Blue Book Series

FUNG BUSINESS INTELLIGENCE

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"Dual Circulation" : Opportunities and Challenges for Export Manufacturers in the Domestic Market

Blue Book of China's Commercial Sector:
Annual Report on China's Commercial Sector (2021 -2022)

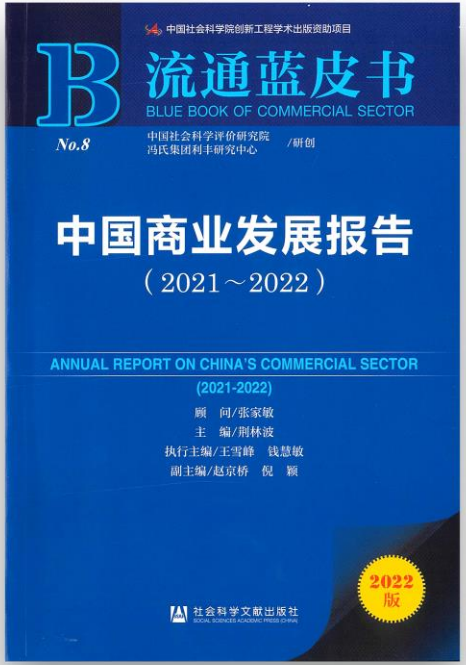
Introduction

Global economies and supply chains have been severely impacted by the outbreak of COVID-19. The export industry, in particular, was dealt a heavy blow by weakened global demand and border closures. Many export orders have been delayed or cancelled, and obtaining new orders have become more difficult. The China-US trade war and geopolitical tensions have further instilled uncertainty in global markets.

Under these circumstances, the Chinese government proposed a "dual circulation" development pattern, which emphasizes growing its domestic market and boosting domestic demand to support its economic recovery and achieve long-term sustainable growth, whilst continuing to deepen its cooperation with foreign markets.

This report discusses the opportunities available for export-oriented businesses, as well as the challenges they face when entering and selling in the domestic market.

The content in this report is based on the Chinese article published in the Blue Book of China's Commercial Sector (2021-2022).



Contents

I. China's Export Industry and the Macro Environment

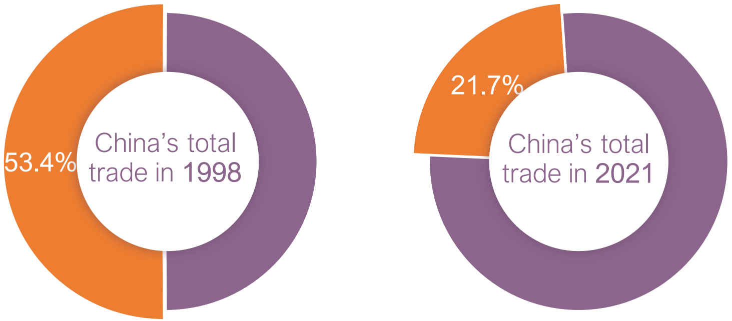
Global Trade and Export Market to Slow Down

Processing trade played a vital role in China's economy since China opened its door to the world more than four decades ago.

Since the global financial crisis in 2008, the proportion of processing trade has fallen as China gradually transitions itself from a manufacturing and export-oriented based economy to a more balanced one by promoting domestic consumption and investment.

At its peak, processing trade accounted for over 50% of China's total trade in 1998. In 2021, processing trade accounted for 21.7% of China's total trade.

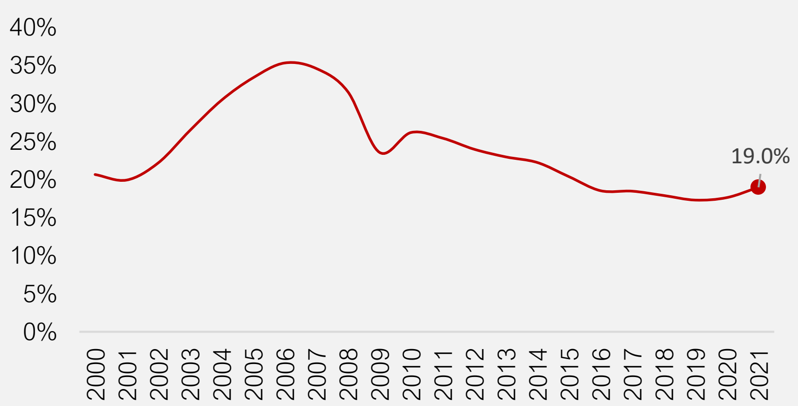
Proportion of Processing Trade to Total Trade in 1998 vs 2021



Source: National Bureau of Statistics, China

The COVID-19 pandemic has significantly shaken the global economy and the supply chain. Geopolitical tensions and rising protectionism have also led to a decrease on the global demand side.

China's Export as % of GDP



The ratio of exports to GDP has shown a declining trend over the past 10 years. Exports accounted for 19.0% of GDP in 2021.

“Dual Circulation”: Expanding domestic demand and promoting consumption

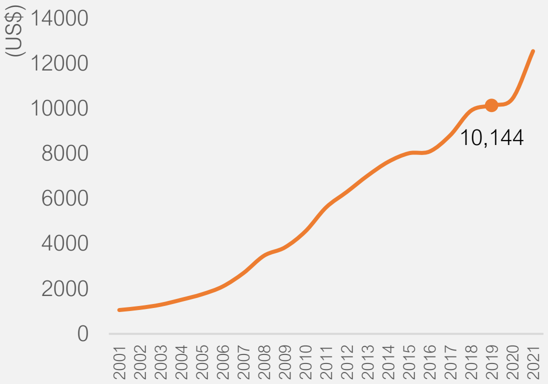
China is transitioning itself from a manufacturing and export-oriented based economy to a more integrated one by expanding domestic demand and promoting consumption.

In March 2021, the National People’s Congress approved *the 14th Five-Year Plan (2021-2025) for National Economic and Social Development and the Long-Range Objectives Through the Year 2035.*

“Dual Circulation” will be the key direction for China’s development during the 14th Five-Year Plan (FYP) period. China will nurture a strong domestic market, expand its middle class, and boost household income to promote domestic consumption and drive growth.

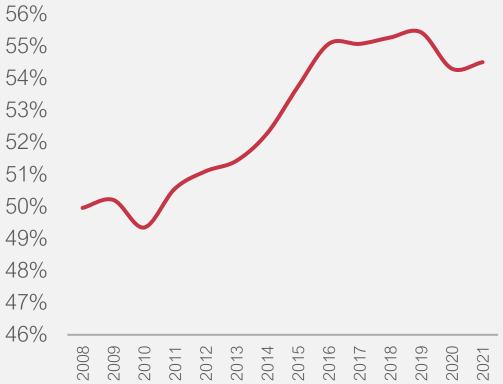
Consumption will be the Main Driving Force of China's Economy

China's GDP Per Capita



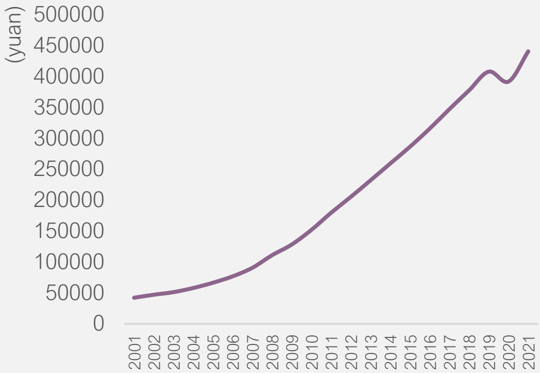
China's per capita GDP exceeded US$10,000 for three consecutive years from 2019 to 2021. According to a report issued by China's Development Research Centre under the State Council, China's per capita GDP is predicted to reach US$14,000 by 2024.

China's Total Consumption as % of GDP



Despite the impact of the pandemic, the final consumption expenditure accounted for 54.3% and 54.5% of total GDP in 2020 and 2021, respectively.

Total Retail Sales of Consumer Goods



The total retail sales of consumer goods grew by 12.5% to 44.08 trillion yuan in 2021, a turnaround from the 3.9% dip in 2020. It put the average annual growth for the past two years at 3.9%.

Source: World Bank, National Bureau of Statistics China

II. Selling Exports Goods in the Domestic Market

Different Business Nature of Export vs Domestic Trade

Export and domestic trade differ in terms of business model, order size, order cycle, inventory risk, and settlement/payment methods. Due to these differences, it is often hard for export-oriented businesses to transition themselves to domestic trade.

	Export Trade	Domestic Trade
Business model	• Mainly involved in the manufacturing phase of the value and supply chain • Some involved in R&D and design, but few have branding, distribution, marketing, and after-sales service capabilities	• Requires full involvement in the entire value and supply chain
Order size	• Large volume of orders placed for selected SKUs months in advance	• Smaller orders spread across a larger number of SKUs on a more frequent basis
Order cycle	• Longer order cycle and turnaround time	• Shorter order cycle and turnaround time
Inventory	• Products are produced according to orders given by the buyer • Buyer assumes inventory risk	• Orders are typically placed after products are produced • Seller assumes inventory risk
Payment	• Usually on open account with ample supply chain financing facilities available, e.g. letters of credit (LCs), factoring, etc.	• Usually on credit, with account periods ranging between 30 days up to 6 months

Key Challenges when Entering the Domestic Market

Selling export goods in the domestic market is not a straight-forward process. Export-oriented businesses are likely to face a number of challenges and institutional barriers when entering the domestic market.

Some common challenges encountered include:

- No domestic selling rights
- Different labelling, testing & certification standards
- Increased tax burdens
- Lack of financial & credit support
- Lack of knowledge about domestic consumers
- Lack of distribution channels
- Lack of knowledge about intellectual property rights & branding

III. Supporting Export-oriented Businesses to Sell Domestically

Government Support Measures to Help Export-oriented Businesses Sell Domestically

Following the outbreak of COVID-19, Chinese government has stepped up its efforts to help export-oriented businesses overcome the barriers and challenges of selling in the domestic market by rolling out a number of regulations and support measures.

ISSUANCE DATE	REGULATION	ISSUING AUTHORITY
April 2020	Notice concerning expanding the pilot policy of selective tariffs on domestic sales	Ministry of Finance, General Administration of Customs & the State Taxation Administration
April 2020	Notice of the Ministry of Finance on temporary exemption of tax-deferred interest on domestic sales tax for processing trade enterprises	Ministry of Finance
April 2020	Announcement of the General Administration of Customs on temporary exemption of tax-deferred interest for processing trade goods sold domestically	General Administration of Customs
June 2020	Opinions of the General Office of the State Council on supporting domestic sales of export products	General Office of the State Council
July 2020	Announcement of the General Administration of Customs on further extending the customs declaration deadline for processing trade goods sold domestically	General Administration of Customs
July 2020	Notice of the Certification and Accreditation Administration regarding streamlining and optimizing the compulsory product certification procedures for export products originally produced for export but subsequently sold in the domestically market	Certification and Accreditation Administration of China
Sep 2020	Announcement of the State Administration for Market Regulation on the implementation of the Opinions on supporting the domestic sales of export products issued by the General Office of the State Council	State Administration for Market Regulation

Government Support Measures to Help Export-oriented Businesses Sell Domestically (Cont'd)

No Domestic Selling Rights

Challenge

Export-oriented companies without domestic selling rights need to obtain approval from multiple government authorities for relevant licenses before they can sell their products in the domestic market. The approval takes considerable time and may lead to missed opportunities

Government Support Measures

The Ministry of Commerce is working on simplifying and eliminating the review and approval procedures for export manufacturers without domestic selling rights to engage in domestic trade.

Government Support Measures to Help Export-oriented Businesses Sell Domestically (Cont'd)

Different Labelling, Testing & Certification Requirements

Challenge

Export-oriented businesses are not familiar with domestic standards. Due to different labelling, testing, and certification standards applied in the export and domestic markets, goods that meet export but not domestic standards cannot be sold locally. The cost of testing and certification can be costly and time-consuming.

Government Support Measures

Export-oriented businesses affected by the pandemic can sell products originally made for the export market in the domestic market till the end of 2020 by making a self-declaration of conformity, given the products meet the quality standards of the export market and China's own mandatory standards. The same rules apply to the labelling of products. Export-oriented businesses can add their own Chinese labels to products but will be held accountable for the accuracy of the contents. The policy has been further extended till the end of 2021 in certain cities.

Government Support Measures to Help Export-oriented Businesses Sell Domestically (Cont'd)

CCC Certification Requirements

Challenge

CCC certification, which is a compulsory testing standard in China currently applied to 103 products in 17 categories that directly affects the personal safety and health of consumers and the environment, e.g. electrical appliances and toys, is required before the products can be sold domestically.

Government Support Measures

The Certification and Accreditation Administration of China has called for further optimizing the CCC certification process for export products sold domestically. Specifically, the certification process for products that have already been certified by another international body where the standards are in line with the existing CCC requirements will be expedited and recognized upon meeting relevant requirements.

Certification bodies will also offer training to help export-oriented businesses better understand the CCC testing requirements. Meanwhile, the Chinese government is looking to downsize the CCC catalogue, further simplifying the certification process and shorten the processing time.

Government Support Measures to Help Export-oriented Businesses Sell Domestically (Cont'd)

Challenge

Exported goods are entitled to tax refunds which are not applicable for domestic sales.

Companies need to pay duty for imported raw materials and value-added tax for goods sold domestically.

Increased Tax Burdens

Government Support Measures

To ease the tax burden and cost for export-oriented businesses, the pilot programme where companies may elect to pay duty for their domestic sales as either imported materials or finished goods in 40 special customs supervision zones would be extended to all 113 integrated bonded zones nationwide to help companies legally reduce their tax expenses. In addition, the interest accrued on deferred tax for domestic sales would be temporarily waived from April 2020 till the end of 2020.

The General Administration of Customs has also released a notice to reduce the tax filing frequencies of eligible processing trade companies for domestic sales-related taxes to a quarterly instead of monthly basis.

Government Support Measures to Help Export-oriented Businesses Sell Domestically (Cont'd)

Challenge

Domestics sales are usually conducted on credit terms. It is common practice for buyers to pay from anywhere between 30 days up to 6 months of the invoice date. This means that a large amount of capital will be tied up for the buyer, posing liquidity, settlement, and credit risk challenges.

Unlike export sales where letters of credit and other supply chain financing solutions and insurance facilities are readily available, financing means are more costly and difficult to obtain for domestic trade.

Lack of Financial & Credit Support

Government Support Measures

To better meet the financing needs of the domestic business model, the government is encouraging financial institutions to offer innovative supply chain financing solutions and extend credit and loan support for export-oriented businesses, in particular SMEs, to help their domestic operation. The government is also calling for insurance companies to provide insurance services or extend insurance protection to cover export goods sold in the domestic market.

Government Support Measures to Help Export-oriented Businesses Sell Domestically (Cont'd)

Challenge

Export-oriented companies may not be allowed to sell goods originally intended for export in the domestic market due to IP issues. Most exporters do not have their own brands or IP rights to sell in China and the trademark registration process in China is a time-consuming process which can take around a year on average to complete.

Lack of intellectual property rights & branding knowledge

Government Support Measures

The government is encouraging export-oriented businesses to negotiate with brand owners to obtain authorization of the use of relevant IPs to sell domestically for orders that have been cancelled by foreign brands. The government will also be offering training and support to export-oriented businesses to help them register their own brands and IPs in China and continue to strengthen the protection of IP rights.

Other Support Initiatives for Export-oriented Businesses

Organizing special events to promote export products on major pedestrian streets and key shopping areas

01

Setting up special areas and counters for export products at major trade fairs such as the China Import and Export Fair and the China Processing Trade Products Fair, and encouraging domestic buyers and major commercial companies to visit these fairs and make purchases

02

Utilizing investment projects to boost domestic sales, and offering export-oriented companies the opportunity to participate in new infrastructure, urbanization, and other major projects across the country

03

E-commerce Platforms Support Export-oriented Businesses

China's e-commerce market is the fastest growing and largest in the world. Mobile e-commerce sales account for a much higher percentage in the domestic market than in the export market. Given that most export-oriented businesses have little experience in e-commerce operations and the entry requirements and costs to sell on leading e-commerce platforms can be high, major e-commerce platforms, such as Taobao, JD.com, Pinduoduo and Suning, have rolled out a series of initiatives to support export-oriented businesses for their domestic sales endeavors.

Support initiatives

- Organizing special promotional events, marketing initiatives and online shopping festivals
- Joining hands with local governments to help local factories promote and sell their products online by hosting live-streaming sessions
- Offering special discounts and consumption vouchers to consumers to buy products from export-oriented businesses
- Providing data, operational, logistics, marketing and financial support to export-oriented businesses
- Setting up dedicated zones/special sections on the platforms for export-oriented products
- Waiving platform joining fees, offering low commission rates, and traffic support to export-oriented businesses
- Offering training sessions to export-oriented businesses to help them understand the domestic market and operate online stores

Support Initiatives Offered by Key E-commerce Platforms

Taobao

- Alibaba launched the 2020 Spring Thunder Initiative in April 2020 to help SMEs during the COVID-19 pandemic. Measures from the initiative include helping SMEs expand into new markets through Alibaba's e-commerce platforms, alleviating immediate financial challenges, helping export-oriented businesses transform and develop their business in the domestic market through resource support, fee reductions and fast-track processing; fostering digitized manufacturing clusters, etc.
- Alibaba's 1688.com, the largest domestic trade wholesale platform in China, launched a digital foreign trade zone, to help foreign trade enterprises quickly expand into the domestic wholesale market.
- Alibaba will also make foreign trade enterprises suppliers for Tmall Supermarket & Taobao's private label Taobao Xinxuan (淘宝心选).

JD.com

- JD.com has been helping export-oriented companies connect with Chinese consumers mainly via its Jingxi app which was launched in September 2019. Jingxi mainly targets users in lower-tier cities in China and encourages buyers to invite friends, family and social contacts to purchase products together to enjoy rewards and discounts. The business model is similar to that of Pinduoduo.
- Apart from helping merchants offload excessive inventory, Jingxi waives the platform joining fees for merchants and charges a low commission rate. It also provides store setup assistance, free training, online traffic boosts, cash allowances and livestreaming show production services to help export-oriented enterprises sell in the domestic market.
- Jingxi cooperates with local governments and factories in various industrial clusters to help factories sell in the domestic market and digitalize their operations.

Pinduoduo

- Pinduoduo launched its first "New Brand Initiative" campaign in December 2018, which aims to support 1,000 factories and manufacturers in developing their own brands and help these companies transform from OEM (Original Equipment Manufacturer) to OBM (Original Brand Manufacturer).
- The campaign enables small and medium-sized manufacturers to reach Pinduoduo's 443 million users and upgrade their brands at a lower cost. The platform provides big data analytics on consumers' needs and comprehensive R&D planning on products.
- Pinduoduo will incentivize manufacturers by directing resources and online traffic to participating brands.

IV. Directions of Development

Directions of Development

01 Integration of Domestic and Foreign Trade

02 C2M Model Gains Further Traction

03 Moving up the Value Chain – from OEM to OBM

Integration of Domestic and Foreign Trade

01

Variations in standards, testing, and certification requirements between domestic products and export products have made it difficult for export-oriented companies to sell in the domestic market without incurring additional time and costs.

02

According to the 14th FYP, the government will continue to promote the integration of domestic and foreign trade laws and regulations, quality standards, certification and accreditation processes, etc. to further accelerate the integration of domestic and foreign trade.

03

The government has also been promoting the “same line, same standard, same quality” (also known as ”Santong” [三同]) programme. Exporters are encouraged to produce goods on the same production line, following the same standards and the same quality requirements for both the export market and the domestic market.

04

The “Santong” programme has been implemented to improve food and agricultural products quality since 2016 and has been expanded to cover general consumer goods and industrial goods since 2020. “Santong" products will help companies reduce production costs and better serve both the export and domestic markets at the same time.

What does “Santong” refer to?

- “Same line" refers to export and domestic products produced on the same production line using the same production systems
- “Same standard” means that the quality and safety management systems of each enterprise conform to the regulations and standards of the import countries/regions. Meanwhile, the product standards should be in accordance with Chinese standards if they are stricter than that of the export market
- “Same quality" means that export and domestic products should be of the same quality.

China’s Consumer-to-Manufacturer (C2M) Model Gains Further Traction

China’s consumer-to-manufacturer (C2M) model is expected to become a new driver in the e-commerce landscape.

C2M is essentially evolving traditional manufacturing from an R&D and marketing-driven process into a consumer-driven one.

Leveraging big data and AI, e-commerce platforms pass on relevant consumer data and insights to manufacturers which can then adjust their production, customize products, as well as innovate new products to more accurately match the needs and preferences of domestic consumers.

In this way, manufacturers can better anticipate product demand, reduce inventory, and save on production costs.

Internet giants, such as Netease, JD.com and Alibaba, have been actively partnering up with export manufacturers to produce products for their own private-label business.

Moving up the Value Chain – From OEM to OBM

- Export-oriented businesses are extending both their upstream and downstream capabilities along the supply chain. A number of enterprises have been cultivating their own brands to capture market share and increase profit margins, transforming from Original Equipment Manufacturer (OEM) to Original Brand Manufacturer (OBM).

- OBM takes care of the entire production procedures, from design, engineer, manufacture, supply chain to marketing. Compared with OEM, OBM usually involves higher production costs.

- The central and local governments have introduced a series of policies and measures to support export-oriented businesses to establish their own brands and to apply for their own trademarks and patents in China.

- The State Intellectual Property Office has reduced the trademark examination period from an average of 10 months to 4 months. It is further optimizing the trademark registration process so that full registration can be completed in 7 months.

- E-commerce platforms have also launched various initiatives to help export-oriented businesses promote their own brands.

Moving up the Value Chain – From OEM to OBM (Contd)

JIAWEISHI'S CASE

- Matsutek (松腾), the parent company of Jiaweishi (家卫士), has long been the manufacturer of many well-known electronic brands including Honeywell, Whirlpool and Philips, with only a small portion sold to the domestic market under its own namesake brand – Jiaweishi.
- The products of Jiaweishi are of comparable quality to the products supplied to other international brands but priced much lower.
- As Jiaweishi has limited marketing experience, the brand was not particularly well received when it was initially launched in the domestic market.
- By participating in Pinduoduo's "New Brand Initiative“ scheme, Jiaweishi was able to better understand Chinese consumers' needs.
- Based on the data provided by Pinduoduo, Jiaweishi removed some of its robot vacuum's features that domestic consumers do not need and was able to lower the price point.
- The modified product became an instant hit after its release, as it has met the needs of consumers from lower-tier cities who were looking for value-for-money products.

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