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Monthly Outlook & Perspectives

Takeaways from the Two Sessions Meetings

Economy

Signals of bolder tax cuts

A clearly defined floor for the GDP growth target

At the annual Twin Sessions meeting, the most hotly debated question has always been the target for economic growth. This year was no exception. But in the end, the announcement of 6.0% to 6.5% GDP growth as the target came as a relief. For this is a relatively wide range and hence is much better than "around 6.5%" as the latter would have generated numerous questions on perceived floor or lower limit of GDP growth, inevitably inviting the question of stimulus. This explicitly defined range does something even more important: it conveys an unambiguous message – the Government will stimulate the economy only if the growth rate falls below 6%.

So the question is: how likely is it that China will resort to using stimulus to prop up its GDP growth rate if it were hit by major external shocks? If we look at the GDP breakdown, as long as consumer demand continues to expand at a close to double-digit rate, we can be assured of a growth rate of 3.5% to 4% based on consumption alone. As overall consumer leverage is low (around 50%) and younger consumers are willing to resort to credit, it is not unreasonable to assume that consumer demand will grow at close to double-digit speed. This means that China should easily be able to attain the target 6% growth rate in 2019 with a moderate dose of fiscal expansion. Such assumptions are not unrealistic but more importantly, thanks to the about turn in the US Federal Reserve's stance this year, the People's Bank of China will have more leeway in its easing efforts (e.g., cuts in reserve requirement ratios for commercial banks). Indeed, much of the downward pressure on the RMB has evaporated thanks to this, and MCSI's decision to raise the percentage of A shares from 5% to 20% could result in more portfolio inflows. Therefore, easing will be undertaken via both a relatively loose fiscal policy and an accommodative monetary policy. Hence the Government should be able to avoid a flood-type fiscal stimulus as in 2008.

Tax cuts, in line with the global trend, could be bolder

In the past two years, more and more economies worldwide have embraced tax cuts (as evidenced by most recent address on budget of the HKSAR Government). In China tax reduction is being seen as a necessary measure for supply-side reform in order to offset the effects of President Trump's tax cuts and higher tariffs. Last year, the Chinese Government cut tariffs from 9.8% to 7.5% and personal income taxes for those in the lower income range (individual income tax threshold raised from RMB 3500 to 5000 per month with additional taxable deductions on education and elder care). This year, the announcement that the government would reduce VAT from 16% to 13% is somewhat bolder than anticipated. Tax cuts are particularly important in China because there have been much lobbying efforts to reduce the cost of doing business from both business community and academia in the wake of President Trump's aggressive tax cuts in 2017. The unexpected rally of the A share market in the beginning of 2019 (up more than 20% so far in 2019) was built on investors' expectation that policymakers would continue to unveil concrete measures to underpin the real economy. Going forward, it is clear that China could cut taxes even further. In fact, whether or not the US-China trade talks conclude on positive note, it makes sense for China to bring its tariff rates (currently 7.5% on average) close to the level of most developed economies (between 2% to 3%). Such actions would not only subdue the persistent criticisms, especially from Washington, on bilateral trade imbalances, but also improve

China's position in future regional trade deals (e.g., RCEP and CPTPP). Regardless of how Brexit will play out this year, the multilateral trade system is likely to remain under mounting stress. So for China, tariff reduction would help her not to fall out of various regional trading blocs initiated by developed countries. The only caveat is that this could further erode the huge current account surplus that China has been enjoying for decades. Hence, at some point, the old question on how to deal with the trade-off between economic growth and a stable RMB exchange rate will resurface.

`Greening' the economy

This year's Twin Sessions meeting set a target of reducing energy consumption by 3% per unit of GDP, underscoring the continued commitment of the Chinese government to building a greener economy. While in concrete terms, this means putting a higher cost on pollution and giving more subsidies for electric vehicles, in a broader sense, this is about promoting the service sector and managing the consolidation of the old economy. "Continued efforts to reduce energy consumption" also implies gradually bringing down the GDP growth rate. In the long run, the GDP growth target should be replaced by objectives in social measures such as job creation.

In conclusion, this year's Twin Sessions meeting has underscored China's commitment to moving to a more sustainable growth trajectory (smaller fiscal stimulus and a greener economy). As the economy moves towards a more domestic-centred growth model, China will see its current account surplus diminishing rapidly and we will quite likely see a minor current account deficit by the end of 2019. Change in the current account balance means that policy-making has to be aimed at improving market access and ensuring an orderly relaxation of capital account controls to facilitate the utilization of foreign capital. Improved market access will bring about more FDI while eased capital account controls will result in two-way portfolio flows. China's persistent current account surplus has been a key factor in holding down global interest rates: the main effect of "a global saving glut", a term coined by former Federal Reserve Chairman Bernanke. So should China reduce its export of savings by running a small current account surplus or even occasional current account deficit (likely in 2019) on the back of consumption boom and a relatively strong RMB, would global interest rates be pushed higher? For China, the essence of financial liberalization is to increase investment choices for savers who naturally demand higher rates of returns, which again means to ease the capital account restrictions gradually. From this perspective, the ongoing trade talks with the US will accelerate the pace of such financial liberalization. This is already happening. For example, the newly approved foreign investment law which aims to level the playing field for foreign investors, a move widely seen as an effort to facilitate the trade talks, comes only 3 months after its first draft was discussed.

While the quick legislative action was lauded by the international community, they wait to see how it will be implemented on the ground. Again, the outcome of US-China trade talk which seems to be heading to the final inning, holds the key to implementations of liberalization.

Retail

Consumer demand undergoes sea-change

Consumer demand continues to be the growth engine of the Chinese economy. Total consumption contributed 76.2% of China’s gross domestic product (GDP) growth in 2018. Amidst fears of total social consumption slowing, the government has made increasing consumption expenditure the focal point of the 2019 plan at this year’s Two Sessions meeting. Notwithstanding the slowing economy, China's consumption structure is improving. While food expenditure has dropped to 28.4% of total consumption - a level comparable to major developed economies - services expenditure on the other hand has climbed to nearly 50%. In order to reach the goal of "continuously unleashing domestic demand”, in 2019 the government will focus its efforts on bolstering rural consumption, improving the quality of consumption through product diversification, as well as supporting the growth of the service sector.

Rural areas top urban areas in consumption growth

In 2018, the rural consumer market grew strongly, registering a growth rate that was 1.3% higher than urban markets. If we take into account the rural online retail market also, the figures are even higher. Sales in rural areas hit RMB 1.37 trillion, jumping 30.4% yoy. But the potential for growth in this sector is even higher provided certain obstacles such as inconvenient timings for delivery services or the low quality of goods are removed. Improving the rural online shopping experience is essential to achieving steady economic growth and improving the standard of living in rural areas. The government has promised to ensure that in 2019 the rural online shopping experience will become on par with that of the rest of the country. In its “2019 Implementation Plan”*, the government outlined some key tasks - improving the postal system, improving services at supply and marketing cooperatives and upgrading service standards in tourism. Cracking down on counterfeit goods in rural areas is also high on the to-do list. With the further development of the rural e-commerce system and delivery infrastructure, consumer demand from rural residents is bound to increase. In addition, as more regulations such as *Work Plan for a Crackdown on Counterfeit and Inferior Goods in Key Areas (2019-2021)* put into practice in rural market, we believe that chain stores and quality convenience stores will be the next wave of business in rural areas.

Embracing online and offline integration

So far China's consumer market has been powered by new forms of retail which integrate online and offline business. Key players in retail innovation such as Alibaba, Tencent, Jingdong, Yonghui and Suning have actively secured partnerships with existing brick and mortar chains including RT-Mart, Carrefour, Wal-Mart to accelerate the deployment of new retail. After several trials in various retail forms such as supermarket, cashier-less retail and social e-commerce, the internet and retail giants have zeroed in on the community convenience store business. Different from both online shopping which requires at least half an hour's delivery time and hypermarkets which are generally located miles away from local communities, community convenience stores are not only close at hand but also able to provide ready-made food as well as daily needs shopping services. Because they are fast and convenient, community convenience stores are viewed as the hottest form of `new retail' as they cater to the needs of the post- 90s and 00s consumers who value instant gratification above all else. In the past few years, the convenience store industry has had a steady influx of capital, which has helped the players to obtain brand awareness and market share. However, capital driven start-ups like OurHours lag behind international brands such as 7-Eleven and Lawson as the former have not yet managed to smooth out the gaps in their supply chain and operations. In the near future, as key players from the technology sector enter the market, the convenience store business will experience a digital transformation in supply chain, operation etc. At the same time, competition in the sector will intensify with local start-ups catching up with the international players.

Expanding imports will lead to better consumption patterns

As per capita disposable income keeps rising and consumers demand better quality products, the consumer goods market will continue to diversify. Of late, Chinese consumers have consistently chosen high quality products over less expensive, lower quality ones and personalized, customized retail experiences. This is why the 2019 Government Work Report which urges companies to "actively expand imports, optimize the import structure, provide the supply of high-quality products, and improve new types of business such as cross-border e-commerce." We can safely bet that in the future China will continue to import high-quality consumer goods in order to satisfy the Chinese peoples' increasingly discerning tastes. Tax cuts and a rapid implementation of the e-commerce law will bolster the demand for high-quality imports.

Consumption of elderly/infant services poised to surge

The Service industry contributed 59.7% of China's economic growth in 2018. This is because Chinese consumers are gradually shifting from buying consumer electronics or household appliances to consuming services. Hence the service industry has become the new driver of growth in the economy with the catalyst being the integration of online and offline shopping experiences. While consumption of services such as entertainment and sports has taken off in recent years, other services, such as services for the elderly and infants, are in high demand but short supply. According to the National Bureau of Statistics, people over 60 years of age account for 17.9% of China's total population, but only 3% eldercare services provided by rest homes are available. Meanwhile, the infant care market, driven by the "two-child economy", is experiencing explosive growth but remains plagued with poor service standards. Thus, given the huge demographic and policy dividends, the elderly and infant services sector will most certainly become two of the areas of extremely high potential growth in the near future.

* *The Implementation Plan (2019) for the further optimization of supply to promote the steady growth of consumption and the formation of a strong domestic market*

Technology

China's tech ambitions unfettered

In recent years, digital technology has been powering growth in the industrial sector. The just-concluded annual "Two Sessions" meeting further spotlighted technology as one of the core pillars of China's development strategy. In particular, artificial intelligence, big data, 5G, high-tech equipment, biomedicine, new energy vehicles, new materials development as well as other emerging technologies were highlighted as key thrust areas. Below are some of the most important technology-related takeaways from the meeting.

AI becomes the new battlefield

Artificial intelligence (AI) has been a key area of focus for China in recent years. For three years in a row, in the government's work report, Chinese Premier Li Keqiang explicitly singled out the development of artificial intelligence as a core focus of national strategy. Compared with the two previous reports, the wording on artificial intelligence in this year's report has changed from "accelerating and strengthening" to "deepening", signalling that the Chinese AI industry has moved into a new phase of serious development. AI applications to traditional industries were also mentioned.

Certain legislation pertinent to artificial intelligence have been put on the agenda in the current Five-year Legislative Plan, such as the digital security law, the personal information protection law and a revision of the science and technology progress law. These legislations are very important as they provide a legal foundation for the development of artificial intelligence.

Given the strong and continuous government support of the artificial intelligence industry, we expect to see AI spreading across the economy at a much faster pace in 2019 as China's AI industry moves from the infancy stage into a rapid development phase.

5G debut with much fanfare

For the first time ever, there was full 5G network coverage at the venues of the Two Sessions meetings. The meetings were also broadcast live in 4K HD format. For years, China's Big Three telecom operators have been actively preparing for 5G. China Mobile, for example, began research in key 5G technologies many years ago and the company even participated in the formulation of international standards for 5G. China Mobile has filed nearly 1,000 patents and over 2,700 standard proposals related to 5G. Its network domain proposals rank first among all global operators and in the wireless domain they are second. In 2018, China Mobile united all sectors of the industry in order to launch 5G trials across 17 cities. This enabled them to tackle technical issues as well as develop experience in the construction and operation of 5G. This year, mobile 5G was used successfully at two big events - the Two Sessions live broadcast and the Central Television's Spring Festival Gala during the Chinese New Year a month ago. In the Gala's Shenzhen sub-venue 4K Ultra HD content transmission was realized for the first time in history via China Mobile's 5G network.

Cheaper network fees to support a Digital China

The necessity of building an information highway is no less crucial than the construction of a transportation network. The implementation of Digital China and AI+ all rely on advanced network connectivity. The two factors that hold the key to success in this area are speed and cost. A network that is both fast and cost effective for enterprises and consumers is what will be successful and sustainable.

With this in mind, this year's government work report once again proposed that roaming charges be waived in order to further reduce network fees. In particular, the broadband fee for small- and medium-sized enterprises is expected to be reduced substantially. At present, network data traffic flow has become the largest source of revenue for operators. And the goal of "speeding up the network while reducing fees" has also switched from reducing fees for voice calls to enhancing network speed and reducing network access fees in an effort to assist the development of Digital China.

China's Nasdaq-style Technology board in the spotlight

China has recently approved the plan for a new 'Nasdaq-style' Technology Board in Shanghai, which will mainly host companies in technology and emerging sectors, such as high-tech equipment manufacturing, new energy, biotechnology, big data and cloud computing. During the Two Sessions meetings, a series of documents including detailed rules for the operation of the board were released. The establishment of the New Tech Board is an important steps to promote the development of China's capital market.

Nearly 20 cities, including Shanghai, Beijing and Guangzhou, have issued relevant guidelines on how to list themselves on the new technology board. They will also assist companies who want to list on the new Tech Board. So far, the number of enterprises in the pipeline is close to 500. In addition, various provinces and cities stand ready to offer monetary subsidies to encourage enterprises to list on the new Technology Board. For example, Shanghai will offer up to RMB 20 million in subsidies to companies listing on the board. Although we can't tell yet how many enterprises will eventually be listed, the new Tech Board will undoubtedly make capital markets better serve the real economy as well as industry leaders with core technologies.

Logistics

"Green" is the key to winning

The Chinese government's Work Report at the just-concluded Two Sessions meeting proposed three policy directions on logistics: tax reduction, green development, and the construction of a rural logistics network.

Tax cuts significantly boost the reductions of the logistics costs

In its Work Report, the government proposed that large scale tax reductions be implemented and spending be increased to ensure that all logistics industries get tax relief instead of tax increases. Already the tax rate for the transportation industry, construction industry and other related industries is set to decrease by 1% to 9%. At the same time, the government will promote the reduction of bridge and road tolls, and bring under control the unreasonable and arbitrary permit and inspection charges and fines for passenger and freight vehicles.

The new tax reduction policy will have a big impact on the logistics industry. As the main link in the production and distribution of goods, if transport and related industries see their tax burdens reduced, this will have a spill over effect across the board, enhancing the cost competitiveness of all enterprises.

Policy and new technologies accelerate the development of green logistics

The Two Sessions Government Work Report explicitly states that "we must strengthen pollution prevention and ecological construction, and vigorously promote green development." Hence `green logistics' has become the new mantra of the logistics industry. While "being fast" will guarantee that the business will not fail, "being green" can ensure its successful and sustained development. As people become more and more concerned and aware of environmental issues, `to be green' will go from being an attractive add-on to a necessity. In the future, even as the express delivery and take-away industries grow exponentially, they will also be held to account for environmental protection and corporate social responsibility.

Express packaging develops new 'green' models

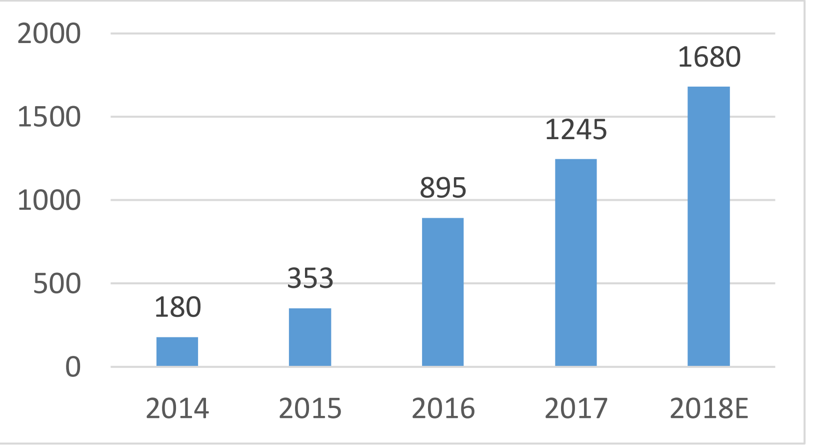
As the new retail model becomes increasingly popular, green logistics is also evolving. Delivery times and distances have already been shortened considerably through the use of nearest delivery point and store shipments. Now it is the turn of packaging to become more environmentally friendly. With the introduction of `original box' (the original box means the manufacturer's packing box) delivery, more and more products are being very lightly packaged. The recycling box plus the original box packaging is another innovative model of light packaging - The recycling boxes can be reused and the original boxes ensure that the goods will not be damaged. As a result, the combination reduces the repackaging process and improves efficiency.

Technology powers the creation of a green supply chain. The first step was the introduction of high-tech hardware such as unmanned aerial vehicles, unmanned warehouses, and unmanned shops. These technologies are ensuring greater levels of efficiency and security. The second wave of high tech solutions involved the introduction of intelligent algorithms powered by data and digital technology. This has made it possible to directly connect suppliers and consumers through mechanisms such as electronic freight forwarding and digital platforms. All these innovations improve efficiency and help in the development of a green supply chain.

Collaborative development in rural logistics and rural e-commerce

In its Work Report, the government urged logistics companies to "strengthen the rural logistics network and support the development of e-commerce and express delivery." The economy of rural areas has been transformed by the rapid development of e-commerce and the share of rural e-commerce retail sales in the entire online retail sales market is constantly expanding.

Figure: Retail sales of rural e-commerce networks in China (billion yuan)



Source: China Merchants Research Institute

However, certain major obstacles remain. There is, for instance, a serious shortage of rural storage bases and the road and rail infrastructure does not cover all areas. A rural e-commerce model of "enterprise + base + online shop" could be developed and resources need to be shared through greater co-operation between e-commerce companies, express delivery companies and community convenience stores. At the same time, a modern and comprehensive logistics distribution system should be established which is suitable to the characteristics of agricultural products.

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