

Jesa Investment & Management Consulting Ltd.

NEWSLETTER

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What is Jesa?

Jesa is a service company headquartered in Shanghai specializing in facilitating start-up of new industrial productions while providing reliable management and control solutions. We operate 4 main branches in China and a foreign office in Ulaan Baatar (Mongolia). Since 1998, Jesa has built a team of 70 specialized employees in addition to 25 engineers following "in loco" projects. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on each single commercial and technical issue. Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients save financial resources and time.

Jesa is currently expanding its services providing support to those companies seeking to develop distribution network and retail system in China as well as in Mongolia. We also perform HR audit and investment analysis (trouble-shot analysis) to verify performances in support to enterprises already established in China.

The Modern Evolution of the Renminbi

The Renminbi was issued by the communist government in 1949 in order to fight the hyperinflation that prevailed in the country at that time. Back in the late seventies, as Deng Xiao Ping began the long reform in China, the protection of the Yuan "People's Money" was so great that it was actually illegal for foreigners to possess any. To get around this, China introduced a double currency system in 1980, where the two currencies were the RMB (for Chinese) and the "Foreign Exchange Certificate" (FEC, for foreigners) which had to be purchased before traveling to the People's Republic of China.



The FEC was also a mean to control the movements of foreigners, as well as their purchases. FEC were only allowed to be used to certain approved designated outlets: various hotels and the so-called "Friendship Stores", which sold imported goods such as Malboro cigarettes and Johnnie Walker Red Label Whisky as well as local products for tourists. FECs could not be used in Chinese shops and restaurants, while Chinese Renminbi could not be used in the friendship shops. Therefore, Chinese people had no access to imported goods. This also meant a different pricing of goods for foreigner and Chinese. Hotels rooms or dishes in the restaurant suffered a double pricing policy, with a higher price for foreigners, obviously.

This double currency led the way to the establishment of a heavy black market. Indeed, FECs were needed by Chinese people who had to travel abroad or buy imported goods. Thus, although the face value of the FEC was a same as a RMB, Chinese dealers would offer foreigners a 20 to 30% premium on the black market. As a result, some people held high amounts of FEC for speculation.

The first January 1994, the double currency system was abolished overnight, which led to a tremendous devaluation of the Yuan: from 5,7RMB/\$ to 8,7RMB/\$. This unexpected move from the Chinese central bank lead many foreign holders of FEC certificates to rush into the friendship stores in order to dilute their reserves of the currency. Chinese illegal holders of the foreign certificates were now unable to convert the FECs, and the latter were now valueless. This led many of them to suicide.

From 1994 to 2005, the Chinese Yuan was pegged against the US dollar at a stable

8.28RMB/\$, a policy that helped the Chinese currency emerge as the Asian strongest currency during and after the Asian financial crisis of 1998. During the financial crisis, indeed, China maintained its policy of not devaluating the RMB, and a stable Chinese currency helped the neighboring countries survive the hardship and made room for their exports as their own currencies depreciated sharply.

However, this policy was criticized by the Americans following the devaluation of the dollar because it was making Chinese exports more competitive. On July 21st, 2005, the peg to the US dollar was removed and the Chinese Yuan was revaluated at 8,11RMB/\$. The People's Bank of China also announced that the Renminbi would be pegged to a basket of foreign currencies instead, and would trade within a narrow 0.3 percent band against this basket of currencies. China has stated that the basket is dominated by a group of international currencies including the U.S. dollar, euro, Japanese yen and South Korean won, with a smaller proportion made up of the British pound, Thai baht and Russian ruble. Now, the exchange rate is fluctuating but still controlled by the bank of China.

There is increasing evidence that the Renminbi is used outside mainland China to accommodate the large and increasing number of Chinese travelling abroad. For instance, the Chinese Yuan is accepted in many shops in Hong Kong and in some hotels in the neighboring Mongolia. More, the increasing foreign direct investment by Chinese enterprises in surrounding countries and regions has helped increase RMB circulation. As an increasing number of people are holding RMBs, the demand for the Chinese currency is increasing. All these factors together with the strength of the Chinese economy have made the Chinese Yuan a strong and increasingly international currency. However, one of the main obstacles to the establishment of the Yuan as the strongest East Asian currency is its lack of full convertibility in the capital account.

Change is underway though, and the Chinese Central Bank is gradually changing its monetary

policies in order to shift gradually towards full convertibility.



More, another symbolic change is occurring. While all the traditional banknotes feature an image of the well respected Mao Zedong, there were attempts to replace him with other national heroes such as Deng Xiaoping (initiator of the reforms that probably lead to China's great economic growth) and Sun Yat-sen ("father" of modern China). Although there is still a long way to go for these changes, the first banknote without the portrait of Mao was introduced this summer.

In commemoration of the Beijing Olympics, this 10RMB features a picture of the National Stadium known as the *Bird's Nest*. Only 6 million copies were issued, triggering a rush to the bank office to buy them: sources report that the bill was eventually sold at 1000RMB per bill.



Beijing considers VAT reform to boost struggling industries

Following a range of tax reforms performed during the past fifteen years, Beijing policymakers are now looking into a nationwide value-added tax (VAT) regime which may save China's eight million companies up to RMB 150 billion (US\$22 billion) annually. Such a favorable reform is in the long run anticipated to encourage more investment in industries affected by the weakening of domestic and global economies.



Injection to stay at double digit growth

The national economy is still expanding, but faced a 1.8 percent lower growth in the first half of this year, compared to same period last year - 10.4 percent compared to 12.2 percent. Similarly export growth slowed from 28.6 percent in the first half of 2007 to 22.6 percent in the same period this year.

Currently, China practices a "production-based" VAT system which has been argued to deter enterprises from increasing investment in fixed assets such as factories and machinery, thereby slowing down technological advancement, as the fixed assets bought by producers for production are subject to VAT. The now considered tax reform would instead allow the companies in China to use fixed-asset investments to offset value-added tax payments owed to the government. This would mean huge benefits for manufacturers that make large investments in fixed assets. It would also mean that China moves to a "consumption-based" VAT regime, already in practice in about 90 percent of the world economies.

Bulky state pockets can take the hit

Taxes are the most important source of revenue for the Government of the People's Republic of China, and greatly affects the country's economic and social development. 26 types of taxes are

employed nationally and 14 of these are applicable to enterprises with foreign investment, foreign enterprises and/or foreigners. One of them is VAT which was first introduced in 1994. The VAT in China is currently 13 or 17 percent depending on the type of good, and accounts for 40-45 percent of total tax revenues. In other words, it has been a huge contributor to China's rapid economic growth.

With the new system, the government would evidently lose more than a hundred billion RMB every year. Mr. An, finance professor at Beijing's Renmin University and deputy chief of the China Taxation Institute, however states that tax losses of this size should not be a big problem for the government. In fact, China's tax revenues have been record high lately. In 2007, they exceeded RMB 4.94 trillion (US\$670 billion), up 31.4 percent from 2006. And either way, the money will find its way back, via the projected increase in manufacturing capacity and growth.

System is already explored in Chinese areas Pilot programs of the VAT reform have already been introduced in Northeastern China, some central regions, Inner Mongolia and the severely hit areas during the Sichuan earthquake in May



this year. The reform has proven successful to boost industrial activity, wherefore the Ministry of Finance and the State

Administration of Taxation now suggest the State Council a nationwide expansion on the system.

The reform, if approved, is expected to be implemented in January of next year.

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