

JESA INVESTMENT & MANAGEMENT CO. LTD.

NEWSLETTER

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NEWS FROM JESA!

By Saro Capozzoli, Founder and GM of JESA Investment & Management Co., Ltd

On January 26th the Chinese Year of Ox started. The ox is the symbol of the prosperity through hard work and fortitude. More than in other years this comes to be such a living matter.

Chinese exports dropped sharply in the last months of 2008, forcing the updating of the growth forecasts for upcoming years. In 2007 China was expected to become the world's third-biggest economy and the world's biggest exporter, overtaking Germany. As a whole China's export remained smaller than Germany's.

At the same time, Chinese imports fell by much more, down by 21%. The biggest impact on the shrinking of imports has been caused by the collapse of the construction industry -which is a big user of imported raw materials – caused by the government's effort to deflate a potential bubble.

Despite this picture, consumer spending and manufacturing investment have so far held up

and there are good reasons to hope that China can regain soon the economic vigor after Government's fiscal stimulus will be kicked in.

This should be one of the reasons why the Foreign Invested Enterprises shouldn't leave or give up Chinese investment in spite of this tough moment. Federico Fubini's article on Corriere della Sera on January 11th is pointed out only one side of the coin.

In the past decades offshoring decisions were based on the benefits coming from the developing countries. As mentioned in McKinsey article "Time to rethink offshoring?" some of these advantages are loosing their attractiveness: in China wages raised considerably and sharp fluctuation in oil prices affected the total cost of products.

These calculations can not be disagreed but it is not fair saying that this is enough to "escape from China". The low cost production can not be considered any more the only pull driver for the investment.

Would it be so unwise look the picture from another perspective?

Companies that are already present on the market as well as new comers are forced to think about new strategies to approach and succeed in the Chinese market. The investment must be carefully planned and the market deeply scanned. The step in the market can be eased by deep market knowledge and experiences.

Benefits of the delocalization will be represented by the proximity to the biggest market that is still needed of services and products. Chinese consumers are the pull driver of the future. Companies already established will take advantage of the market when and if they will be able to hit Chinese consumers' needs.

Jesa is available in supporting foreign companies that want to enter the Chinese Market. Thanks to long lasting experience in China, Jesa can help companies in the analysis of the most suitable entry mode and strategy. We invite companies in considering the opportunities that arise during this crisis period, both in direct investments and M&A. A delay – even only for few years, waiting for economy restoring – could make companies loose worthy opportunities.

China steps toward YUAN convertibility

On Christmas day PRC State Council has launched a pilot project to use Renminbi, also called Yuan, in commercial foreign transactions. This decision represents a step forward towards full convertibility of RMB which would increase the role of the nation's currency.

China's pilot project application will be gradual and on a regional base.

State Council indicated two areas that will be firstly involved in the project; the Yuan will be allowed to be used for settlement between the Yangtze River delta regions and the Special Administrative regions of Hong Kong and Macao. Moreover Guangxi Zhuang Autonomous region and Yunnan Province will be allowed to settle trade payments in Yuan with Russia and ASEAN members (Association of South East Asian Nations that includes Indonesia, Malaysia, Thailand, Laos, etc..).

The Government did not give any details about when and how the program will be implemented.

The pilot program was announced together with other measures designed to support the national export sector. According to Mr Zhao Xijun, Finance Professor at Renmin University of China, once implemented, this action will mitigate the risk of exchange rate fluctuation for Chinese exporters and foreign partners. At the time being the large majority of China's foreign trade is settled in USD or Euro but many analysts forecast a substantial depreciation of dollar in the coming years.

Mainland trade's with Hong Kong, Macao and ASEAN Nations reached 20% of the total trade volume (402,7 billion USD) over the past years. This can cause problems to settlements in US dollar if the greenback fluctuates drastically. The Chinese announcement has been greeted by many in Hong Kong as another benefit given to the territory during the crisis, but this seems to be more than this. In some way it recognizes that Yuan is already used across both borders at least what concerns certain cash transaction (which could be on a large scale). However it is unlikely that the Yuan will be soon used for the majority of mainland trades with Hong Kong or Macao or ASEAN Nations because most of processing trades and shipments involving third

parties will continue to be denominated and settled mainly in US Dollar.

This Government move will also increase the Chinese currency's acceptance in Asia, which will help Yuan to become an international currency in the long term.

Yuan acceptance has been rising recently thanks to Nation's performances and its 1.9 trillion USD in reserves of foreign exchange. Yuan as global currency is considering by many welcomed since the depreciation of the US dollar caused hefty losses to China's foreign reserves.

The use of the Yuan in cross borders transactions could also have political involvement. The widespread use of Yuan or even the capability of China to impose it as Southeast Asia settlement currency will reshape the economic position of Japan in the area. Back to the late 1980s, Yen was supposed to gradually become more important especially in Asia as an important part of the transactions were invoiced in Yen. The Japanese currency was becoming more important in other countries' foreign reserves; nevertheless the use of Yen never became widespread in trade between other countries.

According to Wu Xiaoling, former Vice Governor of the Country's Central Bank and currently Deputy Head of the Financial and Economic Committee, the announcement of the State Council represents a first step to let Reminbi join other international currencies to be used as Forex reserves by other economies.

From its point of view, China should make preparation in its economic structure and its financial regime to go further toward the internationalization of its currency. To let this process go further it is necessary to expand and deepen the Yuan-denominated financial markets, step up the process to realize the full convertibility of the currency and provides investment channels for Yuan holders.

If some analysts believe that the lack of convertibility enabled China to remain untouched during 1998 Asian crisis and during the current financial crisis, Wu strongly believe that the Dragon should not be "self-complacent and close in itself". Otherwise China would suffer when the global economy takeoff again.

Expected VAT reforms in place, expecting to boost domestic economy

Following the global crisis, and the Chinese governments attempt to stimulate the domestic economy, the VAT reform has now become a factual and vital part of China's nationwide 4 trillion RMB (almost 600 billion USD) economic stimulus package.

The VAT reform will "encourage investments and technological upgrading at Chinese companies, boost domestic demand, improve companies' competitive strength and play a role in helping companies to tackle the financial crisis" says Zheng Jianxin, deputy director general of the taxation department of China's Ministry of Finance.

Since 1st Dec 2008, China's export refund rates are changed.

In most countries, VAT is always fully refundable, regardless of type of good. The VAT export system in China allows for deduction of input VAT incurred on goods being exported, but if and how much depending on what category the good falls within. With the December amendments (the

third one in 2008) goods covered now amount to almost 30% of all product "headings" and for almost all of these goods, the refund rate has increased. Goods such as agricultural pesticides, batteries, etc however may no longer enjoy a rebate. Also, some goods such as rubber and plastic products have seen a decrease in refund, as a step in line with the Chinese governments increasing efforts to focus on the environment.

Since 1st January 2009 major changes have been made in the general VAT system:

1. Deduction of VAT incurred on fixed assets

This is a complete new measure for China, and will be applicable to new equipment purchased after 1st Jan 2009 and belonging to the below categories:

- | Machines and machinery
 - | Tools and utensils related to production and operation
 - | Means of transportation (with exception for small motor cars, motor cycles and yachts)
- Immovable property such as buildings and structures will not be deductible.

2. Removal of rules on VAT exemption for imported equipment

Unfavorable to foreign companies involved in fixed asset export to China or located in China and preferring/depending on imported machinery etc., the previous VAT exemption for imported equipment has been abolished. This is however a measure to stimulate domestic producers, and create more fair tax treatment between foreign and domestic enterprises.

3. Rules on refund of "Chinese origin" equipment

Also, the previously preferential VAT treatment of domestically made equipment will be cancelled, as the input VAT incurred now will be refundable in new ways.

The amount of input VAT recoverable can only be used to offset output VAT. Any excess input VAT may be used to offset future output VAT, but no material refund is granted. However, the budgetary "loss" due to the above changes is forecasted at 120 billion RMB (almost 18 billion USD). This makes the VAT reform the most significant change on a single type of tax, throughout Chinese tax reform history. It also means that China moves from a

"production-based" VAT system to a "consumption-based" VAT regime which is used in about 90 percent of the world economies.

Annual Joint-Inspection: compulsory upcoming deadline

The beginning of the year represents for Chinese Companies time to accomplish the regulation of State Administration for Industry and Commerce (SAIC) of People's Republic of China regarding the annual license reviews and audit inspections.

The annual audit process in China is not only focused on financial issues but involved totally seven different Governmental Agencies:

- Bureau of Foreign Trade and Economic Cooperation (BOFTEC)
- State Administration for Industry and Commerce (SAIC);
- Economic Committee;
- Financial Bureau;
- State Administration of Taxation;
- State Administration of Foreign Exchange(SAFE);
- China Custom.

The companies who receive the Business License must accomplish this Annual Inspection between March, 1st and June 30th. Newly-set up companies may be exempted if they are established toward December.

Companies, who do not conduct such inspection, may be punished with penalties up to RMB 100.000 or, in worst case, the revocation of the Business License.

Among the necessary documents that must be submitted to the above mentioned agencies, companies are required to prepare *annual financial statements*, including balance sheets and income statements edited in accordance with the Chinese Accounting Standards.

Foreign Invested Enterprises (FIE's), including the legal representative, must take full responsibility for the truthfulness, legitimacy and completeness of such documents.

These documents must be prepared and submitted before the end of April in order to compute the taxable and distributable profit of the Company. Accordingly, an audit report by a firm of Certified Public Accountants registered in the PRC is required by the Chinese Law.

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