JESA INVESTMENT & MANAGEMENT CO. LTD.

NEWSLETTER

SEPTEMBER 2011

In this issue:

- **News from Jesa: instability and opportunities**
- **China might slash tariffs on luxury goods import**
- **A downgrade behind the corner?**
- **New Individual Income Tax Regulation**

NEWS FROM JESA! Instability and opportunities

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

For the first time, due to the difficult and uncertain economic situation, is quite difficult to write an article without being too pessimistic. Surely bitter taste remains in everybody's mouth thinking about all the opportunities that have been lost by Italian enterprises. If we consider the potential capabilities and excellences of Italy, few internationalization opportunities have been taken because of the lacking of attention to a long term development strategy.

Developing the foreign market and a solid strategy abroad is an important way to mitigate the risk.This is and will still be a difficult period for those enterprises that still rely only on a single market such as the Italian one.

We do hope in an upcoming change of wind and a shift of course to concentrate efforts and resources in discussions about development and strategies rather than focusing on matters that do not help and support the economic recovery.

Even China is not immune to difficult situation, but at least till now it has always reached with political and economic reforms, in addition with liberalization and reforms to open and develop the markets. For sure in such a difficult period China demonstrated to be able to cope with the difficulties created by the crisis in a more complete way.

Jesa constantly monitors the opportunities arising from the Chinese market and is always available to face with the challenges generated by the crisis and develop a strategy to enter such a complex and promising market.Our newsletter always tries to highlight useful information which can be developed jointly with our clients.

ITALIAN VERSION

In questo periodo caratterizzato da una situazione economica altamente incerta e difficile, è per la prima volta complicato scrivere un articolo senza incappare in discorsi già sentiti e senza essere troppo pessimista.

Certamente rimane l'amaro in bocca pensando a tutte le opportunità che sono state perse nel tempo dalle imprese italiane. Se consideriamo le potenziali capacità e le eccellenze del nostro paese, poche delle possibili opportunità di internazionalizzazione sono state colte a causa della mancanza di visione strategica a lungo termine. Lo sviluppo dei mercati esteri e il consolidamento di solide strategie internazionali sono un importante strumento per mitigare il rischio. Questo è e sarà ancora un periodo difficile per quelle imprese che ancora dipendono da un unico mercato come quello italiano.

Speriamo in cambiamenti significativi di direzione che permettano di concentrare gli sforzi e le risorse in discussioni importanti per lo sviluppo e la definizione dii strategie a lungo termine piuttosto che focalizzarsi su questioni che non aiutano la risoluzione di una situazione di crisi economica.

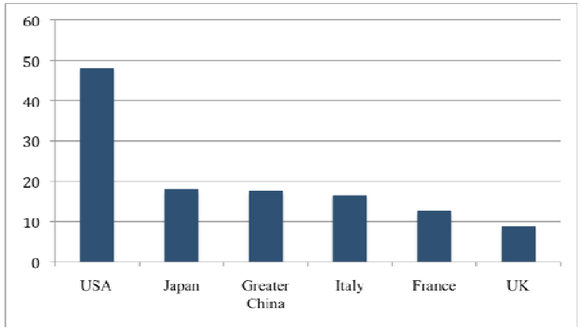
Anche la Cina non è immune dalla necessità di affrontare periodi difficili, ma quanto meno ha fino ad ora dimostrato buona capacità di reagire attraverso riforme politiche ed economiche, congiunge alla liberalizzazione e ulteriore apertura dei propri mercati. Certamente in un periodo così difficile la Cina ha dimostrato di essere in grado di reagire e affrontare le difficoltà in maniera congiunta ed efficace.

Siamo sempre pronti a monitorare opportunità che emergono dal mercato cinese e quindi sempre disponibili a cogliere le sfide generate dalla crisi nel strutturare la strategia di ingresso in questo mercato così complesso ma anche così promettente per le nostre aziende. La nostra news letter cerca sempre di mettere in risalto informazioni utili da sviluppare assieme.

China might slash tariffs on luxury goods import

The Chinese luxury market is growing at an impressive pace. Between 2009 and 2010, it grew by 30% and Greater China became the third largest luxury market in the world, behind USA and Japan.

Luxury Market Value by Country (2010 Billion €)



Source: Altagamma & Bain (2011)

This might appear a little surprising at first sight, given the traditional high savings propensity of Chinese. However, with a double digit growing economy and a new middle class forming, something is changing, especially in the new generations. As a result of the "one child policy" young Chinese have a higher purchase power and have no fear to use it to buy all these luxury products they have seen during their international travels, overseas education or through western medias. Thus, China's luxury market is experiencing a boom and it is forecasted to account for 44% of global sales by 2020. This means that in the next five years luxury expenditures yearly growth (+25%) will outpace spending in education (+16%). However, about half of the Chinese luxury shopping happens abroad.

There are three main reasons for that. First, Chinese are glad to demonstrate that they are rich enough to travel overseas and buying luxury goods abroad. Second, buying a bag in the Via Monte Napoleone shop in Milan, a Chinese consumer can be sure that the bag is genuine. Finally, a key reason is that luxury products are subject to high tariffs in China, which can reach up to 30%. As a result, according to a survey conducted by the Chinese Minister of Commerce, high-end luxury brands' prices are 45% higher than in Hong Kong and 71% higher than in France.

The Chinese government has recently decided to start facing this issue. Currently luxury goods are subject to import duties, custom inspection tax, VAT, business tax and consumption tax. According to Minister of Commerce, Chinese by buying luxury goods overseas cause the government a fiscal loss of about 1 billion RMB. Thus, in order to face this issue and coherently with the 2011-2015 Five-Year plan, which aims to promote internal demand, Chinese officials are considering slashing tariffs on some luxury goods. The duty system is not keeping pace with the changes in consumption patterns in China. Indeed nowadays, middle-class Chinese consumers can easily afford goods once considered luxury products. An example is the imported cosmetics, which are bought by many Chinese but at an extraordinarily high price due to the duties. Indeed, total tax on imported cosmetics is 57 percent (30% consumption tax, 17% value-added tax and 10% tariff).

By lowering taxes they expect to achieve two objectives. On the one hand, more people will be able to afford luxury products therefore promoting internal consumption. On the other hand, China will be able to keep inside the country and higher share of its luxury spending. According to some rumours tariffs might be reduced by 2% to 15% depending by the product category.

The reduction of tariffs can be an extremely interesting opportunity for Italian luxury companies. Indeed, Italian brands are already well recognized in China. Chinese customers consider Armani, Ermengildo Zegna and Versace the top 3 brands for Menswear. Ferragamo and Prada are the favourite shoes producers while Armani and Gucci rank in the top 3 respectively for womenswear and bags. The reduction of tariffs provides an additional compelling reason for Italian luxury companies to expand their business in the country.

However it must be noticed that the proposals still has not passed and, despite the government officials agree that it is only a matter of time before the tariffs will be reduced, it is still uncertain. Indeed, the proposed reform has attracted some criticisms. Indeed, some observers have claimed that slashing tariffs on luxury goods would benefit only the rich part of the population widening the differences between the wealthy and the poor. According to this view, a reduction of the import duties should go at the advantage of the majority of the population and China should not focus on luxury product until a larger number of people will be able to afford them.

A downgrade behind the corner?

The 30th of August the American rating agency Fitch announced "*China faces better than even chance of a another downgrade to its local currency debt rating*". This statement comes after an early warning in April when Fitch had downgraded its outlook on China's RMB denominated debt from stable to negative. Currently China's rating is AA- the same rating as Italy.

Why is the rating agency so concerned about a worsening of China's debt? The answer is simple, the Chinese banks. The Chinese banking sector has expanded its loans to a massive level after 2008. This was a result of the 4 trillion RMB stimulus approved by the Chinese government to avoid a recession as a result of the 2007-2009 financial crisis. Banks were used as an engine to fuel economic development, and China kept growing at 9,6% in 2008 and 9,2% in 2009, while the rest of the world was slipping into a global recession. As a result credit grew by almost 20% in 2008 and 2009 and the volumes of new loans will reach 8 trillion RMB in 2011.

However, there are no exceptions to economic rules. The expansion of credit has fuelled inflation, which in July has reached 6,5% creating a growing concerns among the authorities and the general public. In effort to fight it, the People's Bank of China has raised both interest rates and banks reserves requirements. However the results have been until now unsatisfactory. In addition, easy money has spurred a property bubble in China. The real estate market has become such a relevant worry that, in March, the Premier and Party secretary Wen Jiabao stated, "*exorbitant increases in housing prices in some cities are a top public concern*". It is likely that an eventual decline in the house prices might pose the Chinese banking sector at risk.

A further aspect of concern is represented by the relevant exposure of Chinese banks toward the local governments. According to Moody's the Chinese authorities are understating the actual amount of local governments' debt held by the banks. While the Chinese audit agency estimates that the total amount of these loans is 8,5 trillion RMB, Moody's believe that the actual figure might be around 12 trillion RMB. In addition, it is likely that these undocumented loans are bad quality ones. Therefore, Moody's expects non-performing loans to be between 8% and 12%, potentially reaching 18% in the "stress scenario". Finally, there are also concerns about private business lending. Indeed the aggressive expansion of credit has decreased its average quality and there are concerns that a decrease in the exports, for example due to a double-dip recession in the US, might threaten the ability of some Chinese firms to pay back their debt. Thus, according to Fitch there is a 60% probability that China will face a banking crisis by 2013. Interesting enough this would not be the first banking crisis faced by the country. Indeed the last one is only about 10 years old.

However, a key issue arising is, what is the credibility of the analysis of Moody's and Fitch? At the end of the day, rating agencies have a doubtful track record. Not many will remember that Moody's in 2002 downgraded Japan to A2, at that time the second largest economy of the world, below Botswana. The creditworthiness of the nation was considered equal to that of Mauritius. As 1st

September 2011, about ten years later about the announcement, Japanese government can still borrow at a 1% rate. Definitely, investors are not particular concerned about solidity of the country. Interesting enough, A2 was also how Moody's rated Lehman Brothers until the 15th of September 2008 when the bank declared bankruptcy. What about Enron, which remained rated investment grade by all the major credit agencies until four days before the company filed for the Chapter 11 on December 2nd, 2001? The uncertain track record of "The Big 3" does not mean that we should rather rely on the local credit agency Dagong, which tens to hand out generous AAA ratings to the Chinese overleveraged local governments.

To conclude, it is clear therefore that these analyses should be reviewed with a critical eye. Still, the massive increase in lending, a rising inflation and a constant real estate bubble might become a serious threat for the economic development of China. A prudent investor should definitely keep an eye on them.

New Individual Income Tax Regulation

On June 30, 2011, the 21st Standing Committee of the National People's Congress (NPC) passed *the sixth amendment to the Individual Income Tax Law of the People's Republic of China*.

The amended IIT Law:

1) increased the threshold on employment income from RMB2,000 to RMB3,500;

2) reduced the number of tax brackets from nine to seven and removed 15 percent and 40 percent brackets.

The new IIT rates applicable to employment income are as follows:

Bracket	Monthly taxable income (TI)	Tax rate (%)
1	TI < = RMB 1,500	3%
2	RMB 1,500 < TI <= RMB 4,500	10%
3	RMB 4,500 < TI <= RMB 9,000	20%
4	RMB 9,000 < TI <= RMB 35,000	25%
5	RMB 35,000 < TI <= RMB 55,000	30%
6	RMB 55,000 < TI <= RMB 80,000	35%
7	TI > RMB 80,000	45%

On July 19, 2011, Wen Jiabao, Premier of the State Council, signed the Order of the State Council No. 600 to promulgate *the third revision of Implementing Regulations for the Individual Income Tax Law of the People's Republic of China《中华人民共和国个人所得税法实施条例》第三次修正案* (the "Regulations").

The Regulations are formulated in accordance with the IIT Law.

After the implementation of the IIT Law and Regulations, the standard of expenses exempted from IIT of foreign employees remains RMB 4,800. Therefore, the only factor driving the changes on tax burden will be the alternation of tax rates for foreign employees.

The IIT Law and Regulations came into effect as of September 1, 2011.

Chinese nationals whose gross monthly income is below RMB38,600 will pay less taxes whit the enforcement of the new regulation, while individuals with gross monthly incomes above 38,600 will start paying higher taxes. Under the new IIT Law, individuals whose gross monthly income falls between RMB8,000 and RMB12,000 will receive a maximum tax cut of RMB480, and individuals whose gross monthly income is above RMB110,000 will see the largest increase in taxes of RMB1,195.

For foreigners, this would differ slightly since the IIT exemption threshold is now RMB3,500 for Chinese nationals and is RMB4,800 for foreigners.

CONTRIBUTORS

Scott Sun (supervisor)
Saro Capozzoli
Luca Mattei Gentili

For inquires and suggestions regarding this newsletter or for any other concerns, please contact us anytime at:

elena@jesa.com.cn

And please visit our website:

www.jesa.com.cn

Our Newsletters:

http://ww.jesa.com.cn/newsletter.html

ADDRESS IN SHANGHAI

HOUSE 4, LANE 112, FENYANG RD.
200031 SHANGHAI - CHINA

Tel +86 21 64331555
Fax +86 21 62880072

LEGAL NOTICE

Please consider the environment before printing this document