC) has announced five RRR cuts since 2018 (four times in 2018 and once in early 2019), allowing for abundant liquidity in the interbank market. Due to the restraints over non-standard financing channels that private firms have long been relying upon, the economy is still facing significant pressure in financing. In response to this situation, PBOC has issued a series of policies aimed at guiding the flow of funds and unblocking transmission mechanisms for monetary policy. For example, since October 2018, PBOC has strengthened financing support for the private economy as well as small and micro enterprises by establishing private enterprise bond financing support tools, creating a medium-term loan facility (TMLF) and adjusting the assessment criteria for targeted RRR reduction.

In terms of fiscal policy, the government is increasing its support for aggregate demand by reducing taxes and fees and increasing fiscal expenditure. In October 2018, the new 5,000 yuan / month tax threshold was officially introduced. In January 2019, expenses on children's education, continuing education, major medical care, housing loan interest, renting and supporting the elderly became subject to personal tax deductions. These initiatives will help encourage consumer spending. On October 31, the State Council issued the "Guiding Opinions on Maintaining the Shortcomings in the Infrastructure Sector", after which the approval process of infrastructure investments is significantly shortened. At the end of 2018, the National People's Congress authorised the State Council to issue a new local debt threshold of 1.39 trillion yuan, mainly to support infrastructure investment.

Overall, the above policies have been effective in stabilising market expectations and ensuring the smooth running of the economy throughout the year. Looking forward to 2019, the Chinese economy still faces significant downward pressure. First, debt level of households has increased rapidly in recent years, driven by surging real estate prices, and pressure remains on the recovery of consumption growth. Second, the weakening profitability of industrial enterprises will make companies more cautious in their investments, slowing growth in manufacturing investment. As redevelopment of shantytowns wanes, the growth of real estate investment may slow down. Although the momentum is expected to continue in the rebound of infrastructure investment, it will be difficult to offset the gap left by weakening investments in manufacturing and real estate, resulting in the slowdown of overall FAI investment. Third, export growth is likely to drop due to last year's rush of exports and weakening external demand.

In view of the pressure on consumption, investment and exports, we expect to see government using proactive fiscal policies including tax cuts (in the area of value-added tax and corporate income tax) and government spending to boost aggregate demand; on the other hand, monetary policy will focus on financing the private sector under the premise of maintaining reasonable and sufficient liquidity. The two sets of policies working together will help to ensure the stability of the economy.

This is a critical time for China as it is running out of time to avoid the middle-income trap. The country's per capita GDP is less than one-sixth that of the United States and the current economic difficulties stem from its structural imbalances. External shocks such as the Sino-US trade friction have magnified the problems in the short term. That is to say, although the counter-cyclical adjustment of macroeconomic policy is of paramount importance to stabilising economic growth in the short term; continuing to deepen supply-side structural is the only way out for China. This is also the primary reason why the Central Economic Work Conference at the end of last year emphasized the combination of structural reforms and macro-stimulus policies for high-quality and stable growth.

The world economy

The world economy has been facing challenges along its way to recovery since the beginning of 2018. Trade protectionism and unilateralism have risen, global capital markets have fluctuated, and greater uncertainty has appeared in the global economy. In 2019, as global economic growth will likely slow, the external environment China is facing remains grim. In the United States, the weakening marginal effects of tax cuts, along with the impact of trade protectionism and the Fed's interest rate hikes will, to a large extent, slow economic growth. The Eurozone's economic recovery in 2018 was significantly slowed or even stagnant. In 2019, the downward pressure on the economies of major countries such as Germany, Italy and France may become the main drag on the EU economy. At the same time, political risks such as Brexit, Angela Merkel's decision not to seek re-election, and the upcoming EU election will aggravate the economic uncertainties. The energy market may endure repeated shocks due to the increase in geopolitical risks in the Middle East. Some emerging economies have seen worsening non-financial corporate debt, dependence on international liquidity and fiscal deficits. In the context of increased pressure from trade friction and geopolitical conflicts in 2019, debt risk has risen. However, crisis and opportunity coexists. The US-led international order is undergoing major adjustments, and we are seeing a new round of technological breakthrough and industrial transformation typified by artificial intelligence and big data. For emerging markets including China, the changes will present tremendous opportunities for development.

Special topic : cross-border e-commerce

The scale of cross-border e-commerce has grown rapidly in recent years, following improvements in Internet infrastructure and the establishment of global logistics networks. In 2017, the total value of cross-border e-commerce transactions in China was 8.06 trillion yuan, with a penetration rate of 29%, rising from 12% in 2013.

China's cross-border e-commerce is largely based on exports, judging from its composition over the years. In 2017, e-commerce amounted to 6.3 trillion yuan, accounting for more than 78% of total transactions. China's e-commerce exports have the following features: developed and emerging BRIC economies are major destinations; 3C electronic products and apparel account for over 50% of products; and high brand awareness in emerging markets. In the future, industrial upgrading will help China move up in the value-added export chain. Countries along the route of the Belt and Road initiative — a typical example of China's new era of international cooperation — will inevitably become new markets for exports.

Following the rapid growth in China's consumer market, the share of imports has also increased in the total e-commerce transactions, from less than 15% in 2013 to 23% in the first half of 2018. The e-commerce retail business has seen the most significant growth, indicating the structural improvement of the consumer market. At the end of 2018, in order to support the development of e-commerce retail business, the government introduced a series of policies that adjusted and regulated cross-border e-commerce retail imports, extended preferential measures, and clarified new regulatory requirements. The new set of regulations came into effect on January 1. The new policies not only included measures beneficial to consumers, such as increased transaction limits and larger customs specification, but also marked the end of the industry's transitional period and a more mature market. We expect to see a more rapid increase in e-commerce imports against the backdrop of China's booming consumer market.



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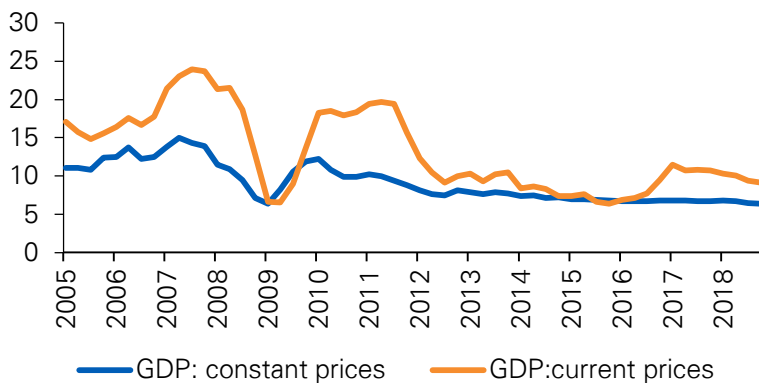
Economic outlook



China's economy remained stable but growth weakened

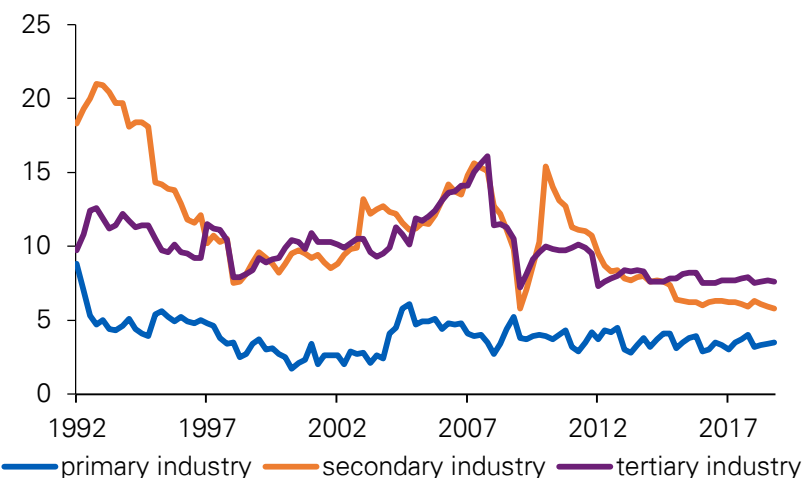
In 2018, China's GDP grew by 6.6%, meeting the expected target of around 6.5%. This was a drop of 0.2 percentage points from 6.8% in 2017, and was the lowest since 1990. In Q4, GDP increased by 6.4% year-on-year, a slight decrease of 0.1 percentage points compared with Q3.

Figure 1: GDP growth rate, quarterly year-on-year, %



Source: Wind, KPMG analysis

The service industry's annual growth rate is ahead of the other industrial sectors, and its contribution to GDP growth is on the rise. In 2018, the service industry grew by 7.6% year-on-year, a slight decrease of 0.1 percentage point from 2017. Its contribution to GDP growth increased from 58.8% to 60.1%. The growth rate of the secondary industry increased by 6% year-on-year, which was 0.25 percentage points lower than in 2017. Its contribution to GDP growth decreased from 36.3% to 35.8%, making it one of the main drags on GDP growth in 2018. The primary industry's annual growth rate was 3.3%, down 0.3 percentage points from the previous year. Its contribution to GDP growth fell from 4.9% to 4.0%.



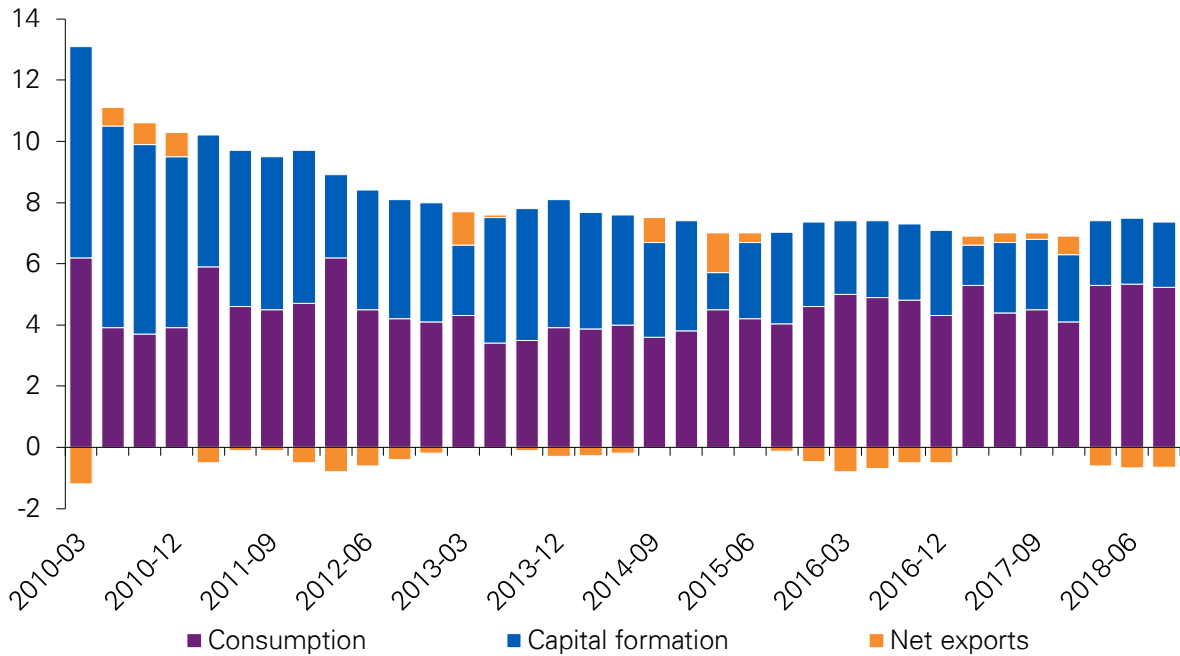
Source: Wind, KPMG analysis

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From the demand side, consumption continued to be the mainstay of stable economic growth. Its contribution to economic growth for the whole of 2018 was 76.2%, up 7.4 percentage points from 2017. Capital formation's contribution to economic growth was 32.4%, 0.3 percentage points higher than last year. External demand's contribution to economic growth remained negative this year, with a cumulative contribution rate of -8.6%.

Figure 3: GDP growth driven by different sectors, cumulative value, %



Source: Wind, KPMG analysis

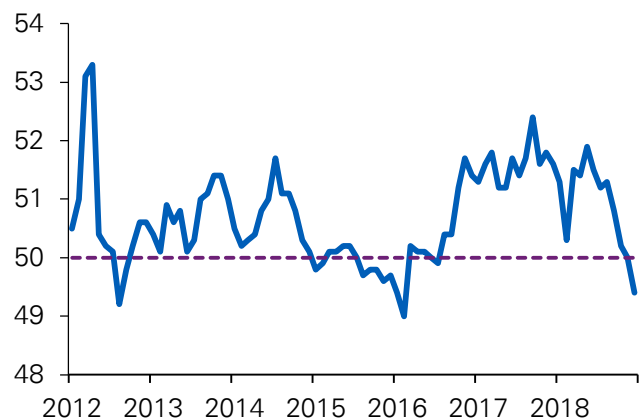
In terms of output, growth in industrial output remained sluggish. In 2018, the growth rate of industrial added value of enterprises above designated size was 6.2% year-on-year, down 0.4 percentage points from 2017. Quarterly data shows that compared with Q3, growth in Q4 fell by 0.3 percentage points to 5.7%, the lowest in 18 years. In December, the nationwide Purchasing Managers' Index (PMI) dropped below the threshold to 49.4. This was a record low since March 2016 and points to further reductions in manufacturing growth.

Figure 4: Industrial added value above designated size, year-on-year, %



Source: Wind, KPMG analysis

Figure 5: PMI, current month value

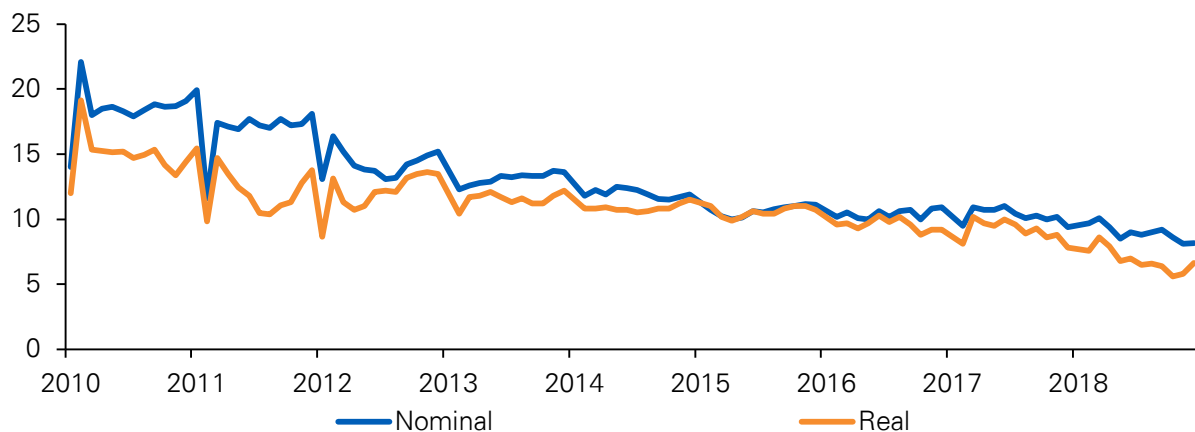


Source: Wind, KPMG analysis

Auto sales fell and consumption growth slowed

At a time when exports and investment are slightly underpowered, consumption played the role of a “ballast stone” in China’s economic growth in recent years; however, it too began to show signs of flagging in 2018. The total retail sales of consumer goods increased by 9% in 2018 (10.3% in 2017), while the growth rate of retail sales above designated size was 5.7% (8.3% in 2017). Both figures are the lowest for a number of years. December data shows a slight rebound in the nominal growth rate of social consumption retail sales (8.2%) and above (2.2%) compared with November, but it was still historically low. The actual growth rate of social consumption retail sales was 6.7% in December, which was a relatively large rebound compared with November (5.8%); this was mainly due to the significant decline in prices in December.

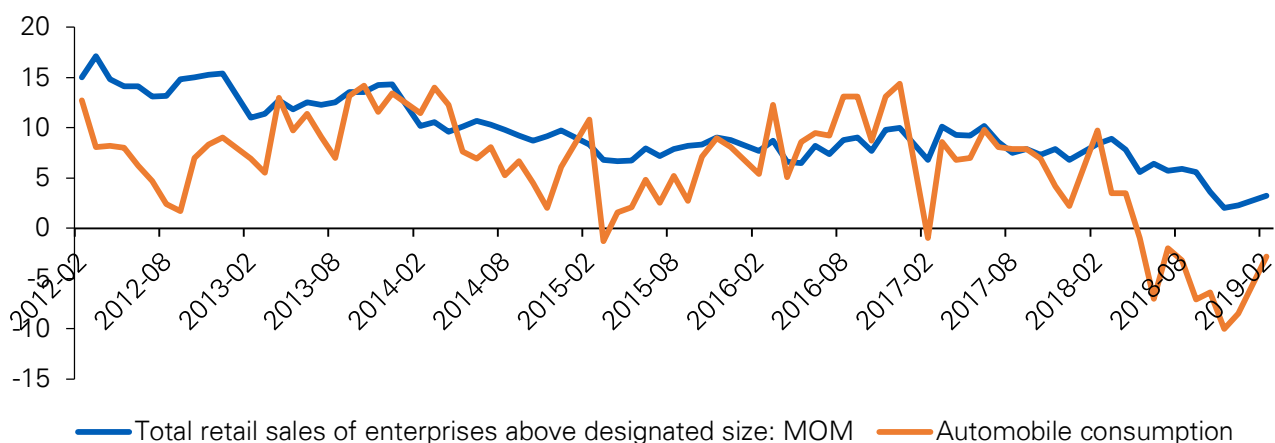
Figure 6: Total retail sales of consumer goods, year-on-year, %



Source: Wind, KPMG analysis

The downturn in auto sales was the main drag on consumption growth in 2018. The growth rate of retail auto sales for the year was -2.6%, nearly 9 percentage points lower than the average growth rate for the previous 17 years. Of this, the year-on-year growth rate in November was -10%, which was a record low for recent years. The growth rate in December was -8.5%, pointing to a slight shrinking in the rate of decline.

Figure 7: Retail sales of goods above designated size vs. sales of automobiles, year-on-year, %

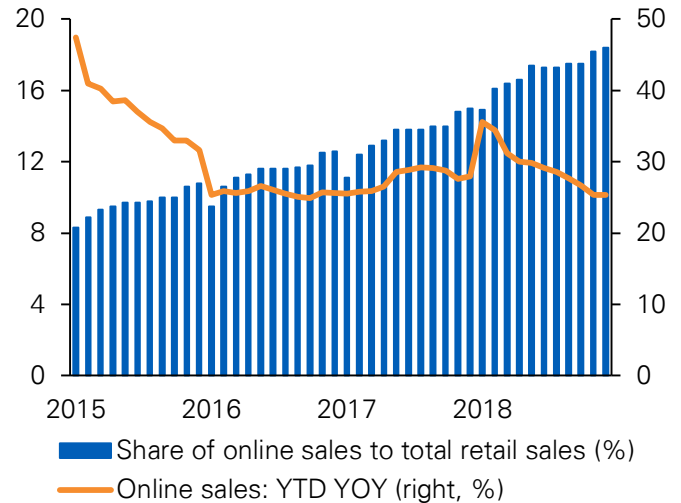


Source: Wind, KPMG analysis



Online retail sales continued to rise, and became one of the main drivers of consumption growth. In 2018, the proportion of physical online retail sales of the total consumer retail sales continued to rise to 18.4%, an increase of 3.4 percentage points compared with the end of 2017. In 2018, the online retail sales of physical goods increased by 25.4% year-on-year, a slight decrease of 2.6 percentage points from 2017.

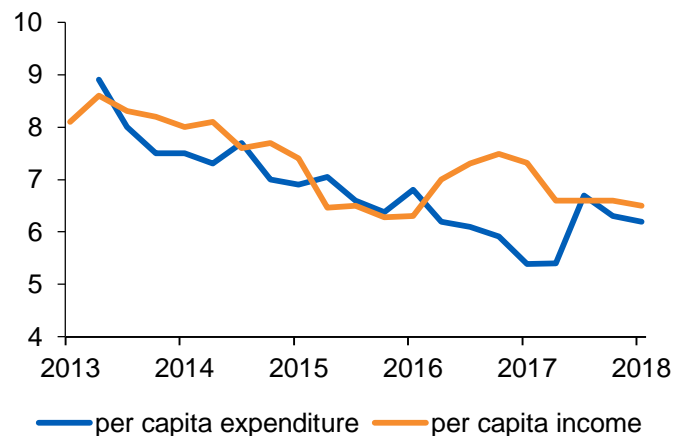
Figure 8: Proportion and growth rate of online consumption of physical goods



Source: Wind, KPMG analysis

The income growth in the household sector steadily decelerated. In 2018, the per capita real disposable income growth rate of national residents was same as the actual GDP growth rate, with 6.5% year-on-year growth, which is 0.8 percentage points lower than 7.3% in 2017. The new personal income tax law — introduced on January 1, 2019 — offered tax deductions in various areas such as pension, children's education, housing interest and care for major illnesses. It is expected to have a positive effect on residents' income and the domestic consumer market. In addition, the per capita real consumption expenditure of national residents increased by 6.2% year-on-year in 2018, which was 0.8 percentage points higher than the 5.4% of 2017.

Figure 9: National per capita disposable income and per capita consumption expenditure growth rate, cumulative year-on-year, %

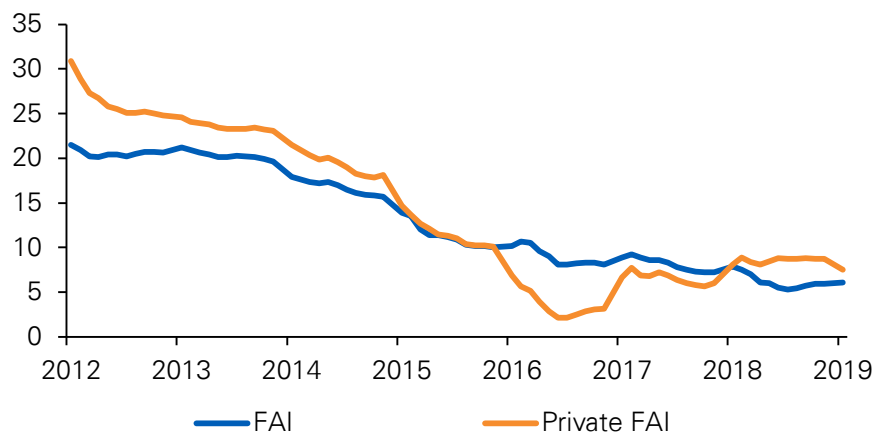


Source: Wind, KPMG analysis

Investment growth moderated, while infrastructure investment picked up

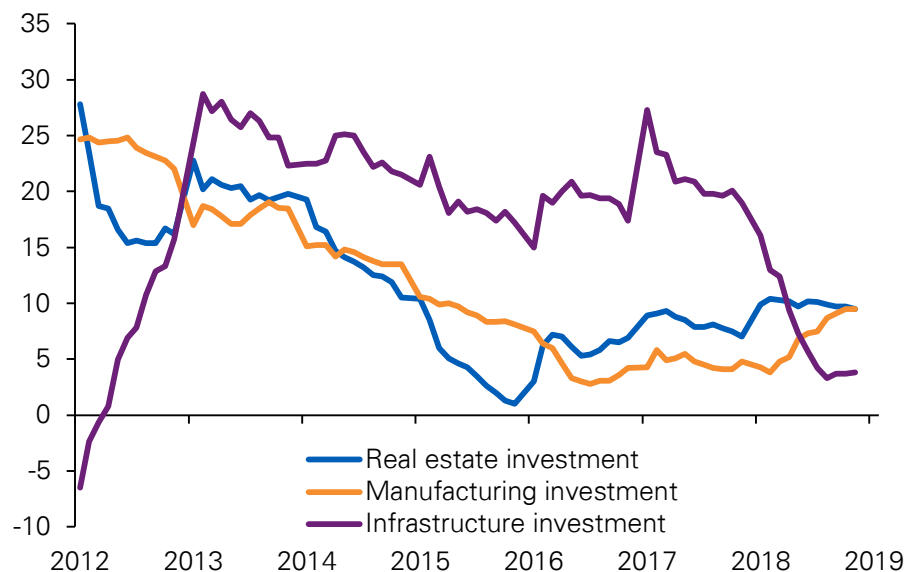
In 2018, the investment growth rate was low yet stable. During the year, fixed asset investment grew by 5.9% — a new low since 2000 and 1.3 percentage points less than for 2017. Private investment activities remained lively, with a cumulative growth rate of 8.7% for full-year 2018 — an increase of 2.7 percentage points over 2017.

Figure 10: Fixed asset investment, cumulative year-on-year, %



Source: Wind, KPMG analysis

Figure 11: Fixed asset investment by sector, cumulative year-on-year, %



Source: Wind, KPMG analysis

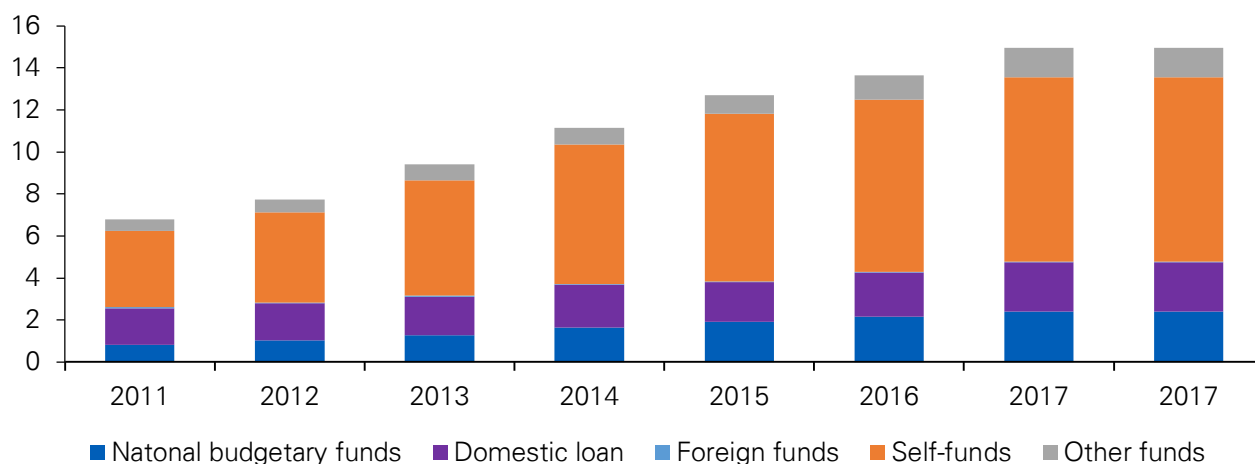
The recovery in manufacturing investment was a bright spot for the Chinese economy in 2018 and benefitted from the improvement in the overall profitability of industrial enterprises. However, the foundations supporting the rapid growth of manufacturing investment have weakened since the second half of 2018 and the profitability of industrial enterprises has continued to decline. In 2018, the total profit growth of industrial enterprises above designated size fell to 10.3%, which was almost 10 percentage points lower than in 2017. The profit growth rate became negative at -1.8% in November, and further dropped to -1.9% in December. Relatively low export-related manufacturing investment is expected due to weakening external demand. In December, the PMI fell below the threshold to 49.4, the lowest since March 2016. Owing to deteriorating enterprise profitability and the onset of shrinking production, downward pressure on manufacturing investment is expected in 2019.

The 2018 Central Economic Work Conference emphasized that the "counter-cyclical adjustment" policy should focus on tax reduction, and clarified that "implementing a larger scale of tax reduction and fee reduction" will reduce burdens for enterprises and help support investment in manufacturing. From the perspective of tax cuts, VAT is China's largest tax category, accounting for 36% of all tax revenue (as per 2017 data). Since May 1, 2018, the VAT rate of manufacturing and other industries has been reduced from 17% to 16%. The VAT rate of industries and products such as transportation, construction, basic telecommunications services and agricultural products has been cut from 11% to 10%. Further reductions in VAT are expected in 2019, which will bring huge dividends to company growth. The manufacturing industry is most affected by the Sino-US trade friction; lowering the manufacturing VAT rate will boost corporate confidence and help companies respond to changes in the external environment.

The growth rate of infrastructure investment fell sharply in 2018, which was the main drag on fixed asset investment. In 2018, the cumulative growth rate of infrastructure investment dropped from 16.1% at the beginning of the year to 3.8% at the end of December. Considering that infrastructure investment accounts for more than 20% of fixed asset investment, its sharp decline has become a major drag on the low growth rate of total investment. In 2018, financial supervision led to a sharp contraction in non-standard financing. This, compounded by local government's invisible debt, was the main reason for the decline in infrastructure investment growth. To address the problem of the rapid deceleration in infrastructure investment, on October 31 the State Council issued the "Guiding Opinions on Maintaining Efforts to Compensate for Shortcomings in the Infrastructure Sector", in which it proposed preventing large fluctuations in infrastructure investment. To fully implement this document, approval for multi-site infrastructure investment projects has been significantly increased. At the same time, there was a significant acceleration in the issuance of local government special bonds in the second half of 2018, effectively alleviating the problem of insufficient funding sources. Since October, the growth rate of infrastructure investment has begun to rebound.

At the end of December, the Central Economic Work Conference also released positive signals to promote infrastructure investment. At the conference, it was stressed that it is necessary to "increase efforts to make up for the shortcomings of the infrastructure sector" and "make larger increases to the scale of local government special bonds." At the end of 2018, the National People's Congress authorised the State Council to issue 1.39 trillion yuan of local debt in advance in 2019. All localities will begin issuing new bonds in January, which is significantly ahead of last year. The overall scale of bonds issued in 2019 could reach 2.2–2.4 trillion yuan, an increase of about 0.9 trillion yuan compared with 2018. The additional local special debts are expected to be mainly used for investment in infrastructure construction. With the greater emphasis on "compensating for shortcomings" in investment, the focus will be on increasing manufacturing technological transformation and equipment renewal; accelerating the pace of 5G commercialisation; strengthening the creation of new types of infrastructure for artificial intelligence, the Industrial Internet and the Internet of Things; increasing investment efforts in inter-city transportation, logistics and municipal infrastructure; making up for shortcoming in the construction of rural infrastructure and public service facilities; and strengthening capacity for the prevention and control of natural disasters. It should be pointed out that a proactive fiscal policy will provoke some recovery in infrastructure investment in 2019, but it is hard to see an overall rebound to the high growth of around 20%. According to our calculations, about 60% of capital investment funds — valued at about 10 trillion yuan in 2017 — rely on self-financing. Assuming there are no significant changes in financial supervision as a whole, 2019 will see a further decline in the likelihood of non-standard financing in 2019, and the rebound of infrastructure investment will continue to face restrictions.

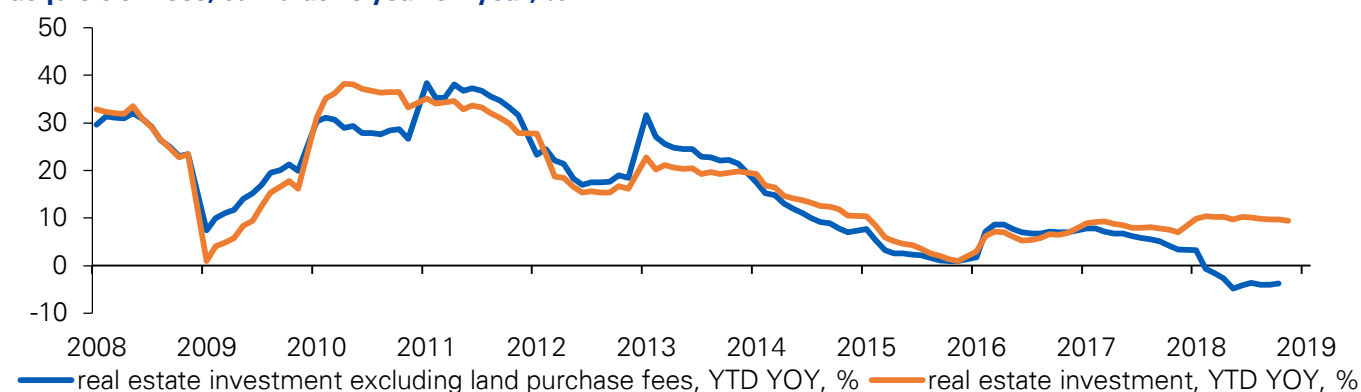
Figure 12: Classification of infrastructure construction by funding sources, 1 trillion yuan



Source: Wind, KPMG analysis

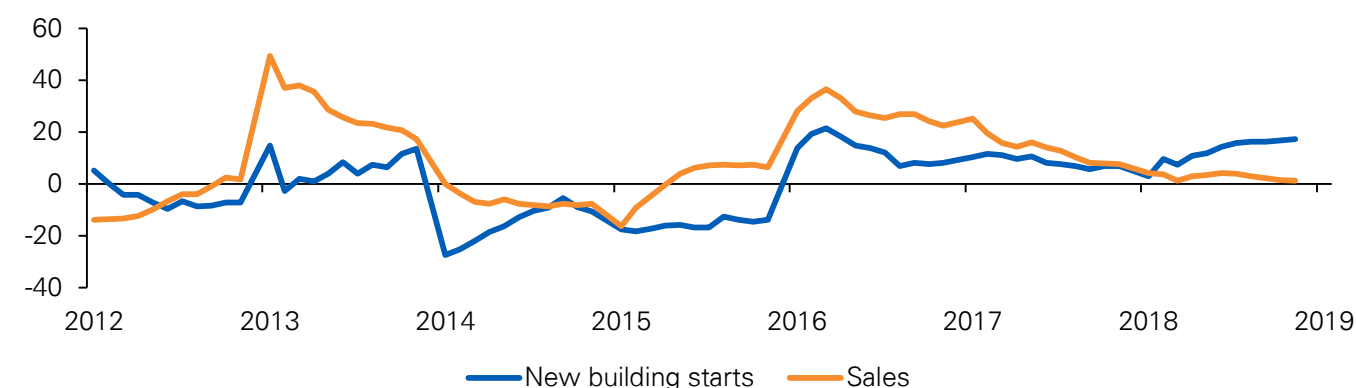
In 2018, real estate investment increased by 9.5% year-on-year, a slight decrease of 0.4 percentage points from the previous three quarters. During the year, real estate investment continued to maintain rapid growth, mainly driven by the rebound in land prices. After the deduction of land acquisition fees, the scale of real estate investment shrank for 10 consecutive months. The real estate investment growth rate during January–November was just -3.7%. There will be greater downward pressure on real estate investment in 2019. On the one hand, in the absence of effective support from the sales market, the high growth of land acquisition fees will be difficult to sustain; on the other hand, the overall tone of the government's strict regulation of the real estate market will not change in 2019. During the latest Economic Work Conference, the real estate policy was not described as a separate important task but included in "the people's livelihood". It also re-emphasized "insisting that housing is used for living in, not for speculation". National-level policies to encourage real estate investment are unlikely. However, the conference also spoke of "policies for cities, classification of guidance and taming the responsibilities of the city's government", indicating that in the context of the downward pressure on the economy, in order to achieve steady growth, more local policy adjustments will be given to local governments to ensure steady development of the real estate market.

Figure 13: Real estate development investment growth rate vs. investment growth excluding land acquisition fees, cumulative year-on-year, %



Source: Wind, KPMG analysis

Figure 14: New construction and sales area of houses, cumulative year-on-year, %



Source: Wind, KPMG analysis

Off-balance sheet financing continued to shrink, while inflation weakened

In Q4, the M2 growth rate remained low, with monthly growth rates of 8.0%, 8.0% and 8.1%, respectively. The growth rate in December was a small rebound of 0.1 percentage points, mainly thanks to the low base.

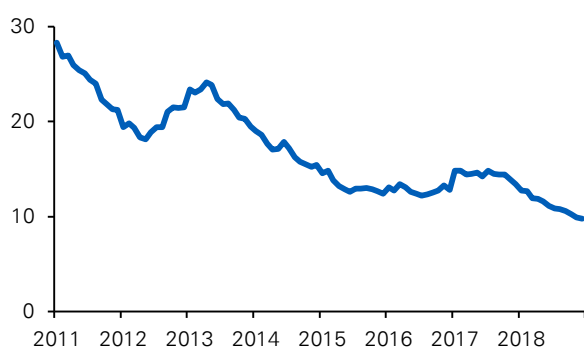
Figure 15: M2, year-on-year, %



Source: Wind, KPMG analysis

The growth rate of total social financing (TSF), which reflects the financing of the financial system for the real economy, continued to fall. In November, the stock growth rate fell to single digits for the first time (up 9.9% year-on-year). In 2018, the growth rate of TSF stocks fell to 9.8% — a record low — indicating continued pressure on financing activities in the real economy.

Figure 16: Social financing scale stock, year-on-year, %

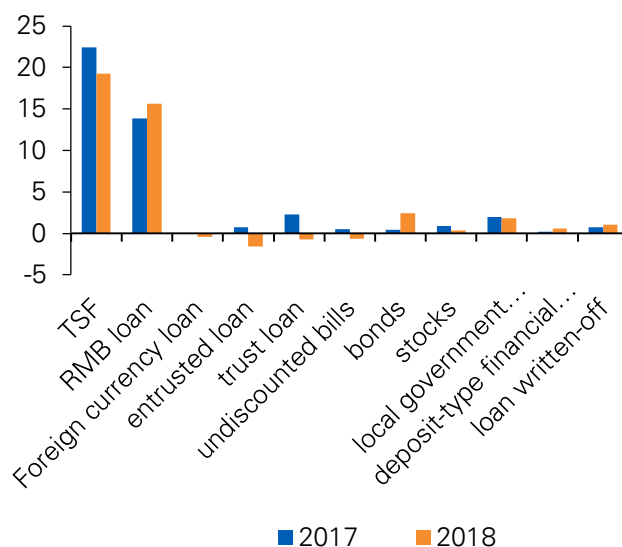


Source: Wind, KPMG analysis

From the perspective of specific financing structure, the contraction in non-standard financing remained the main drag on TSF growth in Q4. The increase in RMB loans and the recovery of corporate bond financing still struggle to make up for the deficiencies in non-standard financing.

In Q4, TSF increased by 3.9 trillion yuan, a reduction of 845.1 billion yuan over the same period the previous year. Of this, the three forms of non-standard financing — entrusted loans, trust loans and undiscounted bills — decreased by 1.3 trillion yuan compared with the same period the previous year (they dropped 627.5 billion yuan in Q4, and increased by 632.7 billion yuan in the same period last year). RMB loans increased by 3 trillion yuan, an increase of 659.4 billion yuan over the same period last year; however, expansion momentum continued, chiefly supported by bills and short-term loans. In Q4, bill financing and short-term loans increased by 539 billion yuan and 143.6 billion yuan, respectively. These two loans' contribution to the year-on-year increase of RMB loans was more than 100%, reflecting the short-term structure of loans and the low-risk preference of financial institutions. In contrast, medium- and long-term loans among enterprises closely related to investment activities decreased by 200 billion yuan year-on-year, reflecting a decline in companies' willingness to invest.

Figure 17: New TSF composition, trillions of yuan

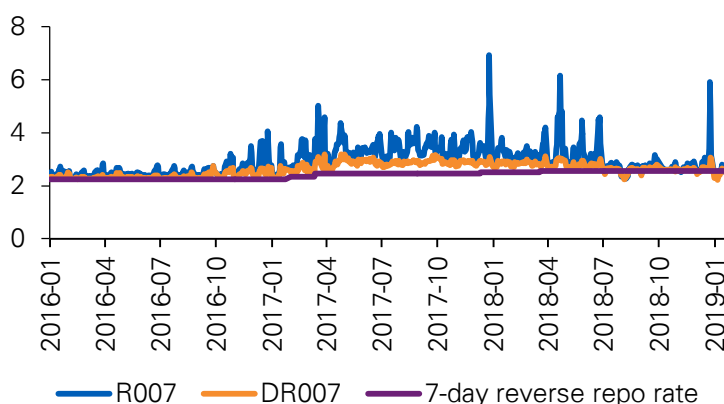


Source: Wind, KPMG analysis

For the whole year, in the context of deleveraging and strong regulation, newly added TSF in 2018 was mainly based on on-balance sheet loans. Non-standard financing contracted significantly. The annual TSF increased by 19.3 trillion yuan, a year-on-year rise of 3.1 trillion yuan. Considering that marginal relaxation of financial supervision is unlikely in the short term, non-standard financing will remain under pressure in 2019, and a significant rebound in TSF is unlikely; a lower risk appetite and weaker total demand in the market will also put pressure on credit expansion.

At present, monetary policy has rapidly shifted from neutral/tight in the first half of 2018 to neutral/loose, which is calculated as the directional reduction of inclusive finance implemented in early 2018 (January 25, 2018). So far, PBOC has carried out five alignments (four times in 2018, once in 2019). At present, there is abundant liquidity in the interbank market. The seven-day pledge repurchase rate of deposit institutions (DR007) and the seven-day pledge repo rate (R007) of banks have been relatively low since July, sometimes even dropping below PBOC's seven-day reverse repo rate. However, most of the small and medium enterprises that represent the private economy still face significant financing difficulties. This is mainly due to the excessively fast tightening of traditional non-standard financing channels and the concerns of the corporate sector about the economic outlook. As a result, to bolster the financial system's financing support for the real economy (especially the private economy and small and medium enterprises), sensible guidance on the flow of funds and market expectations for bank credit is key.

Figure 18: Interbank market interest rate, %



Source: Wind, KPMG analysis

Since Q4 of 2018, the government has taken a series of measures to strengthen financing support for the private economy, as well as small and micro enterprises:

- On October 22, 2018, the PBOC helped establish new support tools for bond financing by private enterprises. It supports private enterprise bond financing by various means such as selling credit risk mitigation tools and guaranteeing credit enhancement, thus improving private enterprises' access to financing.
- On December 19, 2018, the PBOC made the decision to create a "Targeted Medium-term Lending Facility" (TMLF). Based on the growth of loans to small and micro enterprises and private enterprises by financial institutions, this facility will provide long-term, stable funding sources for financial institutions — reducing the financing costs of small and micro enterprises and the private economy.
- On January 2, 2019, the PBOC adjusted the assessment criteria for inclusive corporate loans from "single household credit of less than 5 million yuan" to "single household credit of less than 10 million yuan" to expand the preferential treatment of inclusive finance.

The coverage of preferential policies guides financial institutions to better meet the loan needs of small and micro enterprises.

Looking ahead to 2019, under the premise of maintaining rational and sufficient liquidity, further adjustments will be made to monetary policy based on changes in aggregate demand. Given the current poor transmission of monetary policy, regulatory policy could become increasingly inclined toward the private economy, and will strive to pool its efforts with tax reduction and fee reduction policies to ensure the smooth operation of the economy.

Since Q4, the consumer price index (CPI) has continued to fall, with the growth rate dropping to 1.9% in December. The decline in non-food price growth is the main reason for the decline in CPI growth. Specifically, affected by the sharp drop in international crude oil futures (the Brent crude oil futures settlement price dropped from 84.98 US dollars/barrel on October 1 to 53.8 US dollars/barrel on December 31), the transport and communication CPI growth rate turned negative (-0.7%) in December, and its contribution to CPI — which had increased by 0.33 percentage points from October — became a 0.07 percentage point drag on CPI growth.

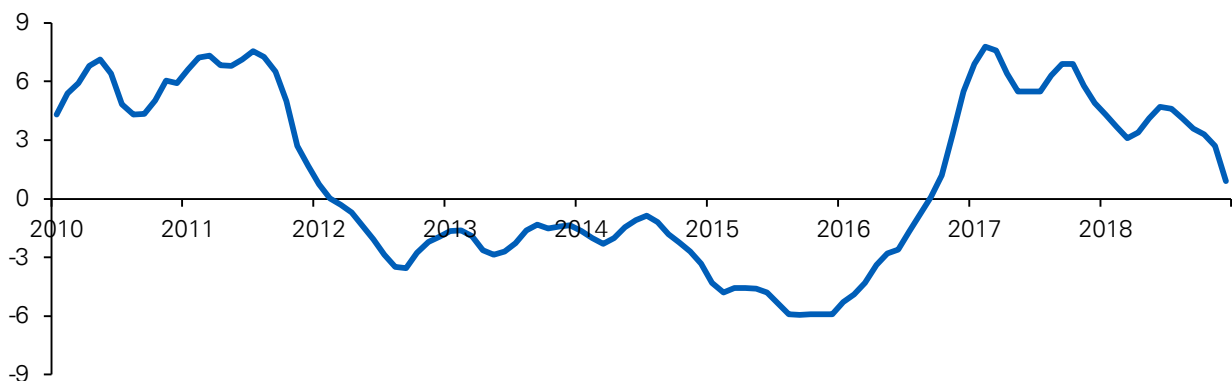
Figure 19: CPI, year-on-year, %



Source: Wind, KPMG analysis

The producer price index (PPI) continued to fall, representing slow growth that has continued for six months. The growth rate in December fell to 0.9%, a new low since October 2016. The link relative ratio maintained negative growth for two consecutive months (growth dropped to -1% in December), a side effect of weakness in domestic demand. In the short term, the Q4 decline in PPI growth is chiefly down to the following two reasons: first, due to the impact of the sharp drop in international oil prices, there was a marked drop in the price growth of oil-related industries (the year-on-year growth rate of oil and gas exploration industry fell to 4.5% from 42.8% in October, and the year-on-year growth rate of petroleum processing, coking and nuclear fuel processing industry fell to 5.7% from 24% in October). Second, the relaxation of restrictions on output designed to protect the environment eased the PPI growth rate for the raw material industry. Of this, the PPI growth rate in ferrous metal smelting and rolling processing industry turned negative from positive.

Figure 20: PPI, year-on-year, %



Source: Wind, KPMG analysis

Throughout 2018, although the CPI increased year-on-year (from 1.6% to 2.1%), its overall growth rate remained moderate, and lower than the government targets of 3%. The PPI growth rate, meanwhile, continued to fall (the year-on-year growth rate dropped from 6.3% in 2017 to 3.5% in 2018), reflecting a lack of effective demand. Looking forward to 2019, weaker demand will remain the primary factor limiting inflation. It is expected that CPI will continue to rise moderately and PPI will turn negative.



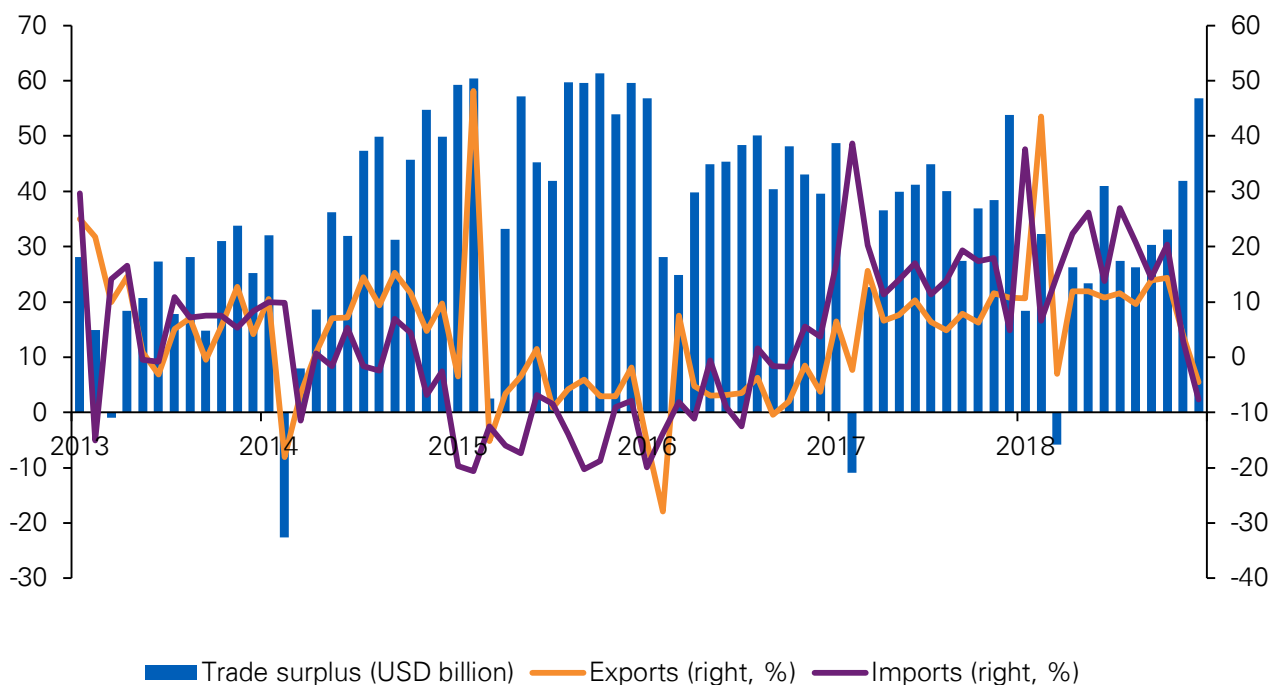
Pressure on export is increasingly evident, while pressure on RMB depreciation is relatively eased

In 2018, China's total foreign trade of goods hit 4.6 trillion US dollars, up 12.6% over the previous year. Of this, exports were valued at 2.5 trillion US dollars, up 9.9%, while imports stood at 2.1 trillion US dollars, up 15.8%. The trade surplus was 351.8 billion US dollars, contracting by 16.2% compared with the previous year.

In Q4, there were early signs of the impact of the trade friction. Combined with weakening external demand, the year-on-year growth rate of exports turned negative (-4.4%) in December, dragging down exports for the whole year. In December, China's exports to its three major trading partners of the United States, the European Union and Japan all fell, with year-on-year growth rates of -3.5%, -0.3% and -1.0%, respectively, which may indicate that the impact of slowing global economic recovery is being reflected in exports.

On December 2, 2018, the leaders of China and the United States agreed to suspend the escalation of the trade friction at the G20 summit. The US tariff rate imposed on US\$200 billion of Chinese exports will remain at the current 10%, instead of rising to 25% as originally planned. Though we will have to wait until the end of the 90-day negotiations for the final outcome of discussions, the peak of the US economy in this round will be conducive to both sides reaching an agreement. However, in view of the experiences in the trade friction between the US and Japan last century, we believe that even if the two sides reach a consensus on time, the economic and trade differences between China and the United States cannot be completely resolved in the short term. Alternate confrontation and dialogue are expected to become the new norm. What's more, enterprises have already been "panic exporting" in expectation of increases in tariff rates and tax rates for goods on the list. As a result, regardless of whether the Sino-US trade friction can be mitigated on schedule, the scale of exports in 2019 has already been partially undermined; compounded with obstructions to the recovery of the global economy, a decline in export growth in 2019 will be a high-probability event.

Figure 21: Import and export growth rate and trade balance



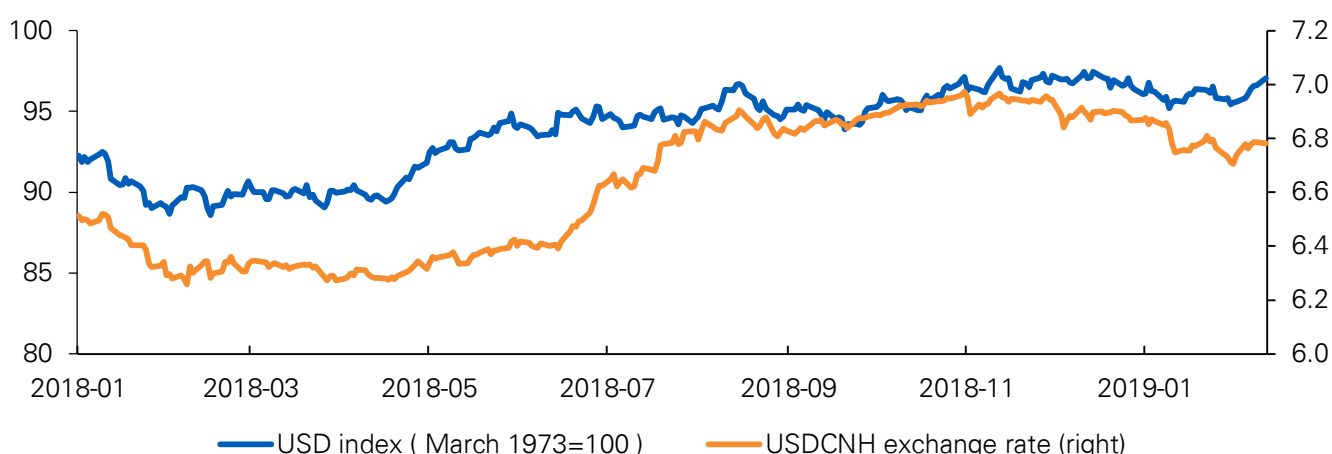
Source: Wind, KPMG analysis

In 2018, the exchange rate of the RMB against the US dollar started high and then trended downwards. This was affected by the strength of the US dollar; but also stemmed from disruption to market expectations caused by Sino-US trade friction. At the beginning of 2018, the US dollar index trended downwards and the exchange rate of the RMB against the US dollar continued to strengthen. The US dollar index began to surge upwards in mid-April. Compounded by tension between China-US economic and trade relations, depreciation of the RMB began to build up. This depreciation began accelerating after the US announced on June 15 a list of tariffs on 50 billion US dollars on goods imported from China. From mid-June to mid-August, the US dollar's exchange rate against the RMB increased sharply from 6.4366 to 6.9467, the depreciation of the RMB against the US dollar exceeded 7% and the CFETS exchange rate index fell by 5.2%. Since then, although the strong US dollar has continued to put pressure on the RMB exchange rate, the series of counter-cyclical adjustments and stable market expectations from the central bank have been successful in resolving the large fluctuations in the RMB exchange rate.

There has been a rapid rebound in the RMB's exchange rate since the beginning of 2019. The spot exchange rate of the US dollar against the RMB fell from 6.8658 on December 28, 2018 to 6.7888 on January 23, 2019, and the CFETS exchange rate rose from 93.28 on December 28, 2018 to 93.87 on January 18, 2019. This is directly related to the recent peak of the US economy and the weakening of the US dollar index; it is also connected to the market's increased adaptability to the fluctuation of the RMB exchange rate and expectation of a turnaround.

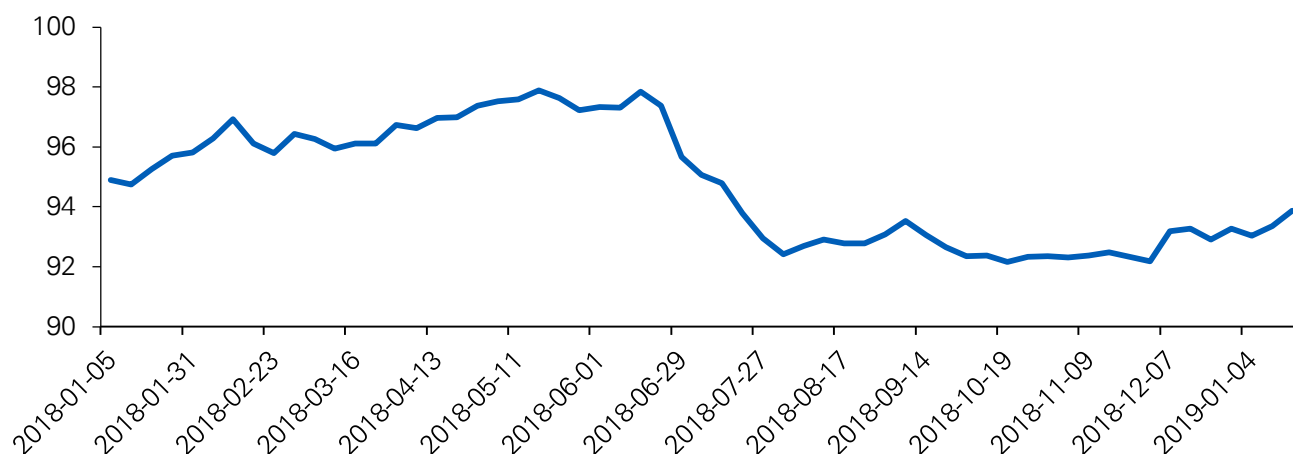
Looking forward to 2019, as the US economy slows and the Fed's interest rate hikes come to an end - and as the Sino-US economic cycle and monetary policy come into line - there will be a reduction in depreciation pressure on the RMB.

Figure 22: US dollar index and RMB exchange rate



Source: Wind, KPMG analysis

Figure 23: CFETS exchange rate index



Source: Wind, KPMG analysis

The global economic recovery slowed

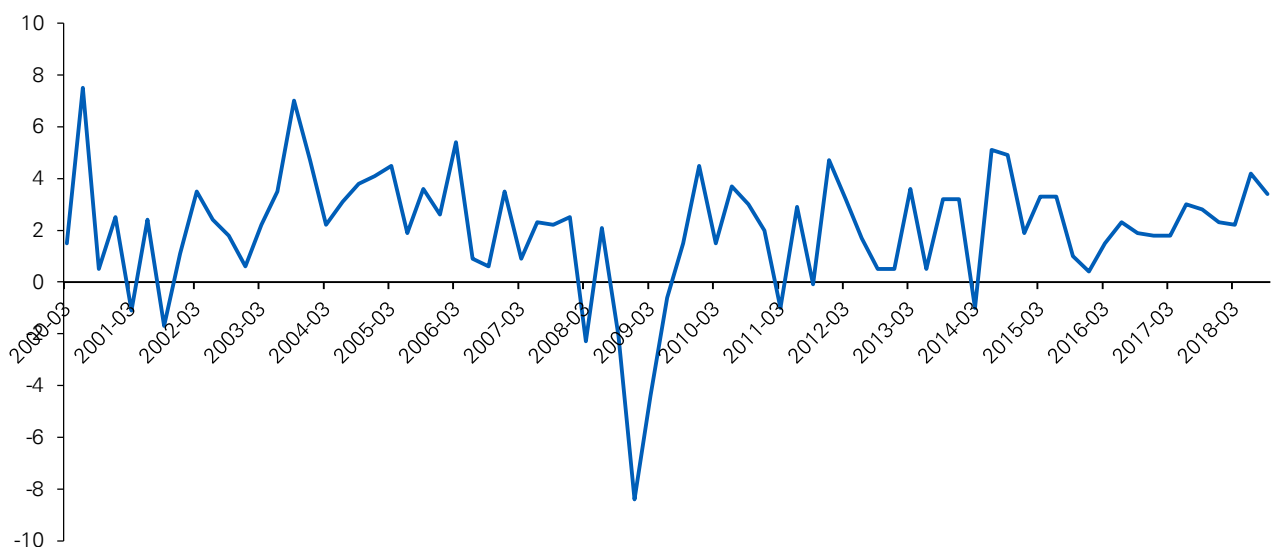
The recovery of the world economy slowed down in 2018. The political and economic risks brought about by geopolitical friction have caused profound changes in the external environment faced by China. The world economy has undergone multiple threats to its recovery since the beginning of 2018. Trade protectionism and unilateralism have risen, global capital markets have fluctuated, crude oil prices have been on a rollercoaster ride over the last year, emerging economies such as Argentina and Turkey have been caught in a currency crisis, and greater uncertainty has emerged in the global economy. New revolutions in technology and industry — typified by artificial intelligence and big data — are also gathering strength.

In 2019, global economic growth is likely to continue its slowdown since the second half of 2018. In January 2019, the International Monetary Fund (IMF) released the latest issue of the World Economic Outlook at the annual World Economic Forum¹. In the issue, global growth prospects were again lowered. In addition, it predicts that the global economic growth rates for 2019 and 2020 will be 3.5% and 3.6%, respectively, down by 0.2 and 0.1 percentage points from the October 2018 forecast.

Developed economies

As of Q3 2018², the real GDP of the United States (after seasonal adjustment) was 3.4% year-on-year, a slight decrease from the growth rate of 4.2% in the second quarter. Stimulated by large-scale tax cuts in fiscal policy, the job market was strong, with an unemployment rate of 3.7% in November — the lowest since the 2008 financial crisis. Domestic consumer spending remained high and stable. The CPI year-on-year growth remained at over 2%. The Fed carried out a fourth rate hike in December 2018, with a rate of 25 basis points and a federal interest rate of 2.27%. At the FOMC meeting in December, the Fed decided to raise the federal funds target interest rate range to 2.25–2.50%, but lowered the economic growth and inflation expectations for 2018 and 2019. Two or three further increases in the federal funds rate are expected in 2019, at 25 basis points each time. At the same time, due to the weakening of the marginal effect of tax reduction stimulus and the impact of overlapping trade protection policies, US economic growth may cool down.

Figure 24: US real GDP, seasonally adjusted annualised rate, %

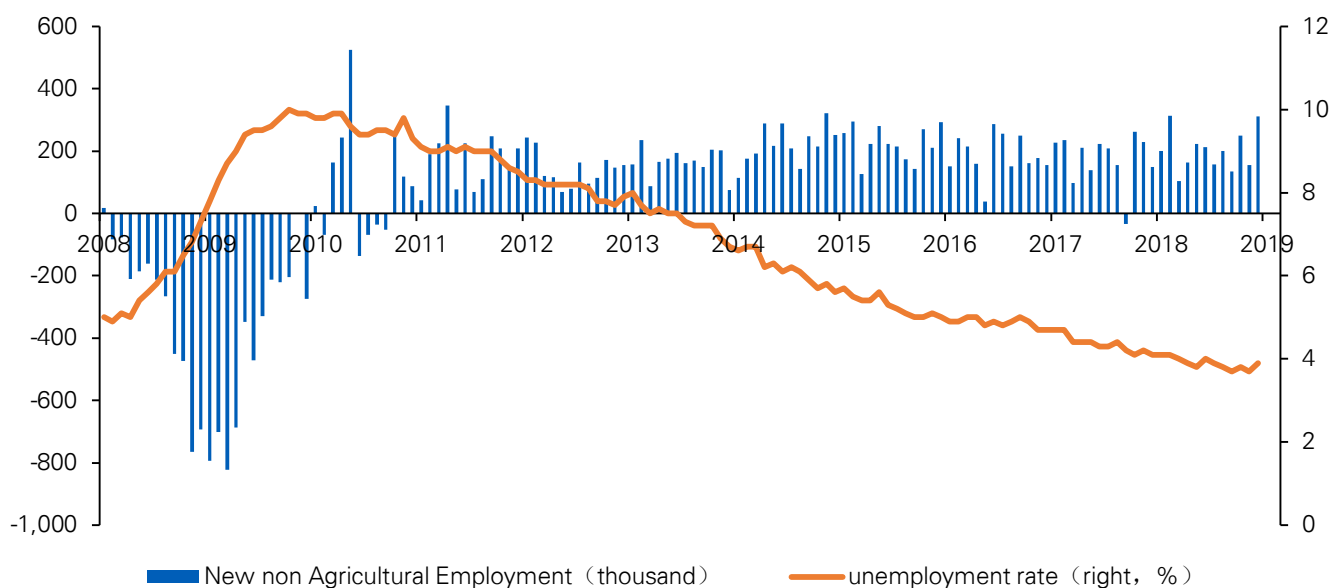


Source: Wind, KPMG analysis

¹ IMF, "World Economic Outlook Update: A Weakening Global Expansion"

² Due to the closure of the US government, Q4 data was not released.

Figure 25: US New non-farm employment volume and unemployment rate



Source: Wind, KPMG analysis

In Q3 2018, real GDP in the Euro Zone increased by 0.6% year-on-year, down 1.1 percentage points from the same period in 2017. The pace of economic recovery has been slow, almost stagnant. In 2019, the IMF expects the Euro Zone's economic growth rate to be 1.6%, down 0.3 percentage points from the October forecast. The downturn in the German, Italian and French economies will be a major drag on the EU economy. At the same time, the high political risks in Europe will bring more uncertainty. On the one hand, the dust will settle on Brexit and a political vacuum will be created due to lack of leadership after Angela Merkel steps down; on the other hand, the EU's rising populist camp may gain a voice in the 2019 European Parliament elections. These combined risks could bring about the rise of European economic conservatism, increasing the possibility of trade friction and bringing greater uncertainty to investment in Europe.

OPEC

In May 2018, the US government announced that it would withdraw from the nuclear agreement with Iran and reintroduce sanctions. This, combined with a bearish predictions for global demand for crude oil in the market, has led to frequent fluctuations in international crude oil prices since August 2018. In December 2018, the Organization of Petroleum Exporting Countries (OPEC) and other oil-producing allies headed by Russia decided to boost oil prices by cutting production by 1.2 million barrels per day from January 2019. 2019 marked the beginning of a major recovery in oil prices. On January 18, the London Brent crude oil futures trading recorded \$62.7/barrel, the highest price since December 2018. According to the IMF's January forecast, international crude oil prices will remain in the range of 55–60 US dollars/barrel for the next five years. The energy market is expected to continue to fluctuate in 2019 due to the uncertainty of bilateral relations between the United States and Saudi Arabia, the continued sanctions against Iran by the United States, and the increased geopolitical risks in the Middle East.

Emerging economies

The IMF's growth forecast for emerging market economies in 2019 and 2020 is 4.5% and 4.9%, respectively — 0.2 percentage points lower than the 2018 forecast³. The downward adjustment of overall growth expectations in emerging markets mainly reflects pressures such as trade frictions and geopolitical conflicts. However, in the long run, with the exception of Asia's emerging economies (which are still expected to maintain high growth rates), the remaining countries face the threat of weak growth and even decline. In terms of political risks, the two major BRICS countries — India and South Africa — will hold general elections in 2019, which may lead to turmoil in political and capital markets. In addition, in the decade following the 2008 economic crisis, debt risk has risen as emerging markets as a whole have exacerbated the size of non-financial corporate debt, dependence on international liquidity, and fiscal deficits.

³ IMF, "World Economic Outlook: Challenges to steady growth", October 2018, <https://www.imf.org/en/Publications/WEO/Issues/2018/09/24/world-economic-outlook-october-2018>

Outlook for 2019

In summary, great uncertainty remains in the domestic and international environment faced by China's economic development. In particular, it remains unclear whether a long-term agreement can be reached over the Sino-US trade friction, which may become the biggest external risk dragging down economic development in 2019. In response to the new risks and challenges that have arisen in economic operations, the Chinese government has strengthened counter-cyclical regulation and carried out short-term adjustments in fiscal and monetary policies. In fiscal policy, measures such as "implementing larger tax cuts and lowering fees" and RRR cuts and targeted support in monetary policy will support private enterprises in 2019 and promote their further growth. In 2019, downward pressure on the economy is expected to mainly be reflected in the first half of the year. As the effects of macroeconomic policies emerge, the downward pressures on economic operations will slow in the second half of the year, and the annual growth rate will gradually stabilise.

In terms of market trends in demand, companies should be focusing on trends in consumption classification. The rationalisation and individualisation of user needs have spawned different consumer demands and groups. Enterprises must enhance the user experience by fine-tuning the way they operate in order to target the needs of different consumer groups. For example, as consumers in first- and second-tier cities continue to place a premium on high quality and experience, consumption demand among young people in small towns marginalised by mainstream platforms will gradually come to the fore. This "long tail" effect must not be overlooked.

From the perspective of the supply side, technological developments have brought opportunities and challenges to enterprises. Enterprises must be active in transforming themselves digitally, and make full use of emerging technologies such as big data, cloud computing and artificial intelligence, and organically combine them with their own business to gain an accurate grasp of the market and acquire a long-term driving force for their development. At the same time, supply-side structural reforms remain fundamental to enhancing China's economic vitality and achieving long-term, sustainable development - and will also be the core objectives of medium and long-term policies.



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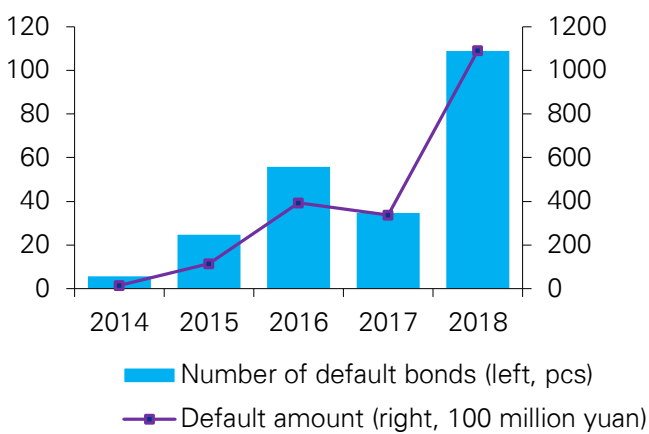
Policy review



A set of policies was introduced to ease the financing woes of the private sector

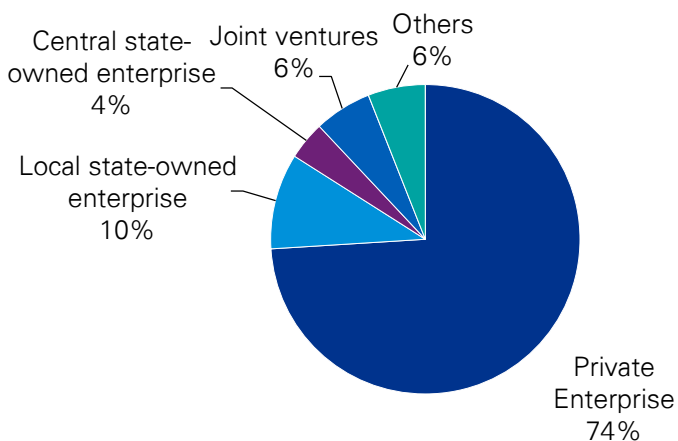
The financing woes of private enterprises have grown increasingly evident since 2018, and bond defaults by private enterprises have become a frequent occurrence. In 2018, there were a total of 124 bond defaults amounting to 120.56 billion yuan — a year-on-year increase of 257%. In terms of issuers, of the 52 companies affected, 38 were private enterprises, accounting for 73% of the total.

Figure 26: Credit defaults in 2014-2018



Source: Wind, KPMG analysis

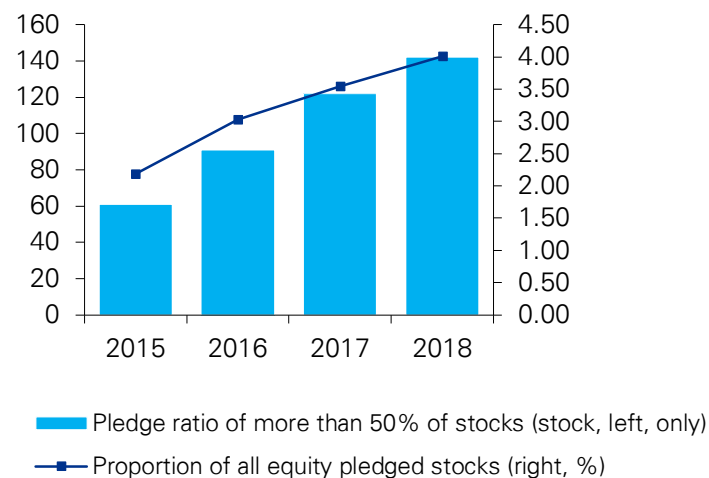
Figure 27: Bond defaults by type of company, 2018



Source: Wind, KPMG analysis

Equity pledge risk among private listed companies has also begun to appear. By the end of 2018, a total of 2,102 private stocks had been pledged, accounting for 96.4% of the total number of A-share private listed companies. In addition, of the 141 stocks with a pledge ratio⁴ of 4% or more, 126 were private enterprise stocks. It should be noted that the “Stock Pledged Repo Trading and Registration and Settlement Business Measures (Revised in 2018)”, which was officially introduced on March 12, 2018, sets a warning line for the overall pledge of a single A-share stock market not to exceed 50%. Such a high proportion of equity pledges and the recent uncertainty in the stock markets make it easy to reach the “close line”, leading to the risk of forced liquidation.

Figure 28: Changes in the number of shares with an equity pledge ratio of over 50%



Source: Wind, KPMG analysis

To solve the credit, bond and equity financing woes of private companies, Central Government committees and local governments began introducing initiatives in Q3 to ease the difficulties faced by these enterprises, providing multi-channel, comprehensive solutions to the operational difficulties they face. Below are some of the measures being taken and their current progress.

⁴ Pledge ratio: the ratio of the number of pledges of a single A share to its A share capital.

Relief measure	Content	Progress
Credit financing	Loans to private enterprises should achieve the so-called "one two five" goal; that is, of new corporate loans, loans from large banks to private enterprises should account for no less than 1/3, and those from small and medium banks should be no less than 2/3. In three years, the banking industry's loans to private enterprises should account for no less than 50% of new corporate loans ⁵ .	<ul style="list-style-type: none"> • Creation of an MTLF, providing a relatively stable, long-term funding source for small and micro enterprises and private enterprises . • In June, October and December of this year, PBOC added a total of 400 billion yuan in refinancing and rediscounting. • Increase the assessment of small and micro enterprise financing in the Macro Prudential Assessment (MPA) ⁶. • Adjust the assessment criteria for inclusive corporate loans to "single household credit of less than 10 million yuan", which is consistent with the previous "two add, two control" policy⁷.
Bailout special debt	The Shenzhen Stock Exchange and Shanghai Stock Exchange launched a special debt for bailouts, established a "green channel", and supported the relevant institutions in raising funds through the issuance of special corporate bonds, specifically to resolve the stock pledge risk of listed companies.	As of the end of 2018, seven special debts for bailouts were issued, amounting to a total of 11 billion yuan ⁸ .
Relief asset management plan	Establishment of a collective asset management plan to support the development of private enterprises, specially designed to help prospective listed companies to resolve the difficulties of equity pledges . "A collective asset management plan was established to support the development of private enterprises, specially designed to help prospective listed companies resolve the difficulties of equity pledges"	As of December 14, 2018, 28 securities companies had established 31 asset management plans and three sub-plans, with a total investment of 41.711 billion yuan ⁹ .
Insurance funds create special products	Allow insurance asset management companies to set up special products to help resolve the liquidity risk of listed companies' stock pledges ¹⁰ . "Insurance asset management companies have been allowed to set up special products to help resolve the liquidity risk of listed companies' stock pledges ¹⁰ ."	At present, three special products totalling 38 billion yuan have been introduced ¹¹ .
Private enterprise bond financing support tools	Through the sale of credit risk mitigation tools (CRMW), guarantee letters and other means, the emphasis is on assisting bond financing for private companies that are experiencing temporary difficulties, but nonetheless have a market, prospects and competitive technology.	From November 2018 to the end of 2018, a total of 47 CRMWs were issued relating to 36 companies. The total planned amount was 7.99 billion yuan, and the total balance of the underlying bonds was 21.52 billion yuan ¹² .
Improving the business environment	Local governments are required to play a role in improving the business environment and monitoring the standardised operation of private enterprises.	<ul style="list-style-type: none"> • Documents intending to relieve private corporates and improve business environment were released by multiple localities. • The National Development and Reform Commission will study and construct the first business environment evaluation system. By 2020, it will conduct business environment evaluation in cities above the prefecture level across the nation.

Source: KPMG analysis of public information

⁵ Guo Shuqing answered questions on financial support for private enterprises, November 09, 2018

⁶ China Monetary Policy Implementation Report for the Third Quarter of 2018, the People's Bank of China

⁷ The People's Bank of China decided to adjust the assessment criteria for the provision of micro-enterprise loans for inclusive finance, the People's Bank of China, January 2, 2019. 7 Interim Measures for the Listing of Exchange Depository Receipts between the Shanghai Stock Exchange and the London Stock Exchange (Consultation Draft) Article 13

⁸ Wind December 31, 2018 data

⁹ Securities Industry Supports Private Enterprise Development Series Asset Management Plan Progress Report (Phase IV), China Securities Industry Association

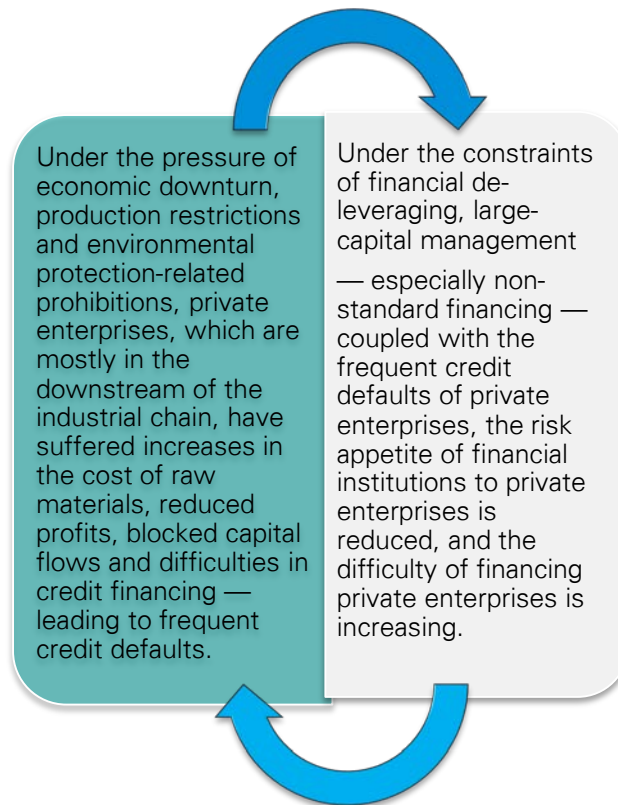
¹⁰ Notice of the China Banking Regulatory Commission on the Relevant Matters Concerning the Establishment of Special Products by Insurance Asset Management Companies--Yinbao Jianfa (2018) No. 65

¹¹ Guo Shuqing answered questions on financial support for private enterprises, November 09, 2018

¹² Wind, January 4, 2019 data

KPMG observations

At present, the difficulties faced by some private enterprises are due to a number of reasons. They are closely related to the private enterprise's own operating and financing structure, as well as the current economic downturn, industrial restructuring and transformation of the financial industry.



KPMG believes that private and financial companies can solve the current problems using the following approaches:

► Private enterprise operations:

1. Adjust their product structure, actively shift from old to new energy to reduce environmental compliance costs.
2. Actively carry out tax structure planning and adjustment, consult professional taxation advisors, and make sensible use of the current tax and fee reduction policies introduced by the government.
3. Adjust the corporate financing structure, transform the past over-reliance on non-standard financing and non-bank financing, and establish a comprehensive and diversified financing structure system.

► Financial institutions

1. Under the guidance of the macro-prudential assessment of new indicators and the "one two five" target, adjust the internal credit structure of financial institutions and implement differentiated credit policies.
2. In the era of financial technology, use innovative technologies to solve the cumbersome credit due diligence process for small and medium private enterprises under the traditional model. Apply e-commerce ecosystem, big data platforms and smart technology to significantly reduce risk monitoring costs and operating costs¹³.

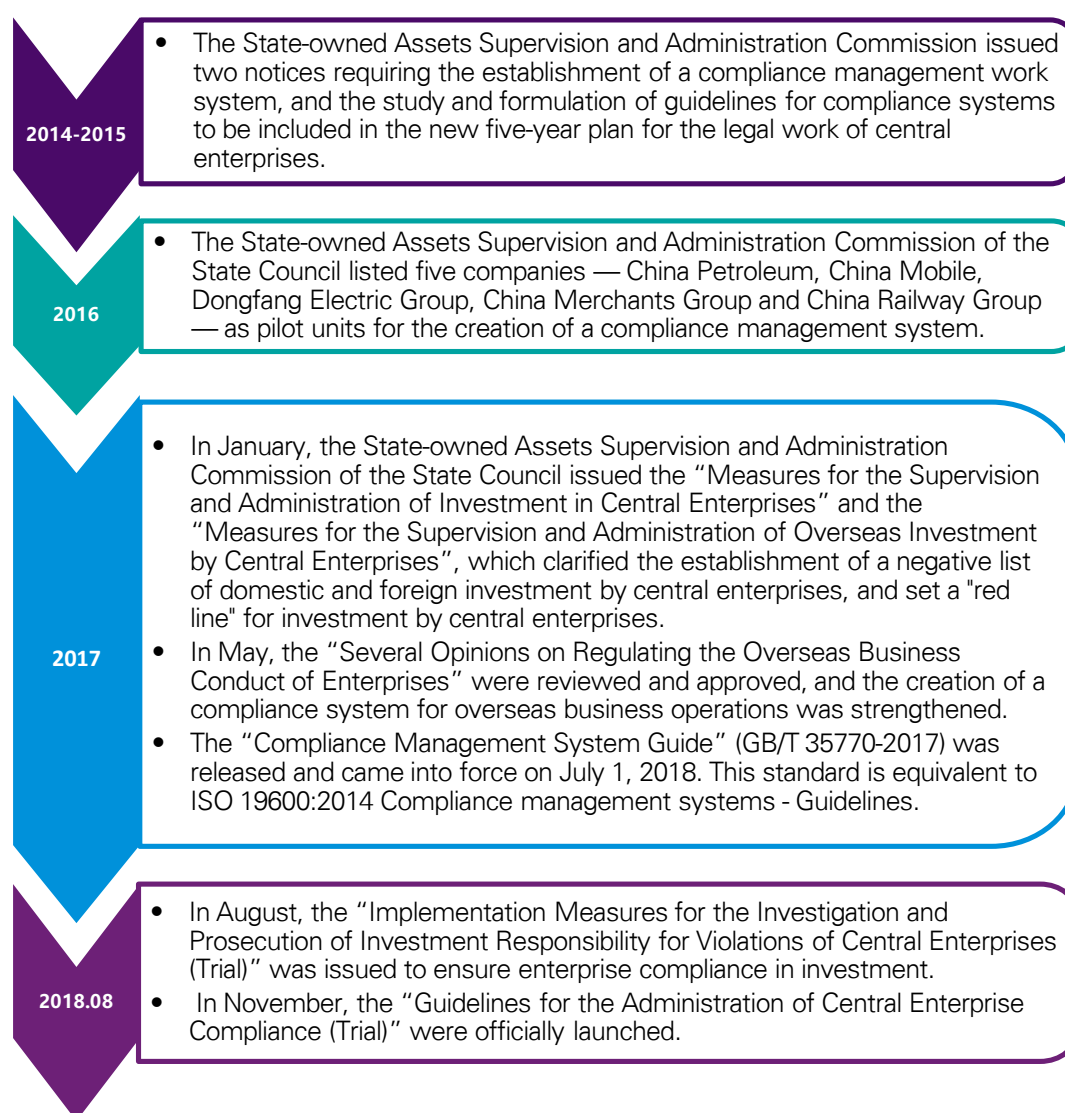
13 "The KPMG Local Service – The 40th Anniversary of the Reform and Opening Up" series of reports – Innovative development ,<https://home.kpmg.com/cn/en/home/insights/2018/07/40th-anniversary-of-economic-reform-and-opening-up/kpmg-way-of-local-services/innovation.html>

The Guidelines on Compliance Management for Central State-owned Enterprises

On November 2, the State-owned Assets Supervision and Administration Commission of the State Council issued the “Guidelines for the Administration of Central Enterprise Compliance (Trial)” (hereinafter referred to as “Guidelines”). The Guidelines aimed to further promote the comprehensive management of compliance by central enterprises; accelerate improvements in legal compliance management; build state-level enterprises ruled by law; and ensure the sustainable, healthy development of enterprises.

As early as 2006, China began exploring corporate compliance management in the financial sector. In 2014, the State-owned Assets Supervision and Administration Commission of the State Council formally proposed bolstering the creation of the corporate compliance management system. Since then, compliance management has entered the fast lane. From a global perspective, the compliance of Chinese central enterprises is still in its infancy. On the whole, given that central enterprises are an important pillar of the national economy, perfecting the compliance management system is of major significance. It not only protects enterprises during their expansion beyond China's borders but also helps improve the domestic business environment, making it more attractive to external investors.

Figure 29: Establishment process of compliance management systems for central enterprises



Source: KPMG analysis based on public information



“Broader compliance” management system

According to the Guidelines, compliance refers to the requirements on central enterprises and their employees to abide by laws and regulations, regulatory requirements, industry standards and articles of association, rules and regulations, and international treaties and rules in operations and management.

Table 1: Some components of the “broader compliance” management system

Type	Name
Laws and regulations	Basic Rules for Internal Control of Enterprises
	Guidelines for Comprehensive Risk Management of Central Enterprises
	Central Enterprise Compliance Management Guidelines
National standards	GB/T35770 Guide to Compliance Management System
	GB/T 27914-2011 Guide to Corporate Legal Risk
International standards	ISO 9001:2015 Quality Management System
	ISO 14001:2015 Environmental Management System
	ISO 37001:2016 Anti-Bribery Management System - Requirements and Use Guide
	ISO 31000 Risk Management System
	ISO 19600:2014 Compliance Management Systems - Guidelines

Source: KPMG analysis of public information

“Four in One” compliance management structure

The Guidelines clarify the top-down compliance management structure, from the most senior departments involved in compliance management (including the board of directors, the board of supervisors, management, the compliance committee), the compliance management officer, and the head compliance management department, to business departments and other participating management departments (including legal affairs, production safety, quality and environmental protection and other relevant departments). They clearly stipulate the responsibilities of compliance management at all levels, emphasizing that the governance level, management level and “three lines of defence” should all do their part in compliance management.

Key points of compliance management under “broader compliance”

Article 12 of Chapter 3 of the Guidelines clearly states that “central enterprises should change with the external environment, draw upon their own realities, and highlight compliance management for key areas, stages and personnel to effectively prevent compliance risks.” In addition, to reduce the potential for Chinese enterprises’ to violate overseas regulations, Article 6 of the Guidelines requires that central enterprises strengthen compliance management of investments abroad.

Figure 30: Key points of compliance management in the Guidelines



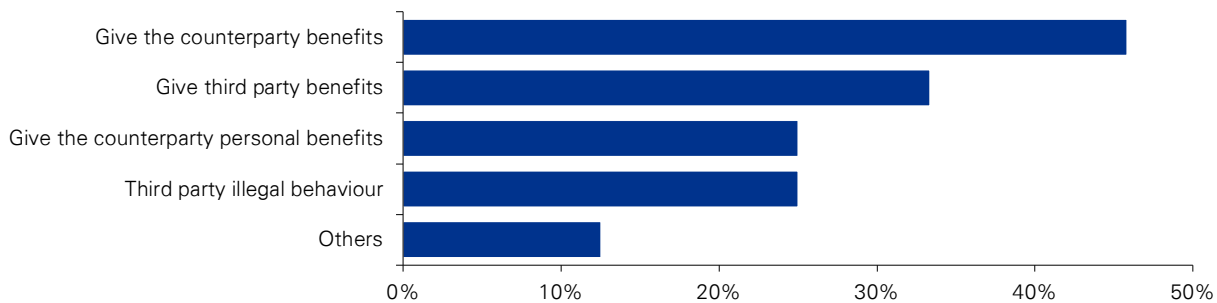
Source: Compiled by KPMG based on the Guidelines

KPMG observations

Extensive promotion of the Belt and Road Initiative has been accompanied by an increase in the frequency of Chinese investment operations abroad, which has also revealed some companies' shortcomings in compliance. In 2010, the World Bank Group, the Asian Development Bank, the African Development Bank Group, the European Bank for Reconstruction and Development, and the Inter-American Development Bank Group signed an agreement for joint sanctions against commercial corruption and fraud. As at the end of November 2018, the sanctions list — which remains in force — contained 94 Chinese companies¹⁴, of which 43 were state-funded enterprises; many of the culprits were large-scale enterprises.

In the Guidelines, compliance restrictions on enterprises' partners were a major highlight in the creation of a compliance management system. According to the 2017–2018 China Annual Compliance Blue Book¹⁵, 15% of the companies surveyed in 2017 had been subject to anti-commercial bribery investigations or punishment as a result of third-party violations committed abroad. For the past two years, third-party violations abroad have become one of the major reasons for investigation or punishment of companies. However, according to the survey, only 35.42% of the surveyed companies had a special third-party compliance management policy; for Chinese companies, this figure was only 17%.

Figure 31: Reasons for enterprises to be investigated or punished for anti-commercial bribery



Source: 2017–2018 China Annual Compliance Blue Book¹⁶, KPMG Analysis

¹⁴ Figures in the World Bank Listing of Ineligible Firms & Individuals do not cover all Chinese enterprises since the list was established. The names of companies are automatically removed from the list when sanctions end, so the companies in the current list are those that remain subject to sanctions; as such, "94" is the minimum estimate.

¹⁵ 2017-2018 China Annual Compliance Blue Book", co-authored by China Corporate Law Research Institute, China Council for the Promotion of International Trade, and Fangda Law Firm

¹⁶ Data from a questionnaire survey of the 2017-2018 China Annual Compliance Blue Book; a total of 288 companies participated in the survey.

The creation of a compliance system has never just been an internal corporate issue. It involves every stage of the company's industrial chain and multi-party relationships in trading activities. Taking China Merchants Group as an example: since trials began in 2016, the Group and its four pilot companies have identified procurement, investment, "three majors and one large" decision-making, and business partners as the commonly occurring areas of compliance risk for state-owned companies. China Merchants Group has now introduced dedicated compliance checks for these four fields¹⁷.

At a complex time when the international trading system is being re-shaped, and against the backdrop of international organisations' and various national governments' commitment to creating a strict compliance management system, companies that overlook the importance of compliance management and stick to past investment habits will inevitably face severe compliance risks and incur significant non-compliance costs.

Considering the requirements of the State-owned Assets Supervision and Administration Commission of the State Council's "Guidelines for Central Enterprise Compliance Management (Trial)" and the status quo of central enterprises, we suggest that central enterprises should set themselves targets, refer to international best practices, adopt measures and establish a sound corporate compliance management structure, and implement them as soon as possible.

Figure 32: Construction framework of a central enterprise compliance management system



¹⁷ China Merchants Group Newsletter: The number of Group's compliance pilot enterprises to be increased to to 8, China Merchants Holdings, 19th January, 2017

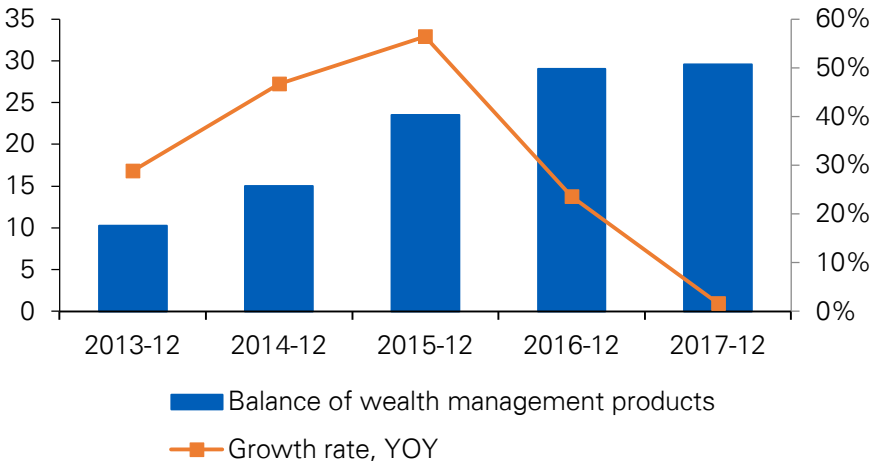
New rules for wealth management subsidiaries of commercial banks

On December 2, the “Administrative Measures for Commercial Banking Financial Subsidiaries” (hereinafter referred to as “Management Measures for Subsidiaries”) were officially issued. As the supporting documents for “Guiding Opinions on Regulating Asset Management Business of Financial Institutions” (hereinafter referred to as “New Regulations for Asset Management”) and “Measures for the Supervision and Administration of Financial Banking Business of Commercial Banks” (hereinafter referred to as “New Financial Regulations”), the release of the “Management Measures for Subsidiaries” is in consideration of requirements for isolating risk in banks’ wealth management business; they also represent the “entrusted by people, managed by people” foundation for asset management by banks’ financial asset businesses and the gradual shift toward specialist management.

Background

In 2013, wealth management by commercial banks entered a three-year period of explosive growth. The balance of wealth management products increased from 10.24 trillion yuan in 2013 to 29.05 trillion yuan in 2016, with a compound annual growth rate of 42%. The growth rate slowed in 2017, yet remained at 29.5 trillion yuan.

Figure 33: Changes in the balance of commercial banks’ wealth management products in 2013–2017¹⁸

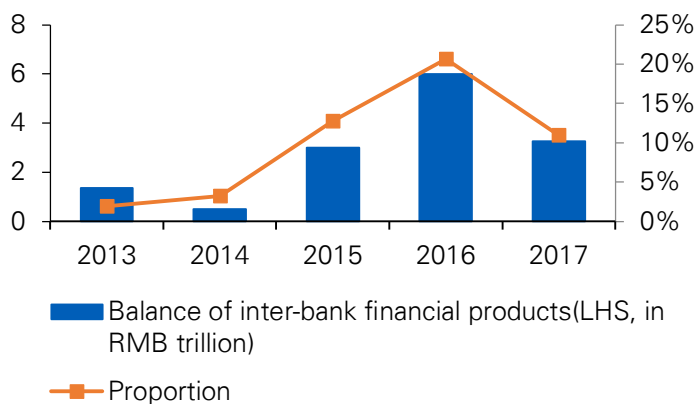


Data source: Annual Report of China Banking Financial Market, KPMG Analysis

These three years of rapid growth, however, also represented three years of risk accumulation. In addition to the problem of “rigid” redemption that has existed since the early days of banks’ wealth management, this period also saw the gradual appearance of fund pool operation, inter-bank arbitrage and multi-layer nested channel business on the investment side. The scale of interbank wealth management grew from 0.49 trillion yuan in 2014 to 5.99 trillion yuan in 2016, an increase from 3.25% to 20.61% as a share of banks’ wealth management. Banks raise funds through the issuance of interbank wealth management products, and then outsource the investment of these funds in non-standard assets through one or more layers of channel business. This gives rise to the problem of maturity mismatch, with bank liquidity risk further increased and at risk of spreading to the entire financial system.

¹⁸ The “survival balance of commercial bank wealth management products” here includes two major categories: principal and non-guaranteed.

Figure 34: Changes in the deposit balance of interbank financial products of commercial banks in 2013–2017



Data source: Annual Report of China Banking Financial Market, KPMG Analysis

To promptly control and correct the rapid growth of wealth management by banks, through the use of new asset and wealth management regulations as indicators and the introduction of supporting documents such as the “Administrative Measures for Subsidiaries”, a financial supervision system for banks has gradually been established. The new wealth management regulations stress that wealth management by banks must return to the basics of “entrusted by people and managed for people on behalf of the people”. They proposed a ban on fund pools, the abolishment of “rigid” redemption, elimination of multi-level nesting, compulsory enforcement penetrative management and the promotion of comprehensive wealth management products — requirements that are reflected in the “Administrative Measures for Subsidiaries”.

► **Carry out risk isolation by establishing a financial subsidiary**

The establishment of wealth management subsidiaries by banks will separate their wealth management business from the existing system, effectively preventing the risks of the wealth management business from being transmitted to the entire banking system. This effectively isolates risk, and as such, encourages banks' wealth management businesses to get back to “basics”. The new financial regulations clearly stipulate: “Commercial banks should conduct their wealth management business through subsidiaries with independent legal status. If the conditions are not met, the commercial bank’s head office.

should establish a dedicated wealth management department to achieve the centralised, unified management of the bank's wealth management business.” This can be viewed as the major means for banks to carry out their wealth management business in the future; as such, the establishment of wealth management subsidiaries will gradually become part of banks' agendas.

According to public information, nearly 30 commercial banks - including China's four biggest banks - have announced that they will be setting up financial subsidiaries with a registered capital totalled at RMB134 billion. The four state-owned banks each contributed approximately RMB10 billion to the capital pool.¹⁹ As a next step, commercial banks should actively prepare their financing subsidiary applications or transitional plans. When making the application, it is recommended that the commercial banks also formulate a detailed application plan for the establishment of the subsidiary to improve the likelihood of success; they should also try to secure preferential policies and incentives from regulatory bodies.

► **Relaxation of the fund side and investment side**

Fund side: The “Administrative Measures for Subsidiaries” have been relaxed to a certain extent in terms of sales starting points and sales channels compared with the new wealth management regulations. This move will further expand the coverage of wealth management by banks, helping them implement inclusive finance as well as present new tests. For example, against the backdrop of the future relaxation of sales channels, how to innovate in sales channels — particularly in the creation of online channels — will become a focus for competition among subsidiaries.

In terms of investment: In the past, due to the restrictions of investment channels and investment capabilities, banks usually entrusted funds raised through the issuance of wealth management products to non-bank institutions, and these on-bank institutions invested in stocks or non-standard claims through leverage. During this process, the trustee could outsource further, resulting in multi-level nested investments. The relaxation of the “Administrative Measures for Subsidiaries” on the investment side eliminates multi-level nesting, which is conducive to “penetrative management” of wealth management by banks.

¹⁹ Compiled by KPMG based on public information.



Sales starting point: Public offerings and private equity financing products can be issued, with public offerings not subject to the minimum sales starting point of 10,000 yuan.

Sales channels: In addition to banking financial institutions that absorb public deposits, sales can also be offered through other agencies.

Stock investment: Publicly funded products can be directly invested in stocks traded.

Non-standard investment: Relaxed quotas for non-standard credit investment, with balance of cancelling non-standard investment not to exceed the limit of 4% of the total assets.

KPMG Observations ²⁰

The establishment of wealth management subsidiaries by banks is beneficial to promoting the integrated operations of banks. It will transform the current model, which is mainly based on spread profit, and will encourage banks to identify new avenues for profit. Wealth management by banks relies on large platforms and strong financing capabilities; when competing for asset management business, they possess the customer resources of the parent bank, a broad coverage network, and extensive customer data, which are all conducive to identifying high net-worth clients with good credit. At the same time, they also face challenges. The low risk appetite of banks and the inherent disadvantages in product design and asset investment skills also limit the development of bank wealth management. KPMG believes that commercial banks need to give full consideration to the following areas when setting up a wealth management subsidiary to carry out wealth management:

► Global vision, local characteristics

The management of wealth management subsidiaries is still a relatively new topic in China, and there is little domestic experience to provide reference. As such, financial institutions must learn from the successful experiences of similar institutions abroad, creating an international outlook. Full consideration must be given to factors such as the domestic market environment, industry competition and customer groups, in order to reflect local characteristics.

► Compliance management, prevention and control of risks

The most important factor in the creation of domestic wealth management subsidiaries is how to use the establishment of subsidiaries as independent legal entities to conduct risk prevention and isolation, and thus achieve the overall control of financial risks. Institutions must have a complete understanding of the background and thinking behind regulatory policies, fully communicate with the regulatory agencies, and establish a financial subsidiary in the form of an independent legal entity that is in line with the regulatory mindset, thus promoting the healthy, orderly development of the industry.

► System optimisation and improvements to governance

Unlike the internal asset management/wealth management departments in existing financial institutions, the wealth management subsidiaries will operate as an independent legal entity. The establishment of the subsidiary must give full consideration to the funding entity and establishing entity, and must formulate a company governance structure in line with advanced governance characteristics. As a new subsidiary established separately to the parent company's original framework, it is able to engage in various forms of institutional investment and respond to market competition more flexibly and quickly.

²⁰ For more details, please refer to KPMG's Asset Management Subsidiary Design and Preparation, KPMG, July 26, 2019



► Technological support, growth in innovation

China's financial industry is currently undergoing a period of rapid development of new financial technology, and technological progress has provided tremendous support to financial institutions. During the design stage of financial subsidiaries, it is recommended that full use be made of financial technology to enhance the technological level of the entire enterprise. There should be effective application of technology in the areas of customer acquisition, marketing, sales, compliance and risk control. For example, big data technology should be used to create a "smart" investment consultancy model that provides efficient, low-cost investment and wealth management strategies. Natural language processing, knowledge mapping and other technologies can be used to build intelligent customer service "chat bots".

► Putting the customer first, guaranteeing returns

Under the new capital management regulations, the "abolish rigidity" regulation requires financial subsidiaries to make ample preparations for product design, product sales, risk prevention and control, and consumer education. Particularly given the current lack of awareness of financial risk among financial customers in China, providing adequate customer education will be a key capability. In the future, financial subsidiaries must be fully customer-centric in order to fulfil the financial needs of customers. They must provide customers with asset management services, help them preserve and increase the value of their assets, as well as provide sufficient education and protection to customers.

Auto investment rules to further push forward the development of NEVs

On December 10, 2018, the National Development and Reform Commission issued the "Regulations on Investment Management of the Automobile Industry" (referred to below as the "Regulations"). The Regulations are associated with, and simultaneously replace, the investment management-related content in the "Automotive Industry Development Policy" and the "New Battery Electric Passenger Vehicle Enterprise Management Regulations" as well as documents including the "Opinions on Improving the Management of Automobile Investment Projects". They are a further expansion of the comprehensive policy documentation for investment management of the auto industry in the new era of reform and opening up.

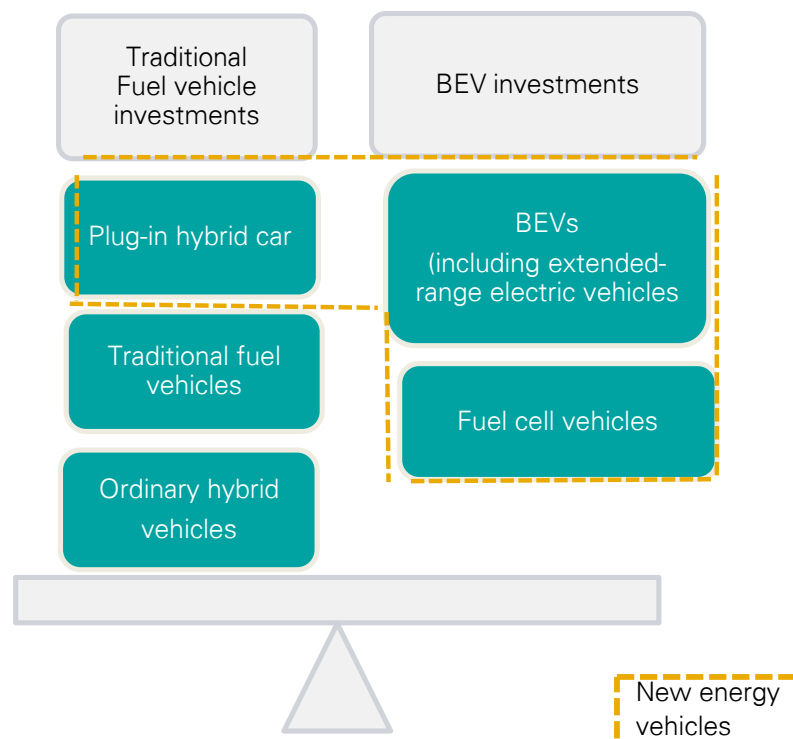
Main content of "Regulations"

The Regulations provide detailed regulations for managing investment in China's auto industry in the areas of direction of industry investment, investment target criteria, project bookkeeping, collaborative monitoring requirements, capacity management and early warnings.

► Guiding the direction of investment in the auto industry

The Regulations classify investment projects by the power train system into fuel vehicle investments and BEV investments. As such, the Regulations clarify that there should be strict control of the production capacity of new traditional fuel vehicles, and active promotion of the healthy and orderly development of new energy vehicles. Traditional fuel vehicle OEMs should increase investment in research and development; adjust their product mix; and develop new energy vehicles such as BEVs, plug-in hybrids and fuel cell vehicles. The overall direction is that traditional vehicle OEMs will gradually phase out their traditional production capacity and gradually shift their business to new energy vehicle projects.

Figure 35: Types of automotive investment projects ²¹

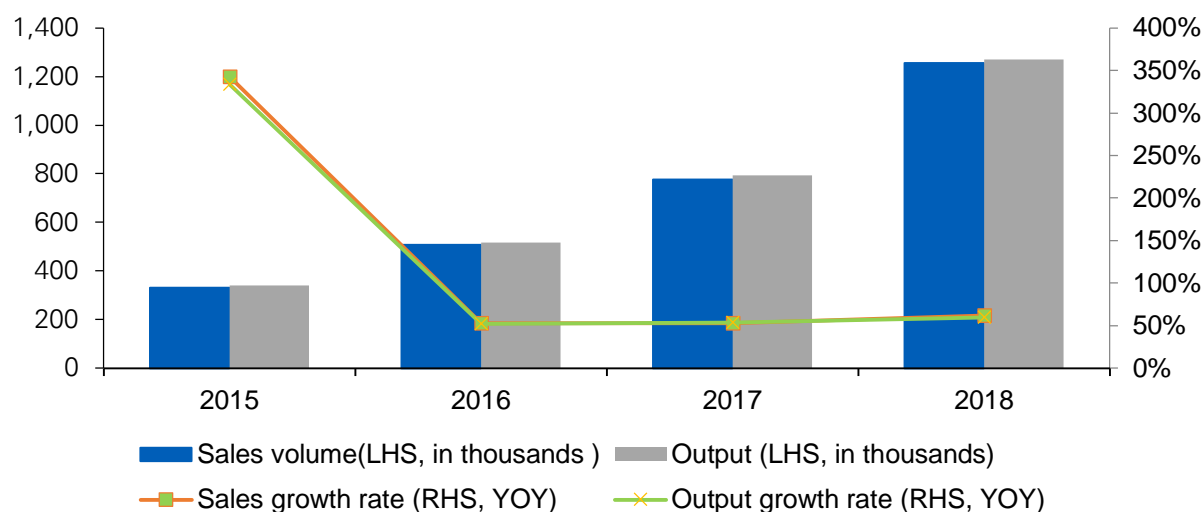


Source: Compiled by KPMG based on the "Regulations on Investment Management of the Automobile Industry"

²¹ Extended-range electric vehicles: A vehicle capable of achieving all of its power performance in battery electric mode; where the vehicle-mounted rechargeable energy storage system is incapable of fulfilling cruising range requirements, the vehicle-mounted auxiliary power supply can be turned on to provide power to the power system to extend battery life; the vehicle-mounted auxiliary power supply device and the drive system have no transmission connection such as a drive shaft (belt). (Source: Electric Vehicle Terminology GB/T 19596-2017)

The Regulations explicitly encourage the development of new energy vehicles. The “Three-Year Action Plan to Win the Blue Sky Defence War”, published by the Government in June 2018, proposed clear production and sales targets: by 2020, the production volume of new energy vehicles should be approximately two million vehicles. According to statistics from the China Association of Automobile Manufacturers, in 2018, the output and sales volume of new energy vehicles in China maintained relatively high growth at 1.27 million and 1.26 million, an increase of 60% and 62%, respectively. Should such growth trend persist, the goal of 2 million vehicles is expected to be achieved ahead of schedule.

Figure 36: Production and sales of new energy vehicles in China during 2015–2018



Source: China Association of Automobile Manufacturers, KPMG Analysis

► Strict scope and access conditions for various types of automotive investment projects

In addition to clarifying the broader direction of investment for the auto industry, the Regulations also set strict regulations for the investment scope and access conditions of various types of automobile investment projects.;

- **Fuel vehicle investments:** The Regulations strictly forbid the establishment of new independent fuel enterprises. In addition, they set strict conditions for increased production capacity targets, for example production capacity utilisation rate, new energy vehicles' share of production and annual R&D expenses.
- **Battery electric vehicle (BEV) investment projects:** Although the Regulations permit the establishment of new independent BEV enterprises, they are more stringent towards the production capacity utilisation of the province where the project is located and investors' R&D capability, to prevent blind deployment of resources and low-standard, redundant construction.
- **Other projects:** The Regulations have clarified conditions for investments in engines, vehicle power batteries, fuel cells, body assemblies, special vehicles and trailers.

► Implement the "Policy simplification and decentralisation, administrative integration and service optimisation" in the auto industry and strengthen supervision

To adapt to the new landscape of China's auto industry, lead the new revolution in the auto industry and invigorate the diversified development of the market, the Regulations would abolish approval for new auto investment projects, comprehensively replacing them with local registration, with auto investment projects to be classified by the provincial Development and Reform Department. This will further reduce the burden on companies and create a more favourable policy environment. However, at the same time as abolishing approval for auto investment projects, the Regulations have also strengthened subsequent monitoring of investment projects, such as the strict access conditions mentioned above; associated departments will also carry out the work of capacity monitoring.

KPMG Observations

► Gradual elimination of the foreign-invested stock ratio in the auto industry, promoting competition in the industry

In April 2018, after indications that China would be relaxing restrictions on foreign share ratio in the auto industry during the Boao Economic Forum, the National Development and Reform Commission responded swiftly by releasing the newly revised 2018 version of the Special Management Measures for Foreign Investment Access (negative list) in June, in which it is clarified that: "In 2018, restrictions on the foreign share ratio for special purpose motor vehicles and new energy vehicles will be lifted; in 2020, restrictions on the foreign share ratio for commercial-use vehicles will be lifted; and in 2022, restrictions on the foreign share ratio for passenger cars and more than two joint ventures will be lifted." New energy vehicles will be a major direction for the auto industry's future development; in addition to domestic competitors, the latest relaxation in foreign share ratios will see the arrival of intensely competitive leading foreign auto companies.

► Following industry subsidies, greater emphasis should be placed on strengthening R&D investment

Given the sudden explosion of new energy automobile manufactures, the gradual reduction in subsidies and the pressure of foreign competitors, while paying due attention to cost control, existing auto companies must not relax their investment in R&D. In comparison with the previous call for comments, though the Regulations have removed specific technical indicators for the investment project products and replaced them with "industry-leading", against a backdrop of widespread technological upgrades throughout the whole industry, without continued R&D and increasing in core competitiveness, it will only be a matter of time before companies are eliminated.

► Active deployment of power battery recycling technology and auto parts remanufacturing technology

China is currently the world's largest market for new energy vehicles. Going forward, major auto companies will inevitably have to face the issue of recycling batteries; if they can deploy battery recycling and auto-part remanufacturing technology early to create a "sales-recycling-remanufacturing" industry chain, they will not only be fulfilling their responsibility of protecting the environment but will also be helping build new cost advantages and increase industry competitiveness.

► Close focus on the market environment and adjustment of production capacity plans

In the latest version of the Regulations, "capacity utilisation" frequently appears as an investment access condition. The Regulations also point to the establishment of capacity-monitoring early warning mechanisms; at the end of January each year, auto companies must submit data to the provincial Development and Reform Department, effectively responding to, and promptly resolving, risks of overcapacity, and increasing capacity utilisation. Against the current backdrop of foreign trade uncertainty, auto companies should actively conduct market environment research and sales scenario analysis, and formulate appropriate production plans to prevent overcapacity.



3

Special topic:
cross-border
e-commerce

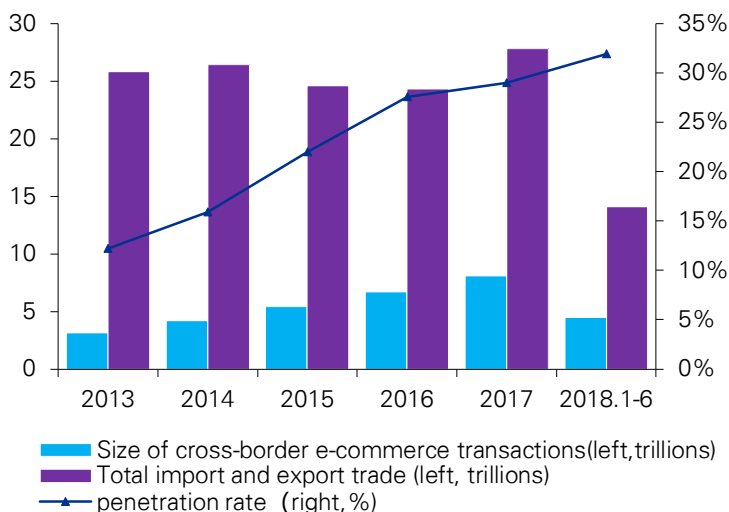


Overview of cross-border e-commerce in China

Overall development of cross-border e-commerce in China

Cross border e-commerce is an emerging business vigorously supported by the Chinese government, and its scale has increased rapidly in recent years following the improvement of Internet infrastructure and the construction of global logistics networks. As per 2017 government statistics, cross-border e-commerce transactions²² in China stood at 8.06 trillion yuan, and penetration rates increased.

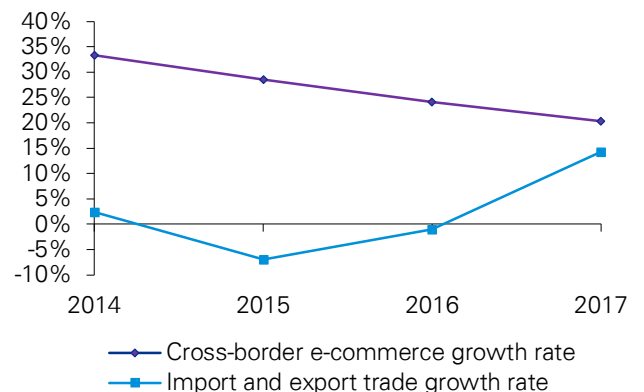
Figure 37: Size and penetration of cross-border e-commerce transactions in China in the first half of 2013–2018



Source: General Administration of Customs, Electronic Commerce Research Center, KPMG Analysis

Comparing the growth rate of foreign trade and the growth rate of cross-border e-commerce transactions in recent years reveals that cross-border e-commerce has maintained relatively high growth against a backdrop of slowing or even negative growth of traditional foreign trade. Driven by initiatives such as the Belt and Road Initiative and the further opening up of China's economy to the outside world, there will be a gradual acceleration in traditional foreign trade's use of modern network technology to shift to the more efficient and convenient trading model of cross-border e-commerce.

Figure 38: Cross-border e-commerce and import and export trade growth rate in 2014–2017



Source: General Administration of Customs, Electronic Commerce Research Center, KPMG Analysis

System improvement and innovation

The rapid development of cross-border e-commerce transactions in China is inseparable from the support and reform of the country's cross-border e-commerce sector. The increasingly broad collaborative network between China and the world has also injected momentum into the development of cross-border e-commerce in the country.

► Continuous improvement of the cross-border e-commerce systems such as the "E-commerce Law"

A major law in the e-commerce field — the "Electronic Commerce Law of the People's Republic of China" which was officially passed in August 2018 — clearly mentions the promotion of the development of cross-border e-commerce. It also speaks of systemic improvements in the areas of cross-border e-commerce taxation, customs clearance, payment settlement, etc. At present, regulatory authorities have issued regulatory documents in the above-mentioned areas, laying a regulatory foundation for unified legislation in the cross-border e-commerce sector. In addition, in terms of customs clearance and quarantine, April 2018 saw the integration of the Inspection and Quarantine Institutions in the institutional reform of the State Council and post-customs related functions, which is expected to simplify the import and export quarantine procedures.

²² Cross-border e-commerce penetration: The ratio of cross-border e-commerce transactions to total import and export trade

Table 2: Legislation in China's cross-border e-commerce taxation, customs clearance, payment and settlement

Field	Regulatory authority	Document
Clearance quarantine	General Administration of Customs	Announcement on the Relevant Supervision Matters Concerning Cross-border E-Commerce Retail
		Import and Export Commodities — Announcement of the General Administration of Customs No. 194 of 2018
		Announcement on Real-time Access to Cross-border E-Commerce Platform Enterprise Payment Related Raw Data — General Administration of Customs Announcement No. 165 of 2018
		Announcement on Adding Customs Supervision Method Code (General Administration of Customs Announcement No. 57 of 2014, General Administration of Customs Announcement No. 75 of 2016)
	6 departments including the Ministry of Commerce	Notice on Improving the Supervision of Cross-border E-Commerce Retail Import Supervision — Shang Cai Fa [2018] No. 486
	13 departments including the Ministry of Finance	Announcement on Adjusting the List of Cross-border E-Commerce Retail Import Commodities — Ministry of Finance Announcement No. 157 of 2018
Tax policy	Ministry of Finance General Administration of Customs General Tax Administration	Notice on Perfecting Cross-Border E-Commerce Retail Import Tax Policy — Finance Tariff [2018] No. 49
	Ministry of Finance General Administration of Customs General Tax Administration Ministry of Commerce	Notice on Taxation Policy for Retail Export Goods in Cross-border E-Commerce Comprehensive Experimental Zone — Cai Shui [2018] No. 103
	Ministry of Finance General Tax Administration	Notice on Cross-border E-Commerce Retail Export Tax Policy — Cai Shui [2013] No. 96
Payment settlement	State Administration of Foreign Exchange	Notice on Launching a Pilot Program for Cross-border Foreign Exchange Payment Services of Payment Agencies — Huifa [2015] No. 7

Source: KPMG analysis of public information

► "Point + plane" cross-border e-commerce innovation pilot model

China's innovative application of the "pilot + experience promotion" cross-border e-commerce model includes the State Council-approved cross-border e-commerce comprehensive pilot zones and the Customs Administration-approved online shopping bonded import pilot cities, creating the "point + plane" cross-border e-commerce innovation pilot model.

Since Hangzhou became the country's first cross-border e-commerce pilot zone in 2015, China has established three batches. 35 such zones, in addition, in the cross-border e-commerce retail import sector, the General Customs Administration added "online purchase bonded imports" (regulatory method code 1210, 1239)²³ in 2014 and 2016. As of November 2018, there were 37 online shopping bonded cities in China.

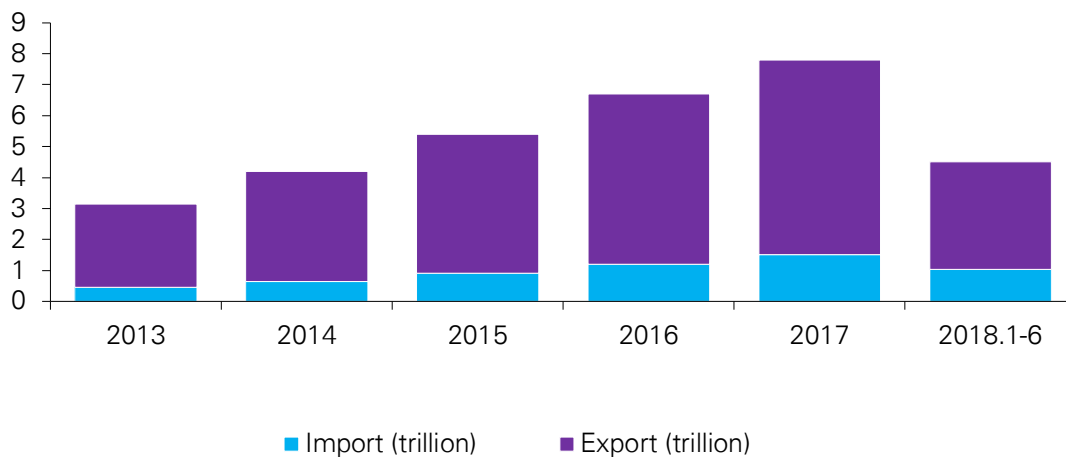
Below we will discuss the development of cross-border e-commerce in China from two aspects: cross-border export e-commerce and cross-border import e-commerce.

²³ Online shopping bonded import model (1210 applies to online shopping bonded import pilot cities, 1239 applies to non-pilot cities: e-commerce companies or e-commerce platforms will transport the entire batch of goods into special e-commerce zones in special customs supervision areas or places, Customs declaration, customs establish e-commerce management books. After domestic consumers purchase goods online within the zone, the e-commerce enterprise or platform entrust a customs

Market analysis of e-commerce exports

A look at the structure of China's cross-border e-commerce imports and exports over the years reveals that the country's cross-border e-commerce is mainly based on exports. In 2017, cross-border e-commerce exports amounted to 6.3 trillion yuan, accounting for more than 78% of total cross-border e-commerce transaction volume.

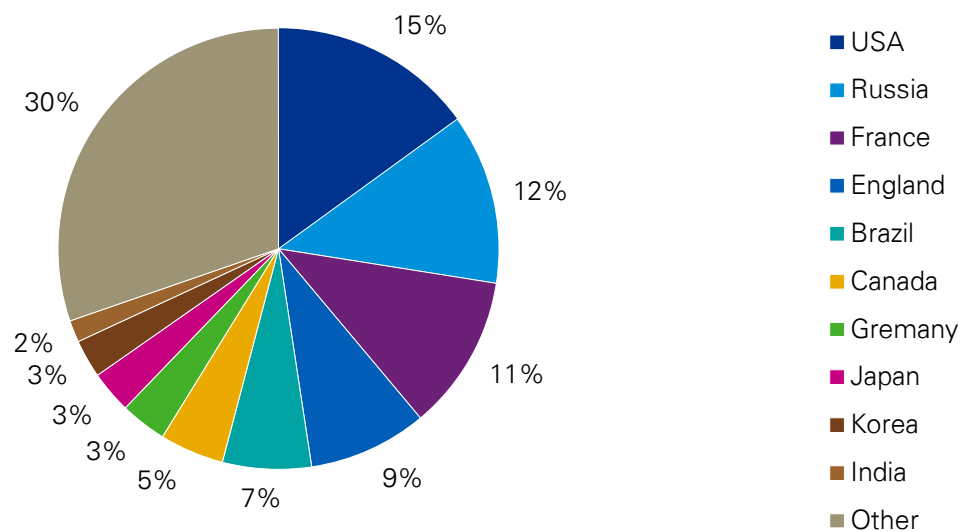
Figure 39: China's cross-border e-commerce import and export structure



Source: E-Commerce Research Center, KPMG Analysis

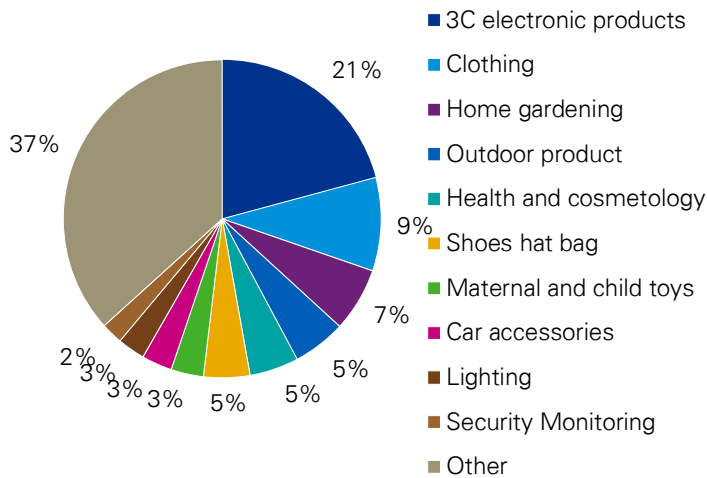
Research shows that in 2017, China's top 10 ultimate export destinations for cross-border e-commerce were the US, Russia, France, the UK, Brazil, Canada, Germany, Japan, South Korea and India. In terms of seller type, in 2017 sellers were mainly involved in 3C electronic products, clothing, home gardening and outdoor products.

Figure 40: China's top 10 destination countries for cross-border e-commerce exports in 2017



Source: E-Commerce Research Center, KPMG Analysis

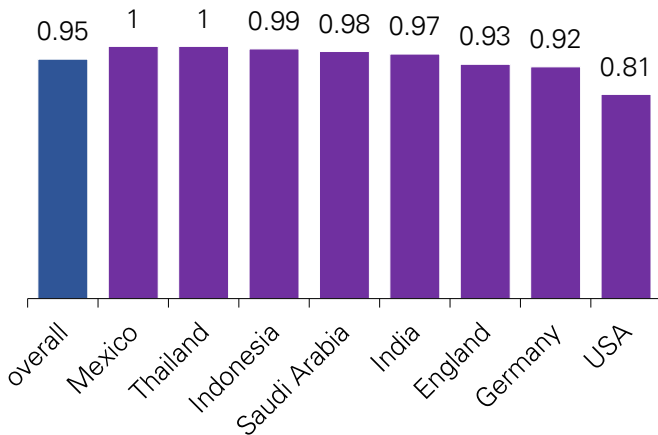
Figure 41: Distribution of cross-border e-commerce exporters in 2017



Source: E-Commerce Research Center, KPMG Analysis

From the perspective of export competitiveness, in recent years, the quality of Chinese products has improved and brand awareness has also increased. According to a survey by KPMG and Facebook,²⁴ Chinese brands are widely recognised verses. Consumer products led the way, with 95% of the respondents having heard of Chinese consumer brands. Nearly three-quarters of the respondents (72%) said they trusted Chinese consumer brands. In addition, awareness of Chinese brands in developing markets was clearly ahead of mature markets, indicating that there is room for improvement in awareness of Chinese brands in developed markets.

Figure 42: Awareness of Chinese consumer brands by country



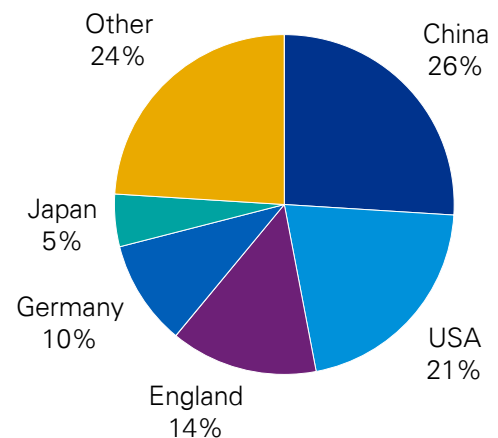
Source: "Leading Chinese Cross-Border Brands – The Top 50", KPMG and Facebook

²⁴ Leading Chinese Cross-Border Brands – The Top 50, KPMG and Facebook, September 2018, <https://home.kpmg.com/cn/zh/home/insights/2018/09/leading-chinese-cross-border-brands-the-top-50.html>

²⁵ PayPal Cross-Border Consumer Research 2018, PayPal

In addition, according to a survey by global online payment service provider PayPal²⁵, China was the most popular destination for global cross-border shopping in 2018. In the previous 12 months, 26% of online shoppers surveyed said that they had bought products from China — putting it at the first place in the survey.

Figure 43: Most popular cross-border destinations for global shoppers in 2018



Source: PayPal, KPMG analysis

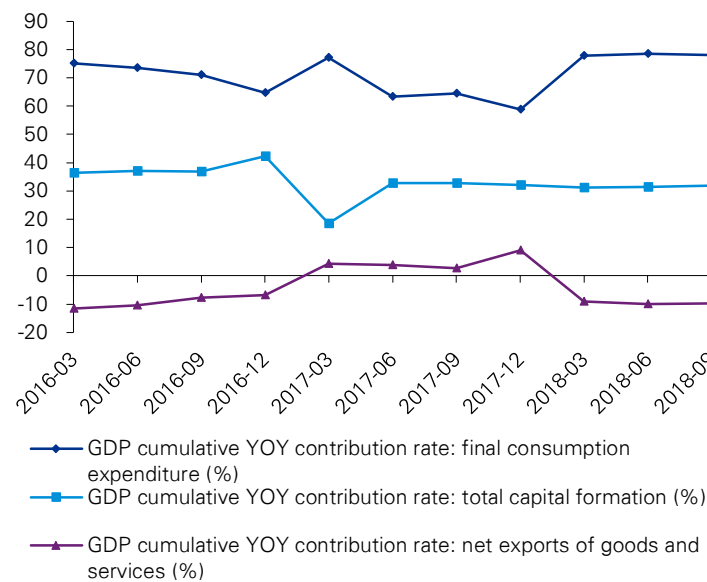


The market analysis of e-commerce imports

Current status of cross-border import e-commerce

Recent years have seen a shift in China's model of economic growth from the original investment-led and export-oriented economy to consumption as the main driving force for economic growth. Consumption's contribution to economic growth has remained at 76% since 2018. In 2018, the total retail sales of consumer goods hit 38.1 trillion yuan, up 9% year-on-year²⁶

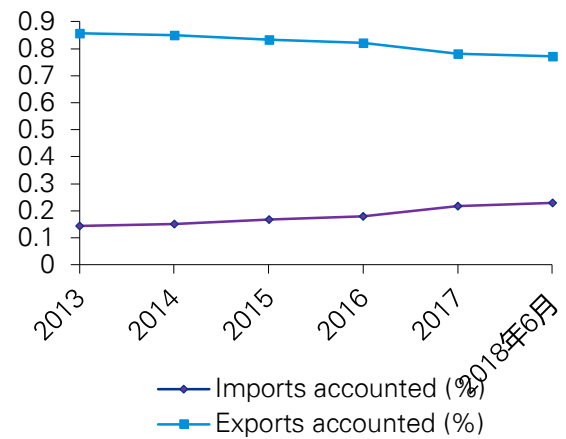
Figure 44: Contribution of investment, export and consumption to GDP growth Mar 2016 – Sep 2018



Source: Wind, KPMG analysis

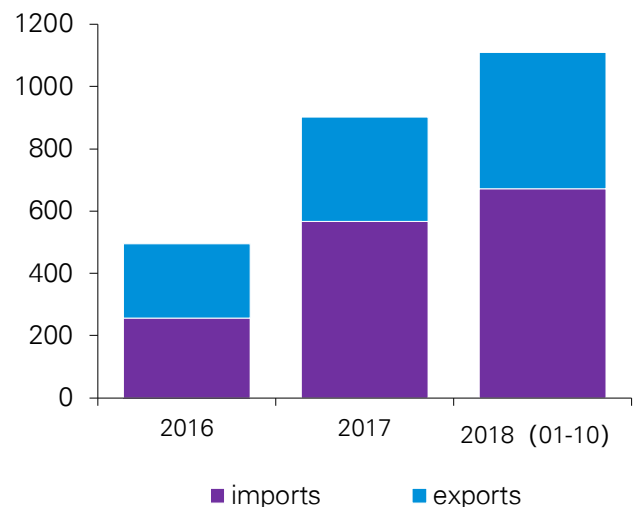
This trend is also reflected in the structure of cross-border e-commerce imports and exports. Although imports account for a relatively small proportion of cross-border e-commerce transactions, recent years have seen a sustained increase in their proportion, rising from 14.3% in 2013 to 22.9% in the first half of 2018. The performance of cross-border e-commerce retail has been more significant. In recent years, cross-border e-commerce retail imports have been dominant in 2C. According to customs statistics, between January and October this year, cross-border e-commerce platform retail imports that passed customs totalled 67.18 billion yuan — more than the total for 2017 and representing a year-on-year increase of 53.7%.

Figure 45: Import and export proportion of cross-border e-commerce in June 2013–2018



Source: E-Commerce Research Center, KPMG Analysis

Figure 46: Cross-border e-commerce retail imports and exports in 2016–2018 (Unit: 100 million yuan)



Source: Ministry of Commerce, China E-Commerce Report 2017, General Administration of Customs, KPMG Analysis

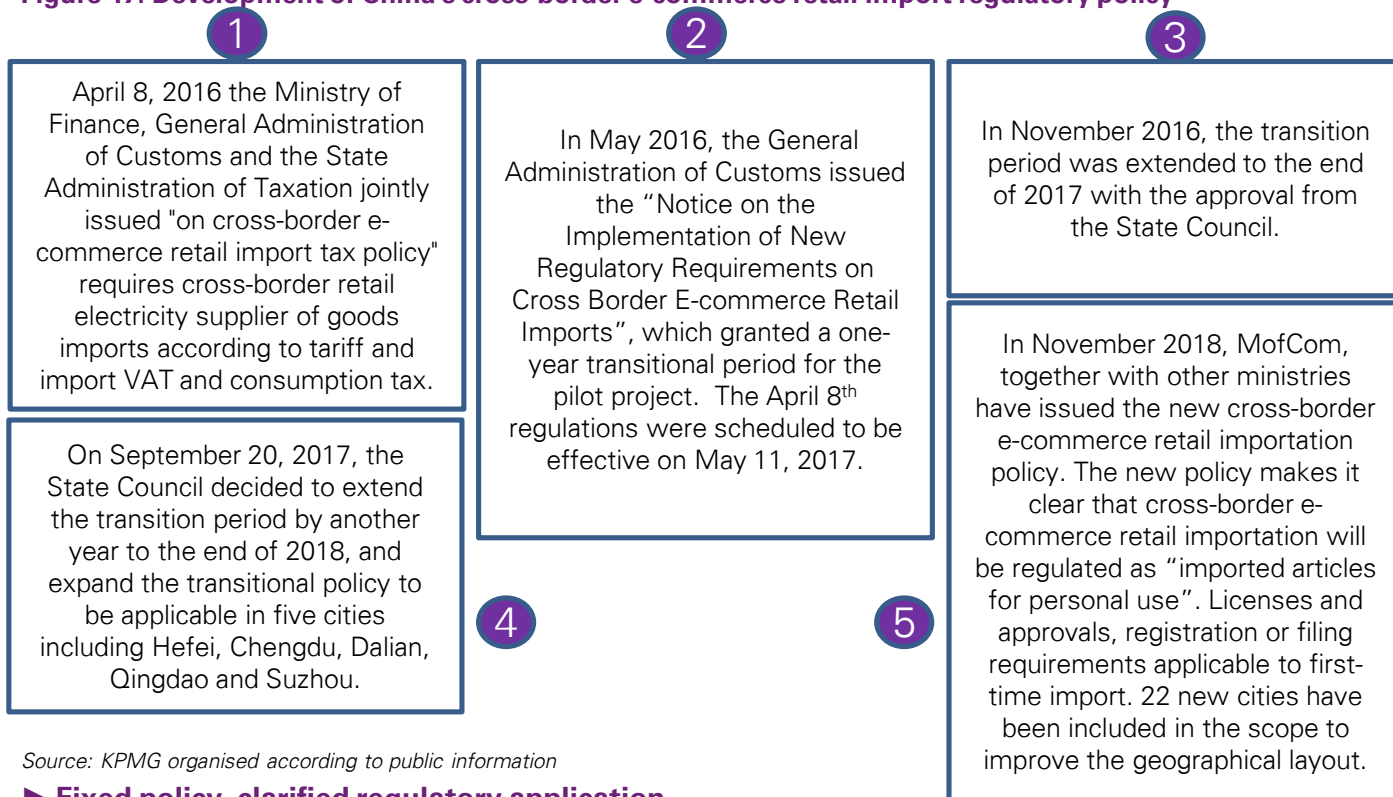
²⁶ State Council Policy Routine Briefing: The relevant person in charge of the General Administration of Customs introduces the relevant policies after the transition period of cross-border e-commerce retail import, December 7, 2018

New cross-border e-commerce retail import policies

A favourable policy environment is an essential condition for the rapid development of the cross-border e-commerce import business. As an emerging business model encouraged by the state, the central government and various regulatory authorities have introduced policies to release consumption power, such as tax cuts — most notably individual tax reform.

In terms of regulatory policies, the State Council executive meeting on November 21 decided to extend and improve the cross-border e-commerce retail import policy and expand the scope of application. Subsequently, the Ministry of Commerce and other associated departments issued new cross-border e-commerce retail import policies²⁷ that adjusted and regulated the cross-border e-commerce retail import business, expanded preferential measures, and clarified new regulatory requirements. The new policy officially came into effect on January 1, 2019 and has the following features:

Figure 47: Development of China's cross-border e-commerce retail import regulatory policy



Source: KPMG organised according to public information

► Fixed policy, clarified regulatory application

The cross-border e-commerce retail import supervision policy has experienced three stages: "408 Tax Reform New Deal²⁸ – New Deal Run-in Transition Period – Cross-border E-Commerce Retail Import New Deal". The new policy finally provides an official determination of the transitional period of cross-border retail importing, which has been extended several times. It has clarified that "cross-border retail imported goods are monitored as imported goods for personal use, with no permit, registration or filing required for first-time imports", thus providing a stable policy environment for the development of cross-border retail imports.

Comparison project	Before January 1, 2019	After January 1, 2019
Single transaction limit	2,000 yuan	5,000 yuan
Annual transaction limit	20,000 yuan	26,000 yuan
A single item that exceeds a single limit but does not exceed the annual limit	In accordance with general trade management	Full taxation of goods at the cross-border e-commerce channel
Goods that exceed the annual limit	In accordance with general trade management	In accordance with general trade management
Total number of tax items in the commodity list	1258 tax items	Added 63 tax items with huge demand by the public, bringing the total to 1321

²⁷ Ministry of Commerce: Notice on Improving the Supervision of Cross-border E-Commerce Retail Import Supervision - Shang Cai Fa [2018] No. 486; Announcement on Adjusting the List of Cross-border E-Commerce Retail Import Commodities - Ministry of Finance Announcement No. 157, 2018 - Ministry of Finance; Notice on Perfecting Cross-Border E-Commerce Retail Import Tax Policy--Finance Tariff [2018] No. 49 - Ministry of Finance, General Customs Administration, General Tax Administration; General Tax Administration: Announcement on the Relevant Supervision Matters Concerning Cross-border E-Commerce Retail Import and Export Commodities--Announcement of the General Administration of Customs No. 194 of 2018

²⁸ 408 New Tax Reform Policy: Notice on Cross-Border E-Commerce Retail Import Tax Policies, jointly issued by the Ministry of Finance, General Customs Administration and General Tax Administration on April 8, 2016

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► **More relaxed supervision, but stricter compliance requirements**

Commercial retail goods imported via cross-border e-commerce are to be monitored as imported goods for personal use, with no permits, registration, or filekeeping required for first-time imports of the said goods. This relates to the basis of specific supervisory requirements and has been a considerable focus of attention among companies in the industry.

The new policies impose more stringent requirements and clarified the rights and responsibilities for participation in different areas. For example, the illegal manufacture or transmission of false "three tickets" information (payment slip, logistics bill and purchase order) to facilitate resales will be punished according to law; Persons involved may face criminal prosecution; the use of other citizenship information to illegally engage in cross-border e-commerce retail import will be handled by customs as a smuggling violation. In addition, consumers are prohibited from reselling goods that they have purchased for "personal use"; retail operations performed by cross-border e-commerce is the final stage of the distribution of goods.

The new policies also include cross-border e-commerce retail import companies in the customs credit management system. These companies will be subject to different customs management measures based on their credit rating. The customs credit management rating is of paramount importance to the efficiency of companies' clearance through customs, with the average inspection rate of high-rated enterprises being less than 20% of those with an ordinary credit rating.

Impact of the new policies on cross-border e-commerce retail imports

The cross-border e-commerce industry caters to fast-growing diversified consumer demands, and is closely related to the interests of consumers. The new policies have a major impact on the development of the industry.

► **At the end of the transitional period, the cross-border e-commerce industry will face major development opportunities**

For the industry, the shift from "temporary supervision of goods for personal use" to "supervision of imported goods for personal use" means that the current approach to supervision has become a long-term arrangement. The formation of a sustained, stable policy environment, enables cross-border e-commerce companies to make long-term business plans. The new policies provided affirmation and support for the cross-border e-commerce industry, its healthy, normalised development and maintenance of a fair market environment.

► **Multiple benefits to consumers**

With limits lifted and list expanded, an increasing number of high-end consumer goods can be imported through the cross-border e-commerce retail channel, enlarging the operational scope of cross-border e-commerce operators as well as providing a broader range of options to consumers.

► **"Online shopping bonded + offline pick-up" model still in discussion**

The new policies define "online shopping bonded + offline pick-up" as "forbidden in principle". However, experience stores and self-collect businesses outside the bonded areas have been highly anticipated by cross-border e-commerce operators and consumers. Room for discussion is also retained in the new policies for special circumstances; how to standardise and clarify special circumstances, how to conduct actual operations, how management is to be carried out by regulatory authorities etc. — all await further discussion and attention.

► **Clearer, more stringent legal compliance requirements**

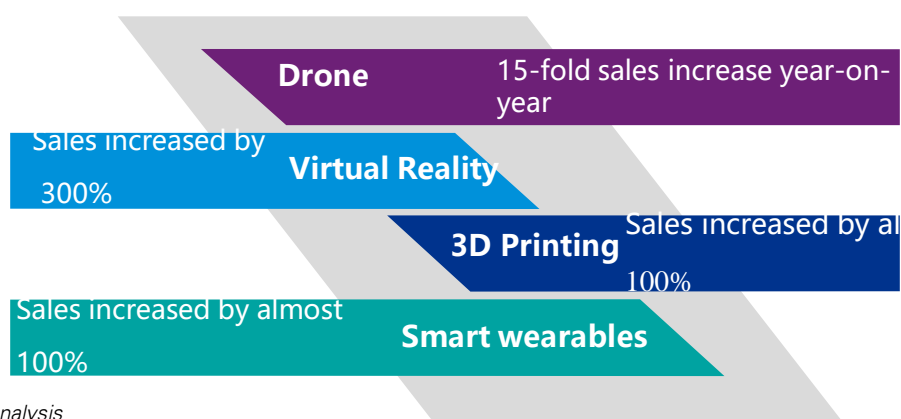
While enjoying benefits and concessions, cross-border e-commerce companies, cross-border e-commerce platforms, domestic service providers and consumers must pay greater attention to their own compliance, and must fully understand the items they are required to comply with in their business, focusing on the responsibilities and obligations they should be fulfilling, and strengthening compliance.

New trends of China's cross-border export e-commerce in the new era of reform and opening up

► Against a backdrop of industrial upgrades, China's cross-border e-commerce exports shifting to high-tech products

In recent years, China's cross-border e-commerce exports have shifted from labour-intensive, low-tech and low added-value products to high-tech, high added-value products, gradually achieving the transformation from "Made in China" to "Created in China". According to a report released by eBay²⁹, as of the second half of 2017, year-on-year sales growth for emerging tech products from Chinese sellers (UAVs, virtual reality products, 3D printing, smart wearable devices and smart home products) exhibited a relatively high increase in the global market. The demand for innovation in the functionality of emergent tech products in the new era of consumption has prompted companies to accelerate new iterations of products, further boosting product upgrades. As a result, Chinese enterprises should keep their fingers on the pulse of market trends and strengthen investment in R&D.

Figure 48: Sales of Chinese sellers' emerging technology products on the eBay platform



Source: eBay, KPMG analysis

A well-formed logistics chain will provide further guarantees of the quality of exports. As an innovative logistics warehousing tool for cross-border e-commerce exports in the new era, overseas warehouses play an important role in transforming traditional approaches to logistics, improving the efficiency of logistics and enhancing customer experience. In recent years, under the guidance of national policies, Chinese companies have been actively deploying overseas warehouses. According to partial statistics, more than 200 companies in China have set up more than 500 warehouses overseas³⁰. However, they have encountered a number of difficulties in operating these warehouses, such as policy issues in the host country (administrative licences, taxation policies, etc.), cost pressures brought by heavy investments and cultural differences. After rapid increases over the past several years, more cautious and rigorous distribution of overseas warehouses is expected in the future.

► Active deployment of new growth points for cross-border e-commerce exports to countries along the Belt and Road Initiative

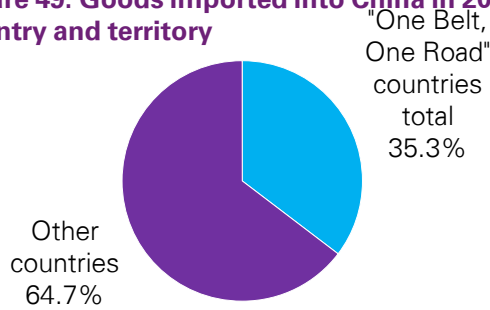
China's trade cooperation with the Belt and Road countries has continued to develop. According to statistics from the General Customs Administration, in 2017 China imported a total of 982.26 billion yuan from Belt and Road countries, accounting for 35.3% of total imports. The GDP, population and trade volumes of the 71 countries along the Belt and Road accounted for 18.4%, 48% and 27.8%³¹, respectively, of the global total. Such a vast market offers huge growth opportunities for Chinese cross-border commerce.

²⁹ "Leading the Future – eBay Emerging Technology Category Cross-Border E-Commerce Retail Export Industry Report", eBay, October 12, 2017

³⁰ "The Global 72-Hour Logistics Network is Such a Refining", People's Daily Overseas Edition, June 6, 2017

³¹ Big Data Report of Trade Cooperation under the Belt and Road Initiative 2018", Belt and Road Big Data Center of the State Information Center, May 2018

Figure 49: Goods imported into China in 2017 by country and territory



Source: General Tax Administration, KPMG analysis

In recent years, as the Internet infrastructure and logistics facilities of countries along the Belt and Road have continued to improve, cross-border commerce has become a major element of the Belt and Road collaboration. Since 2018, China has established bilateral e-commerce collaborative mechanisms with nine countries: Panama, Russia, Argentina, Kazakhstan, Iceland, Rwanda, the United Arab Emirates, Kuwait and Austria. As at the end of 2018, China had signed off on e-commerce partnerships with 14 countries and territories.³²

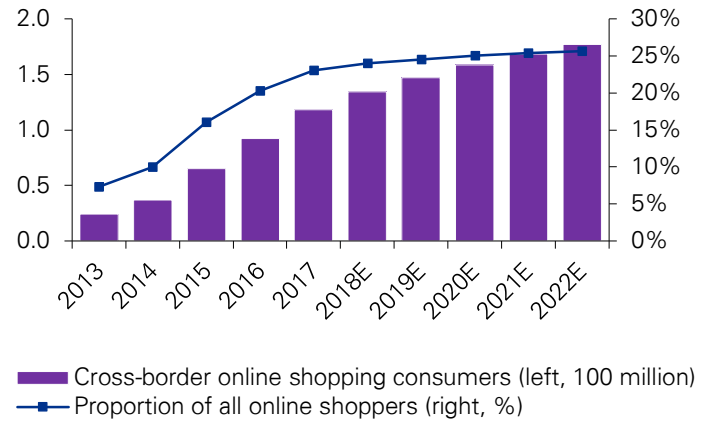
Enterprises involved in cross-border exports are seizing the opportunity to go beyond China's borders. Along with actively deploying their cross-border export businesses in countries along the Belt and Road, they should also focus on product market research, such as products' suitability to local cultures.

In the context of upgrades in consumption, Chinese cross-border retail imports offer potential

In 2018, the Chinese Government issued a number of policies aimed at boosting consumption to stimulate the Chinese people's consumption potential. In terms of consumer potential, according to disclosure³³ of the National Development and Reform Commission, the size of China's middle-income demographic is set to exceed 400 million in 2018.

According to statistics from e-Marketer, there were 118 million Chinese cross-border consumers online in 2017; by the end of 2018, this figure rose to 134 million, accounting for 24% of the global total. This shows that there is tremendous room for growth in Chinese cross-border e-commerce imports.

Figure 50: Scale and predictions for Chinese cross-border consumers online, 2013–2022



Source: e-Marketer, KPMG analysis

China is set to drive – and lead – the formulation of international regulations for e-commerce

In 2016, cross-border e-commerce was included in the topics of the G20 summit for the first time. Subsequently, the e-Commerce World Trade Platform (eWTP) advocated by Alibaba was written into the 20th National Group Leaders Hangzhou Summit Bulletin. eWTP has become a major driving force in promoting global inclusive trade and the growth of the digital economy. It has also helped advance the formulation of international regulations and mechanisms for cross-border e-commerce. In March 2013, the first eWTP Digital Free Trade Zone was established in Malaysia. A year later, the eWTP Ecology Foundation was announced in Hong Kong, which was a major step towards eWTP's globalisation. Over the last two years, eWTP's presence has spread to Southeast Asia, Europe and Africa. China will continue to have a major impact on the formulation of regulations for global cross-border e-commerce, extending its extensive experience across the world.

³² Yang Tao, deputy inspector of the Department of Comprehensive Affairs of the Ministry of Commerce, said at the Belt and Road Cross-border E-Commerce International Cooperation Summit Forum, December 2018

³³ Ning Jizhen, deputy director of the National Development and Reform Commission, interprets the spirit of the Central Economic Work Conference at the 2018-2019 China Economic Conference, December 22, 2018

Appendix: Key indicators

			2017	2018	2018					
	Index	Unit	Annual data	Annual data	Jul	Aug	Sep	Oct	Nov	dec
Main economic activity indicators	Nominal gross domestic product	One trillion yuan	82.1	90.0	22.95			25.36		
	Actual gross domestic product	Year-on-year, %	6.8	6.6	6.5			6.4		
	Industrial added value above designated size	Year-on-year, %	6.6	6.2	6.0	6.1	5.8	5.9	5.4	5.7
	Total profits of industrial enterprises	Accumulated year-on-year, %	21.0	10.3	17.1	16.2	14.7	13.6	11.8	10.3
	Total retail sales of social consumer goods	Year-on-year, %	10.2	9.0	8.8	9.0	9.2	8.6	8.1	8.2
	Fixed asset investment completion	Accumulated year-on-year, %	7.2	5.9	5.5	5.3	5.4	5.7	5.9	5.9
	New construction area of housing	Accumulated year-on-year, %	7.0	17.2	14.4	15.9	16.4	16.3	16.8	17.2
	Housing sales area	Accumulated year-on-year, %	7.7	1.3	4.2	4.0	2.9	2.2	1.4	1.3
	Real estate industry land acquisition area	Accumulated year-on-year, %	15.8	14.2	11.3	15.6	15.7	15.3	14.3	14.2
	China Manufacturing PMI	Index	51.6	50.9	51.2	51.3	50.8	50.2	50.0	49.4
Foreign trade and investment	Export amount	Year-on-year, %	7.9	9.9	11.4	9.1	14.5	14.3	3.9	-4.4
	Import amount	Year-on-year, %	16.1	15.8	26.9	19.9	14.3	20.3	2.9	-7.6
	Trade balance	Billion dollars	419.6	351.8	27.1	26.7	31.7	33.1	41.9	57.1
	Actual use of foreign investment (non-financial)	Billion dollars	131.0	135.0	7.8	10.4	11.5	9.7	13.6	13.7
	Foreign direct investment (non-financial)	Billion dollars	120.1	120.5	8.1	8.8	7.9	7.6	14.9	16.0
Financial market	RMB exchange rate	USD/RMB	6.75	6.62	6.70	6.84	6.84	6.93	6.94	6.89
	RMB real effective exchange rate index	Index	120.6	124.2	122.9	121.8	122.5	121.9	121.8	122.7
	Shanghai Composite Index (end-of-term value)	Index	3307	2,494	2876	2725	2821	2,603	2,588	2,494
	Money supply (M2)	Year-on-year, %	8.1	8.1	8.5	8.2	8.3	8.0	8.0	8.1
	Social financing scale stock	Year-on-year, %	12.0	9.78	10.8	10.8	10.6	10.2	9.9	9.8
	New social financing scale	One billion yuan	19440	19,260	1216	1929	2205	742	1,524	1,590
	New RMB loans	One billion yuan	13523	16,166	1450	1280	1380	697	1,250	1,080
Shanghai Interbank Offered overnight interest rate	%	2.63	2.48	2.33	2.20	2.47	2.31	2.39	2.37	
Price	CPI	Year-on-year, %	2.1	2.1	2.1	2.3	2.5	2.5	2.2	1.9
	Industrial producer ex-factory price index	Year-on-year, %	3.5	3.5	4.6	4.1	3.6	3.3	2.7	0.9
	Crude oil	USD/barrel	50.9	64.9	70.7	67.8	70.1	70.8	56.6	49.0
	Rebar	Yuan / tonne	3878	4,177	4120	4426	4524	4,579	4,367	3,955
	70 commodity prices of new commercial housing in large and medium cities	Year-on-year, %	8.5	7.3	6.6	8.0	8.9	9.7	10.3	10.6

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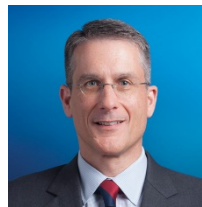
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