The China Business Review

January–February 1989

SPECIAL REPORT: Sino–South Korean Trade

Hainan
China's Treasure Island?

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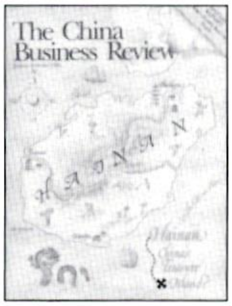
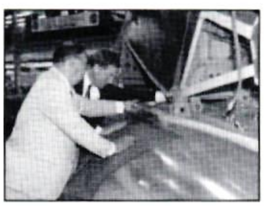
Departments



Cover: Rich in natural resources, Hainan must develop an industrial infrastructure. *Artwork by John Yanson.*



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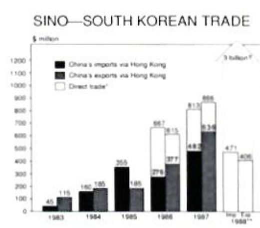

China and South Korea: Total bilateral trade is expected to surpass $2 billion in 1988. **Page 36.**

CUTTING BACK ON CUTBACKS

Beijing's decision to extend from early December to late January the deadline for finalizing a nationwide list of construction projects to be postponed or cancelled is unmistakable evidence that the central government is encountering grave difficulties in convincing ministries and local governments to accept retrenchment policies. Rather than achieving the goal of reducing domestic investment, the new campaign to "rectify the economic order" may demonstrate instead that power once given is not easily taken away.

Although localities are making a show of obeying the cutback directive with high-profile announcements of cancelled luxury property projects, they are nevertheless devoting considerable resources to getting around the policy. According to central government statistics, only about 25 percent of the 4,755 projects that localities have agreed to postpone or cancel were actually under construction. Localities have also fiercely resisted any cutbacks in productive projects.

Beijing's ability to enforce its demands appears limited. Recentralizing control over revenue distribution is not an option in light of the inevitable political fallout. Nor does the central government appear ready to change significantly the manner in which it distributes money to the provinces for vital projects for fear of delaying national development priorities. Diversion of such funds to other purposes by local governments has been a major cause of excessive growth in the money supply, since Beijing has proved willing to supplement funding in specially designated areas.

Credit may become a partially effective tool for Beijing in adjusting revenue dispersal. As banks tighten their lending policies, Chinese enterprises are experiencing increasing difficulty raising renminbi (RMB), even for projects that have foreign currency funding. While tight credit will probably not cause many projects to be cancelled, it may force some to slow down in the face of temporary fundraising problems.

Some may find a bright side to the present situation, however. Beijing's difficulties in trying to curb domestic investment highlight the success of reform policies calling for the decentralization of power within China.—Martin Weil

TAKING THE "N" OUT OF "NME"

The US government has taken a step toward acknowledging the Chinese claim that China can no longer be viewed as a single, nonmarket economy (NME) producer. In a November 2 preliminary finding of dumping against Chinese headwear manufacturers, nine dumping margins—rather than a single one encompassing all of China—were set by the Department of Commerce.

The case, brought by the Headwear Institute of America against various classifications of Chinese hats, is the first in which the US government has recognized that Chinese foreign trade corporations have decentralized, and that therefore exporting entities in these sectors should be evaluated independently in dumping actions. The final decision, expected next spring, is unlikely to reverse the preliminary finding.

The US government stopped short of defining China's headwear sector as market-driven, however. While recognizing that headwear producers are now responsible for profits and losses and subject to bankruptcy laws, it also found that "trading companies may be subject to foreign exchange targets and . . . cotton cloth may still be subject to State control." Conflicting evidence was also cited concerning enterprises' access and control over foreign exchange, and convertibility of the RMB.

The finding is significant to China for several reasons. First, it serves as partial confirmation that trade reform has made progress, and this may facilitate China's accession to the General Agreement on Tariffs and Trade (GATT), which requires an open foreign trade system. Also, should the US government find that certain sectors of the Chinese economy are market-driven, different standards would be applied to determine dumping. Currently, US dumping law assumes that prices and costs in NMEs cannot be meaningfully determined, so surrogate countries are used as yardsticks to estimate costs.

If the US government does adopt the position that portions of China's economy are market-driven, US petitioners could bring countervailing duty charges against China to determine whether the State is unfairly subsidizing exports. Previous cases brought against NMEs have been unsuccessful—in 1983, the US Court of International Trade decided that since NME prices are not based on market forces, it was impossible to determine what constituted a subsidy.

A countervailing duty case against a Chinese market-oriented industry would break new legal ground. Countervailing duty laws are directed at export subsidies given by central governments, but do not mention subsidies given by specific industrial ministries or bureaus. Whether countervailing duty provisions could be selectively applied to a given industrial sector would have to be adjudicated.

While the US government is unlikely to find soon that any Chinese industry is market-driven, the preliminary decision in the headwear case takes a large step in that direction, and sets a trend worth watching. —Karen Green

PLAYING FOR KEEPS

China's toy exports to the United States have grown by 1,000 percent in the last five years, and thanks to more liberal policies and higher disposable incomes from economic reforms, Chinese are enjoying more toys and games at home as well. Not only are traditional Chinese pastimes like kite-flying and *weiqi* (known as "go" in Japan and the West) enjoying a revival, but Western games are also becoming more widespread. As players—and police—are finding, however, some games are being taken quite seriously indeed.

Pocket billiards, first introduced to China during the Qing Dynasty, made a comeback during the late 1970s. Storefront pool halls and curbside tables, set up and taken down on a whim, have recently sprouted up in a number of China's major cities. Although China Youth News holds that the game can "cultivate people's minds and make them patient," some players may be more interested in cultivating their pocketbooks. As gambling is illegal in China, police in Beijing have confiscated tables and detained players suspected of gambling, but the sheer number of players will make betting difficult to control.

In Shanghai, the ancient Chinese entertainment of cricket fighting has seen a surge of popularity recently, accompanied by an intense interest in betting on the side.

The contest features two crickets battling each other until one of them loses interest and turns away—or in some cases, succumbs to injuries—and generally lasts a matter of seconds. Training lore can reach arcane levels, with breeders advocating doses of red pepper or frequent baths to groom a champion. The popularity of the matches is indicated by the results of a recent police raid that netted 24 gamblers and a pot of $2,700.

That sum is small potatoes, however, compared to the amounts of (fake) money that can be won in Monopoly, Parker Brothers' famous encapsulation of capitalist acquisitiveness. A game with the object of accumulating money and property while forcing competitors into bankruptcy may seem out of place in socialist China, but officials have actually praised the game as a useful tool for teaching the functions of a market economy.

The Chinese version of the game is called *qiangshou*, or "strong hand," and is played in the usual way, with a few exceptions. For example, players are not allowed to buy their way out of jail, because *qiangshou*'s Chinese manufacturer, the Lishen Toy Factory of Shanghai, does not want to encourage lawlessness.

The Lishen factory has itself absorbed the game's freewheeling capitalist spirit. Though Parker Brothers claims it has a universal copyright on the game, Lishen contends that since the copyright was never registered in China, Parker Brothers has no grounds for legal recourse. Lishen is not so cavalier about its own rights, however: it has successfully sued another Chinese factory making the game for copyright infringement, and forced the rival factory to halt production.

For manufacturers and players alike, *qiangshou* certainly conveys the need for maintaining a competitive edge in a capitalist world. One frequent player, 11-year-old Tang Qi of Shanghai, for example, claims he always wins at *qianqshou*—and admits that stealing money from the bank when no one is looking helps him do it.

—PB

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Council Recommendations to the Bush Administration

Attention and action are needed to deal with both new and unresolved issues

The inauguration of a new administration serves as a natural point to stop and assess where US–China economic relations stand, and what policies the US–China Business Council should advocate over the next four years. The Bush Administration is not expected to depart significantly from President Reagan's approach favoring expanded relations with China, but unresolved problems such as export controls and the protection of intellectual property are likely to increase in urgency and importance over the next four years. The Council proposes that the following actions and policies be undertaken to speed the resolution of these and other issues, and thus continue the progress of US–China commercial relations.

Export controls

US objectives in instituting an export controls system in 1949 were aimed at guaranteeing economic vitality as well as military security. Current implementation of export controls for China bolsters the military objective, but too frequently ignores US economic security. Not only are American companies encountering stiffer competition from Coordinating Committee for Multilateral Controls (COCOM) countries, but the increasing availability of dual-use technology from non-COCOM countries is making many export restrictions unrealistic and costly to US industry.

American firms also suffer competitive disadvantage within COCOM, not because the other participants "cheat," but because under the policy of national discretion countries have considerable latitude in prescribing controls over their own companies. Since the United States chooses to retain the strictest control system, national discretion in effect means that companies in competitor nations can ship to China more promptly and with fewer restrictions than American companies can.

There has been much progress on export control reform in the past five years, but more needs to be done. In particular, the burden of proof of harm to national security must shift from the exporter to the government. The administration should adopt the following measures:

- conduct a high-level review of the continuing need for restrictions on the sale of telecommunications equipment to China;
- expedite US implementation and ensure US conformity with China export control relaxation agreements reached at COCOM;
- balance the Defense Department's de facto veto power in licensing decisions with a review of the commercial costs of denying an export license to China;
- conduct an early and comprehensive review of items controlled for export to China with a goal toward focusing on goods and technology that are truly strategically sensitive;
- remove China from COCOM over the long term to reflect the fact that China is a friendly country and not part of the Warsaw Pact.

Software copyright protection

Pirating in China of PC, mainframe, and workstation-based software costs American companies hundreds of millions of dollars annually. Though China's lack of technical expertise in modifying more complicated software has prevented mainframe and workstation-based software from being pirated on the same scale as PC software, as China's technical and marketing skills improve, the long-term risk remains.

The Council advocates a concerted government–private sector campaign to encourage movement toward more comprehensive copyright protection in China. Specific programs should include:

- providing the Chinese government with assistance in drafting copyright legislation;
- educating the Chinese on the benefits of copyright protection to their economic development;
- joining with Chinese organizations to promote enactment of copyright laws in China.

Patent protection for chemicals and pharmaceuticals

China's first patent law, which became effective in April 1985, formally recognized that technology is proprietary and thus should be accorded protection as intellectual property. China's patent system has since developed rapidly, but contains a number of serious deficiencies in the chemical and pharmaceutical sectors.

For example, there is no product protection for chemicals in China. Thus, it is only possible to protect chemical inventions by obtaining a patent for the method used to synthesize the new chemical. Competitors can usually avoid such process-limited patents by developing alternative processes. Chinese patent law also cannot be used to prevent importation of a chemical made by a patented process.

In addition, patent life in China is only 15 years from filing—short by international standards. This period is simply not long enough for companies to recoup research and development costs.

State Council officials have indicated that the patent law is likely to be amended in 1989. The Council is lobbying officials in the Patent Office, Ministry of Foreign Economic Relations and Trade (MOFERT), the State Science and Technology Commission (SSTC), and the State Council to address remaining problems. The Council has presented the following recommendations:

- introduction of product protection for chemicals;
- making actionable the importation of a product made by a patented process;
- extending the patent term to 20 years from filing.

Bilateral investment treaty (BIT)

The purpose of a BIT is to protect American investments overseas by ensuring stability, fairness, and transparency in the host country's treatment of business activity (*see The CBR*, Nov–Dec 1988, p. 8). The United States began to negotiate a BIT with China in 1983, but little progress has been made due to significant differences over national treatment, scope of arbitration, and whether Chinese domestic laws may override treaty obligations.

Certain breakthrough provisions in the recently signed Sino–Japanese BIT have encouraged some to revive US negotiating efforts. However, a fundamental question must first be addressed: does the United States really need a BIT, or might an alternative better serve US interests? The tremendous growth in US investment in China (now over $3 billion) suggests that American investors are undeterred by the lack of an investment protection agreement. Companies have found that Chinese laws, regulations, and contract terms provide adequate protection. In fact, the two governments seem more interested in concluding an agreement for their own reasons than on behalf of the business community whose interests they purport to represent.

The Chinese want an agreement because it would appear to put a US government "seal of approval" on investing in China. The US government, on the other hand, wants to preserve the purity of its model BIT agreement. Under these circumstances it is clear that the chances of concluding a treaty both governments can accept are remote.

A better alternative is to accept that the treaty cannot be negotiated at this time, and settle instead for an "agreed minute." The minute would spell out the areas of agreement and disagreement, the protections China is prepared at this point to grant, and guarantee that American investors would continue to receive most favored nation (MFN) treatment and would not be discriminated against vis-a-vis investors from countries that have investment treaties with China. While it would not bind either side, a minute would at least give the business community a clearer picture of what protections China is prepared to grant foreign investors at this time. It would also represent a step forward in the expansion of US–China commercial relations, and prevent potentially damaging wrangling over failed negotiations.

China's accession to GATT

China formally expressed its desire to rejoin the General Agreement on Tariffs and Trade (GATT) in early 1987 (*see The CBR*, May–June 1988, p. 32). US government negotiators have maintained that in order for China to accede to GATT, China must institute a national trade regime that is consistent nationwide, without special enclaves like the open cities and SEZs; establish a system of foreign trade law that is public and clear to overseas trading partners; remove nontariff trade barriers; implement scheduled and verifiable price reform; and adopt selected safeguards that allow other GATT contracting parties to claim market disruption against China. China has basically agreed to the first three points, but the last two, particularly pricing, remain problematic.

China's own GATT agenda includes resumption of GATT contracting party status; acquisition of less developed country (LDC), market economy, and permanent MFN status; and accession to the Generalized System of Preferences (GSP).

The Chinese wish to resume rather than accede to contracting party status in GATT, in order to face less stringent restrictions. Likewise, recognition as an LDC would result in more tolerance within GATT for steps China takes to protect its balance of payments position. Recognition as a market economy would enable China to avoid import commitments in exchange for GATT participation, and negotiate on tariffs instead. As China's current tariff classifications are very broad, however, granting specific concessions is difficult, and therefore may not appreciably help foreign exporters.

The United States is the only major country not to have granted China GSP treatment, which is requisite for GATT membership and MFN status. GSP would give China substantial tariff reductions on exports to the United States.

Understandably, the Chinese are trying to gain maximum benefit for minimum concessions. The Bush Administration must continue to exert strong pressure on the Chinese accession process to ensure that China does not disrupt the GATT regime or give too little in exchange for GATT benefits. Allowing China to enter the GATT without concrete price reform obligations, for example, will distort the GATT system and set a dangerous precedent for future accessions, particularly that of the Soviet Union. The United States should acknowledge China's desire for resumption, LDC, and market economy status *only* if China adequately demonstrates that its foreign trade regime is GATT-compatible, and that it will provide a combination of meaningful tariff concessions, import commitments, and improved foreign trade record-keeping with more detailed statistical and tariff data.

Foreign exchange

China's renminbi (RMB) currency is seriously overvalued, as indicated by the existence of various exchange rates, both official and unofficial. The official rate is ¥3.72/$1, but foreign investors in China with RMB profits are compelled to exchange RMB at rates around ¥7/$1. Importers are having trouble sourcing Chinese goods for export, as domestic Chinese buyers are offering ¥7 or ¥8/$1 for potential export products, while the foreign trade corporations with which importers sign contracts can offer domestic enterprises only ¥1 or ¥2 above the official rate.

The existence of multiple exchange rates is not GATT-compatible. The administration should urge the Chinese to devalue the currency as quickly as possible, with a long-term goal of free and full convertibility.

Concessionary financing

Over $10 billion in concessionary loans from 20 countries has been committed to China. As most of the loans are tied to the purchase of goods from the lending country, the United States, as the only major industrial nation that does not have such a concessional loan or mixed credit program, is at a competitive disadvantage.

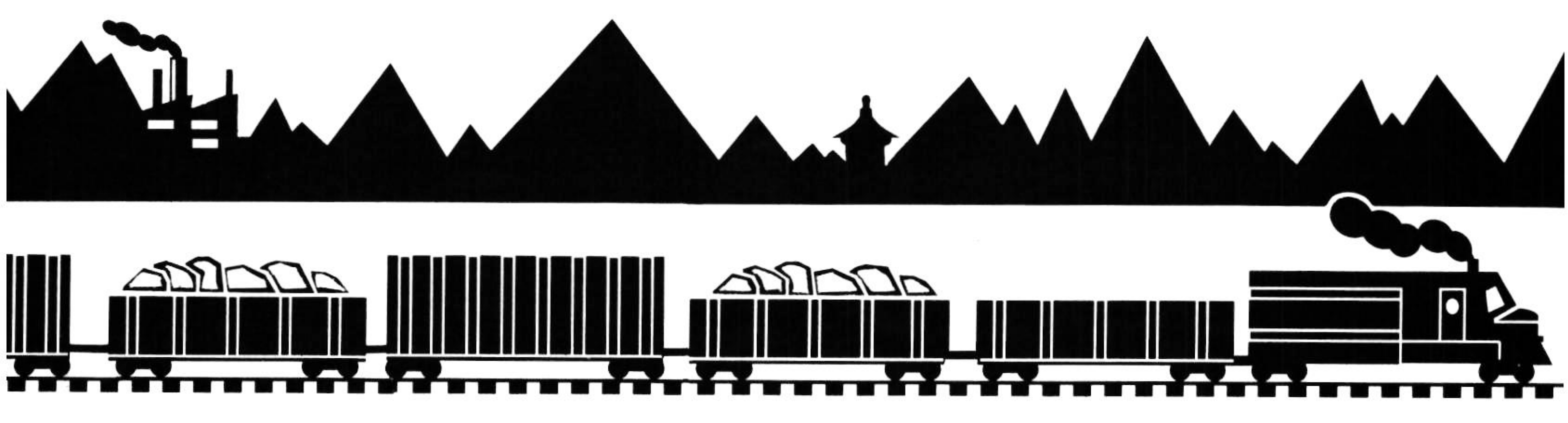
The Reagan Administration sought to reduce the advantages these programs gave other countries through an agreement in the Organization for Economic Cooperation and Development (OECD) that called for untied loans and advance notification. However, the agreement has failed to make significant changes in the margin of commercial advantage. The United States government, therefore, should take action to initiate a concessional trade finance program.

US financing need not be as lavish as that provided by other countries, but should be targeted at industries in which the United States is competitive, such as power equipment, telecommunications, and chemicals, and for which the China market will be competitive in the future. Some money should also be allocated to assist competitive small and medium-size projects.

The Council's work continues

US–China commercial relations have made substantial progess since normalization 10 years ago, and there is every reason to believe that the second decade will see even more dramatic growth. US companies are aware that much of the responsibility for becoming or remaining competitive in the China market falls on them. But the best efforts of companies cannot succeed if the Chinese and American governments act in such a way as to place US companies at a competitive disadvantage, or place obstacles in the way.

The Council will continue to work with the Chinese, both directly and through the US government, to improve the business climate in the PRC. The Council will also press the Bush Administration and the US Congress to create a legal, regulatory, and policy climate here conducive to competitive participation in the growing China market. 完



Du Guodong Picks up Promotional Tips for TEDA

Michael D. Swaine

Radiating warmth and enthusiam, proficient in English and promotional techniques, Du Guodong represents a new breed of Chinese official. As deputy director of the Industry Development Department of the Tianjin Economic-Technological Development Area (TEDA) being developed near Tianjin, Du is charged with attracting foreign investors to locate production facilities in TEDA. As part of the development area's escalating efforts to attract foreign investment, he recently spent over three months at the San Francisco headquarters of Unison International, a trade, investment and consulting firm active in China. Two other San Francisco-based firms, Houle & Associates and C.K. Consultants, joined Unison in a year-long project funded by the US government's Trade and Development Program (TDP) to improve TEDA's land-use planning and marketing operations. The three companies helped devise strategies for attracting foreign investors, and participated in the actual promotional effort along with Du Guodong. Unison Chairman C.B. Sung found that "Du Guodong symbolizes TEDA's overall approach to promotion and the positive, enthusiastic attitude of its leadership."

Since TEDA was established in late 1984, a 4 square kilometer area—or about one-tenth of TEDA's total area—has been developed. Located about 100 miles from Beijing, 30 miles from Tianjin city, 3 miles from the industrial city of Tanggu and close to airports, railway lines, Tianjin port, the Dagang oil field, and a vast hinterland of raw materials, TEDA has invested about $120 million in infrastructure to provide support for the 200 foreign-invested manufacturing enterprises it hopes to attract by 1990.

Photo courtesy of Unison

Du Guodong points out TEDA features that may interest foreign investors.

Exploring business abroad

Trained in Tianjin as a semiconductor engineer, Du Guodong became familiar with Western technology and business practices during years of travel abroad for the Tianjin No. 4 Semiconductor Factory, a leading Chinese manufacturer Du joined in 1965. Between 1979 and 1984, Du visited the United States, Japan, West Germany, France, and Singapore to survey state-of-the-art semiconductor manufacturing and technology, and to facilitate its importation into China.

Du's background made for a good fit between him and TEDA, which focuses on attracting Western high-tech manufacturers. Du joined TEDA's advanced technology department in 1984, and was charged with negotiating high-tech ventures inside the development area in which TEDA itself had invested, now numbering about 50. Du also directed support and service operations for existing TEDA enterprises. His major activity, however, was promotional work, since TEDA's top leaders had recognized early on the importance of marketing. When Du's department was absorbed by TEDA's industrial development department in 1987, he was made deputy director, continuing his former activities and placing greater emphasis on promotion in response to increased competition for foreign investment among special development zones both in China and elsewhere in Asia.

Smiles and quick responses

As part of the TDP project, Du was sent to the United States this year to promote TEDA opportunities to potential investors. Naturally energetic and amiable, Du learned to make effective approaches American-style. After dealing with people in various Western countries, Du notes that "Each has their style of doing things, but I genuinely prefer the American approach—more personal, direct and realistic, and yet friendly and relaxed." He attributes to his contact with Americans his disarming sense of humor, saying, "I have found the most valuable trait I've developed while in the US is a sense of humor in business encounters. Humor always helps to take the edge off a possibly tense situation!"

In addition to a friendly approach, Du was also impressed by the fact that effective promotion work requires quick responses to company requests for information, and frankness in transmitting that information—an area in which foreigners and Chinese don't always concur. "You need an open, transparent approach in dealing with interested companies, hiding nothing and leav-

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Michael D. Swaine works on trade and joint venture development for Unison International and was extensively involved in the TEDA project. He holds a Ph.D from Harvard University and is an expert on China's political economy.

ing no surprises for the future. If we can't do something, or if something will present a big problem, we say so up front." Du was aided in his direct mail efforts, presentations, and company contacts by the TEDA staff in Tianjin, who supplied Du with the information prospective investors sought, especially details on potential Chinese joint venture partners.

Learning from capable competitors

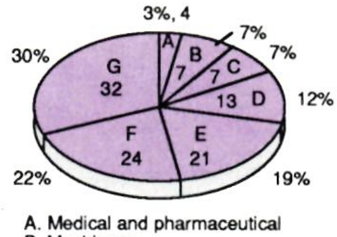
Since TEDA may eventually establish a permanent overseas presence, Du visited the US representative offices of other Asian foreign investment areas to see how they handle promotion. One point reinforced by the San Francisco office of the Singapore Economic Development board—which is staffed by three people—is that an effective overseas promotion presence can consist of a few capable people, in contrast to typically overstaffed but often inefficient Chinese offices. When TEDA's promotion staff expanded from 20 to 90 between 1985 and 1987, Du says "We soon learned that it's not the numbers, but the quality of the people involved that counts." TEDA's promotion staff has since been reduced to around 15 people, and may be streamlined even further.

Du's trip brought home to him that maintaining an effective overseas presence is the key element in foreign investment promotion, and demands a tremendous amount of time and effort. "Permanent US investment promotion representatives for places like Singapore spend a lot of their time simply following up on contacts made long before, just to keep things alive with companies that have initially expressed an interest in investment but have yet to make any sort of decision. It is time-consuming but very essential work."

Plans and improvements

TEDA's 116 joint venture and wholly foreign-owned venture contracts signed to date comprise one-third of all Sino-foreign joint ventures located in China's 14 economic-technological development areas, and total nearly $150 million of investment. Hong Kong leads with 57 joint ventures and wholly foreign-owned enterprises, while the United States has invested in 20 and Japan in 15. The ventures will manufacture products ranging

CATEGORIES OF INDUSTRY IN TEDA
By percent and number of ventures



A. Medical and pharmaceutical
B. Machinery
C. Building material and hardware
D. Non-manufacturing
E. Electronics and electrical
F. Chemicals, foodstuffs, cosmetics, and plastics
G. Light industrial (apparel, textile, shoes and sporting goods)

SOURCE: TEDA

from bicycles, ceramic tiles, and pharmaceutical equipment to various electronic items, including computerized telephone switches and semiconductor devices.

To attract further foreign investment, Du would like TEDA to offer better incentives, support services, and facilities for foreign investors, simpler joint venture approval procedures, more freedom for enterprises, and a more knowledgeable labor force. And he would start by improving his own staff. "Many of our promotion people in Tianjin still rely too much on interpreters in their contacts with foreign businessmen, and this creates a bad impression. There is also a great need to be personable and well-dressed. We often tell our people that they should be more concerned with their appearance and general behavior. This has a lot to do with TEDA's image."

Improvements will be necessary to achieve Du's ambitious goals. "I want to see TEDA serve as the base for a technological and industrial center in Tianjin, offering a broad range of manufacturing capabilities that are competitive with those found overseas. I know how far [China] must go to be truly competitive on a global level. But I believe we can do this in TEDA by attracting a larger number of enterprises making high-technology products that can meet world standards. Our goal is not just to earn foreign exchange through exporting, but to raise China's overall level of industry and technology. This is also my life's goal."

Du plans to continue improving his English skills and learning about investment, trade, production, and promotion. If other officials adopt Du's approach, China's global competitiveness is bound to rise along with the level of foreign investment.

Legal Lessons in Aircraft Leasing

The breakup of CAAC's monopoly is creating more opportunities—and possible pitfalls—for foreign aircraft lessors

Ellen R. Eliasoph

To many involved in China trade, mention of China's air transport system conjures up images of infuriating ticketing personnel, hours spent fuming in filthy airports waiting for planes that never arrive, and bizarre in-flight occurrences such as live chickens in the aisles. Horror stories about the Civil Aviation Administration of China (CAAC) form part of the stock repertoire of every experienced China hand.

Yet foreign aircraft company executives may see a different picture. In recent years, the rapidly modernizing CAAC system has afforded substantial business opportunities to manufacturers and financiers of commercial aircraft and related equipment. Indeed, the aerospace industry has been one of the bright spots of China trade since 1985, when China's State Council initiated major reforms of the air transport system.

The reforms aim to break up CAAC's long-held air transport monopoly by reallocating its air route empire among six regional carriers, encouraging the formation of new independent airlines, developing additional routes, and expanding and modernizing the entire system (*see* box). CAAC will become the administrative agency in charge of the system, playing a role somewhat similar to that of the US Federal Aviation Administration.

Following announcement of the reforms, China's purchases of foreign-made aircraft surged dramatically (*see The CBR*, July–Aug 1986, p. 36, and Sept–Oct 1987, p. 34). Many of these purchases have been financed through cross-border leasing transactions, while some aircraft that were originally purchased for cash have been refinanced on a sale and lease-back basis. According to CAAC's Department of Finance, since 1980 CAAC has entered into approximately 60 lease agreements for aircraft in the Lockheed L-100 or larger size range. As of year-end 1988, the estimated value of CAAC's leases of foreign aircraft totaled $1.45 billion.

Intricate transactions involve many parties

Unlike Chinese leasing arrangements involving smaller types of equipment, in which Chinese leasing companies often deal directly with Chinese lessees, most of China's aircraft leasing transactions have been cross-border leases involving lessors from Hong Kong, Japan, the United States, and elsewhere. The classic cross-border leveraged lease transaction involves at least three parties—an owner-lessor, a lessee, and one or more lenders (who provide the long-term debt financing that the lessor uses to finance the purchase of the aircraft). It is a heavily tax-motivated arrangement in which the lessor, as owner of the aircraft, has traditionally been able to obtain tax benefits in its own country (through the use of depreciation allowances) and pass some of these savings on to the lessee in the form of lower rental costs. The attractive pricing that results from such arrangements is the major factor driving Chinese airlines to choose cross-border leasing over domestic leasing or straight purchase options.

According to CAAC officials, the typical leasing transaction involving one of CAAC's regional airlines generally takes the following pattern. First, the lessee must obtain approval from both CAAC and the State Council of its proposal to purchase an aircraft. After the proposal is approved the lessee can begin to negotiate the purchase contract with the foreign aircraft manufacturer. Although in principle the regional airlines have the right to negotiate on their own behalf, they are often represented by the China Aviation Supplies Corporation (CASC), which acts under authorization from CAAC to negotiate and sign the contract. After the purchase contract is signed, CAAC and the airline determine the optimal means of financing—cash, loan, or lease. If the lease option is selected, the rights to the purchase contract are assigned to the entity that will enjoy the legal and tax benefits of ownership during the term of the lease contract. The lease contract is then negotiated by the leasing office of the CAAC Finance Department and signed by the airline, often with CAAC acting as a co-signer.

Most of the leases signed with CAAC and the CAAC airlines have been finance leases, and have given CAAC—or, in some cases, CASC acting on behalf of one of the CAAC airlines—the right to purchase the aircraft during or at the end of the lease term, which is generally 10-16 years. Semi-annual rental payments are normally required.

Despite the recent reorganization of the CAAC airlines into distinct corporate entities, it is obvious that CAAC remains deeply involved in the procurement process. In fact, according to CAAC Finance Department officials, the foreign exchange used to pay for aircraft purchases is still centrally controlled by the Finance Department, and is released to

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the regional airlines only for purchases approved by the department.

Approval procedures for independent airlines . . .

Most of the new independent airlines formed in the mid-1980s do not require CAAC approval for aircraft procurement decisions. Instead, they must file project proposals with the local government agencies in charge of their operations. If the new airline does not have authority to use its foreign exchange earnings on its own, it must obtain approval from the State Administration of Exchange Control (SAEC) to make lease payments in foreign exchange.

Despite decentralization, however, CAAC has still been able to influence the development of the independent airlines. In some cases inexperienced new airlines, such as Xiamen Airlines, have specifically asked for and received CAAC assistance in structuring and negotiating leases with foreign companies. But at other times CAAC has tried to impede the progress of potential competitors. Although tension between CAAC and the independent airlines undoubtedly persists today, this was particularly true during 1985–87, when the newly formed entities were unsure about the scope of their operating authority and legal power. The experience of Shanghai Airlines, the first airline to be established without any investment from CAAC and to be run independently of any CAAC management assistance, offers an example.

. . . allow for undue central influence

In 1985 Shanghai Airlines, bypassing traditional CAAC procedures, purchased five used Boeing 707s from the United States for cash. Subsequently, it was widely reported that CAAC "retaliated" by using its control over China's air route system to deny the planes permission to fly. During the year it took to resolve this conflict, Shanghai Airlines had little to do besides select and train its flight crews and attendants.

It is widely rumored that Zhao Ziyang himself had to step in to settle the dispute. In 1987 the airline was finally permitted to fly its planes on Shanghai–Guangzhou and Shanghai–Beijing routes, as well as for some chartered flights. But this service was discontinued in March 1988 due to government orders, prompted by an air crash in Chongqing, that restrict the use of old aircraft. Shanghai Airlines has now sold the 707s and suspended all service pending acquisition of three new Boeing 757-200s, scheduled for delivery in 1989 and 1990.

Although the actual story of the Shanghai Airlines–CAAC dispute is undoubtedly more complicated than one of defiance and revenge, it is likely that rivalry between the two parties served to exacerbate any already existing problems, as Shanghai Airlines clearly intends to compete aggressively for a large share of the business in the greater Shanghai region, China's fastest-growing aviation hub.

CAAC's control over the issuance of import licenses for foreign aircraft may afford it an additional opportunity to influence the development of independent carriers. The foreign parties to lease contracts should confirm before signing that the lessee has obtained, or will be able to obtain, such an import license.

In short, because CAAC's commercial and administrative functions have not yet been clearly separated, the possibility for abuse of its administrative authority remains. This situation should improve as CAAC's role as administrator of the air traffic system becomes better defined, and as all parties concerned become accustomed to competition in a sector where absolute monopoly once reigned. But in the meantime, lessors and lenders dealing with any of the independent airlines should regard the possibility of CAAC obstructionism as a practical risk, and should seek to obtain realistic information on the status of the lessee's operations.

Assessing the status of Chinese lessees

As China's aviation sector becomes increasingly decentralized, many newly formed entities are taking part in leasing transactions. Their relative inexperience is bound to result in some confusion regarding business and legal issues. Foreign parties should take care to ascertain the legal status of potential lessees and, where more than one entity is involved, find out which is ultimately responsible for performing the contract. By examining the lessee's constituent documents, one can determine whether the airline has independent corporate existence and the legal authority to enter into agreements directly with foreign companies. It is also critical to determine the extent of the airline's access to, and control of, foreign exchange.

Likewise, foreign lenders and lessors should now pay closer attention to financial guarantees. To date, the Bank of China (BOC) has provided guarantees for all aircraft lease transactions. But as the regional airlines begin exercising their autonomy and aircraft procurement activity becomes dispersed, other institutions can be expected to begin acting as guarantors.

If BOC is not the guarantor, lessors and lenders should confirm that the guarantor is one of the 100 or so entities that are authorized by the SAEC to issue foreign exchange guarantees. In addition, because neither the SAEC nor the People's Bank of China (PBOC) is legally obligated to honor a guarantee issued by one of the authorized institutions, it would be prudent to confirm the creditworthiness of any proposed guarantor. Lessors and lenders should also make sure that their transactions conform to China's legal requirements relating to the issuance of foreign exchange guarantees (*see The CBR*, Jan–Feb 1988, p. 40).

Familiar contracts with unexpected twists

Although Chinese negotiators in other fields have made known their preference for short, simple contract documentation in Chinese, aircraft leasing seems to be a different case. Although experience has varied, CAAC has generally been willing to agree to documentation quite similar to that used in cross-border transactions carried out elsewhere. This relatively accommodating attitude likely stems from China's awareness that, if it wishes to obtain the aircraft it needs, it must "play ball" with manufacturers, lessors, and lenders on their own terms. In addition, the sheer complexity of the documentation used in these transactions would discourage even the most zealous negotiator from attempting to deviate to any significant extent from standard formats.

The representation and warranties, closing conditions, covenants, and events of default in the cross-border leasing documentation used in China have been roughly compatible with international standards, and the documentation has usually been in English. Even the sensitive issues of governing law and consent to suit outside of China have been resolved in a manner deemed satisfactory by foreign parties. In leasing transactions to date, CAAC has accepted Hong Kong, Japanese, New York, and British governing law, and on a number of occasions has consented to the jurisdiction of foreign courts for dispute resolution purposes.

Foreign parties should not, however, be lulled into a false sense of security when leasing transactions appear to be structured and documented in a fairly conventional manner. Because legal and procedural considerations specific to China can be a serious stumbling block, lessors and lenders should take care to ensure that contracts address such issues.

Registering leases and planes

All lease contracts must be registered with the SAEC pursuant to the 1987 Interim Provisions for the Monitoring of Statistics on Foreign Debt, which define "foreign debt" to include cross-border financial leasing. Registration must be carried out at the local exchange control bureau within 15 days after the contract is signed. Failure to register can result in fines and inability of the lessee to remit rental payments overseas.

The 1987 Regulations on the Control of Airworthiness of Civil Aircraft contain detailed stipulations concerning aircraft registration, and are administered by CAAC through the central Aircraft Registry. Although one article in these regulations requires that civil aircraft to be flown within China must obtain a certificate of airworthiness from CAAC, another article says that if a foreign civil aircraft is leased, CAAC may "examine and approve the certificate of airworthiness issued by the country in which the aircraft was originally registered." In practice, however, CAAC requires new planes to obtain Chinese certification. The airworthiness certificate must stipulate the type of activities for which the aircraft is to be used, the term of effectiveness of the certificate, date of expiration, and any conditions and restrictions relating to safety.

Another article requires civil aircraft to be flown within China to possess a nationality registration certificate issued by CAAC. But this same article adds that civil aircraft registered in China "shall have People's Republic of China nationality," a problematic point for those foreign lessors that, out of concern for their ability to perfect and exercise security interests, prefer to maintain the foreign registration of leased aircraft. CAAC strongly resists this approach, however, and has reportedly even reviewed some past transactions with a view toward convincing the parties to de-register aircraft that are registered in foreign jurisdictions, and re-register them in China.

Sensitive security and mortgage issues

As more players get involved in aircraft leasing and foreign lenders begin to obtain their payment guarantees from organizations other than the BOC, lessors and lenders will likely seek additional ways to create effective security interests, rather than relying primarily upon payment guarantees. This prospect entails an additional set of China-specific legal considerations.

China has no central registry dedicated to the recording of security interests, and regional provisions such as those of Shanghai or the Shenzhen Special Economic Zone, while providing for the registration of security interests in moveable assets, generally apply only to assets that are physically situated in, or owned or operated by, companies based in the areas in question.

Nonetheless, China's rudimentary legal framework for creating and recognizing security interests, can—and has—been used to provide lessors and lenders some satisfaction. The major national law addressing

CHINA'S DEVELOPING TWO-TIER AIR TRANSPORT SYSTEM

The breakup of the CAAC monopoly has created two tiers of civil aviation companies. One group, which still looks and acts very much like CAAC, consists of six regional entities taking over CAAC's routes:

- Air China International, based in Beijing, will operate many of the major international routes, service to Hong Kong, and some domestic routes;
- China Northwest Airlines, based in Xi'an, will provide domestic service, focusing primarily on cargo transport;
- Shanghai Eastern Airlines, based in Shanghai, will operate service to Japan and Hong Kong and will also fly some domestic routes;
- China Southern Airways, based in Guangzhou, will operate domestic air routes and service Hong Kong and Southeast Asian countries;
- China Southwest Airways, based in Chengdu, will fly domestic routes and will provide service to Tibet, Burma, and Thailand;
- China Northwest Airways, based in Dalian, will primarily provide domestic service.

According to CAAC officials, as of December 1988, only Air China International, Shanghai Eastern Airlines, and China Southwest Airlines had actually been organized. The other three airlines are expected to be formed by mid-1989. The official emphasized, however, that until CAAC's administrative and commercial functions are completely separated, CAAC will maintain control over many important commercial decisions affecting the six airlines, such as plane procurement.

The second tier of China's civil aviation system consists of a variety of regional airlines and air service companies that have no direct antecedents in the CAAC system and were formed, for the most part, after 1985. Three of these entities—the Xinjiang Civil Aviation Company, the Yunnan Aviation Company, and the Heilongjiang Aviation Corporation—are joint ventures between CAAC and the respective provincial authorities. Eight other regional companies, formed primarily with local capital, appear to be poised to compete with the six CAAC airlines in some regions. These airlines are based in Beijing, Shanghai, Guangzhou, Shenyang, Chengdu, Xian, Lanzhou, and Dalian.

Other new airlines have been set up to provide specialized services. They include entities such as the Industrial Aviation Services Corporation, based in Taiyuan; the Guangzhou Helicopter Corporation; the China Ocean Helicopter Corporation, located in Shenzhen; the China Capital Helicopter Corporation, headquartered in Beijing; the Flying Dragon Professional Aviation Corporation (engaged in geological investigation, mine exploration, and chemical spraying); and the Rising Dragon Goods Transport Corporation. Many more specialized airlines are likely to be established in the years to come.

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security interests is the 1986 General Principles of Civil Law of the PRC (the "Civil Code"), which provides in general terms for the creation and recognition of security interests. Additional support can be found in regional provisions, various specific procedures that have been formulated by several major Chinese banks, and the broad provisions of the Law of the PRC on Contracts Involving Foreign Interests relating to the validity of contractual obligations.

In a cross-border leveraged lease transaction, the principal security agreement is likely to be a mortgage between the lender and lessor, but the lease agreement with the Chinese lessee may also provide for the lessor's right to repossess the aircraft if the lessee defaults. If the mortgage document is a foreign law agreement between the lender and the lessor, it is advisable to have the Chinese lessee sign it as a witness and issue a letter of awareness stating that it knows of the mortgage and will honor it. The lease agreement should also refer to the mortgage, explicitly providing whether the lease is terminable upon default and foreclosure under the mortgage, and if applicable, acknowledging that the mortgagee has a first priority lien on the aircraft. In addition to carefully recording the details of the mortgage when registering the aircraft at the Aircraft Registry, the parties to a lease transaction should notify all relevant Chinese entities of any mortgage and other security interests that have been created.

The assignment of contract rights, insurance proceeds, and other sums payable to the lessee is another form of security that is often required by foreign parties involved in Chinese aircraft leasing transactions. In such cases, the assignment documents are typically governed by foreign law. However, foreigners should be on notice that the law governing the powers of Chinese parties to assign contract rights to foreigners remains somewhat unclear and therefore must take special care to ascertain and implement all procedures required to render such assignments effective under Chinese law.

Tax preferences . . .

Chinese taxation practices demand special attention from foreign parties involved in leasing transactions in China. A host of legislation detailing


Photo courtesy of Boeing

Xao Guobin, president of Xian Aircraft Factory, and Jim Johnson, vice president and general manager of the 737/757 Division of Boeing Commercial Airplanes, examine the first Chinese-made vertical fin to be installed on a Boeing 737, delivered in March 1988.

both tax reductions and increases has been introduced, but some areas are still not clear. Therefore, careful coordination with the Chinese lessee is required to maximize potential to qualify for exemptions and to minimize the tax burden on foreigners.

Assuming that the lessor is a foreign company with no taxable business establishment in China, the lease payments will be subject to taxation on a withholding basis under the PRC Foreign Enterprise Income Tax Law (FEITL). The FEITL regime provides for a 20 percent tax on rentals, interest, and certain other types of income derived by a foreign entity with no permanent establishment in China. Pursuant to regulations issued by the Ministry of Finance in 1983 and the subsequent "Interest Regulations," the 20 percent tax on interest and rentals was reduced to 10 percent through 1990. Accordingly, many of the bilateral tax treaties China has concluded with foreign countries, including the United States, United Kingdom, and Japan, set the maximum withholding tax rate on rentals and interest at 10 percent.

In addition to reducing the withholding tax rate, the Interest Regulations provide preferential tax treatment for international lease-financed equipment purchases. The Interest Regulations treat the leasing fees as having three components: one portion of the fees is attributed to the purchase price of the equipment; a second portion is attributed to interest, or the lessor's cost of funds; and the remainder is attributed to the "spread"—the lessor's real profit. The portion attributed to the purchase price of the equipment is exempted from tax if the lessor can demonstrate that the interest does not exceed the interest rate on buyer's credits charged by the state banks of the lessor's home country. The remaining portion is subject to withholding tax at 10 percent.

The Interest Regulations also provide that leasing income derived from transactions involving compensation trade will by exempted from withholding tax.

. . . and pitfalls

In addition to the tax on rental income, there are other potential liabilities of which foreign parties should be aware. China's Interim Stamp Tax Regulations, effective since October 1, 1988, may sharply increase the costs of concluding cross-border lease agreements. The Regulations provide that stamp tax is payable on leasing contracts, including those for aircraft, at the rate of .1 percent of the lease. Moreover, the tax is not to be split among the parties to the contract, but is to be paid by each of the lessors and the lessee on the full value of the contract.

A variety of certificates received from Chinese governmental authorities are also subject to the stamp tax. Although Ministry of Finance officials have advised in private discussions that pending formulation of special rules for foreign-related transactions, such transactions will temporarily be exempt from the tax, lenders and lessors should certainly take it into account when requesting tax indemnities from Chinese lessees.

Finally, unless an exemption is obtained, it can be expected that Chinese customs duties and consolidated industrial and commercial tax will be levied upon the importation of aircraft. These fees are generally borne by the lessee-purchasers.

Negotiating tax reductions

In aircraft leasing transactions, it is standard international practice for the lessor to seek broad tax indemnities from the lessee to cover potential taxes in all jurisdictions in which the aircraft will be operated, and to protect the lessor in the event that it cannot obtain or maintain the tax benefits it expects to realize from the transaction.

One common form of indemnity is a provision that the lessee will increase (or "gross up") its payments to the lessor in the event a tax is imposed on the rental fees, in order to ensure that the lessor receives, on an after-tax basis, the full amount of the fees as specified in the contract. Even when Chinese lessees agree to such tax indemnity language, the extent to which it is enforceable under Chinese law is not entirely clear.

China's Ministry of Finance has long objected to gross-up provisions on the ground that it is unfair to shift the tax obligations from foreign taxpayers to Chinese entities, and has generally maintained that such provisions are unenforceable. Accordingly, in some loan transactions, local tax authorities have prohibited Chinese borrowers from making the grossed-up interest payments called for by their loan agreements. Yet it appears, on the other hand, that certain borrowers—including the BOC—have been exempted in practice from this policy.

If local and central tax authorities designate a lessee or a particular transaction as qualifying for preferential treatment, it may be possible to negotiate reductions—or even exemptions—from Chinese taxes. These may be granted to the airline with respect to its own income, or they may be broader, covering the rental payments to be received by the foreign parties.

In view of the importance of the airline industry, Chinese tax authorities may be willing to give China's airlines relatively free rein to negotiate agreements containing clauses that conform to those commonly found in international practice. Foreign parties involved in leasing transactions should find out whether the lessee has received permission to implement such clauses and, if not, should work with the lessee to obtain them.

Examining the fine print

Foreign lessors and lenders, relieved to find that the aircraft leasing documents they negotiate in China look "international," may be tempted to overlook the specific quirks of China's legal environment. But in the past few years, China's legal framework for leasing has become better articulated, requiring lessors and lenders to pay more attention to legal and procedural details. At the same time, the decentralization of China's air transport industry has brought a host of new players into the process, which requires increased vigilance in such matters as corporate identity and authority, approval procedures, and creation of security interests. As aircraft leasing in China continues strong into the next decade, foreign lessors should continue to closely monitor the rapidly changing environment for both new opportunities, and new legal requirements and procedures. 完

Leasing Update

A range of problems make this a difficult area for US companies—but a few have persevered

Sharon E. Ruwart

Aircraft deals are only the most visible examples of foreign involvement in China's leasing activities, which have expanded to encompass virtually all sectors since China first ventured into leasing in 1980 (*see The CBR*, Jan–Feb 1986, p. 29). One Chinese leasing source estimates that the value of leased equipment in China jumped from virtually zero in 1981 to over $5 billion in 1988, with up to $10 billion worth of additional output value generated by the leased equipment.

Sino-foreign leasing joint ventures account for nearly half of China's 50 leasing companies, and most of the foreign partners in these joint ventures are Japanese and European banks and companies. Legal, technical, and financial problems on both sides have so far prevented all but a few US companies from taking advantage of China's leasing boom. US companies that are currently involved in leasing activities stress that patience and realistic long-term expectations are vital to establishing a presence in China's leasing sector.

Different approaches to leasing

The main obstacle to increased US activity in the China leasing sector is a fundamental difference in the way each country regards and practices leasing. For Chinese enterprises, leasing is simply a useful mechanism for extending the payment schedule for equipment purchases—as with aircraft, for example. Chinese leasing companies are charged with identifying enduser needs, finding a source, negotiating the purchase of equipment, and importing it. At the end of a lease, the enduser nearly always purchases the equipment.

US leasing contracts, on the other hand, contain many more options than straight purchase, allowing, for example, the exchange of equipment at the end of a lease. Many US lessors seek to remarket equipment that comes off-lease without being purchased by the initial enduser, whereas most Chinese enterprises today are not interested in leasing used equipment. In general, the greater complexity of US leasing deals—in terms of tax arrangements, accounting practices, and end-of-contract options—means greater risk for US lessors, and therefore expectations of greater profit margins than Chinese endusers usually will agree to. US interest rates, roughly double today what Japanese and European lessors can offer in China, further erode the US lessors' potential to offer financing arrangements that are mutually attractive to lessor and lessee.

The main obstacle to increased US activity in the China leasing sector is a fundamental difference in the way each country regards and practices leasing.

The success in China's leasing sector of Japanese organizations, which have investments in 75 percent or more of the Sino-foreign joint venture leasing companies, derives in part from the resemblance between the Chinese and Japanese views toward leasing. "Japan tends to see leasing as an extension of product sales to China. A Japanese bank will invest in a leasing company that finances the purchase of Japanese goods, often from the same industrial group to which the bank belongs," according to John Krafft, general manager of China Nonferrous Leasing Corporation (CNLC). Krafft's employer, Los Angeles-based First Interstate Bank Corporation of California, holds a 20 percent stake in the leasing joint venture.

Chinese for their part admit that they do not fully understand the complexities of leasing American-style. Li Heilang, general manager of Shanghai International Leasing Co. Ltd., says, "Mutual understanding is so far insufficient for both sides to do business. We do not understand all of the techniques used in the international leasing market. US companies handle the matters of residual value and maintenance quite differently from Chinese companies, for example. Both sides need to make compromises in order to cooperate more."

A range of practical problems

A range of practical problems compound the difficulties created by differing concepts of leasing. For example, China's time-consuming approval procedures—which for leasing deals involve the enduser's department in charge, the local arm of the Ministry of Foreign Economic Relations and Trade (MOFERT), guarantor banks, and customs authorities—add to the cost of doing business and further erode the already-slim profit margins US lessors stand to gain.

Obtaining adequate guarantees for deals from Chinese banks can also prove problematic for foreign les-

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sors. Long the exclusive preserve of the People's Bank of China (PBOC), guarantor rights have now been extended to a number of banks authorized to deal in foreign currency—some of which may not be reliable. San Francisco-based ATEL Financial Corporation, a leasing company interested but not yet involved in the China market, has seen several deals die because the promised guarantees did not pass credit checks.

Other obstacles facing all foreign firms include Chinese accounting regulations, which do not clearly designate ownership of leased assets, and also prevent lessors from taking tax deductions on equipment depreciation. The need for substantial legislative action to address these and other problems leave them unlikely to be resolved soon.

Lack of legislation

Both the US and Chinese leasing communities agree that China's leasing environment would be greatly enhanced by the promulgation of national leasing legislation. Chinese policymakers are currently reviewing the fifth draft of a leasing law, but major disagreements between the Chinese government and the leasing corporations have stalled progress.

The differences center around control over the industry. To meet growing market demand, leasing companies want more control over capital to facilitate purchases of equipment. Rather than waiting for an enterprise to win approval to lease the equipment, the leasing company could have equipment already on hand and then actively market it to enterprises. Chinese lessors would also like to see the formation of a national leasing organization to regulate the industry, rather than the cumbersome current system involving MOFERT, customs authorities, and banks.

Beijing is unwilling, for now, to relinquish control over the industry. While Chinese lessors regard the current draft version of the law to be more complete and satisfactory than past attempts, it is unlikely to be promulgated any time soon.

Modest investments and expectations

Those US companies that have become involved in China's leasing sector have done so via modest investments in joint ventures that have allowed them to get to know the market slowly and thoroughly, without heavy emphasis placed on short-term profitability. For example, First Interstate Bank of California's stake in CNFL in Beijing represents 20 percent of the venture's $3 million total capital. And GATX Leasing Corporation of San Francisco holds a 2 percent share of Tianjin International Leasing Company (TILCO), which has total capitalization of $5 million.

CNFL, which has been in operation since February 1985, has four part-

ANATOMY OF A LEASING DEAL

The following describes the progress of a typical deal arranged and partially financed by China Nonferrous Leasing Corp. (CNFL), a Sino–foreign leasing joint venture with a 20 percent share held by First Interstate Bank of California. The Chinese lessor is an aluminum foil production company. CNFC made all arrangements to import all three pieces of equipment, and financed one of them.

1. In 1986, the Chinese aluminum company decided to replace an aging aluminum foil production line with a rolling mill, separator, and grinder for a total cost of around $6 million. This technical renovation project was approved by the China National Nonferrous Metals Industry Corporation (CNNC) under its own authority.

2. The company proceeded to sell the old line for renminbi (RMB), which it exchanged for US dollars in a swap center to buy a foreign grinder and separator, and to make a down payment on a foreign rolling mill. The company then approached CNFL to finance the rolling mill with a lease.

3. CNFL examined approval documents, including the preliminary feasibility study, evidence of availability of guarantee, and CNNC approvals, and discussed the leasing procedures and costs with the enduser. In March 1987, the enduser paid a commitment fee of ¥1,000 to CNFL, and signed a letter authorizing CNFL to source the equipment.

4. CNFL then selected and contacted potential suppliers in four countries, asking for bids either on the whole line or the separate components. After reviewing eight bids, the enduser invited five suppliers to Beijing for negotiations.

5. Technical negotiations were held in Beijing among the enduser, the suppliers, CNFL, and a CNNC research institute. (The institute's role was to ensure that the technology offered was appropriate; it did not participate in negotiations.) Afterward, CNFL began commercial negotiations with four of the suppliers.

6. As commercial negotiations neared conclusion, the enduser completed a final feasibility study incorporating detailed costs, and obtained CNNC approval. Between May and July 1987, CNFL signed purchase contracts with three suppliers on behalf of the enduser. Funding for the lease of the rolling mill was arranged through the Italian supplier from an Italian export credit agency.

7. CNFL and the enduser then signed a leasing contract stipulating that 70 percent of the cost of the mill was to be financed through a four year lease, with equal semi-annual payments to CNFL to be made in arrears (after the term of the lease began). Repayment is to come from export proceeds of the company's products unrelated to this project.

8. Representatives from the aluminum foil company visited the plants of the suppliers in Italy, Holland, and West Germany.

9. CNFL applied for and obtained import licenses for the equipment from MOFERT, as well as a waiver of import duties on the lease-financed equipment. A guarantee of the lease amount from a provincial branch of the Bank of China (BOC) was then submitted to CNFL. The BOC head office in Beijing agreed to open letters of credit according to the delivery schedule of the components.

10. With all procedures in place, the suppliers were notified that the contracts could be put in force. The aluminum foil company provided CNFL with funds for down payments, which were then made against bank guarantees from the European supplier banks. Equipment delivery began in mid-1988, and was completed by the end of the year.

11. The lease will be fully paid out in 1992, and the equipment purchased by the enduser for ¥10.—John Krafft

ners in addition to First Interstate: China National Nonferrous Metals Industry Corp. (CNNC), Bank of China Trust and Consultancy Company, Industrial and Commercial Bank of China (ICBC), and Banque Nationale de Paris. Originally approved as a specialized leasing company operating only in the nonferrous metals sector, CNFL's mandate was broadened in late 1987 to allow participation in virtually any sector. To date the company has leased such items as casting and rolling mills, acid processors, an induction furnace, and a graphite electrolyte machine.

TILCO, in operation since September 1986, involves five Chinese, four
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…, and that they expect their involvement in China to expand, though gradually. Their cautious approach shows that adjusting expectations to the realities of the China market is an essential first step to business satisfaction. Another key step for both companies has been the choice of Chinese partners, which can play critical roles at every stage of a complex leasing deal.

Building networks

Selecting appropriate Chinese partners can facilitate every aspect of the leasing process, including identifying, financing, and bringing off a deal (*see* box). For example, as each transaction must be accompanied by a reliable credit guarantee from a Chinese bank, having a well-established Chinese financial institution as a partner to provide funding as well as to carry out credit checks can be a great help. Industrial corporations or organizations with projects in-house that can provide leasing opportunities are also valuable joint venture partners.

Choosing partners with branch offices throughout the country also helps the venture to locate and follow up on opportunities. For example, CNFL receives referrals not only through its official partner, the planning department of CNNC's head office in Beijing, but also through CNNC's provincial branches. Local offices of partner ICBC also scout for opportunities. Krafft estimates that CNFL's leasing network encompasses about 50 enterprises and bank branches, some of which receive a share of the commission fee on a successful deal. Krafft also suggests that US leasing companies strengthen links to US companies that can supply technology and equipment China needs, and consider entering the market through lease–sublease arrangments with the US supplier and Chinese enduser.

EDS Financial Corporation, a Dallas-based subsidiary of Electronic Data Systems Corp., is now exploring ways to enter the China leasing market in the same slow, steady way that has proved satisfactory for GATX and First Interstate. According to Jedd Keith, general counsel for EDS Financial Corp., the company is considering the initial step of leasing computer equipment to its parent company's data processing joint venture in Beijing, and perhaps remarketing equipment to other enterprises in China when it comes off-lease. Should this arrangement prove successful, the leasing company would consider expanding its operations to encompass other types of equipment deals, particularly aircraft for China's fledgling regional airlines (*see* p. 12). Eventually, EDS Financial Corp. might be interested in becoming a partner in a leasing joint venture.

Taking the long view

US lessors who are both already active in China or considering some kind of leasing involvement have recently seen encouraging signs indicating that the Chinese are working to increase their understanding of leasing practices abroad. An exchange of visits sponsored by the Department of Commerce sent US leasing executives to China in May 1987, and hosted a return visit of Chinese leasing officials last November. While the exchange is not likely to result in any specific business opportunities, both sides enhanced their understanding of each other's constraints—such as the US companies' lack of control over interest rates, and the Chinese companies' obligations to function within State plans—and potential for cooperation.

China's leasing sector will continue to grow as more enterprises seek to obtain advanced equipment and technology as easily and with as little cash up front as possible. For the most part, however, US companies will not get involved in the industry until Chinese officials and enterprises increase their understanding of more sophisticated lease arrangements, such as those involving used equipment, remarketing opportunities, and longer lease terms, and thus expand the need for the types of leasing services US lessors are accustomed to providing. Those companies already in China must continue to view profitability from a long-term perspective. As John Krafft says, "If your aim is short-term returns, don't come." 完

Hainan: Facts, Figures, and Fantasies

Finding the treasure on China's "treasure island" requires potential investors to weigh a multitude of factors

Richard E. Gillespie and Sharon E. Ruwart

The opening to foreign investment of Hainan Island, China's newest province and largest special economic zone (SEZ), adds an intriguing new twist to China's coastal development strategy. The central government's formula for developing Hainan—creating an agricultural and industrial base with an export-orientation, and retaining both socialist and market features while absorbing massive infusions of foreign investment and technology—represents a bold new initiative, built on the foundation of experience of China's first four SEZs.

For more than three decades after the founding of the People's Republic in 1949, Hainan—considered primarily as a defensive bastion—remained the sleepy backwater it had been for centuries. The island's small population (comprised mainly of non-Chinese minority groups), lack of infrastructure, and inaccessibility kept it effectively isolated from the attention of both central and Guangdong provincial authorities.

From 1983 on, however, Hainan assumed a higher profile and priority as Beijing's coastal development strategy emerged, and the island's development was accorded political as well as economic consideration. Comparable to Taiwan in terms of size and resources, closer to Hong Kong than to Shanghai, and situated strategically nearby Southeast Asian countries, Hainan appeals to central authorities as a possible proving ground for the one country, two systems reunification formula that Beijing has advanced both to Taiwan and Hong Kong.

After early bouts of over-enthusiasm gave way to a more sober assessment of the island's assets and needs, Chinese planners recognized that Hainan's full-scale economic development cannot be attained with domestic resources alone. Potential foreign investors were bombarded with increasing barrages of "Hainan hype" by central and local authorities even before the island was designated a province and SEZ in March 1988. Hundreds of delegations of foreign businesspeople have been ushered around the island in recent months, and enticed with promises that Hainan would offer foreign investors better incentives than those of China's other SEZs as well as nearby Asian countries.

Investment incentives have now been promulgated, a provincial government formed, and ground broken on a number of major infrastructure projects, developments that represent significant progress in a very short time. Yet even the most optimistic planners know that Hainan's development will be anything but smooth—its needs are great, its government and commercial leadership inexperienced, its funds relatively sparse, and its claims on Beijing's resources contested by the other SEZs.

The author's August 1988 visit to Hainan, along with copious research efforts and discussions with Chinese officials and potential foreign investors, lead to the conclusion that the massive foreign investment Hainan hopes for will not materialize until a more experienced political leadership and labor force is assembled; a clearer and more attractive investment program implemented; and more power plants, roads, airport and hotel facilities are built. Nevertheless, an economic vitality reminiscent of other Pacific Rim countries in the 1960s and 1970s—untidy and as yet unfocused—is readily apparent around the island. Clearly, no matter how long it takes to reach its lofty development goals, Hainan's days as a backwater are over.

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Ambitious—and confusing—development plans

The development plans that have been unveiled for Hainan resemble a "wish list" of objectives and projects rather than a coherent formula for progress. The magnitude of needed improvements in every sector requires tough choices and strict prioritizing, and neither Beijing's planners nor Hainan's new government has yet come to grips with this necessity.

Development goals are themselves a chief point of confusion between central and provincial authorities. While Hainan officials talk of bringing Hainan up to the level of advanced countries within 20 years, the State Council voices more modest hopes of getting Hainan up to the level of China's coastal cities within the same time frame. An even more cautious State Planning Commission blueprint for development up to the year 2005 (prepared with assistance from Japanese economists), calls for the island to attain the level of an average Chinese city at a cost of one-third of the ¥15–¥20 billion that Hainan authorities want to spend.

The short-term development scenario envisioned by the island's authorities is equally vague, calling for infrastructure development over the next three years, development of a "minimum" industrial base within five years, and achieving "economic takeoff" (spontaneous development stimulated by market forces) by 1998. The development patterns of both Hong Kong and Taiwan are apparently being studied for possible emulation.

Amid the confusion, certain broad and sketchy lines of planning have emerged. As a first step, for example, the island has been divided into five development zones, each focusing on different sectors (*see* map, p. 24). Although development priorities within each zone are unclear, the broad plan calls for an initial emphasis on sectors that are either already somewhat developed, or have the potential to be brought up to speed quickly. Agriculture, light industry, infrastructure, and tourism will accordingly be emphasized during the first phase of development.

The development of the island's tourism industry highlights some of the inherent contradictions in Hainan's plans. On the one hand, planners have listed tourism as a priority sector, and are actively seeking foreign investment to develop the island's spectacular southern coastline and scenic mountain locales. On the other hand, Hainan's overall plan calls for limiting low-yield capital construction projects such as hotels and resort facilities, and last fall's nationwide cancellation of a number of such projects calls into question Hainan's potential for obtaining the necessary central funds for tourism development efforts.

Other practical issues have forced Hainan to prioritize development decisions. To earn badly needed foreign exchange, export-oriented light industrial ventures will be emphasized to start. Central and provincial funds will initially be concentrated in establishing high-yield, energy-efficient enterprises in the critical areas of energy, water supply, communications, and transportation. After a period of several years, heavy industry projects, including petrochemical, petroleum, and metal and mineral processing facilities, will be emphasized. Around the turn of the century, high technology manufacturing enterprises are slated to become the new focus.

A plethora of planners

Knowing that the island lacks the resources to go it alone, provincial planners are trying to convince their mainland counterparts to participate in the island's development. For example, cooperation is being fostered between Hainan and mainland localities with complementary economies in production and distribution. The Haikou–Beijing agreement signed in June 1988 provides a model, calling for cooperation in pharmaceuticals, food, electronics, building materials, and other light industrial export items, as well as the joint construction of a high-technology zone on Hainan. Between September 1987 and April 1988, Hainan authorities approved the establishment of 203 enterprises with links to mainland Chinese enterprises, which will presumably facilitate the distribution of Hainan products.

Giving mainlanders a stake in Hainan's development may help the island's economy, but it will also further confuse the muddled lines of authority over the province. Although Hainan's elevation to provincial status brought it out from under the administrative aegis of Guangdong Province, regional as well as central authorities will undoubtedly continue to play a significant—and at times, intrusive—role on the island until the local government hierarchies are fully fleshed out and capable of asserting their responsibilities (*see* box, p. 22).

For example, while there has been talk of allowing Hainan complete freedom over its development programs, central authorities such as the State Planning Commission will clearly have a vital and decisive role to play in allocating funds, and thus in setting priorities. As a further example, the central government retains ultimate approval authority for the level of Hainan's foreign borrowing each year, although the Hainan government may solicit foreign loans on its own.

Friction between Beijing and Haikou's new leadership—whose principal figures remain tarnished by a 1985 corruption scandal—is likely to persist over the pace, cost, and priorities of the island's development.

Where will the money come from?

Years of meager subsidies from Guangdong Province, together with inadequate central support, have left Hainan a barely developed infrastructure and a minimally diversified economic base. While no reliable estimate is available of the cost of developing Hainan's infrastructure, the total is likely to top the ¥4.77 billion China spent on Hainan projects from 1983–87, or the ¥10 billion spent by Shenzen SEZ—which is one-tenth the size of Hainan Island, and better developed to begin with—on basic infrastructure improvements since 1980.

Hainan's new government estimates that meeting its ambitious goals will cost ¥200 billion over the next two decades. A State Planning

Photo courtesy of Ying Price

Long stagnant, Hainan's domestic economy has become more dynamic and entrepreneurial in the wake of its elevation to provincial status.

Commission blueprint calls for a more modest expenditure, starting with ¥18 billion total investment from 1988–92. Hainan's own annual revenues now amount to a meager ¥250 million.

Recognizing the need for greater subsidies, Beijing reportedly agreed in 1988 to allocate Hainan ¥200 million in annual low-interest loans, together with a ¥300 million annual subsidy for capital construction and enhancement of the investment environment. The funds will come from the various ministries overseeing particular Hainan projects.

Funding from other provinces will help only marginally. Although they may agree to help Hainan enterprises distribute finished goods and purchase raw materials, mainland entities are unlikely to go as far as providing the actual funds that Hainan so desperately needs.

Hainan authorities hope a massive influx of foreign investment— ¥5–¥6 billion from now until 1992—will enable them to forge ahead in a variety of sectors simultaneously. The resources of international development agencies may also be tapped, as with the World Bank loan to Hainan's Daguangba hydroelectric power project. Regardless of the amount of foreign investment or concessionary loans Hainan obtains, however, the bulk of the burden will rest on China's own development coffers.

Energizing the island

While planning authorities seem to be having trouble establishing a reasonable timetable and order of development, the energy sector is clearly the top priority by any measure. All of the island's manufacturing, industrial, and service enterprises now suffer from severe energy

HAINAN'S HIERARCHY

A little over four months after Hainan officially became a province in April 1988, the first Hainan Provincial Conference convened to constitute a new government for the island. During the session, Liang Xiang was named governor, Xu Shujie became provincial party secretary, and five vice governors and seven Standing Committee vice chairmen were named (*see* list). A total of 42 party and government departments were also created.

Xu comes well prepared for his new job, having served as Guangzhou party secretary from 1980–85. He also chaired the Hainan provincial preparatory commitee, with Liang as his deputy.

While Liang gained administrative experience from his term as mayor of Shenzhen SEZ, he also brings to his new post a dubious reputation. While mayor, Liang was accused of abusing the SEZ's economic freedoms by allowing corruption and black marketeering to flourish. He was edged into retirement in 1985, and held several obscure titles until his appointment to the Hainan post.

A number of Liang's colleagues in the new government are also tainted by scandal, having been involved in the notorious 1985 scam in which Hainan and Guangdong officials used their privileges to import cars and other high-tech products to Hainan and resell them on the mainland at a handsome profit.

Another troubling aspect of the new government is the suggestion that Hainan natives do not have a voice in the government equal to mainlanders. The top 13 officials include only one local man, and no other natives rank above deputy level. A rather raunchy local pun holds that Hainan political aspirants suffer from "deputy position syndrome," or *fu ke bing*, which is a homophone for "venereal disease."

It may be premature, however, to worry too much about potential abuses of authority in the new province. With its enormous financial needs, Hainan will greatly rely on central government funding for years to come—and Beijing will be watching very closely to see how its money is spent. —Jennifer Koch Brick

GOVERNOR
Liang Xiang

VICE GOVERNORS
Bao Keming
Meng Qingping
Wang Yuefeng
Xing Yejiang
Zou Erkang

STANDING COMMITTEE
Xu Shujie, chairman
Cao Wenhua, vice chairman
Pan Qiongxiong, vice chairman
Zheng Zhang, vice chairman
Yang Wengui, vice chairman
Lin Ying, vice chairman
Wu Kuiguang, vice chairman
Bao Keming
Miu Silu
Wang Yuefeng
Liu Guinan
Wei Zefang
Li Zhimin

PEOPLE'S POLITICAL CONSULTATIVE COMMITTEE
Yao Wenxu, chairman
Huang Zigui, general secretary
Chen Kegong, vice chairman
Zhang Jintao, vice chairman
Zhou Zheng, vice chairman
Hu Kai, vice chairman
Zhou Song, vice chairman
Li Mingtian, vice chairman
Lin Hongzao, vice chairman
Chen Hong, vice chairman

OTHER OFFICIALS
Li Tianxian, chief procurator, Hainan Provincial People's Protectorate
Ding Guo, president, Hainan Provincial Higher People's Court
Pang Weiqiang, military district commander
Zhan Yijiao, Logistics Department director
Dong Fanyuan, Provincial Discipline Inspection Committee secretary

shortages and frequent power outages. In 1987, one-third of Hainan's population of 6 million had no electricity at all, and only two-thirds of planned production capacity could be met because of power shortages. At present, the island's electric power generating capacity totals only 390 MW. In 1987, the island's total power consumption totaled under 130 KWH, which is less than the amount used annually by the Baoshan steel complex in Shanghai.

Nearly 80 percent of Hainan's power supply is derived from hydropower stations, whose effectiveness is curtailed by an annual five-month dry season. A persistent drought, well into its second year, has further depressed energy resources.

To compensate for the erratic water supply, planners hope to reduce Hainan's dependence on hydropower by constructing several major thermal power plants. The first 100 MW phase of construction of a 350 MW thermal power station in Haikou began in 1985, and the remaining 250 MW will be installed by 1989. An additional 150 MW will be provided by two thermal power plants to be completed in 1989 at Macun. Construction of a 500 MW thermal power plant for the Sanya area, to be completed in two stages, began in 1988.

Additional power sources planned include the 250 MW hydroelectric station at Daguangba in the island's center, to be constructed with a $180 million World Bank loan. The feasibility of constructing a nuclear power facility for the island is also reportedly being considered.

Overall projections call for the island's total power capacity to increase to 700 MW by 1991, and to 1,300 MW by 1995. By the year 2000, capacity may attain 2,100 MW.

Building new power facilities raises the question of how to fuel them. The northwestern district of Changpo is home to a significant deposit of brown coal, but its low energy content (1,000–1,500 kilocalories) and high sulphur content (about 2 percent) give it relatively poor prospects for use in Hainan or elsewhere in China. The high cost of shipping coal to the island will likely direct the search for feedstock to other materials, and much attention has already been given to Hainan's onshore and offshore petroleum reserves. A number of foreign and Chinese companies have done exploratory drilling in the Fushan District in northern Hainan, and the Atlantic Richfield Co. (ARCO) and China National Offshore Oil Company (CNOOC) recently signed a contract to develop offshore reserves in the Yinggehai Basin south of Hainan, which may prove to be a key catalyst to energy and industrial development (*see* box).

Until the energy situation improves, many Hainan enterprises will no doubt continue to adopt the make-shift measures they have used for years, powering commercial ventures with portable generators that can be seen in restaurants and along main streets all over the island. This is not an option for major industrial ventures, however.

Improving port facilities

Improving Hainan's port facilities is essential for meeting both import needs and export objectives. The island's 38 usable ports—the main ones are at Haikou, Sanya, and Basuo—handle 7.5 million dwt per year and local officials hope to double the total by 1990. This will be accomplished by adding berths to the three main ports, creating a deepwater port at Yangpu, and further developing existing facilities at Qinglan, and Wuchang (*see* map).

The most ambitious part of the plan is the projected deepwater port at Yangpu, to be built virtually from scratch to include two 30,000 dwt, three 20,000 dwt, and three 10,000 dwt berths by 1995. Hainan planners envision an eventual total of 20–30 berths, some of which can accommodate up to 50,000 dwt ships. The central government has agreed to provide loans for only two 10,000 dwt berths at Yangpu, and Hainan is seeking foreign funds for the rest.

Hainan's port improvement program reflects yet again the lack of definition and prioritization that afflicts its planners. With ports such as Basuo operating at far less than capacity, why construct a major new port at Yangpu? No official word has confirmed highly touted reports that Hainan will be designated a free port, which would serve as a significant lure to the foreign investment needed to develop ports and other infrastructure facilities.

Building a road network

Hainan's current road network totals 12,000 km, with three major roads linking the island's counties and major cities (*see* map). The main routes are three north–south arteries that link Haikou to Sanya and pass through the island's eastern, central, and western regions.

While these two-lane routes are surprisingly well-built, with smooth asphalt lanes and adequate shoulders, they must be expanded to accommodate increasing industrial and commercial requirements. Plans for the easternmost Haikou–Sanya road involve rerouting to reduce the length of the road by 52 km, as well as upgrading the paving to sustain high speed and higher volume traffic. Efforts to upgrade the other roads, along with construction of three major east–west links to be completed in 1995, will result in a grid of roadwork extending vertically and horizontally through Hainan's 12 counties, and linking the major ports. In the longer term, a round-the-island superhighway is planned for completion by 2005.

Expanding railroad lines

Hainan's railroad network totals a mere 214 km, linking the Shilu iron ore mine to Basuo and Sanya. The Shilu–Basuo link is exclusively for iron ore transport, while the Basuo–Sanya route handles goods and some passenger traffic. Plans have been developed to connect Basuo with Yangpu and Haikou by adding another 188 km of track from Chahe. Scheduled for completion in 1992, the new railway will serve as the main artery in western Hainan, while highways will remain of paramount importance in the east.

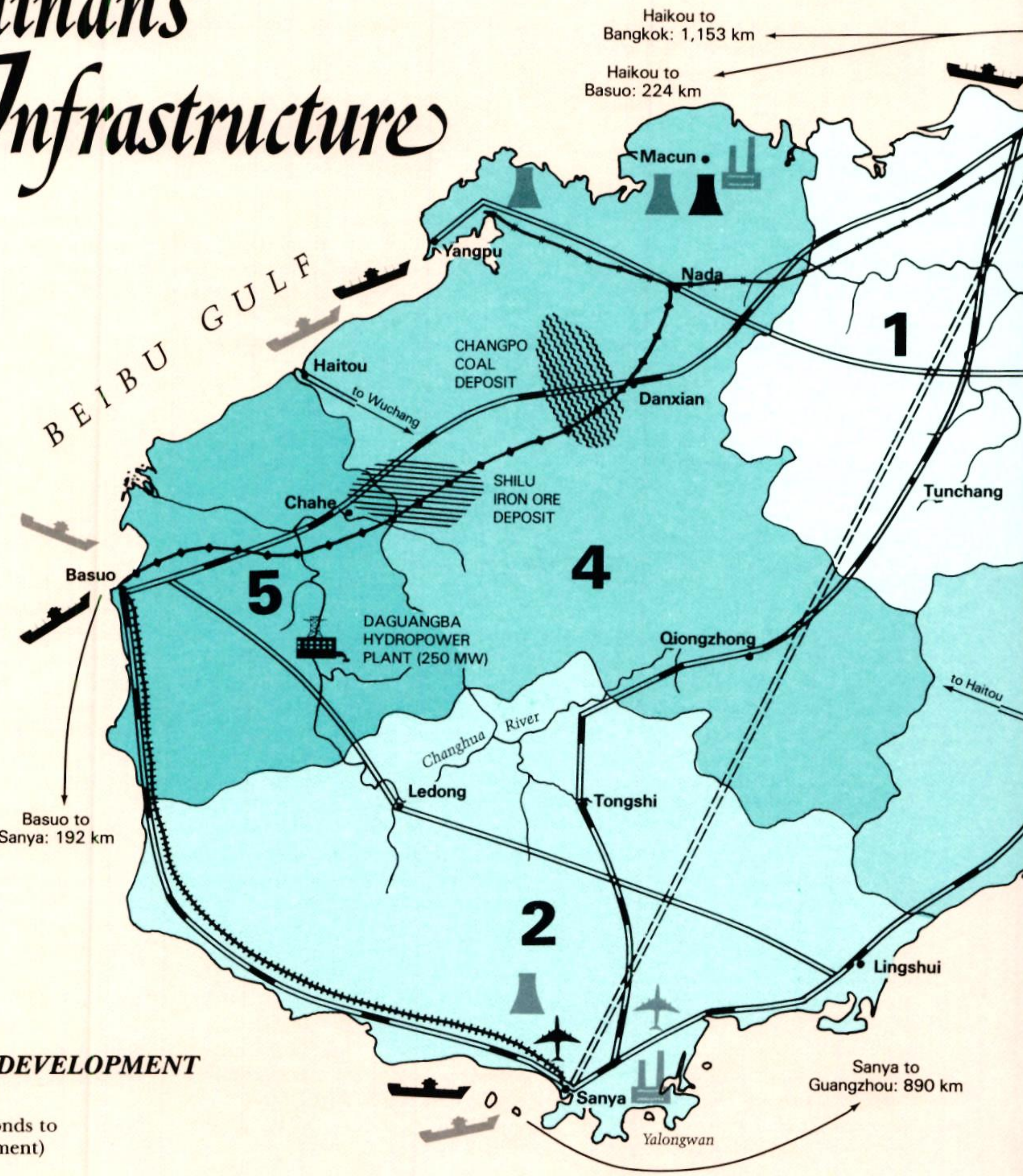
While the new link will improve transportation on the island, a much broader rail network is essential to fully exploit Hainan's substantial metal and mineral resources, as well as to transport raw materials and manufactured products to ports and industrial enterprises.

Upgrading two airports

Hainan is now linked to the outside world by two small airports, one at Haikou and the other at Sanya, which served a total of 125,000 passengers on CAAC and charter flights in 1986. Both airports require upgrading to handle the increasing flow of tourists and businesspeople.

Only the Haikou airport receives international flights. Recent efforts by Beijing to expand the airport have

Hainan's Infrastructure



ECONOMIC DEVELOPMENT DISTRICTS

(number corresponds to order of development)

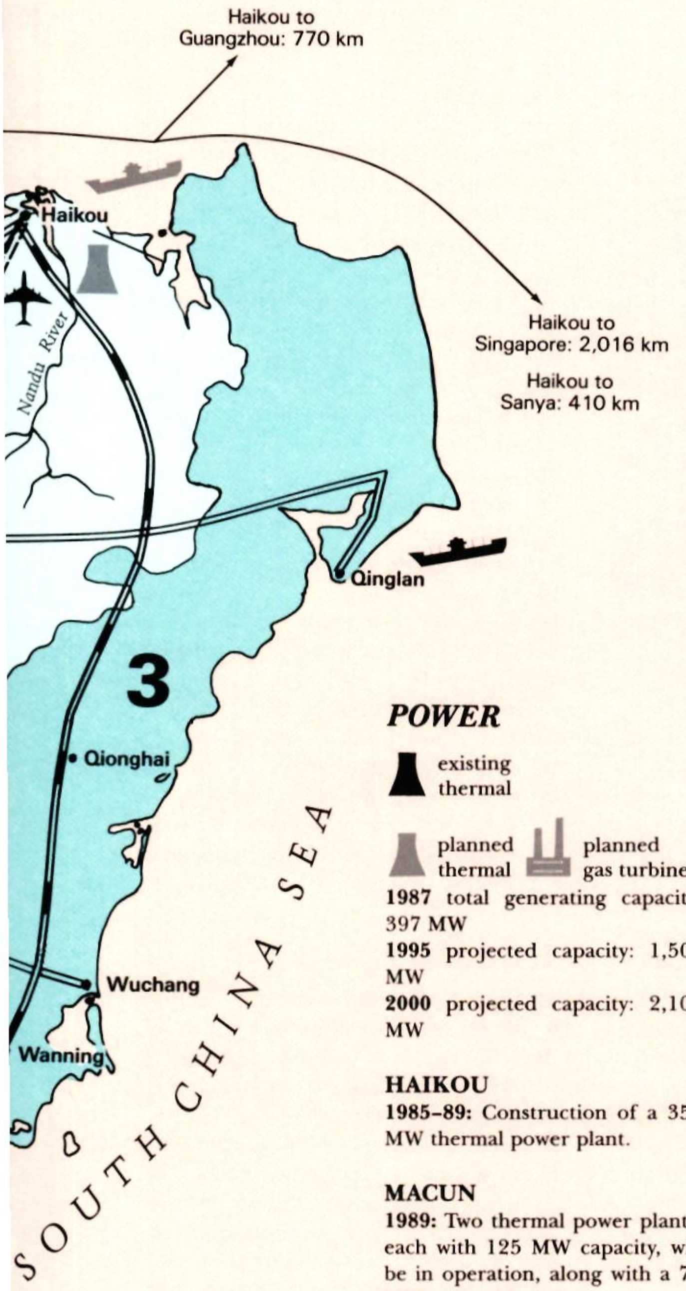
1—NORTHERN Light industry, food processing, rubber products, electronics, machinery, service industries

2—SOUTHERN Tourism, high-tech industry

3—EASTERN Agriculture, food processing, light industry

4—NORTHWESTERN Titanium production, aquatic products, petrochemicals

5—SOUTHWESTERN Iron and steel, cement, heavy industry



POWER

existing thermal

planned thermal

planned gas turbine

1987 total generating capacity: 397 MW

1995 projected capacity: 1,500 MW

2000 projected capacity: 2,100 MW

HAIKOU

1985–89: Construction of a 350 MW thermal power plant.

MACUN

1989: Two thermal power plants, each with 125 MW capacity, will be in operation, along with a 70 MW gas turbine plant.

YANGPU

1990: A 650 MW thermal power plant will begin operation.

SANYA

1988: Construction began on a 500 MW thermal power plant, to be completed in two stages. A 200 MW gas turbine plant is currently being designed.

DAGUANGBA

1988: Construction of a 250 MW hydroelectric plant began late in the year, and will be in operation in 1992.

PORTS

existing

planned

1987 total handling capacity: 7.5 million dwt

1990 projected capacity: 15 million dwt

HAIKOU

Haikou, which has the island's only rolling loading line, has regular passenger and cargo service to Guangzhou.

1988: One 5,000 dwt berth, one 3,000 dwt berth.

1990: Two 10,000 dwt berths and two 20,000 dwt berths to be added.

YANGPU

Yangpu will be the island's only deepwater port. Planners hope its eventual capacity will reach 20–30 berths, some capable of accommodating up to 50,000 dwt ships.

1988: Two 20,000 dwt berths, two 3,000 dwt berths

1995: Two 30,000 dwt berths, three 20,000 dwt berths, and three 10,000 dwt berths to be added

BASUO

1988: One 18,000 dwt berth for iron ore, and one 5,000 and one 10,000 dwt berth for general cargo. Two additional 10,000 dwt berths were to be completed in 1988.

SANYA

Sanya is and will remain primarily a passenger service port.

1988: Two 5,000 dwt berths, to be upgraded to 10,000 dwt.

QINGLAN

Qinglan and Wuchang will handle light industrial goods and container traffic.

1988: One 25,000 dwt berth; no upgrade information available.

WUCHANG

1988: One 1,000 dwt berth; no upgrade information available.

AIRPORTS

existing planned

HAIKOU

The existing facility services flights to and from Guangzhou, Beijing, Hong Kong, Singapore, and Thailand and can accommodate 737s. Construction of a new international airport in Haikou's suburbs is being considered.

1990: Capacity will be expanded to accommodate 767s.

SANYA

The existing facility accommodates 737s, and services flights to and from the mainland. A new airport, Fenghuang International, is currently being developed near Sanya.

1990: Fenghuang will accommodate 737s.

1995: Fenghuang will accommodate 767s.

ROADS

existing

planned

planned superhighway

Current network: 12,000 km

Three of the eight existing east-west roads will be expanded into major arteries: Basuo–Lingshui, Yangpu–Qinglan, and Haitou–Wuchang (route to be upgraded not yet specified).

1990: The existing 324 Haikou–Wanning–Sanya route will be upgraded and shortened by 52 km.

1995: The three existing north-south roads will be expanded.

2005: A 70 km Haikou–Sanya superhighway will be completed.

RAILROADS

existing

planned

Current network: 214 km from Basuo to Sanya

1995 projected network: 486 km

1990: 79 km Chahe–Nada link to be completed.

1992: 109 km Nada–Haikou link and 60 km Nada–Yangpu link to be completed.

Map prepared by Bryan Batson based on Chinese press reports, interviews with Chinese officials in Beijing and Haikou, and US Foreign Commercial Service reports. Artwork by Kenny Grady.

Photo courtesy of Ying Price

The flourishing aquaculture facilities in eastern Hainan may provide short-term investment opportunities.

increased its capacity, and it now receives Tridents, Boeing 737s, and 757s on regularly scheduled flights to Guangzhou and Beijing, and charters to Hong Kong, Singapore, and occasionally Thailand. The airport is targeted for upgrading to all-weather status, and a new air-conditioned terminal building was planned for completion by the end of 1988. A feasibility study is also underway for a new international airport at Haikou, to be built away from the suburbs and closer to the sea to accommodate increased traffic and urban growth.

The Sanya facility, which was converted to civilian use in 1985, can only handle smaller aircraft such as the Soviet Antonov 24. Currently receiving about five flights per week from Guangzhou, its capacity must be greatly expanded in order to help the development of tourism on the southern coast.

The Hainan government plans to construct a new international airport in Sanya's Fenghuang (Phoenix) northern suburb by late 1990, using both local and foreign financing. Hainan authorities are reportedly negotiating some sort of soft loan package with Scandanavian Airline Services (SAS), Sweden's national airline. The discussions are being facilitated by American Anna Chennault, widow of the late Major General Claire Chennault of World War II Flying Tiger fame. No site construction was evident last August, however, and completion of the airport on schedule is unlikely.

Air traffic control facilities for both domestic and international flights over Hainan will be improved with the construction of an automated air traffic control center near the Fenghuang Airport in mid-1990. The American firm Lockheed Electronics Company, aided by a $375,000 grant from the US Government Trade and Development Program, is designing the facility.

China is now negotiating with the International Civil Aviation Organization to establish a flight path from Bangkok to Hong Kong over Hainan, which should lead to stopover flights that stimulate both of the island's airports.

Expanding and upgrading the Haikou and Sanya airports, which can be accomplished more quickly than other transportation infrastructure projects such as port improvement, will do much to facilitate foreign business activities.

Communications concerns

Inadequate telecommunications connections on Hainan cause frequent delays on calls both within the island and on outside connections. Foreign businesspeople report that communication with Hainan by phone from outside is often virtually impossible due to an acute shortage of telephone lines. Hainan's current communications network depends mainly on microwave systems, with a 960-line system linking areas within the island and a 1,800-line system connecting the island with the outside world.

Plans call for installing 7,000 digital lines in Haikou in 1988, and increasing the number to 25,000 by 1990. Sanya is expected to install 3,000 digital lines in 1988, which will be expanded to 10,000 by 1990. These projects will reportedly involve international bidding. Hainan planners hope to increase the average number of telephones to one for every 10 residents by 1990.

Both central and provincial communications officials have also discussed establishing earth stations for communications satellites, near Sanya or on the Xisha Islands south of Hainan, to link the island with China's nationwide satellite network. No firm plans have yet been formulated, however.

Improving Hainan's telecommunications capabilities is crucial to attracting foreign investors to explore opportunities on the island. Although the system today presents frustrations, it is likely to make significant progress within the next year.

Skilled labor shortage

Hainan's development and industrialization plans will be hampered by the shortage of trained personnel, which is particularly acute even compared to the rest of China. During its years of isolation, many of Hainan's most capable workers left to seek greater opportunities on the mainland. With few technological or industrial advances to spur demand, specialized education and training facilities on the island failed to prepare a work force that can take on the challenges of development. In 1987, for example, Hainan had only 7,200 college and 320,000 middle school students.

Hainan's growing significance in recent years has to some extent stemmed the exodus of skilled labor. Since 1983, China has recruited some 100,000 mainland college graduates to teach and work in Hainan, and in the heady months following the birth of the new province, some 150,000 young people flocked to the island to pursue opportunities in what was expected to be a flourishing, dynamic growth economy. In general, however, the mainlanders, who seem to have settled in Haikou, Sanya, and the major eastern cities, seem discouraged by the lack of ready opportunity and by the prospect of long, hard work ahead. And given the limitations of Hainan's educational facilities, the number of trained workers is likely to lag far behind the island's needs for some time to come.

Attracting overseas funds

As the state of Hainan's infrastructure clearly shows, the island has a long way to go to build and sustain a thriving, diversified market economy, much less produce large quantities of manufactured goods for export. To attract the foreign investment needed to accomplish its economic goals, Hainan officials promised that the province's investment incentives would be more attractive than those of the other SEZs or nearby Asian countries. While the legislation, promulgated in August 1988, did not live up to all of the enticing promises (*see* p. 31), some of the incentives compare favorably to provisions in the other SEZs and will prove attractive to foreign investors.

Hainan emphasizes that foreign investors will have greater scope and flexibility in their investments. For example, natural resource and infrastructure projects will be open to foreign developers, and special flexibility will be permitted to investors involved in both infrastructure and industrial enterprises. Land-use rights can be secured for a maximum term of 70 years, longer than most of the other SEZs. Foreign exchange will reportedly be freely transacted in open markets. Building materials may be imported duty-free, and no limitations have been placed on capital construction investment. The province has the authority to approve foreign invested projects up to $30 million.

For the first time in China, Hainan will permit foreign banks to establish full service branch offices or joint venture banks dealing in foreign exchange accounts, stocks and securities, and renminbi (RMB) business. Hong Kong's Nanyang Commercial Bank Ltd. opened the first foreign branch office in March 1988, and several other banks are reportedly negotiating offices. Chinese officials have also promised that foreign insurance companies will also be permitted to open offices and underwrite policies for projects in Hainan, but such statements have not been substantiated by legislation.

Hainan's current investment legislation leaves room for improvement—regulations in such areas as securities and land-use rights are unclear, and no rules at all exist concerning arbitration or corruption—and it is of course unclear at this point how effectively the existing incentives will be implemented. Hainan has much to gain by permitting foreign investors the promised scope and flexibility for their investments—and much to lose by failing to do so—since the island's development ultimately depends so much on foreign funds.

The pattern of foreign investment

Some 300 Sino-foreign cooperative ventures for Hainan received Chinese government approval in 1980–87, including 100 joint ventures, 183 cooperative enterprises, and several wholly owned foreign ventures, for a total of $202 million in foreign investment. An investment surge in 1988 saw some 235 new FIEs established, with $253 million total investment. As of August 1988, some 426 FIEs from 10 different countries were in operation, including 169 equity joint ventures, 209 contractual joint ventures, and 48 wholly foreign-owned enterprises.

Over 75 percent of the 235 FIEs established last year are engaged in industrial production in the agriculture, construction, post and telecommunications, transportation, commerce, and public utilities sectors. Over 68 percent of the new projects were funded by Hong Kong investors, with 24 percent established with Japanese investment. Companies from Thailand, Singapore, Malaysia, and the Philippines invested in 13 projects for a total of $9.9 million, and unconfirmed sources report that three projects were established by Taiwan investors for a total of $930,000.

The pattern of foreign investment in Hainan to date shows that Asian investors, particularly those from Hong Kong, have been actively investigating small-scale opportunities that complement their domestic needs, particularly for raw materials and low-cost production of low-end manufactured goods. While a number of big-ticket opportunities exist, notably in the areas of petroleum and

ARCO DEAL LEADS US INVOLVEMENT IN HAINAN

Atlantic Richfield Co. (ARCO), along with its joint venture partner Kuwait Foreign Petroleum Exploration Company (KUFPEC), signed an agreement on November 23, 1988, with China National Offshore Oil Corporation (CNOOC) to jointly develop the Yacheng 13-1 natural gas field about 100 km south of Hainan Island, which is estimated to hold up to 70 billion cubic meters of natural gas. The project is likely to be a catalyst in developing Hainan's energy resources, and represents the most substantial US company involvement in Hainan to date.

The agreement was reached four years after the two sides signed a similar contract in 1985, which was renegotiated in the wake of the collapse of oil and gas prices in 1986. Both sides reportedly compromised on price and allocation issues to push the deal through. The cost of the project has not been officially released, but various sources estimate it at $400 million. The contract stipulates that CNOOC will hold a 51 percent interest; ARCO's subsidiary, ARCO China, will hold a 34 percent interest; and KUFPEC will take a 15 percent share through its subsidiary Santa Fe Minerals (Asia) Inc.

ARCO expects engineering work to begin in 1989, and actual construction to start in 1991 for a projected completion date of 1993.

The oil field, which is located at 109°, 2' east and 17°, 30' north, was discovered during ARCO's 1983 explorations, and could eventually produce up to 500 million cubic feet of natural gas per day, to be piped undersea to Hainan's southern coast to supply feedstock for energy and other ventures on the island. Eventually the pipeline may also supply gas to Shenzhen SEZ, Guangdong, and Hong Kong.

A joint feasibility study for the project, involving ARCO and Japan's Nissho Iwai Corp., is now underway to determine the potential for exporting liquified natural gas from the Yacheng field to Japan in order to earn foreign exchange to import equipment for the project. —SER petrochemicals, the bulk of foreign investment for some time to come is likely to be directed toward small and medium-sized projects in manufacturing ventures.

Appealing to overseas compatriots

Hainan's active efforts to advertise Hainan opportunities to potential foreign investors have been directed most aggressively toward overseas Chinese. Investors from Hong Kong, the closest capitalist enclave and home to many Chinese of Hainan origin, have been the first to answer the call, accounting for most of the foreign investment to date.

Hainan recently established the Huahai Company in Hong Kong, a trade and investment development office headed by former Shenzhen vice mayor Zhen Xipei. The company has already helped put together a consortium of Hong Kong and Chinese interests to finance construction of the second phase of the Macun thermal power plant with a $200 million loan. Another Hong Kong group, the Hong Kong–Macao International Investment Company, signed an agreement in March 1988 to establish Hainan's first industrial development district, negotiating a 60-year lease for a 300 hectare area.

A special effort is being made to involve Hong Kong interests in developing south Hainan's tourism facilities, which are now scarce, underutilized, and poorly run. Several Hong Kong groups have already gone into this sector. For example, Hong Kong developer Henry Ying Tung Fok is working with the Hainan Tourist Corporation to develop the spectacular southern coastal area of Yalongwan (Dragon Tooth Bay) into a resort area, with Fok providing a $6.7 million loan for the venture.

On the north side of the island, the Hong Kong-based Tower Hotel has teamed with the Haikou Tourism Company to build the Haikou Tower Hotel, the island's first Sino–foreign joint venture hotel. Because of the lack of local tourism regulations, the hotel has suffered from problems ranging from fluctuating tax and customs rates to unregulated taxi fees. Nonetheless, the hotel reported a satisfactory 65 percent occupancy rate last July.

Because of their proximity as well as their cultural links with Hainan, Hong Kong businessmen can be expected to form the core of foreign investment on the island in the years ahead. Overseas Chinese from other Asian countries are also getting involved, with investors from Thailand, Singapore, Malaysia, and the Phillipines putting $10 million into 13 projects to date. The most publicized of these deals has been the Chia Tai Group of Thailand's agreement to invest $2.54 billion to develop pig raising, prawn breeding, and petrochemical projects.

Japanese target natural resources and labor

Japanese investors are lured to Hainan by the prospect of establishing cheap manufacturing facilities and exploiting the island's natural resources. For example, the trading company Nissho Iwai is now conducting a feasibility study for a liquid natural gas (LNG) facility, and is being assisted by Bechtel Corporation in the pre-feasibility stage.

Capitalizing on the island's appeal to Japan, Hainan authorities have announced their intent to seek substantial yen loans. In April 1988 the Japanese government announced a yen-denominated loan package of $806 million to finance the construction of new port facilities, a Haikou airport terminal, highways, and energy and communications systems.

While the monetary level of Japanese investment is not yet substantial, Japan clearly has a long-term interest in Hainan's development, as shown by the Japanese assistance given to the State Planning Commission in formulating a development blueprint for the province. A modest Japanese financial infrastructure is already in place on the island, and is likely to grow.

Forging ties with Taiwan

For political as well as economic reasons, Hainan is making a special appeal to Taiwan businesses to demonstrate that Taiwan's brand of rapid economic development can be emulated under a socialist system. Authorities have announced that a special export processing zone will be set aside for Taiwan-invested projects.

On a purely pragmatic level, China's coastal areas offer many attractions—including access to low-cost labor and raw materials—to Taiwan companies that want to upgrade their domestic factories and move low-end production facilities for textiles, electrical products, and machinery into less expensive Asian countries. The Chinese hope especially to attract small and middle-range investors who are having a hard time surviving in Taiwan because of increased US pressures over trade imbalances.

Although Taiwan businesses are officially prohibited by their government from directly investing in mainland China, including Hainan, indirect investment activity through Hong Kong subsidiaries has been quietly growing in recent months (*see The CBR*, Nov–Dec 1988, p. 10). Hainan may find, however, that the greatest obstacle to attracting Taiwan investment comes not from Taipei, but from Xiamen and the other SEZs, which have closer geographic, linguistic, and cultural links to Taiwan than does Hainan—not to mention better developed infrastructures and economies. Moreover, many of the

FOREIGN TRADE ORGANIZATIONS IN HAINAN

Hainan is still in the process of organizing and coordinating its foreign trade and activities, and for some time to come it may be difficult to identify the appropriate authorities. China's major national institutions and corporations dealing with foreign trade—from MOFERT to CEROILS—have branches in Hainan, mostly located in Haikou and/or Sanya. Two major groups deal specifically with foreign trade and economic development. The Hainan Foreign Trade Group includes the Hainan Foreign Trade Corporation, the Hainan Foreign Trade Development Corporation (both with branch offices in Sanya), and the Hainan Foreign Trade Service Corporation. The Hainan Foreign Economic and Trade Group includes the Hainan Joint Trading Group, the Hainan International Trust and Investment Corporation, the Hainan Overseas Trading Corporation, and the Southern Import–Export Corporation, whose shareholders include the Guangdong Foreign Trade Corporation. In addition, a total of 250 trading companies authorized to handle imports and exports will be set up in both cities.

Two additional offices in Haikou—the Foreign Economic Working Commission and the Department for American Area Affairs—will presumably handle activities involving North and South American companies.

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investment incentives in Xiamen SEZ are the same or close to Hainan's preferential probitions.

US investors cautious

Hainan's inadequate infrastructure and labor skills have and will continue to inhibit investment in the industrial and manufacturing projects in which US companies have increasingly invested on the mainland, with the exception of offshore petroleum projects. To establish bases from which to monitor and explore opportunities, some American companies have applied to open representative offices on the island. General Motors has led the way since last November, when it established an office for its W. Westland Industrial Corporation subsidiary, which markets a variety of automotive, chemical, electronics, and household appliance products. The corporation is reportedly considering investments in furniture, chocolate, and frozen food production.

Other US companies are cautiously exploring investment opportunities, mainly in low-risk areas such as agribusiness and light industry. One firm, for example, is negotiating a modest $2.2 million project to raise chickens and produce chicken powder for the US market. Huang Hai Mei Company, a Sino–US electronics joint venture, has purchased a stake in the Hainan Electronics Group Corporation. And in September 1988 Mississippi Governor Ray Mabus visited Hainan and discussed with authorities possibilities for technological exchange in various agribusiness sectors, such as animal husbandry, fertilizer, fish breeding, forestry, and processing, as well as energy and transportation.

The largest US involvement to date is ARCO's agreement to develop offshore oil reserves to power Hainan enterprises (*see* box).

Evaluating opportunities

Identifying and evaluating investment opportunities on the island is difficult, since firm statistical data can be hard to come by. In the near term, small-scale, limited risk ventures in several areas may yield profits. In the longer term, big-ticket investments in the petroleum and petrochemical sectors look profitable.

▶ **Agribusiness.** Agribusiness ventures, with an emphasis on processing, look particularly promising in the short run. Hainan's fertile soil is conducive to producing rubber, tea, cocoa, coffee, pepper, and cashew nuts, and successful farms growing these products for export can be found in the eastern part of the island. Investment opportunities exist for processing ventures for oil-bearing crops, fruit trees, and sugarcane. Improving the technology used in the production of tea—one of the island's top agricultural foreign exchange earners—is a high priority. The island's potential for growing pineapple for export is being closely studied.

More tropical than Taiwan, Hainan's agricultural environment is less favorable, however, with leaching of the soil and water shortages posing persistent problems.

Aquatics, particularly fish breeding, is another agricultural highlight, and overseas Chinese investors are already moving into this area. Opportunities also exist in the animal husbandry sector, particularly in pig breeding.

Agribusiness projects may be a good place for foreign investors to begin in Hainan, as they require less capital, energy, and skilled labor than large industrial projects. Agricultural products also have export potential in addition to strong domestic and mainland markets.

▶ **Light industry.** Processing and assembly ventures, especially in the consumer electronics industry, present worthwhile short-term opportunities, as they provide quick returns on small investments. The island's eastern development zone will focus on export-oriented light industrial projects in food processing, instruments and meters, consumer electronics, and textiles. Hainan expects that its SEZ status will allow for expanded textile export quotas, and is promoting low-technology textile ventures such as sweater-making in the eastern development zone. Production of the island's major products, synthetic fibers and cotton yarns, has increased rapidly in the past two years.

▶ **Petroleum.** Developing Hainan's substantial onshore and offshore reserves is a top priority for Hainan planners, and a number of foreign companies besides ARCO are already active. Both CSR Orient Oil of Australia and Norwegian State Oil Company (Statoil) have undertaken exploratory drilling in the Fushan depression near Haikou, which holds an estimated 50 million tonnes of oil reserves. The Norwegian National Oil Company has also done exploratory drilling offshore near Sanya.

The Hainan Mobil petroleum Service Company Ltd, a joint venture between the Hainan Provincial China Travel Service and Mobil Oil's Hong Kong subsidiary, Shamlik Investment and Trade Company, may invest $10

Photo by Richard E. Gillespie

Hainan's spectacular southern coastline, the designated focus of tourism efforts, has attracted developers from Hong Kong, Japan, and the United Kingdom.

million over the next three years to build seven large offshore and land refueling stations.

▶ **Petrochemicals.** Petrochemicals is another priority sector for attracting foreign investment, and plans call for the establishment of a major petrochemical complex somewhere in the south to be fueled by Yinggehai feedstock. Other projects on the drawing board include an oil refinery, three synthetic ammonia plants, and a chemical plant to produce 200,000 tonnes per year of methanol and caustic soda.

Italy's Anni Chemical Company signed a letter of intent in July 1988 with the China Hainan Petrochemical Corporation to build a $580 million ethylene plant. The 250,000 million tonnes per year facility will use naptha feedstock and produce polyethylene, polypropylene, and butane. Anni's engineering subsidiary Snamprogetti is undertaking a feasibility study for the project.

Thailan's Chia Tai Group will reportedly invest $2.4 billion in petrochemical projects, with $800 million slated for a polyvinyl chloride plant.

The enormous investment required to develop Hainan's petrochemical potential will undoubtedly render most overseas investors cautious in their near-term involvement, unless foreign governments make concessionary financing available for these projects.

Anthony Russell, China Area Manager for Hongkong and Shanghai Banking Corp., is one of the many foreign businesspeople to have closely examined opportunities on the island. Russell, among others, strongly recommends that unless they are prepared to install their own generating equipment, most foreign investors would be best advised to wait for two years or so until construction of Hainan's new power stations and other infrastructure projects have been completed. For those investors who decide to move in now, dramatic improvements in certain areas, such as communications, can be expected within the year.

Putting the "treasure" in treasure island

The complacency that characterized Hainan's early promotional efforts has disappeared as the central government has become more involved in the island's development—and become aware of the magnitude of the task ahead. Hainan's leaders now seem to comprehend that the island must improve its incentives significantly to attract foreign investors who may be deciding among several Asian locales. Despite the island's abundance of compelling natural attributes, China will have to expend great and costly efforts to develop an adequate infrastructure, a more experienced and competent provincial administration, and a skilled labor force. Although achieving these goals will take many years, the efforts being made to reach them clearly signal that Hainan is a backwater no more. 完

Foreign Investment Incentives in Hainan

Recent legislation breaks some new ground, but fails to create an investor's paradise

Jamie P. Horsley

Even before China elevated Hainan Island to provincial status in April 1988, Chinese officials had promised that Hainan would be more special and preferential than China's four other special economic zones (SEZs). Accordingly, foreign companies eagerly awaited the promulgation of the State Council Provisions for the Encouragement of Investment in and Development of Hainan Island, which became effective in May 1988. Despite the promises, however, prospective investors were disappointed by the provisions, which did not provide significantly better incentives than those available in the more conveniently located and better developed SEZs: Shenzhen, Shantou, and Zhuhai in Guangdong Province, and Xiamen in Fujian Province.

The subsequent promulgation of the Various Provisions on Speeding up the Development and Construction of the Hainan Special Economic Zone (the "Hainan Provisions"), and the Preferential Taxation Measures for the Encouragement of Investment in Hainan Province (the "Tax Measures"), both issued by the Hainan Provincial People's Government in August 1988, considerably improved upon the State Council's provisions in several respects, particularly in the area of taxation. But although this first spate of legislation represents an important start in attempting to break beyond the bounds of existing regulatory schemes, significant gaps remain in areas such as intellectual property protection, arbitration, and business regulation. Hainan's investment climate therefore appears insufficiently attractive, as yet, to lure the droves of foreign investors that Hainan's planners are counting on to help fuel its ambitious development program (*see* p. 20).

Favorable tax treatment

Hainan permits foreign investors to establish the three types of foreign investment enterprises (FIEs) recognized under Chinese national law, and offers more or less the same tax rates and holidays as the other SEZs for technologically advanced, export-oriented, and service enterprises, and for productive enterprises engaged in manufacturing, communications, and transportation. As is standard in the SEZs, FIEs in Hainan will be taxed on their net income at a flat rate of 15 percent, and profits remitted abroad by foreign investors in equity joint ventures will be exempted from the 10 percent withholding tax imposed under the 1980 Joint Venture Income Tax Law. Hainan goes beyond the other SEZs, however, by providing additional tax incentives to encourage investment on the island.

▶ **Exemption from local income tax.** As of July 1, 1988, all Hainan enterprises except State-owned banks and insurance companies are exempted from local income tax. In contrast, the other SEZs retain the discretion to impose local income tax.

▶ **Extended tax holidays for infrastructure projects**. Enterprises engaged in developing and operating certain types of infrastructure projects—such as ports, wharves, airports, highways, railways, electric power plants, coal mines, and water conservancy and agriculture projects—that are scheduled to operate for at least 15 years are granted a tax exemption for five years beginning in the first profit-making year, and a 50 percent reduction in tax for the following five years. Outside of Hainan, comparable tax treatment is available only for the construction of ports and wharves by equity joint ventures.

▶ **Tax holidays in autonomous minority counties.** Productive enterprises and infrastructure projects established in Tongshi Municipality and the eight autonomous minority counties of Hainan that are scheduled to operate for at least 10 years will be exempted from income tax for 10 years beginning in the first profit-making year, and pay tax at half-rate for the following 10 years. These areas will also be permitted to decide how to tax tourism projects within their jurisdictions, which include some of Hainan's choice southern coastal areas such as Yalongwan (Dragon Tooth Bay).

▶ **Tax refunds for re-invested profits.** Foreign investors that re-invest their profits within China are entitled to a standard 40 percent refund throughout the country, including Hainan. However, those that re-invest in Hainan infrastructure and agricultural projects will receive a 100 percent tax refund on the re-invested portion.

▶ **Exemption from withholding tax on passive income.** As of August 1988, enterprises that do not have taxable establishments in Hainan but do have certain types of passive income—such as dividends, interest, rentals, fees for the use of proprietary technology, and other unspecified income—will be exempted from

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withholding tax on such income, which is normally taxed at the rate of 10 percent of the gross amount in the SEZs and open coastal cities, and 20 percent elsewhere in China.

Hainan has also announced that the period for depreciation of fixed assets stipulated under national law will be shortened, but the Financial and Taxation Department has not yet promulgated the regulations.

While Hainan's tax incentives are more favorable overall than those available in the SEZs, they are not as daring as many potential investors had hoped, and leave some issues unresolved. For example, there are no regulations specifying how representative offices of foreign companies established in Hainan are to be taxed. Since representative offices are not allowed to actually conduct business in China, and therefore do not earn a direct profit, under China's national tax legislation many of them end up paying income tax based on their business costs or on artificially deemed profits. Exempting such offices on Hainan from all taxes might encourage foreign companies to come investigate and develop business opportunities on a permanent basis. In addition, a reduction of the normal income tax rate from 15 to 5–10 percent, and an extension of tax holidays for service and manufacturing projects would help lure companies that are comparing the investment climate in Hainan to countries like Thailand and Singapore.

Sales tax rules treat all enterprises alike

Hainan has further modified its tax laws by establishing new sales tax provisions that put foreign investors on an equal footing with domestic Chinese enterprises. Although Chinese tax officials estimate that the new system will lessen the resulting tax burden on foreign investors, it is still too early to tell what the ultimate effect of these changes will be.

According to Hainan's new method of calculating sales tax, FIEs that sell products within Hainan will no longer be subject to the 1958 consolidated industrial and commercial tax (CICT), which is imposed on gross revenues or total value and currently applies to FIEs throughout China. Instead, they will pay value-added tax (which is calculated on the value added at each stage of production), product tax, and business tax, which now apply only to domestic Chinese enterprises.

Moreover, with the exception of mineral oil, cigarettes, liquor, and sugar, which will be subject to product tax and value-added tax at half-rate, all other products of Hainan enterprises sold within Hainan Island will generally be exempted from those taxes. This reflects similar exemptions available in the other SEZs. If, however, otherwise exempt products contain materials or components that were imported duty-free, the products will be subject to product and value-added tax at half-rate when sold in Hainan, and full rate when sold on the mainland. With the exception of crude oil, finished oil products, and several other products stipulated by the State, all other products are exempted from product and value-added taxes when exported abroad.

If enterprises engaged in service trades, transportation, communications, and commerce that were formerly subject to CICT would be subject to a higher tax rate under the business tax, they may continue to be taxed at the former rate until their approved periods of operation expire.

Like the other SEZs, Hainan allows machinery, equipment, raw materials and spare parts, means of communication and transportation, office equipment, and other items necessary for the construction and production of enterprises to be imported duty-free, and exempt from payment of product or value-added tax. The other SEZs, however, still impose CICT at 50 percent the normal rates on imports of mineral oils, tobacco, liquor, and certain other articles besides those brought in for personal use.

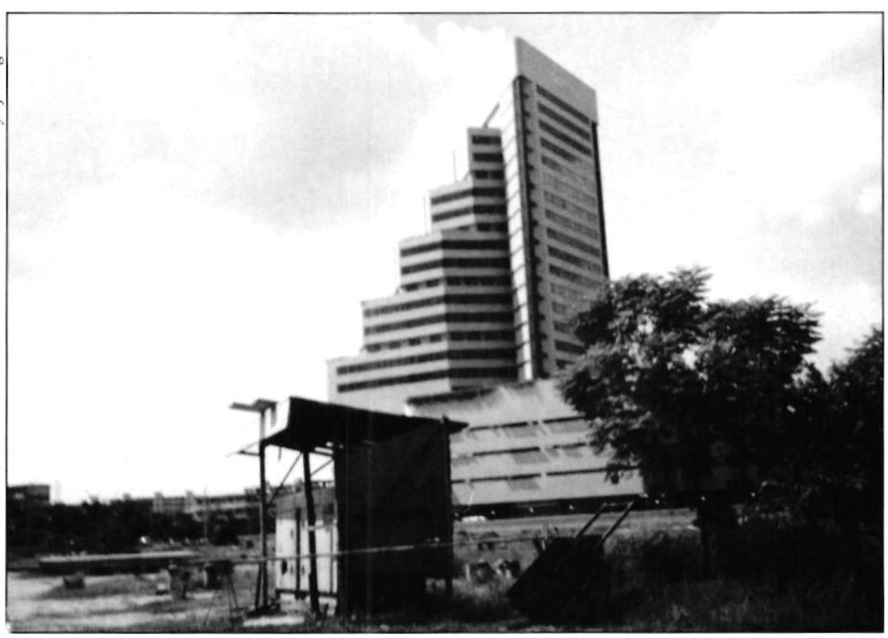
Goods that are imported for sale within Hainan will enjoy a 50 percent reduction of customs duty, and export goods made within Hainan (including those made using raw and processed materials imported from the Chinese mainland with more than 20 percent value added in Hainan) will be exempted from export customs duty and tax.

Although rumors persist that Beijing is considering making Hainan into a free port, most of the Hainan Provisions dealing with import–export trade resemble laws in force elsewhere in China. Hainan does appear to differ significantly from the other SEZs, however, in allowing Hainan enterprises greater scope to participate in foreign trade.

Import–export restrictions eased, but not abandoned

Although elsewhere China continues to strictly control the right to engage in foreign trade, the Hainan Provisions specify that all enterprises registered in Hainan may engage in import and export trade without having to obtain special trade approvals. Presumably, this does not

Photo courtesy of Ying Price



f foreign banks take advantage of the provisions permitting them to engage in RMB transactions on Hainan, the new Bank of China building in Haikou will soon be flanked by competitors.

mean that FIEs will be allowed to act freely as trading companies, but will only be allowed to trade goods that they make, as is true elsewhere in China. Commodities not subject to national or provincial restrictions will be released by Customs based on the relevant sales contracts, but commodities subject to quotas or licensing restrictions must be reported to the relevant departments in Hainan, which will coordinate with the State.

Imports for sale within Hainan of both State-restricted mechanical and electrical goods, as well as commodities subject to unified trading by specialized foreign trade companies, are to be promptly reported to the State by the Hainan Trade and Industry Department. Imports of goods subject to quotas imposed by the State Planning Commission and the Materials Supply Ministry must be reported by the Hainan Economic Planning Department. Quotas for such goods will be allocated by public bidding according to regulations not yet issued, and Customs will release such goods based on the import quota, license, and approval document issued by the Hainan Trade and Industry Department or Economic Planning Department.

Although earlier reports had claimed that Hainan's exports would not be subject to China's export quota system, the Hainan Provisions do set forth procedures required for handling the import and export of restricted goods. This is not unexpected in light of the 1985 auto scandal, when Hainan officials imported 185,000 foreign cars duty-free and re-exported them to the Chinese mainland for substantial profits. Hainan's much-discussed free port status still seems a long way off.

Longer term for land-use rights

Many areas in China have published land-use regulations which permit Chinese and foreigners to purchase long-term land-use rights from the State. According to the Measures for Land Administration in Hainan (the "Land Measures") issued in February 1988, land-use rights in Hainan, as in other parts of China, may be sold, transferred (by way of gift, bequest, or otherwise), or mortgaged for compensation. The maximum grant of land-use rights is 70 years, the same as in Xiamen SEZ, but longer than the 50-year maximum permitted elsewhere in China. These land-use rights appear to be broader than those previously granted to FIEs, as they are not tied solely to the FIE's use but have a marketable value. Under joint venture land-use regulations, the land right is generally coterminus with the joint venture term, and it has never been clear what happens to the land-use right upon dissolution of the

INVESTMENT INCENTIVES COMPARED

	HAINAN	SHENZHEN	XIAMEN	ZHUHAI	SHANTOU
Maximum term of land-use grants (in years)	70	50	70	50	50
Land-use fee sqm/ yr (RMB)	not yet determined	0.2–1.6	5 (export-oriented enterprises exempt)	0.5–1	5–10
Local income taxes	exempt	Localities retain discretion to decide			
Exemption from income tax if profit is reinvested	40% on reinvested portion, or 100% for profits reinvested in infrastructure and agriculture	40%	40%	40%	40%
		Export-oriented and technologically advanced firms that reinvest for at least 5 years will be refunded all tax paid on reinvested portion			

Source: Jamie P. Horsley and Council files venture. The Land Measures, however, specify permissible procedures for sale of land-use rights.

The Hainan Provisions further stipulate that Hainan will implement preferential—but as yet unspecified—policies for land used for energy, communications, water conservancy and similar infrastructure projects. The Hainan Bureau of State Land is to determine the terms of land-use grants for different uses and locations, and publish detailed rules on land sales and land management. The Land Measures state that foreigners, in particular, will be encouraged to develop large tracts of land, especially in the province's coastal islands.

The Land Measures also provide that if the value of the land increases during the term of land use, the purchaser of the land-use rights must pay "land value-added tax" on such increase. However, no provisions on such a tax have been promulgated. It is also unclear whether land users must pay an ongoing land-use fee in addition to the price for obtaining the grant of long-term rights and payment of land value-added tax. Such fees are charged to grantees of long-term land-use rights in the other SEZs, but not in Shanghai.

Securities rules still unclear

Like those regarding land use, Hainan's laws concerning the issue of stocks and bonds are also ambiguous in places. The Hainan Provisions stipulate that Hainan enterprises can entrust banks or other financial institutions to issue on their behalf renminbi (RMB) or foreign exchange stocks and bonds that can be freely exchanged on capital markets. While national law permits only a few collectively owned enterprises to issue stock, and only State-owned enterprises to issue bonds, the Hainan legislation implies that *all* enterprises in Hainan—including FIEs—may issue stocks and bonds.

However, the rules regulating the securities market are to be separately stipulated, and investors must await those regulations before seeing how innovative Hainan will be in this area. Both Guangdong Province and Xiamen SEZ permit State-owned and collective enterprises and "enterprises combining different economic forms," including FIEs (although not wholly foreign-owned enterprises in Guangdong), to issue stocks and bonds. It is to be hoped that Hainan will follow their lead, and thus permit foreign investors to tap local savings for financing and development.

Although some elements of the laws regarding land use and stocks and bond issues look promising, investors will have to wait for further legislation and closely monitor prevailing conditions before the scope and impact of legislation in these areas can be clearly assessed.

A free foreign exchange market?

Although the Hainan Provisions promise that Hainan will enjoy a free foreign exchange market—which would greatly assist foreign investors to repatriate their profits—the island has not yet lived up to that promise. Early reports that Hainan would permit foreign currency to circulate freely have not been borne out in practice.

Permitting foreign businesspeople to engage directly in business in Hainan through branch offices, rather than FIEs, would also demonstrate that Hainan is indeed "special and preferential."

The Hainan Provisions stipulate that the exchange rate will be "adjusted" on the foreign exchange adjustment markets within the province, and that any individual or enterprise can freely buy and sell foreign exchange on such markets, although it is not clear whether such exchanges need to be carried out through a swap center (*see The CBR*, Sept–Oct 1988, p. 10). Whereas access to swap centers in the rest of China is still highly restricted and primarily available only to foreign-invested and State enterprises, this liberal provision suggests that anyone from anywhere in China can go to Hainan to change currencies. When the foreign exchange trading center in Haikou was established in October 1987, however, it did not allow individuals or entities from outside Hainan to participate.

The Hainan Provisions also state that all foreign banks and Chinese-foreign joint venture banks in Hainan may be approved to engage in RMB transactions, but this approval power does not appear to have been exercised to date. Whether such restrictions will be lifted remains to be seen.

Further legislation needed

Hainan officials are now drafting further legislation that they hope will consolidate and bolster the advances the Hainan Provisions and Tax Laws have already made. Foreign investors would also like to see Hainan revise some of its already promulgated legislation to further extend tax holidays, reduce normal income tax rates, implement a comprehensive duty-free trade policy, and exempt representative offices from taxation.

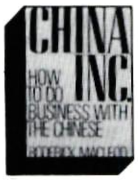
Furthermore, Hainan should pay special attention to intellectual property protection, arbitration, and corruption, none of which are covered in its existing legislation. Hainan should protect intellectual property rights by doing away with the national requirement that technology licenses can last only 10 years, and should promulgate an unfair competition law under which claims could be made for violation of rights in unpatented know-how, unregistered trademark and copyright, and unfair trade practice cases.

If Hainan is truly bold, it will establish an arbitration center staffed by an international body of arbitrators that offers a choice of applicable arbitration rules. Permitting foreign businesspeople to engage directly in business in Hainan through branch offices, rather than FIEs, would also demonstrate that Hainan is indeed "special and preferential."

Whether Hainan can complete its stated task of creating an ideal investment environment will depend not only upon its will, but also on whether it receives enough autonomy from Beijing to enact and implement such bold legislation. Considering how far it has come in such a short time, Hainan has made an impressive start at enhancing its investment climate—but it still has a long way to go before it succeeds in creating a "treasure island" for foreign investors. 完

BOOKSHELF

书刊介绍



China Inc.: How to Do Business With the Chinese, by Roderick Macleod. Toronto: Bantam Books, 1988. 224 pp. $19.95 hardcover.

Chinese negotiators think of each business deal as part of a larger picture encompassing not only immediate financial considerations, but also political, local, national, and industrial factors. Western businesspeople, by contrast, consider negotiations a tightly focused, linear progression culminating in a discrete transaction.

Macleod's book exemplifies this contextual way of thinking. Instead of progressing from point to point to demonstrate causes and effects, the book sets out China business "horror stories" in chapter two, and not until chapter eight explains what may have caused them and how they could be mitigated or avoided. The chapters in between construct the cultural framework necessary for understanding the explanation.

Unfortunately, Macleod relates each point in the book to so many others that the result is sometimes confusing. The Cultural Revolution, for example, is mentioned in a number of different contexts. It may be necessary to refer repeatedly to chapter subheadings to keep in mind the ostensible subject of the section. This confusion is compounded by the repeated use of comparative examples from the West. Though at times the book is overwhelmingly anecdotal, Macleod's willingness to reveal many of his own mistakes in order to illuminate the reader is enlightening, and overall the style is pleasing. The book reads unusually well for a business primer.

Macleod's book also contains many small pearls that will give new perspective even to seasoned China hands. He stresses, for example, that being patient is not enough—the cost of patience must be built into feasibility studies. For instance, how much will it cost if the export license takes six months? If China undergoes a policy change that delays the contract one year? Is the deal still viable with the delays built in? Most delays are forseeable, argues Macleod, and so should not cause undue stress.

The book's only substantive flaw is its insistence on the oversimplistic construct of China as a single monolithic corporate entity. While the notion helps to illuminate the vast bureaucratic interplay, some contentions are overdrawn. China does not have a single way of doing business; variations are found among sectors and regions. Moreover, China can no longer afford to obscure its foreign trade system in "internal" regulations restricted from foreign scrutiny. China is not a corporation, and these regulations should not be accorded the status of trade secrets. If China is to become a full member of the international economic system, it must make public heretofore "secret" regulations.

More ruthless editing would have made this good book a truly fine one. Macleod is clearly a top-notch China hand, and he offers valuable insights on why negotiations bog down, choosing a consultant or facilitator, and pointers on what to include in contracts. Read it on the flight over or on a long train ride in China, or simply as an alternative to the more typically concise and informative—but also linear and dull—how-to books on China business.

—Karen Green

US-China Trade: Problems and Prospects, edited by Eugene K. Lawson. New York: Praeger, 1988. 329 pp. $49.95 hardcover.

One of the persistent frustrations of doing business with China is that useful information on the subject is highly dispersed throughout a myriad of guides and how-to manuals. Some emphasize straight trade to the exclusion of negotiating tactics. Others describe China's foreign trade institutions without discussing the political and economic factors that influence their dealings with foreign companies.

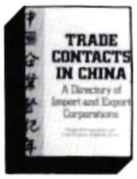
This book is a refreshing departure from the piecemeal norm, providing solid advice on all of these subjects in a straightforward and authoritative manner that should please both China newcomers and old hands.

Each of the book's seven sections contain contributions by experts on various topics, including Sino–US trade prospects, China's changing economy and international role, legal issues affecting traders and investors, organizational and financial strategies, commercial opportunities in certain sectors, and negotiating practices. The book is well-indexed, and contains a detailed and up-to-date bibliography of references on commercial relations with China.

The rich mix of articles makes it hard to pick favorites, but some parts of the book really stand out. Stanley Lubman and Jerome Cohen offer graceful and eminently practical discussions of China's legal environment and problems foreign businesses can expect to encounter. Business strategies, contract vehicles, and financing options discussed in the articles by Kim Woodard, Carolyn Brehm, and R. Barry Spaulding should be required reading for anyone considering a China venture. Chapters by Clark Randt and Melvin Searls on commercial negotiations with China are less detailed than Lucian Pye's classic reference work, but provide concise introductions to this important subject. Allan Whiting, Robert Michael Field, and Barry Naughton present with skill and authority the complex subjects of China's economic reforms, industrial planning, and integration into the global economy.

A few topics are not covered, including China's latest round of trade reform, which began after the book had gone to press, the commercial implications of China's bid to join the GATT, and problems faced by US firms in obtaining competitive export credits. Also, the book cries out for an introduction summarizing the broad range of material in the component sections.

These shortcomings do not detract from an otherwise fine book. For everyone interested in knowing more about Sino-foreign commercial relations, it performs a real service by pulling together information normally found only by hunting through dozens of texts. It is a useful and highly welcome reference. —Jeffrey R. Taylor, US Bureau of the Census



Trade Contacts in China: A Directory of Import and Export Corporations, London: Kogan Page (in association with China Prospect Publishing House), 1987. Distributed in the United States and Canada by Gale Research Company. 357 pp. $110 hardcover.

This directory of China's numerous trade organizations is a typical example of the reference genre. The first of the book's three main sections contains background material on trade practices in China, but without enough detail to be useful to the novice China trader. The organizational charts in this section offer some insight into the relationship between some of the major corporations and the various ministries, but are marred by glaring omissions, such as two of the major trading corporations under MOFERT (MEHECO and CHINAPACK). Even though the charts do not claim to be comprehensive, such gaps compromise the credibility and usefulness of the text.

Section two comprises the bulk of the book, a list of about 600 Chinese trading corporations. The method of alphabetizing by parent company is a convenient and welcome approach. Each entry lists the company's name, address, telephone, telex, and cable numbers, describes the company, and gives information on branch offices and subsidiaries. While the section encompasses an impressive number of corporations, it gives no indication of how the corporations are affiliated or when they were established. Branch office and subsidiary listings for some corporations are incomplete. For example, the latest brochure for the China Silk Corporation (which has since changed its name to the China National Silk Import-Export Corp.) lists 17 branches in China and nine representative offices abroad—but only four appear in this directory.

The book's most innovative feature is section three's handy index to all the trading corporations divided into 49 industry categories, as well as an index of corporations by province. The appendix contains several maps, a list of China's ministries and commissions, and names and addresses of China-related organizations, including diplomatic offices abroad and reference sources. Beware of omissions and errors, however—the US-China Business Council's address, for example, is given incorrectly.

A handy reference guide to China's trading organizations is always useful, especially since they are proliferating at such a rapid rate. Compared to similar books, however, this guide breaks no new ground and offers no new insights.

—Beverly Musolf Lopinto

CHINEASE. Montreal: Arrakis Technologies, 1987. Distributed by China Books and Periodicals, 2929 24th St., San Francisco, CA 94110. Three diskettes. $67.50. (Demonstration disks available for $5 each).

The delicate brushstrokes of Chinese characters have taken over 5,000 years to evolve into their present form. Now reading and writing these ancient characters can be taught in the most modern way with the appearance of *CHINEASE*, an introduction to written Chinese that can be self-taught using a personal computer.

Although the eight-lesson course teaches only 80 characters, it provides a good introduction to Chinese for anyone interested in learning the basics. The program covers the evolution and formative principles of Chinese characters, correct writing techniques, the *hanyu pinyin* romanization system, the tonal pronunciation system, and a dictionary of all the characters in the program. It is menu-driven with simple instructions on advancing and backtracking through the lessons.

The program emphasizes stroke order, and shows each character almost magically drawn on the screen stroke by stroke. After each stroke appears it is numbered before the next stroke is drawn. The direction of the brush stroke is always clear, unlike the examples in some textbooks.

Several delightful animated illustrations appear throughout the program. One shows the evolution of the character *shan*, or mountain, from 1000 BC—when it resembled very closely a sketch of three peaks—to its present form of three vertical lines underscored by a single horizontal stroke. Informative and entertaining, the illustrations add fun to the learning process.

Unfortunately, *CHINEASE* lacks audio tapes for pronounciation purposes, although tapes are expected to be on the market in two to three months. The makers are also considering adding a digital voice system that would speak directly from the computer.

This program is ideal for those interested in beginning Chinese, but an intermediate student is likely to find it more entertaining than challenging. For a fraction of the cost of enrolling in a class, however, *CHINEASE* offers the beginner a fun, easy, and inexpensive introduction to this rich and challenging language.

—Alan Deharpport

BOOKS RECEIVED

Essential Chinese for Travelers, by Fan Zhilong. San Francisco, CA: China Books & Periodicals, 1988. 260 pp. softcover book and 90-minute cassette tape. $16.95.

Foreign Direct Investment in the People's Republic of China (Report of the Roundtable organized by the UN Centre on Transnational Corporations in cooperation with the Ministry of Foreign Economic Relations and Trade, Beijing, 25 and 26 May 1987). New York: UN Centre on Transnational Corporations, 1988. 115 pp. Sales No. E.88.II.A.3. $15.50.

Living Treasures: An Odyssey Through China's Extraordinary Nature Reserves, by Tang Xiyang. New York: Bantam Books, 1987. 196 pp. $29.95 hardcover.

A New English-Chinese Dictionary (Revised and Enlarged), by Ge Chuangui. Seattle, WA: University of Washington Press, 1988. 1,770 pp. $19.95 hardcover.

Despite the lack of official ties, China and South Korea are building economic links

Crossing the Yellow Sea

Ken Yun

For both China and South Korea, the Yellow Sea may turn into a yellow brick road leading to a treasure trove of trade opportunities. The attraction of complementary resources, along with more flexible domestic policies on both sides, has enabled the two countries to establish increasingly lucrative economic ties despite the lack of political relations.

Ten years ago trade between China and South Korea was estimated at around $120 million. By 1987, bilateral trade had grown to between $1.5 and $2 billion, and is expected to enter the $2.5–$3 billion range in 1988. Both countries are thus thought to rank among each other's top 10 trading partners, though complete and accurate statistics are difficult to compile because most trade is conducted indirectly through Hong Kong, Japan, and Singapore. What is clear, however, is that the total far exceeds China's trade with North Korea, which totaled $513 million in 1987.

Politics bow to pragmatism

Until the late 1970s, China's alliance with North Korea effectively deterred Beijing from any favorable stance toward ties with South Korea, and Chinese officials refused to engage in business transactions if South Korea was mentioned as the destination of exports. Contracts signed with Hong Kong and Japanese firms expressly prohibited the movement of Chinese products to South Korea.

In 1979, however, China's new open door policy prompted Deng Xiaoping to announce that China should learn from South Korea's development strategy. Soon thereafter, China purchased 300,000 Korean black-and-white television sets through Hong Kong. Though China has consistently tried to avoid the appearance of approving trade with South Korea, this act in effect sanctioned indirect trade between the two countries.

After several years of sporadic contact, Sino–South Korean trade surged dramatically in 1985, when China shipped 1 million tonnes of anthracite coal on a foreign flag carrier directly to Korea. Both direct and indirect trade have risen consistently ever since (*see* graph), as both countries have found mutual benefit in growing economic contact.

Complementary economies

South Korea and China appear to be natural trading partners. The bulk of China's exports to Korea consists of raw materials—coal, corn, nonferrous metals, and textile raw materials such as silk and cotton fibers. Korea in turn exports man-made fibers, steel products, manufactured goods, and machinery to China (*see* map).

In addition, Korean technology is considered by many economists to be more suitable for China than that offered by Japanese or Western suppliers, which is often too expensive and too sophisticated. A newly industrialized economy, Korea possesses the kind of mid-level production and processing technologies that are now urgently needed in China. And a number of Korea's leading industrial sectors, such as steel and petrochemicals, correspond to Chinese development priorities.

Longer term prospects for both sides appear still more attractive. In addition to supplying valuable raw materials, China could become an important new market for Korean companies hurt by protectionist pressures in traditional export strongholds like the United States. Korea's push for a larger share of the China market should be aided by the steady appreciation of the Japanese yen, as well as by rising domestic labor rates in Korea, which will make China an increasingly attractive investment site for production of processed goods. Growing economic ties with Korea will also allow China to decrease its trade dependence on Japan, whose surplus represents the largest component of China's trade deficit.

Increasing unofficial access

Governments of both countries have adopted measures to facilitate and increase economic exchange. While China's alliance with North Korea has led Beijing to withhold official sanction or even recognition of South Korean trade (*see* p. 42), some encouragement is nevertheless being given to develop economic ties. Shandong Province, for example, has been permitted to send delegations to Korea, and has announced plans to open a trade promotion office in Seoul through its Hong Kong branch. Seoul will in turn open promotional missions in Beijing and Qingdao through its Hong Kong trade promotion office. Jilin and Liaoning provinces are expected to follow Shandong's lead.

China has also eased restrictions on movement of Korean personnel and shipment of Korean goods to the mainland. South Korean ships and crews are now permitted to ship Korean goods directly to China, as long as the ships are registered with a

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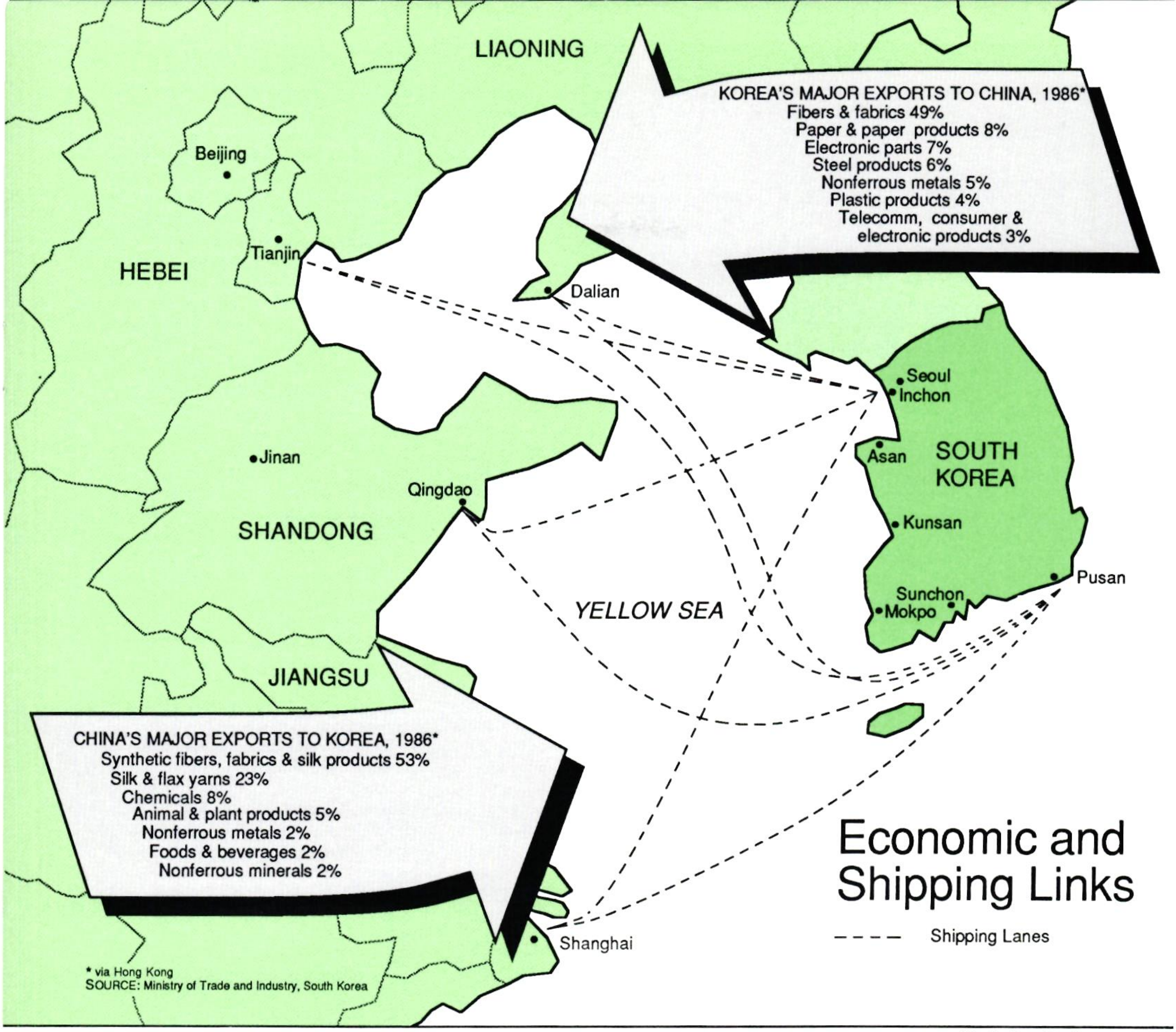
Artwork by Elizabeth Stewart



Map by Steve Turtil

third country and do not fly the Korean flag. Even for goods that move directly, however, the paperwork is often concluded in a third country. Both countries profit from this arrangement, as shipping directly can shave up to 20 percent on transport costs.

The Korean government has adopted a higher profile approach to trade relations with China, both because of its political rivalry with North Korea and for internal political reasons. During the South Korean presidential election campaign in late 1987, for example, Roh Tae-woo, the eventual winner, announced his desire to visit China and predicted that relations would be normalized within five years. Although Korean officials now seem to have learned to temper their public enthusiasm about China with a little more realism, they clearly maintain high expectations and confidence about the future of China trade. This confidence is reflected in a new ministerial-level committee set up by Korea's Economic Planning Board to deal specifically with trade with Communist countries. As Soviet–South Korean trade totaled only $200 million in 1987, however, trade with China may be expected to occupy most of the committee's time.

Building a base for trade

Roh Tae-woo's pledge to expand trade relations with China includes a development plan for Korea's west coast, which directly faces China. The plans target the southwestern Cholla provinces, and will not only balance the disproportionate degree of development between eastern and western Korea, but will also provide the infrastructure necessary to turn the region into a base for trade with China.

Korean planners are counting on the region's cheap land and labor rates to attract capital investment in three new industrial complexes to be located at Asan Bay, Kunsan Port, and Taebul. The plans also include a T-shaped industrial belt to connect Kunsan with three other industrial cities. A 505 km long highway from Inchon to Sunchon will provide a further link between major coastal cities.

Kunsan Port, 15 hours by sea from Qingdao and Yantai in Shandong Province, will play the key role in providing a strategic base for Sino–Korean trade. Other western ports, such as those at Inchon, Asan, and Mokpo, will also be upgraded.

Korea's west coast development plan reflects and complements China's coastal development strategy. Measures adopted all along the coast to improve the investment environment, such as Shandong's establishment of eight export processing zones in Qingdao, Yantai, Weihai, Weifang, Zibo, Longkou, Rizhao, and Jinan, should prove attractive to South Korean as well as other foreign investors. The province has also reportedly gone a step further by presenting a list of 62 foreign investment opportunities to South Korean businesses in areas such as tires, garments, and machinery.

Korean conglomerates lead the way

Korean investors are, in fact, already active in China. Although reports are difficult to verify, some 20 to 50 companies are estimated to have investments in China, and some 80 more joint ventures are reportedly under discussion (*see* list). The Korean *chaebols*, or conglomerates, have set the pace, using their political clout, financial resources, and foreign subsidiaries to back their first forays into China business.

Daewoo Corporation was the first Korean concern to establish a joint venture in China through a Hong Kong subsidiary established expressly for that purpose. Four years of talks finally resulted in an agreement with the foreign economic committee of Fuzhou City in Fujian Province. Daewoo contributed $12.5 million for a 48 percent stake in a refrigerator manufacturing plant in Fuzhou, which became operational in June 1988. The company has since signed a contract to establish a second joint venture in Fuzhou, and has also opened a liaison office in the city.

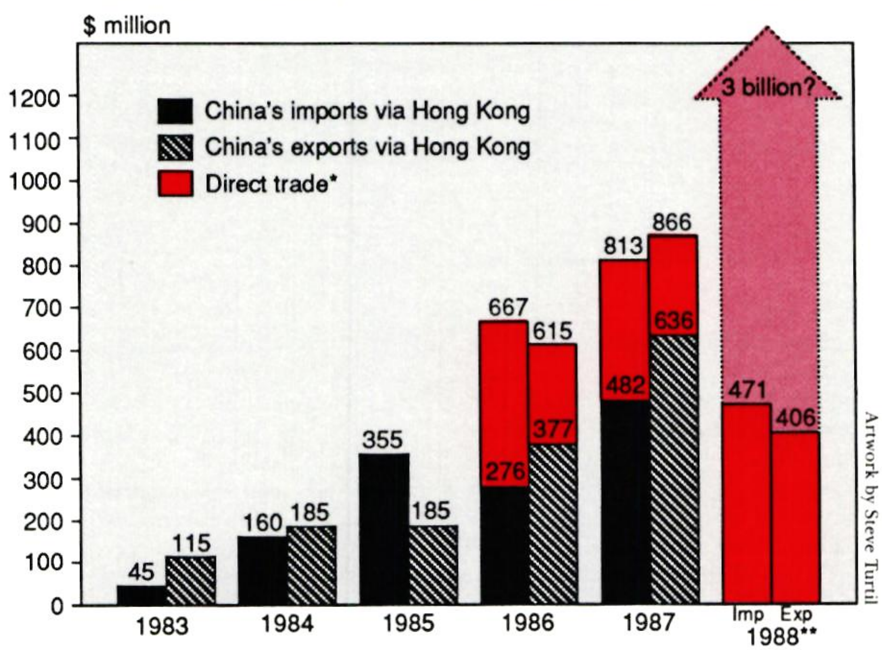
Other Korean conglomerates, including Lucky-Goldstar, Hyundai, and Samsung, which has a liaison office in Beijing, have also undertaken China ventures, and Hyosung, Ssangyong, and Sunkyong are expected to establish presences soon. Many of these companies are preparing for future China business by expanding their Hong Kong branch offices and sending executives to Taiwan for Chinese language training.

Small and medium-sized Korean companies are also showing interest in the China market. The Export and Import Bank in Seoul reported 128 consultations with firms interested in investing in China through the first 10 months of 1988. The Federation of Korean Industries (FKI) has formed a special committee for economic cooperation with China, and the Korea Foreign Trade Association (KFTA) and the Korean Chamber of Commerce and Industry (KCCI) also maintain task forces to advise and monitor China trade. The Korea Federation of Small Business (KFSB) is trying to arrange a trip to China for entrepreneurs in the steel, paper, textiles, and electronics sectors. The Korean Society for the Advancement of the Machinery Industry, which is affiliated with the State-run Korea Institute for Economics and Technology, sponsored a mission to search for joint venture and sales opportunities to four Chinese provinces in November 1988, and will invite officials from Heilongjiang Province to Korea in return.

Korean banks have been trying to establish agreements with Chinese banks in order to finance growing bilateral trade. Six of Korea's top banks—the Hanil Bank, Cho Hung Bank, Bank of Seoul, Commercial Bank of Korea, Korea First Bank, and the Korea Exchange Bank—have signed correspondence agreements with the Shenzhen branches of the Hong Kong Shanghai Bank and Standard Chartered Bank, and with Hong Kong branches of China and South Sea Bank and Bank of Communication.

Hong Kong and Shanghai Bank, in conjunction with the Industry and Commerce Bank of China, and the Hong Kong branch of Standard Chartered in conjunction with CITIC Industrial Bank, have invited three groups of top Korean bankers to China to meet with Chinese regional financial and economic officials since July 1988. (Reflecting political sensitivities, the bankers entered China on tourist visas.) Korean bankers are eager to establish relations with the Bank of China, which currently uses foreign banks such as the Bank of Tokyo in Seoul to conduct remittance and settlement procedures between Chinese and Korean banks.

SINO—SOUTH KOREAN TRADE



SOURCE: Economic Planning Board and Ministry of Trade and Industry of South Korea
Korean press reports

* Direct trade estimates based on Korean press reports
** Half-year data

DEALS INVOLVING CHINA AND SOUTH KOREA

Trade

Daewoo Motor Co., an equity joint venture between the Daewoo group and General Motors Corp., shipped 175 LeMans race cars to China in October 1988, the first ever shipment of South Korean passenger cars to China. The company expects to export about 500 cars to China by the end of 1988.

Honam Oil Refinery Co., a joint venture between South Korean business interests and Caltex Petroleum Corp. of Dallas, ordered 380,000 barrels of heavy crude oil from China in June 1988.

Korea Press shipped a film cassette plant and raw materials to China for use in Fuji Co. of Japan's China operations.

The **Office of Supply** in South Korea ordered 15,000 tons of pig iron from Inner Mongolia in June 1988, 3,000 tons of ingot aluminum in August 1988, and is expected to import an additional 10,000 tons of aluminum in 1989.

Namhae Chemical Corp. contracted to export 150,000 tons of compound fertilizer to China National Chemicals Import-Export Corp. The fertilizer will be exported directly beginning in January 1989, and the contract is renewable after one year.

Pohang Iron and Steel Co. will import 300,000–500,000 tons of Chinese coal for use in its steelmaking operations.

Samsung Semiconductor Telecommunications Co. has received Chinese orders for 34,000 EPABX circuits, and from June through December 1988 shipped 40,000 bilingual word processors to China. Samsung also installed 200 km of optical cables linking Shanghai, Tianjin, and other cities, and has signed a similar contract with the Guangzhou telephone office. China has agreed to import Samsung faxes, phones and keyphones, and other telecommunications equipment for the 1990 Asian Games in Beijing.

Ssangyong Construction Co. has joined a consortium including several Chinese organizations and Parsons Corp. of California to bid on a $100 million project to rebuild Dalian Port in Liaoning Province.

San Kwong and **Kook Je** traded electronic products, textiles, industrial equipment, and consumer goods worth $100 million to China for agricultural products and industrial material in 1985.

Investment

Daewoo Corp. established Korea's first joint venture in China in Fujian Province with the Fuzhou city government. The venture, which became operational in June 1988, will assemble 300,000 refrigerators per year. Daewoo invested $12.57 million for a 48 percent stake and will take charge of operations for 20 years. In August 1988 Daewoo signed a contract to open its second joint venture in Fuzhou, a refrigerator compressor plant. Daewoo Electronics and the Fuzhou city government each hold 40 percent shares, and a Daewoo corporation and a Chinese company each hold 10 percent. The $50 million venture will have an annual production capacity of 750,000 refrigerator compressors, 80 percent of which will be sold domestically. Daewoo is also reportedly discussing the construction of cement production and oil refinery joint ventures in China.

Orion Electric Co., a subsidiary of Daewoo, is building a plant to manufacture color TV tubes in Kumi, Korea, in a joint venture with a Chinese partner. The equity venture is expected to produce 3 million color TV tubes annually for export to China, and marks the first time that a Chinese interest has set up a joint venture in South Korea.

Cheil Sugar Co., South Korea's leading food processor, has invested $20 million to set up an artificial seasoning plant in Guangdong Province. The plant will produce an average of 3,000 tonnes per year of monosodium glutamate.

Lucky-Goldstar is constructing a joint venture glass bulb manufacturing plant with a Chinese partner in Zhuhai SEZ. The factory will begin manufacturing glass bulbs for color picture tubes in 1989.

Handoo Fisheries Co. is reportedly preparing to establish a joint venture fishery in China.

Hyundai Motor Co. is planning to build a joint venture assembly line in Hubei Province with a Chinese partner at a cost of approximately $300 million. The plant will produce 300,000 passenger cars and small trucks and 100,000 mini-buses annually.

Ilyang Pharmaceutical Industrial Co. is conducting a feasibility study to examine a potential joint venture with a Hong Kong company in southern China to produce a ginseng drink.

Kia Industrial Co. has reportedly reached an agreement with a public corporation in Yantai City, Shandong Province, to establish a passenger car, microbus, and truck producing joint venture.

Korea Steel Pipe Co. and **China Metallurgical Import-Export Co.** have established a joint venture steel pipe plant in Yantai City. Each partner holds 50 percent of the $30 million venture, which will produce 60,000 tons per year of water pipes.

Pohang Iron and Steel Co. is negotiating a joint venture steelmaking plant in China, probably in Shandong or Liaoning. The Korean and Chinese partners will likely be joined by a third country partner.

Sammi Corp. and **China Construction Engineering Corp.** have established CSN, a building materials joint venture in Macao. Sammi exported construction materials worth $10 million to China in 1987, and 100 tons of seamless pipes in 1988.

Samyang Foods Co. plans to build a plant in China to produce Ramyon instant noodles.

Samsung Electronics plans to invest $60 million for a 30 percent stake in a refrigerator plant that will be built in Beijing in 1989. Samsung is also reportedly interested in establishing TV and VCR manufacturing plants in Shenzhen or Zhuhai SEZs.

Banking

Bank of China and **Ssangyong Securities** are reportedly discussing the establishment of a joint venture bank to be based in Hong Kong.

Korea Exchange Bank has concluded an agreement with Shenzhen branches of the Hong Kong Shanghai Bank and the Standard Chartered Bank allowing Korean and Chinese companies to open letters of credit and import-export contracts through these banks.

Hanil Bank, Cho Hung Bank, Bank of Seoul, Korea Exchange Bank, Korea First Bank and **Commercial Bank of Korea** have signed foreign exchange contracts with Hong Kong Shanghai Banking Corp. and Standard Chartered Bank in China, as well as with the Hong Kong branches of the China and South Sea Bank and the Bank of Communication of China.

Shipping

China National Foreign Trade Transportation Corp. has chartered a Panamanian-registered container ship to ply twice a month between Shanghai and Pusan via Japan.

Chunkyung Shipping Co. Ltd. chartered a Hong Kong shipping company in July 1988 to begin direct semicontainer shipping service between Pusan, Inchon, Shanghai, and Tianjin.

Heung-A Shipping Co. Ltd. has chartered a Hong Kong-registered ship to ply between Dalian and Qingdao and South Korean ports.

Sejin Shipping Company provides direct service between South Korean ports and Shanghai and Xinxiang.

Dongnama Shipping and **Hyundai Merchant Marine Co. Ltd.** are reportedly negotiating with China to establish direct shipping services between South Korea and China.

Compiled by Pam Baldinger from press reports and Council files. The accuracy of this list is not independently confirmed by *The CBR*.

Beware of "China fever"

Though only political decisions can unlock the full potential of Sino–South Korean trade, a number of economic problems will have to be addressed if trade is to flourish in the unofficial interim. For example, both countries must increase their limited knowledge of the other, especially in South Korea, where the current epidemic of "China fever" (*see* p. 46) seems to be based more on political aspirations and delusions of the "billion buyer market" than on realistic assessments of business opportunities and problems.

Both sides are undoubtedly aware that conducting negotiations and business agreements through third countries is costly, time consuming, and complex, and results in legal ambiguities such as which laws should govern arbitrations or where suits can be filed. The Chinese policy restricting Korean nationals to three-month visas further complicates matters by forcing Korean companies to hire Japanese or American passport holders to manage their China operations.

Moreover, Korean investments in China do not enjoy official protection. South Korea has reportedly broached the topic of a bilateral investment treaty to protect Korean investment in China, but in the absence of diplomatic ties, such an agreement is unlikely.

Despite the problems, however, both countries seem optimistic about future trade relations, and time and experience should temper Korea's "China fever." Though political recognition seems unlikely in the near future, present conditions indicate that economic ties will continue to grow, which should in turn add to stability in the region. 完

Expanding relations will add stability to the Asia Pacific region

Political Implications of Sino–South Korean Trade

Ralph N. Clough

The recent rapid growth of trade between China and South Korea has demonstrated that the desire to exchange goods can break down the most solid and longstanding political barriers. Trade having led the way, these neighboring countries have also begun to expand exchanges of athletes, officials, scholars, and tourists, despite the adamant opposition of China's ally, North Korea. The anachronistic separation of China from South Korea is gradually giving way to a more normal relationship as both countries assume increasingly active roles in Asia and the world.

Two decades of hostility

In 1950 Chinese troops rescued the North Korean regime when United Nations forces were on the verge of unifying Korea under the South Korean government of Syngman Rhee. China recognized the North Korean capital of Pyongyang as the only legitimate government on the Korean peninsula, and supported Pyongyang's ambition to unify Korea on its own terms. For the next 20 years, China and South Korea faced each other in frozen hostility.

The United States made South Korea a key link in a chain of alliances formed to contain the PRC. Staunchly anti-communist, South Korea maintained warm relations with the Republic of China on Taiwan, and sent troops to fight alongside US forces in Vietnam, while China aided the North Vietnamese. Both Beijing and Seoul forbade trade and other contacts between their two peoples.

The shock of President Richard Nixon's unexpected rapprochement with Beijing in 1972 caused President Park Chung-hee to reassess South Korea's anti-communist pos-

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Ralph N. Clough is a professorial lecturer at the Johns Hopkins School for Advanced International Studies in Washington, DC. He is the author of Embattled Korea: The Rivalry for International Support *(Westview Press, 1987).*

POINTS OF CONTACT

MAY 1983
A Chinese delegation arrives in Seoul to negotiate repatriation of plane hijacked from China.

OCTOBER 1985
A Chinese delegation attends the annual meeting of World Bank-IMF in Seoul.

NOVEMBER 1985
One million tonnes of anthracite coal are shipped directly from China to South Korea on a third country vessel.

NOVEMBER 1985
South Korean businessmen participate for the first time in a Chinese trade fair.

SEPTEMBER 1986
China sends a delegation to the Seoul Asian Games.

DECEMBER 1987
Roh Tae-woo pledges during the South Korean presidential campaign to increase contact with China, and to develop Korea's west coast as a base for trade with China.

MARCH 1988
The Korean Labor Ministry announces that three Chinese workers will undergo training in Korea through the Asia and Pacific Skill Development program.

MARCH 1988
South Korea announces that Chinese who apply directly for patent and trademark protection will be accorded national status.

JUNE 1988
China auctions off an Indonesian freighter when a South Korean firm lodges a debt complaint directly with Chinese authorities.

JULY 1988
A Chinese delegation of tourism officials visits Seoul and agrees to start tourist exchanges between the two countries.

JULY 1988
Beijing and Seoul agree to inaugurate regular container ship service between Shanghai and Pusan via Japan.

ture. He announced his willingness to establish diplomatic relations with China and the Soviet Union if they ceased "hostile activities," recognized the sovereignty of the Republic of Korea (ROK), and stopped aid to North Korea. In 1973, he dropped South Korea's objection to membership of both Koreas in the United Nations. Thereafter, South Korea actively sought trade and other relations with China and the Soviet Union.

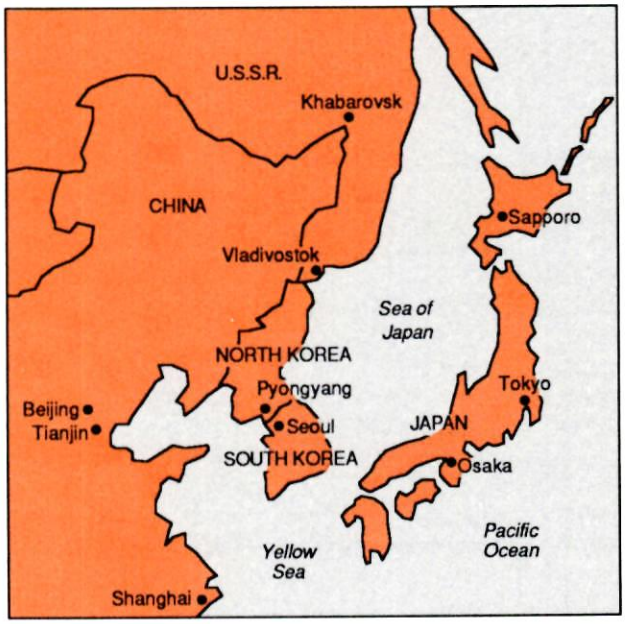
North Korea rejected membership of both Koreas in the United National on the grounds that it would perpetuate the division of Korea. President Kim Il Sung also pressed his allies to refrain from contacts with South Korea. The Soviets were the first to rebuff Kim's demands. In order to be chosen as host country for important international conferences and sports events, they had to agree to admit all qualified participants, including South Koreans. Beginning in the early 1970s, South Koreans appeared at such events in the Soviet Union, despite bitter protests from Pyongyang.

In the 1970s, hosting international events had not yet become important to China, whose relations with the Soviet Union had become increasingly hostile. As late as 1979, Beijing turned down opportunities to host international sports meets rather than admit South Koreans to China at the cost of offending Pyongyang.

Trade begins and quietly grows

China's attitude toward South Korea began to change with the opening to the outside world that formed the basis of the economic reform program adopted in 1978. As Chinese isolationism and the drive for economic self-sufficiency gave way to an emphasis on foreign trade, the booming economy of nearby South Korea beckoned irresistibly.

Hong Kong was an ideal place for Chinese and South Koreans to quietly strike deals for the transshipment of goods. By 1981, two-way trade through Hong Kong had grown to over $200 million. In 1982, trade dropped sharply after Pyongyang protested to Beijing, but it soon crept upward again. The size of the South Korean economy and its complementarity to China's made South Korea a far more attractive trading partner for China than North Korea.



Artwork by Steve Turtil

South Korea's political aims

For South Korea, trade with China was far more important politically than economically, as the two Koreas carried on an intense competition for international recognition. By the mid-1980s, over 60 nations had established diplomatic relations with both Seoul and Pyongyang, but the big powers most important to the two Koreas—China, Japan, the Soviet Union, and the United States—clung to their cold war stance of maintaining relations with only one of the two.

The United States and Japan, with the approval of South Korea, urged "cross-recognition," expressing willingness to establish diplomatic relations with North Korea if the Soviet Union and China would establish relations with South Korea. But North Korea adamantly opposed this proposal, and the Soviet Union and China bowed to its wishes.

Since 1974, North Korea has pressed for official talks with the United States aimed at replacing the 1953 armistice agreement with a peace treaty and thus leading to the withdrawal of US forces from South Korea. The United States, however, unwilling to lend credibility to North Korea's attempts to portray South Korea as a US puppet, has refused official negotiations with North Korea unless the Soviet Union or China engage in official negotiations with South Korea. Washington has stressed North–South dialogue as the best way to ease tension on the peninsula.

Unexpected incidents force contact

Except for trade—which the Chinese officially denied was taking place—South Korea made little progress in developing relations with China until 1983. But in May of that year, the hijacking of a CAAC plane to South Korea forced the PRC to send

JULY 1988
An economic and trade delegation from Dalian arrives in Korea.

AUGUST 1988
A Shandong trade mission arrives in Seoul to discuss establishing a representative office.

AUGUST 1988
A representative of the National Institute of Fishery Promotion makes the first official visit by a South Korean to China.

SEPTEMBER 1988
China participates in the Seoul Olympics.

SEPTEMBER 1988
China authorizes CITS to arrange tours for Koreans through Hong Kong.

OCTOBER 1988
Korea Trade Promotion Corp. announces that it expects to open offices in Beijing and Shandong by December 1988.

OCTOBER 1988
Korea's Economic Planning Board creates a ministerial level government task force to deal with trade with Communist countries, particularly China.

OCTOBER 1988
China participates for the first time in the Seoul International Trade Fair.

OCTOBER 1988
A private consultation body comprised of representatives from Korean business associations and corporations is established to study trade with communist countries.

NOVEMBER 1988
South Korean defense manufacturers attend Defense Expo China in Beijing as official observers.

NOVEMBER 1988
CITIC chairman says that CITIC may consider opening an office in Korea.

NOVEMBER 1988
A mission from the Korea Society for the Advancement of the Machinery Industry visits four Chinese provinces to explore joint venture and sales opportunities.

a team of officials to Seoul to negotiate the return of the plane, passengers, and crew. Other incidents during 1985 that required official negotiations to resolve included the defection of a Chinese military aircraft to South Korea, the sinking of a South Korean fishing boat by a Chinese freighter, and the return of a Chinese navy torpedo boat and crew that had drifted into South Korean waters after being disabled as the result of a mutiny on board.

These incidents demonstrated the need for some mechanism to compensate for the lack of diplomatic relations between the two neighbors. In 1985, as a temporary expedient, the two countries began to pass official comunications to each other between the Korean Consul General in Hong Kong and China's senior representative there, the director of the New China News Agency.

Friendly exchanges follow

More important than such occasional incidents in breaking down Chinese resistance to South Korea's politically motivated overtures was China's desire to play a larger role on the world stage. South Korea itself was becoming an actor whose importance could not easily be ignored. For example, in order to qualify for hosting UN-sponsored conferences in China, China was compelled in 1983 to begin admitting South Korean officials. From 1984 on, South Korean athletes also began to be admitted to international tournaments in China, and Chinese athletes showed up in Seoul. When the annual meeting of the World Bank–IMF was held in Seoul in 1985, a large Chinese delegation attended.

The two events that attracted the most international attention to South Korea were the Asian Games in 1986 and the Olympic Games in 1988. North Korea tried in vain to prevent China from participating in these affairs and adding to South Korea's prestige. The Olympics, which attracted teams from nearly all the communist countries, strengthened China's willingness to brush aside North Korean objections and expand contacts with South Korea.

During 1988, interaction between the two countries reached an unprecedented level. Thousands of Chinese visited South Korea last year, including not only the large Olympic delegation, but Chinese economic officials, scholars, and seamen. Travel agencies reached agreement on South Korean tourist travel to China and arrangements for trade and investment moved toward institutionalization.

Sino–Soviet relations likely to benefit

During the period of most intense Sino–Soviet hostility, Beijing and Moscow used to attack each other over contacts with South Korea in order to gain a few points in Pyongyang. Today, both accept the necessity for contacts with South Korea, and neither country condemns the other for such action. Although they still compete for influence in Pyongyang, their rivalry in this regard is much less combative than in the past, in part because they share a lack of enthusiasm for Kim Il Sung's policies. Beijing and Moscow officially endorse Kim Il Sung's principal pronouncements on policy toward South Korea, but in private Chinese and Soviet officials and scholars disparage Kim's cult of personality, his plan for a dynastic succession, his rigid adherence to a State-planned economy, and his resistance to opening North Korea to the outside world.

China's expanding relations with South Korea facilitate the warming of Soviet–South Korean relations. When Beijing and Moscow tacitly agree on the need to deal with South Korea, North Korea's ability to manipulate them is greatly reduced. Thus, the Soviet Union not only rejected Pyongyang's pleas to stay away from the Seoul Olympics, but even sent the prestigious Bolshoi Ballet to add luster to the cultural program organized by South Korea to complement the sporting events. Recent trade talks between Soviet and South Korean officials suggest that two-way trade is likely to grow well beyond the level of some $200 million reached in 1987. South Korea could become a natural contributor to the development of the Soviet Far East, established as a priority by Mikhail Gorbachev's 1986 speech in Vladivostok.

The main thrust of Chinese and Soviet policy in East Asia is to draw upon the region's vibrant economic growth to benefit their own modernization. Since South Korea is a dynamic contributor to regional modernization, while North Korea stands on the sidelines, the advantages of expanding relations with South Korea are obvious, even though both Beijing and Moscow must maintain a foothold in North Korea for strategic reasons. A peaceful environment in Northeast Asia is essential to the success of Chinese and Soviet modernization plans. Consequently, both are likely to use such influence as they may have on the two Koreas to encourage constructive North–South dialogue and easing of tension.

Japan sees stability in new ties

Japan's support for cross-recognition rests on a conviction that the diplomatic presence of all four big powers in both Korean capitals would make the Korean peninsula more stable and would reduce risk of conflict there. Consequently, the Japanese have long encouraged the expansion of contacts between China and South Korea in the belief that a step-by-step increase in "cross-contacts" by all four big powers will eventually lead to cross-recognition.

Past South Korean governments have been uneasy about Japanese trade and other contacts with North Korea, particularly during the period when South Korea had no comparable contacts with China. Now that the Chinese have shed many of their previous inhibitions regarding contacts with South Korea, the Roh Taewoo government has taken a more relaxed view of Japanese contacts with the North. Dropping the previous policy of trying to isolate North Korea, the Roh government encourages Japan and the United States to develop trade and contacts with North Korea as a means of drawing it into the international community.

In September 1988 the Japanese government dropped restrictions on contacts between Japan and North Korea adopted after the bombing of a Korean Airlines plane by North Korean agents in November 1987. Contacts between Japan and North Korea will probaby grow, though trade totals will likely rise slowly from the 1986 figure of $358 million due to North Korea's lack of marketable exports.

The Japanese are gratified by China's willingness to increase contacts with South Korea, and by the South Korean government's more flexible attitude toward Japanese

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Send to: *The China Business Review,* 1818 N St., NW, Suite 500, Washington, DC 20036 relations with North Korea. A balanced expansion of these two sets of relationships has long been a goal of Japanese foreign policy.

US interests well served

Except for increased competition for certain US exports—for example, cheaper Chinese corn may compete with US corn in the South Korean market—the effect on US interests of China's growing relationship with South Korea will be favorable. It will open the way to increased US contacts with North Korea, thus improving prospects for eventual cross-recognition. The speed of expansion of Sino–South Korean relations is likely to serve as a catalyst for a surge in cross-contacts by the other three big powers, adding to their stake in continued stability on the peninsula. The big powers will thus be in stronger positions from which to encourage productive North–South negotiations. Two fundamental US interests will be served by the China–South Korea rapprochement: a decline in the risk of conflict in Korea, and the stimulation of economic activity in the Asia-Pacific region. 完

Can US firms meet the Asian leadership challenge?

The US Role in Sino–South Korean Trade

K.A. Namkung

Sino–South Korean relations are but one—albeit the most dramatic—example of the growing economic regionalism of East Asia. Comprised of three groups of countries—the NICs (Taiwan, South Korea, Singapore, and Hong Kong), ASEAN (Thailand, Malaysia, Singapore, Brunei, Indonesia, and the Philippines), and China—the East Asian region promises to be one of the world's most economically dynamic in the years to come. In today's East Asia, ideology is taking a back seat to pragmatism, allowing Taiwan and South Korea to trade with socialist neighbors, and socialist nations to trade with other capitalist Asian countries.

Japan has taken a central role in nurturing Asian regionalism, and has increasingly displaced the United States as the leading economic power in the western Pacific. The Japanese have invested enormous sums to build up a regional expertise second to none, while American businesses have been fairly indifferent to the growing economic integration of East Asia, as is clearly illustrated by the respective roles Japan and the United States have adopted toward the growing economic relations between China and South Korea.

Japan's initiative pays off

Since the early 1980s, when Japan stationed a high-level diplomat with China expertise in Seoul, Japan has played a behind-the-scenes but crucial role in fostering relations between China and South Korea. High-level Japanese government officials have delivered messages from Seoul to Beijing, for instance, and the Japanese Foreign Ministry routinely provides advice to its South Korean and Chinese counterparts on strategies for dealing with each other. Japanese business executives have accompanied Korean colleagues to China, and their companies have provided the third-country affiliations required for Korean travel to the mainland. Japanese companies have also made handsome profits from opening letters of credit for Korean and Chinese companies to engage in indirect trade. Certain large Japanese corporations probably know more about the Sino–Korean economic relationship than the principal parties do themselves.

Both South Korea and China, however, are aware that Japanese policies relegate China to the role of raw materials supplier (most Japanese investment in China has been extractive), encourage the export of cheap South Korean goods toward China and away from Japan, and drive China and South Korea into eventual competition with each other—and not with Japan—for export markets.

In addition to suspicion of Japan's economic motives, the legacy of World War II adds historical limitations to the role Japan can play in East Asia. Therefore, while receptive of Japanese advice and impressed by Japanese economic strength, both countries remain wary of Japan's long-term goals in the region.

The United States, by contrast, is relatively unconstrained by unsavory past associations, and thus is in a position to foster and take advantage of burgeoning East Asian regionalism. Yet US businesses have not shown much interest in Sino–South Korean relations to date, nor attempted to carve out a role for themselves in this emerging relationship. Such an attitude may result in serious consequences, both short and long term.

Short-term US losses—but long-term gains

Sino–South Korean ties will lead to reverses for US exporters in certain sectors. Agricultural producers, for example, will see their Asian market shares shrink as China's agricultural reforms and increasing crop productivity permit China to export competitively to both Korea and Japan. US exporters of products such as food grains, corn, raw cotton, and soybeans have already witnessed this phenomenon.

American exports of machinery and plant equipment may also suffer, as the Chinese increasingly look to South Korean sources to supply equipment and technology required

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to modernize industrial facilities. Between 1984 and 1987, the volume of industrial machinery and transportation equipment China imported from South Korea increased from $37 million to $156 million, and this figure is likely to double in 1988. The decline in US exports can only exacerbate America's trade deficit problems and increase American protectionist pressures directed toward Asian producers.

US businesses must look beyond these short-term losses, however, and focus on the long-term opportunities inherent in the new economic relationship between China and South Korea. The two countries' new economic ties represent the dissolution of ideological barriers and the formation of a significant new market in East Asia that may eventually resemble post-1992 Europe. If American firms wish to play a leading role in forging and benefiting from this Asian economic community, they will increasingly have to play the role of middleman in new relationships that cut across ideological barriers. Sino–South Korean relations provide just such an opportunity. Should US companies fail to respond, they will effectively concede leadership in Asia—and countless business opportunities—to Japanese competitors.

Assuming a catalyst role

Sino–Korean relations need an American catalyst. Though their trade is booming (*see* p. 40), current growth levels cannot be sustained indefinitely, especially given the limitations of indirect trade. Koreans can invest in only so many refrigerator, TV assembly, and automobile factories in China, as these industries are generally not given top priority in China's modernization program. Korean investors will eventually have to move into higher technology, higher priority sectors, a move that presents great possibilities for cooperation with American firms.

American companies should take advantage of Korea's high skill level and lower labor costs to form consortia to invest in China. Leadership along the lines of Combustion Engineering's efforts to lead a group of firms—including some from Korea—in building a petrochemical facility in Siberia is needed in China.

A number of practical advantages can be gained by establishing consortia with Korean firms, such as diffusing relatively high levels of risk and placing Korean managers at Chinese work sites to minimize production costs, serve as frontline "cultural buffers," and ensure quality control of low-wage production processes. In addition, American companies may find it advantageous to let their Korean partners, who in recent years have demonstrated their ability to cut through Japan's multi-layered distribution system, market Chinese joint venture products in Japan.

A new view of East Asia

In order for US companies to take advantage of the opportunities presented by a regional Asian market, they must abandon the tendency to look only at individual Asian economies, and instead begin formulating strategies that recognize and address group interaction within the East Asian economic community. Individual American corporations must find a role that will enable them to take better advantage of the new wealth generated by such interactions. The sheer size of this future market cries out for a heavier concentration of American corporate resources in the western Pacific region. The opportunities for lucrative participation are there—but the question remains as to whether American companies are up to the challenge. 完

South Korean firms temper their enthusiasm for China

Fevers and Frustrations

Jerome Alan Cohen

In negotiating contracts with China, South Korean businessmen face special problems—legal, commercial, and psychological—that reflect the absence of diplomatic relations between the two countries. Yet some Korean businessmen appear so bedazzled by the prospect of trade with China that they seem to have contracted a severe case of "Marco Polo-itis," similar to the paralysis of critical faculties that afflicted many Western businessmen on their first trip to "the central kingdom" in the late 1970s. As South Koreans move beyond their already substantial—if still largely indirect—trade with China to discuss investments and other more enduring business relationships, however, they will feel these problems more acutely. American observers will recall the period preceding normalization of US–China relations in 1979 as a time of similar frustrations.

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Getting in and staying safely

Since projects to be located in China are generally negotiated there, the first challenge confronting South Korean negotiators is to obtain the necessary Chinese visas. Getting there has not been half the fun for Koreans, however, as there is no Chinese embassy, consulate, or commercial office in South Korea to handle applications. South Korean companies with Hong Kong offices may be able to reduce the inconvenience of obtaining visas, as Korean negotiators frequently pass through Hong Kong since there are no direct air links between South Korea and China. Although China has improved its visa processing procedures as the number of South Korean visitors has increased, extra time, expense, and uncertainty are still routine, bringing home to all South Koreans—before they even arrive in China—their unequal status there.

Koreans' diplomatic disadvantages become more apparent after crossing the border. Korean travelers have neither an embassy nor any other official outpost to turn to for advice and assurance in China, a country from which they have long been cut off and about which they still know little. Although both South Korea and China adhere to the Vienna Convention on Consular Relations, it is of little assistance should a South Korean be detained by Chinese police, and there is no bilateral consular agreement that provides protection.

The absence of diplomatic relations also denies Seoul direct access to Chinese officials to discuss a detainee's fate. By contrast, if China detains an American businessperson, a bilateral agreement stipulates that such action must be reported to a US consulate, along with information as to the nature of the charges and the place of detention. A US consul must also be permitted to communicate with and visit the detainee, to assist in engaging legal representation and an interpreter, to send supplies, and to attend any trial. As more than one American citizen who has run afoul of Chinese law has discovered, these provisions are in fact honored by China.

Legal vulnerabilities

Once Koreans actually do get into China, it is difficult for them to stay long, as they are not permitted to establish representative offices there. Although in principle they may set up representative offices for subsidiaries established in countries that have diplomatic relations with China, relatively few South Korean companies appear to have done so to date. This is partly because of difficulties encountered in the approval process, such as China's refusal to register subsidiaries that use a Korean parent company's name.

Similar problems arise with respect to whether the Korean parent company will be allowed to sign contracts other than ordinary trade contracts, or whether—as is usually the case—it is required to act through one of its subsidiaries in a third country. In certain cases the parent company may seek to obtain protections denied to it by investing in China through a wholly or partly owned third country subsidiary.

Because treaties take precedence over domestic legislation in China's legal hierarchy, a company planning a project in China must take account of relevant agreements between its government and Beijing. Such agreements may confer significant benefits. For example, if South Korea had a tax treaty with China like the United States and many other countries do, Korean companies would be assured reduction of China's withholding tax on technology transfer fees, Korean banks would gain a similar benefit on their interest income, and Korean personnel would generally be exempted from China's individual income tax if they reside in China for less than half a year.

If, like Japan and other major Western countries (except the United States and Canada), South Korea had a mutual protection of investment agreement with China, the specter of expropriation that haunts Korean companies would appear less menacing. Such agreements not only put legal limits on expropriations and require compensation, but can also facilitate foreign exchange convertibility (*see The CBR*, Nov–Dec 1988, p. 8). South Korean negotiators are well aware that the absence of such protections leaves their companies vulnerable to discriminatory treatment.

The Chinese know full well that South Korea has been gripped by "China fever," and have sought to take advantage of Korean firms' unfamiliarity and eagerness to close deals in China by insisting upon unrealistic contract terms.

Taking advantage of China fever

South Korean negotiators face commercial problems that are even more difficult than their legal problems. The Chinese know full well that South Korea has been gripped by "China fever," and have sought to take advantage of Korean firms' unfamiliarity and eagerness to close deals in China by insisting upon unrealistic contract terms. The Chinese have tended to offer Koreans projects that have been rejected by other investors, or "hand-me-downs" available because the original parties could not fulfill their financing obligations, or otherwise regretted their involvement.

Moreover, the enthusiasm shown in Beijing by many respected business leaders from Seoul has not only whetted the appetites of Chinese companies seeking foreign cooperation, but has increased their expectations of Korean companies. This situation often engenders feelings of frustration and resentment in South Korean negotiators. On the one hand, they wish to overcome all obstacles and vindicate the optimism and public assurances of their chairmen by concluding contracts with the Chinese. On the other, they are faced with Chinese demands that are often an affront to their business judgment and that do not win favor back in Seoul. Resistance to such demands usually leads to criticism from the Chinese side for "dragging one's feet" and "not carrying out the chairman's orders." A veteran South Korean negotiator sums up his experience by saying, "I feel like the ham between two slices of bread."

Assurances given by visiting Korean chairmen are perceived as credible in China not only because of the impressive track records of Korean companies at home and abroad, but also because of the Korean government's explicit approval and implicit support for the China efforts of these companies. If South Korea—despite the absence of a trade agreement providing for most favored nation (MFN) status and other benefits, an export–import bank, insurance subrogation, and other government-to-government arrangements—is willing to back its companies in China, Chinese assumptions that South Koreans will sign contracts even when risk–reward ratios are clearly unacceptable on a commercial basis become suddenly understandable.

Yet it is far from clear that South Korea is prepared to underwrite major business risks in China. The Roh Administration, under increasing popular pressure for progress in relations with China, undoubtedly wants to be supportive of business initiatives there. Nonetheless, it is concerned that should it bail out Korean companies that yield to unrealistic Chinese demands in order to gain immediate kudos, it may instead earn popular condemnation for unduly supporting big business.

Korea underestimates its position

Psychological factors also create difficulties for Koreans during negotiations. Koreans often sense an arrogance in Chinese negotiators that they attribute to the lingering influence of imperial China's Sinocentric worldview. Proud of their commercial sophistication and international accomplishments, Korean negotiators bristle at any hint that they are modern tribute-bearers. They also tend to become discouraged at the fluctuating enthusiasm of their Chinese counterparts, whose tactics inevitably reflect the ups and downs of North Korean pressures upon Beijing.

These psychological tensions probably account for the tendency of some Koreans to overemphasize and dramatize the current difficulties in negotiating with China. There is an inclination to exaggerate what the Chinese know about South Korea and to underestimate the bargaining position of Korean companies, despite the fact that the Soviet Union and Eastern European countries have entered the competition for Korean cooperation. Korean companies also pay insufficient attention to the decade of reasonably successful China experiences of Western investors, themselves recovered victims of China fever.

A healthy future

Despite the problems, however, the future of Sino–Korean cooperation is far from bleak. Developments in East Asian politics point to a further thaw in Sino–South Korean relations—even normalization may only be a few years off. The anticipated reciprocal establishment of semi-official trade offices should reduce the current high level of inconvenience of doing business by facilitating visas, dispensing information, and helping to settle disputes. A semi-official infrastructure of bilateral agreements may also soon emerge to fulfill the functions ordinarily served by formal diplomatic arrangements.

There are also signs that Korean excitement over China may be subsiding, to be replaced by a more relaxed and realistic evaluation of the China market. This in turn should induce Chinese negotiators to adopt the same kind of flexible spirit vis-a-vis Korean companies that they have increasingly been displaying toward other foreign investors, with correspondingly favorable results for both sides.

Koreans and Chinese not only share a common heritage, but they have confronted similar problems in their modernization efforts. As their contact expands, and as each country trains more specialists knowledgeable about the others' language, society, government, economy, and legal system, the environment for negotiating and implementing mutually beneficial contracts should improve. China fever can be fairly serious—but it passes with proper treatment. 完

CHRYSLER CORPORATION

Behind the wheel of China deals

The Chinese are so impressed with Chrysler chairman Lee Iacocca's biography, the best-selling *Iacocca*, that they've made it required reading for managers of top State-run enterprises. And management techniques are not all that the Chinese have obtained from Chrysler. In July 1987 Chrysler signed a licensing agreement with First Automobile Works (FAW) of Changchun, Jilin Province, China's largest automotive manufacturer, to provide technology, machinery, and equipment to manufacture Chrysler 4-cylinder engines.

FAW is building a new plant in Changchun to house an assembly line from Chrysler's Trenton, Michigan, engine plant, which was dimantled and shipped to China last July. In the second half of 1989, FAW will begin producing engines to be used in light trucks and cars produced by FAW and other Chinese automotive companies. The plant will initially produce up to 150,000 2.2L engines per year, and plans call for capacity to eventually double. FAW has also purchased the technical rights for more advanced fuel injection and turbocharge systems, and Chrysler is reportedly conducting feasibility studies for joint production with FAW of upscale autos to serve as both official cars and taxis in China. FAW currently manufactures the luxury Red Flag limousine.

Chrysler's 1987 purchase of the American Motors Corporation (AMC) gave the company another stake in China in the form of a 31 percent interest in the Beijing Jeep Corporation (BJC), a joint venture between AMC and Beijing First Automobile Works. Though the plant was forced to halt production temporarily in 1986 due to a foreign exchange shortage, Iacocca announced during his China visit last October that Chrysler may increase its stake in BJC to 49 percent within the next two years. The investment increase would take the form of imported equipment such as stampings and pressers for parts, which would allow 40 to 60 percent of the jeep components to be made locally. Chrysler hopes eventually to boost BJC's current annual output of 5,000 Cherokee Jeeps to 100,000.

MERCURY MARINE

Slow boat to China shows that patience pays off

Mercury Marine's efforts to break into the China market show that patience and hard work pay off. After 10 years of negotiations, October 1988 found the Brunswick Corporation subsidiary celebrating the start of operations at a new joint venture in Shanghai.

The Jiangxi Marine Company Ltd., a $5 million equity joint venture between Mercury Marine and Weimin Machinery Factory of Jiangxi Province, will produce, market, and service outboard motors and boats in China. The 30-year contract calls for the transfer of Mercury's technology, production techniques, and marketing and management methods to the joint venture. Weimin Machinery Factory will contribute the land and factory building in addition to a labor force over 800 strong.

The joint venture will primarily produce Mercury 7.5 and 9.8 horsepower engines, although a small number of fiberglass boats will also be manufactured. Output of the venture is mainly intended for use by China's domestic security forces, though one of the lower horsepower motors is targeted for export to Southeast Asia. The venture is expected to generate $8 million annually.

Although Mercury Marine originally entered negotiations with a large Beijing conglomerate in 1978, the company concluded that modernizing the product line of an existing Chinese outboard manufacturer would be the most feasible way to enter the China market. To that end, Mercury spent five years consolidating its relationship with the Weimin Machinery Factory, and the Jiangxi Marine Company was signed into existence last June. The venture is governed by a Chinese board of directors, and managed by a former Mercury Marine plant manager.

Though the joint venture is of modest size, Mercury Marine executives believe that Jiangxi Marine will help China become a competitive producer of world-class outboards. Both sides have already exhibited the patience and determination it will take to reach that goal.

CARGILL, INC.

Largest agricultural processing JV to start up this year

In its first equity investment in China, Cargill Southeast Asia Ltd., a subsidiary of the Minneapolis-based multinational corporation, has established a cottonseed oil joint venture in Jinan, Shandong Province, China's largest cotton producer. The Hong Kong-based subsidiary owns 60 percent of Shandong-Cargill Ltd., while Shandong Supply and Marketing Cooperative has a 30 percent stake, and China International Trust and Investment Corporation (CITIC) Hong Kong holds 10 percent.

The $12 million joint venture, China's largest to date for processing of agricultural sideline products, received its business license in May 1988, and hopes to begin production in late 1989. The plant will process 100,000 tonnes per year of cottonseed to yield semi-refined cooking oil as well as several byproducts including cottonseed meal (a high-protein animal feed ingredient); hulls, also to be used for animal feed; and linters (high-quality cellulose). All products will be sold both in China and abroad, except for the low-value hulls, which are only for domestic use.

Shandong-Cargill will be the first plant in China capable of eliminating the poison gossypol from cottonseed oil. And in another first, the venture will be the only Cargill operation to maintain its own fleet of trucks, to avoid dependence on the weak local transportation infrastructure.

—Bryan Batson

The China Business Review 1988 Index

Compiled by Bryan Batson

CHINA BUSINESS

中外貿易

Jennifer Koch-Brick

The following tables contain recent press reports of business contracts and negotiations exclusive of those listed in previous issues. For the most part, the accuracy of these reports is not independently confirmed by *The CBR*. Contracts denominated in foreign currencies are converted into US dollars at the most recent monthly average rate quoted in *International Financial Statistics (IMF)*.

US-China Business Council member firms can contact the library to obtain a copy of news sources and other available background information concerning the business arrangements appearing below. Moreover, firms whose sales and other business arrangements with China do not normally appear in press reports may have them published in *The CBR* by sending the information to the attention of the Business Information Center at The US-China Business Council.

中外
贸易

SALES AND INVESTMENT THROUGH OCTOBER 31

Foreign party/Chinese party
Arrangement, value, and date reported

Agricultural Commodities

China's Imports

Saudi Arabia
Supplied 300,000 tonnes of wheat. 9/88.

Investments in China

Nichirei Corp., Nomura China Investment Co., and Mitsui Norin Marine Products Development Co. (Japan)/Guangdong
Established joint venture to raise prawns primarily for export. (50-50). 7/88.

Melaka Tong Bee Snd. Bhd. (Malaysia)/Beijing Chemical Industry Corp.
Will establish United Dragons Corp. to produce natural rubber. $4 million. (MAL:51%-PRC:49%). 11/88.

China's Investments Abroad

NA (Liberia)/Hunan Forestry International Economic and Technical Cooperation Corp.
Established 10-year wholly owned enterprise to exploit forest resources. $200,000. 9/88.

Abbreviations used throughout text: BOC: Bank of China; CAAC: Civil Aviation Administration of China; CAIEC: China National Automotive Import-Export Corp.; CCTV: China Central Television; CEIEC: China Electronic Import-Export Corp.; CEROILFOODS: China National Cereals, Oil, and Foodstuffs Import-Export Corp.; CHINATEX: China National Textiles Import-Export Corp; CITIC: China International Trust and Investment Corp.; CITS: China International Travel Service; CNCCC: China National Chemical Construction Co; CNOOC: China National Offshore Oil Corp.; CPIC: China National Corporation of Pharmaceutical Economic and Technical International Cooperation; ICBC: Industrial and Commercial Bank of China; INSTRIMPEX: China National Instruments Import-Export Corp.; MLI: Ministry of Light Industry; MOCI: Ministry of Coal Industry; MOPI: Ministry of Petroleum Industry; MPT: Ministry of Posts and Telecommunications; MWREP: Ministry of Water Resources and Electric Power; NA: Not Available; NDSTIC: National Defense, Science, Technology, and Industry Commission; NORINCO: China North Industries Corp.; SINOCHEM: China National Chemicals Import-Export Corp.; SINOPEC: China National Petrochemical Corp.; SINOTRANS: China National Foreign Trade Transportation Corp.; SITCO: Shanghai Investment and Trust Corp.; SPC: State Planning Commission.

Agricultural Technology

China's Imports

John Deere International Ltd. (US)/CTIEC
Will supply tractor and combine parts through World Bank loans. $1.1 million. 8/88.

Johson-Loft Engineers Inc. (US)
Supplied corn oil bleaching, refining, winterizing, and deodorizing plant. 9/88.

Price-Chen International Inc. (US)/Hebei
Will build and operate corn oil processing plant. $3 million. 9/88.

Investments in China

Arbor Acres Farm Inc. (US) and Mitsui Corp. (Japan)/Beijing Huadu Corp.
Established 20-year joint venture chicken breeding farm using US chickens, to be marketed by Mitsui. 9/88.

Aquiline Resources Services TTE Ltd. (Singapore) and NA (Malaysia)/ Beijing Huadu Corp.
Will cooperatively run chicken feed factory and pig farm. 9/88.

NA (Singapore)/Tianjin
Signed joint contract to breed chickens. $26 million. 9/88.

Pacific Development and Marketing Co. (US)/Dengkou County, Nei Mongol
Signed agreement to grow American tomatoes on trial basis; if successful, will jointly fund tomato juice processing plant. 11/88.

Other

International Board for Plant Genetic Resources/Academy of Agriculture
Will cooperate in exploration and collection of crop resources. 9/88.

Chemicals, Petrochemicals, and Related Equipment

Other

Instituto de Credito (Spain)/BOC
Will provide $150 million of mixed loans for development of detergent and alkyl benzene complex. 9/88.

Chemicals (Agricultural)

China's Imports

Sandoz Ltd. (Switzerland)/CTIEC
Will supply 5,000 kg pesticide through World Bank loans. $32,500. 8/88.

Speichem (Cergy Pontoise) (France)/CTIEC
Will build methionine plant and upstream facilities; methionine is a poultry feed additive. 9/88.

Tecnimont, subs. of Montedison SpA, and Snamprogetti (Italy)/CTIEC
Will supply urea and synthetic ammonia production equipment. 9/88.

Tecnimont (Italy)/Dalian Chemicals Industrial Co.
Will supply synthetic ammonia production equipment. 10/88.

Impex Group Ltd. (US)
Sold chemical fertilizers. 10/88.

Construction Materials and Equipment

China's Imports

Siempelkamp (FRG)/CTIEC and Shaowu Timber Yard, Fujian
Will supply shave board production line and glue manufacturing equipment. $9.2 million (DM17 million). 9/88.

Rieber & Son (Norway)/CTIEC and Jingzhou Construction Plastics factory, Hubei
Imported plastic floor tile production line. $4 million. 10/88.

Investments in China

China Resources (Holdings) Co. (HK)/Liuzhou Cement Factory, Guangxi
Established joint venture cement warehouse. 9/88.

Consumer Goods

Investments in China

Citizen Watch (Japan)/Jiangmen, Guangdong
Established Wah Kong Precision (Jiangmen) Ltd. wholly owned venture to produce low-priced mechanical watches. (Registered capital: $2 million). 8/88.

NA (Japan)/Kongfengchun Cosmetics Factory, Hangzhou
Will establish Chunsili Co. Ltd. to produce cosmetics. (50-50). 8/88.

Fujitsu General Co. (Japan)/China Huanyu Electronic Joint Co.
Will jointly produce window-type air conditioners. 8/88.

NA (US) and NA (HK)/Baoquan, Heilongjiang
Established Haubao Down Corp. Ltd. joint venture to produce goose-down products. 9/88.

NA (Japan)/Dalian Construction Parts Co.
Established Dalong Co. Ltd. to produce sanitary chopsticks. (JA:49%-PRC:51%). 9/88.

RJP (HK), Sanpo Lock Ltd., and Incommerce Ltd. (Japan)/Shenzhen SEZ
The wholly owned venture will produce security locks in Shenzhen. (HK:45%-SLL:45%-IC:10%). 9/88.

NA (US)/LIGHTINDUSTRY
Established Union Light Trading Corp. to produce hair regeneration liniment. 9/88.

QSS International Co. (US)/Hebei ETDZ, Glass Research Institute, and No. 3 Pottery Factory, Hebei
Established 15-year pottery joint venture. $7 million. 9/88.

Cryodynamics (US)
Signed letter of intent to produce refrigerators in Shanghai. 10/88.

R.J. Reynolds, subs. of RJR Nabisco (US)
Began operations at joint venture cigarette factory. $21 million. 11/88.

Jerry Auerbach (US)/Shanghai State Farm Industrial Corp. and Hua Ye Factory
Established Heart Toy Co. to produce plush toys. $966,000. 11/88.

Electronics, Electrical Equipment, and Computer Software

China's Imports

Kaiseihin Co. (Japan)/CTIEC and Beijing Chemical Works
Will provide technology and equipment for fluorescent crystals for color television tube manufacture. 8/88.

AST Research Inc. (US)/MOC and MOF
Sold 3,500 personal computers. 9/88.

CMS Enhancements Inc. (US)
Will sell data storage devices and PC accessories. 9/88.

China Hewlett-Packard, subs. of Hewlett-Packard Co. (US)/Hua Xia Group
Will assemble and sell 200 32-bit HP 9000 Series 300 workstations in Fujian. 9/88.

Graham Magnetics, subs. of Carlyle Corp. (US)
Will supply magnetic tape for computer use. 9/88.

Digital Equipment Corp. (US)
Will supply eight computer network systems through World Bank loans. $1.8 million. 10/88.

CADKEY Inc. (US)/Shanghai Metallurgical & Mining Machine Factory
Signed agreement to provide various software packages. 10/88.

Stratus Computer Inc., Shared Financial Systems, and Visa International (US)/BOC
Will develop electronic processing system for credit card transactions. 10/88.

Investments in China

Motorola Inc. (US)
Will set up wholly owned semiconductor plant. 9/88.

Showa Electric Wire & Cable Co. and Shinko Shoji Co. (Japan)/Tianjin
Will establish joint venture to produce glass delay lines for televisions and VCRs. $620,000. (SWC:20%-SSC:5%-PRC:75%). 9/88.

Luks Industrial (HK) and Akai Electric (Japan)/Shenzhen
Established HK-Japanese joint venture to produce video cassette recorders in Shenzhen. 10/88.

Matsushita Electrical (Japan)
Will open video cassette recorder manufacturing joint venture in Beijing. 10/88.

Gold Peak Industries (HK) and Shinwa Co. (Japan)/Huiyang, Guangdong
Established joint venture to produce car stereos in Guangdong. 10/88.

Itoman & Co. (Japan)
Producing switching regulators in Shenzhen. 10/88.

Digital Equipment Corp. (US)
Building independent venture in Shenzhen to produce computer components. 11/88.

Engineering and Construction

Other

Bank of Tokyo (Japan)/Novel Dyeing and Printing Mills, Shenzhen
Will provide $18 million long-term loan to finance construction of factories. 11/88.

Environmental Equipment and Technology

Investments in China

Japan
Changchun Sino-Japanese People's Friendship Water Works began operation of water purification facility. 9/88.

Other

Degremont Co. (France)/Tianjin
Will supply instruments and equipment to Dongjiao sewage treatment plant through French government assistance. $9.5 million (FFr60 million). 9/88.

Dojin Kagaku Kenkyusho (Japan)/New Technology Development Corp.
Signed agreement to provide technology and assist in manufacturing water analysis kits. 10/88.

Finance and Banking

Other

UK
Agreed to lend $530 million (£300 million) in low-interest loans over next three years. 9/88.

The World Bank
Provided $37 million soft loan for Ningxia irrigation project. 9/88.

Asian Development Bank
Approved 21-year, $46.5 million loan for plastics industry. 10/88.

Canada
Signed $700 million loan agreement. 10/88.

France
Signed $107 million loan agreement. (FFr682 million). 10/88.

Societe Generale (France)/Bank of Communications
Signed $15.7 million (FFr100 million) buyer's credit agreement. 10/88.

An international consortium/Dongfeng Chemicals Industry Co. Ltd.
Will provide 10-year, $120 million syndicated loan. 10/88.

Food Processing and Food Service

China's Imports

Danish Turnkey Dairies Ltd. (Denmark)/CTIEC
Will supply one milk separator and parts through World Bank loans. $244,000 (DKr1.75 million). 8/88.

Investments in China

Heineken (Holland)
Will establish joint venture in Shanghai to produce beer. $30 million. (50-50). 9/88.

Brownies (Canada)
Will open fast-food chicken outlet in Beijing. 9/88.

Amit Co. Ltd. (HK)/Beijing International Business Service Co.
Established Beijing Pizza Co. Ltd. 9/88.

Leasing and Insurance

Other

Crownlife Insurance Co. (Canada)/PICC
Signed memorandum of intent to cooperate on insurance matters. 9/88.

Yasuda Trust Bank, Yasuda Trust and Leasing Co., and Overseas Leasing Co. (Japan)/Funan Financial Co., Hainan
Signed business cooperation agreement and plan to establish leasing company. 9/88.

Machine Tools and Machinery

China's Imports

Fujisawa Electric Co. (Japan)/Shunde Pearl River Refrigerator Factory and Hunan North Industry Co.
Will provide extruding machines for refrigerator door frame production. 9/88.

Mitsui Corp.(Japan)
Will supply two switch point milling machines through World Bank loans. $4.3 million. 9/88.

Investments in China

Alpha (Japan)/Hangzhou Huaxing Enterprise Co.
Will set up Alpha Tools to produce sintered carbide tools. 10/88.

Other

Wiedemann, div. of Warner & Swasey Co. (US)
Signed service and maintenance agreement for punch press machinery. 9/88.

Media

Investments in China

KB Communications Inc. (US)/China Film Import and Export Co.
Formed Silk Road Music Inc. to manufacture and distribute Western recordings in the PRC, and release PRC recordings abroad through subsidiary of KB. 8/88.

NA (Canada)
Formed joint venture to shoot film in Xian on China's first emperor. 10/88.

Other

Maxwell Communication Corp. (UK)/China Daily Typesetting and Printing Co.
Will supply typesetting equipment in exchange for typesetting services. 9/88.

Radio France/Central Radio
Signed accord to jointly produce radio programs. 9/88.

Franco Giovale, an Italian producer
Will shoot film based on *Judge Di* stories partially in China. (Portion shot in China to cost $15 million.) 10/88.

Medical Equipment and Devices

China's Imports

Pack-All Systems (Canada)/Huayang Leasing Co.
Sold medical products plants which will be dismantled and reassembled in Shandong. $2.25 million. 8/88.

NA (FRG)/First Hospital of Beijing Medical University
Sold 12 sets of dialysis equipment. $200,000. 9/88.

Investments in China

NA (US)/CAS
Opened factory to produce pulse supersonic electrocardiogram devices. 8/88.

Rare Antibodies and Antigens Supply Co. (US)/Shanghai Municipal Blood Center
Established Shanghai Reis Blood Products Co. Ltd. to produce blood products. 10/88.

Japan Medical Supply/Dalian Medical Appliance Factory and Dalian Science & Engineering College
Established Dalian JMS Medical Appliances to manufacture transfusion sets and syringes. (Registered capital: $7 million). 10/88.

Metals, Minerals, and Processing Equipment

China's Imports

Mannesmann Demag Huettentechnik (FRG) and Italimpianti (Italy)
Will construct steel plant and seamless pipe mill. 9/88.

Mitsui (Japan)
Will supply two sets steel frog milling machines through World Bank loans. $3.1 million. 9/88.

Norway, Sweden, Denmark, and the Netherlands/China National Nonferrous Metals Import and Export Corp.
Will provide government loans to import key equipment and technology for the Guangxi Pingguo Aluminum Factory. 10/88.

Yamatake-Honeywell (Japan), subs. of Honeywell Inc. (US)/China Metallurgical Import and Export Corp.
Will supply digital instrumentation system for sintering plant in Hubei. 10/88.

Seco/Warwick Corp. (US)/Southwest Aluminum Fabrication and Datong Locomotive Works
Will supply two heat processing furnaces. 10/88.

Investments in China

Ervin Industries (US)/Shanghai Shenjiang General Enterprise Co. and CETDC
Established Shanghai Shenjiang-Ervin Metal Alloy Corp. joint venture to manufacture Amasteel products. 8/88.

Top five steel manufacturers (Japan)/Shijiusuo, Shandong
Will establish joint venture to build fully integrated steel plant. 8/88.

Other

Japanese (Sanyo) Bank/Tianjin Trust and Investment Co.
Granted seven year, $20 million loan to help fund seamless steel tubing mill. 10/88.

STS International (US)
Met with PRC delegation to discuss details of 25-stand rod mill project. 10/88.

China's Investments Abroad

Wai Hing Co. (HK)/CITIC
Formed Citisteel Inc. to buy out and run Phoenix Steel Corp (US); Citisteel will now produce carbon plate. $13.5 million. (HK:20%-PRC:80%). 10/88.

Military Equipment

Investments in China

Cadillac Gage Textron (US)/MACHIMPEX
Jointly developing low-cost tank. 10/88.

Mining Equipment

China's Imports

Sweden/Chengzi Colliery, Beijing
Provided technology, equipment, and loans for coal slurry factory. 9/88.

Other

Prosprefor International (Sweden)/Wuhan Iron and Steel Complex, Hubei
Will conduct feasibility study of possible exploitation of Chengchuo Iron Mine through grant from Swedish government. $1.1 million (SKr10 million). 8/88.

Packaging and Paper and Pulp Equipment

China's Imports

EKPAC Engineering Ltd. (HK)/CTIEC
Will supply two packaging machines through World Bank loans. $1.6 million (HK$9 million). 8/88.

Forindeco and Svotfos (Norway)/CTIEC, Yalujiang Paper Mill, Liaoning
Sold 100 tpd used paper production line, including equipment, computers, technical documents, and technical services. $2.9 million (NKr19.4 million). 8/88.

Glittering Investment Co. Ltd. (HK), agent of Toshiba Machinery Co Ltd. (Japan)
Will sell plastic film production equipment and technology. $4.6 million. 9/88.

Mitsuwa (Japan)/Liaoning Provincial Farm Machine Industry Co.
Started joint venture to produce packaging machines. 10/88.

Other

Tufpak Inc. (US)
Signed letter of intent to distribute autoclavable biohazard bags, with possibility of joint venture production. 10/88.

Velmet Paper Machinery Inc. (Finland)/Xian Paper Machinery Plant
Will establish Xian Velmet Paper Machinery Co. Ltd. to produce paper-making machines. $13 million. 10/88.

Petroleum, Natural Gas, and Related Equipment

China's Imports

Getty Oil International (Orient) Inc., subs. of Texaco Inc. (US)/CNOOC
Will explore for oil near mouth of Pearl River. 9/88.

Huanan Oil Development Ltd. (Japan)/CNOOC
Will explore for oil near mouth of Pearl River. 9/88.

Landmark Graphics Corp. (US)/MPI
Signed letter of intent to provide geological interactive workstations. 9/88.

Daniel Industries Inc. (US)
Will supply steam flood generation equipment for heavy crude oil recovery. 9/88.

Western Petroleum Services International Co., subs. of Western Co. (US)/MACHIMPEX
Will produce and supply oilfield services equipment and related technology. $26 million. 9/88.

Japax Nanhai Ltd. (Japan)/CNOOC
Will explore for oil near mouth of Pearl River. 9/88.

Simitran Corp.(US)
Will supply three training simulators and spare parts for The World Bank Daqing Oilfield Project. $1.1 million. 10/88.

Gustavson Associates (US)/Bohai Oil Corp., subs. of CNOOC
Will conduct in-depth geological and reservoir engineering study in Bohai Gulf. 10/88.

GeoQuest Systems Inc. and Digital Equipment Corp. (US)/CNOOC and MOPI
GeoQuest will supply interactive geophysical exploration systems which are built around DEC computers. $12.6 million. 10/88.

China's Investments Abroad

Pacific Oil Refining Co. (US)/SINOCHEM
SINOCHEM plans to buy 50% of the refinery. 9/88.

Power Plants and Power Equipment

China's Imports

Foster Wheeler Trading Co. AG (Switzerland), subs. of Foster Wheeler Corp. (US)/CITIC, Sunburst Energy Development Inc., and Jiangsu Investment Corp.
Awarded contract for two coal-fired generators for Ligang Power Station, Jiangsu. $75 million. 10/88.

TECHNOPROMEXPORT (USSR)/Huaneng International Power Co.
Will supply two supercritical parameter generating sets. 10/88.

Investments in China

Sema Group, merger of Cap Group Plc (UK) and Sema-Metra (France)/State Science and Technology Commission
Will conduct project on automatic monitoring and safety systems at Daya Bay, Guangdong, financed by the EEC. 9/88.

Tinwai Inc. (HK), subs. of a U.S. firm/Baotou Generator Factory, Nei Mongol
Will jointly develop wind-driven generators. (Registered capital:$4.8 million.) (HK:40%-PRC:60%). 9/88.

Netherlands
Will invest in wind energy project. 10/88.

Other

Sansha Electric Mfg. (Japan)/Shanghai Voltage Regulator Factory
Will supply technology for power regulators. 10/88.

Property Management and Development

Investments in China

Nara Nichinichi Shimbun (Japan)/Shaanxi Ribao
Will set up 462-room hotel in Xian. 9/88.

Group Pelege (France)/Beijing Municipal Housing Corp.
Will construct Beijing International Finance Building. $100 million. 9/88.

China Overseas Building Development Co. (HK consortium owned by PRC.)
Won international land tender for 7.03 sq. km. site to develop in Shenzhen. $8.1 million. 9/88.

Other

Hokkaido Takushoku Bank, Fuji Bank (Japan), and Standard Chartered Bank (HK)
Granted 10-year, $18 million credit for construction of Beijing guesthouse. 9/88.

Ministry of Economic Cooperation (FRG)/Shandong
Will aid in building international tourism school. 10/88.

Six international financial institutions/CITIC Industrial Bank, subs. of CITIC
Signed 11-year, $30 million syndicated loan for construction of Guo An Hotel in Xian. 10/88.

China's Investments Abroad

Ambanc Ltd. (US)/CITIC
CITIC bought limited partnership in Cedar Meadows Apartments in Arizona. 9/88.

Scientific Instruments

China's Imports

Control Data Corp. (US)
Sold meteorological processing and forecasting system. $12.6 million. 10/88.

Investments in China

NA (Japan)/China Aeronautical Technology Import and Export Co.
Established Chengcheng Industrial Co. Ltd. to produce sputtering film pressure sensors and other sensors. 8/88.

NA (US subs. of Applied Geological Co., Japan)/MOPI
Established Junfeng Co. for trial production of seismographs. 9/88.

UOP, joint venture between Union Carbide Corp. and Allied-Signal Inc. (US)/Shanghai Molecular Sieve Factory
Established Shanghai UOP-UCC Molecular Sieve Co. $10 million. 10/88.

Ships and Shipping

Investments in China

Royal Nedlloyd Group (Netherlands)/SINOTRANS and Shanghai International Trade Information and Exhibition Co.
Established Shanghai Exportrans Ltd. to transport foreign exhibitions in the PRC. 9/88.

Neptune Orient Lines Ltd. (Singapore)/SINOCHEM
Established Orient Stella Shipping Pte. Ltd. to expand tanker chartering operations. 10/88.

Other

United Parcel Service (US)/SINOTRANS
Signed parcel handling cooperation agreement. 10/88.

Kuehne and Nagel (FRG)/SINOTRANS
Signed agreement allowing rail container shipping between the two countries. 10/88.

China's Investments Abroad

China Interocean Transport Inc.
Purchased warehouse facility in Compton, California. $1.55 million. 10/88.

Telecommunications

China's Imports

Samsung Semiconducter & Telecommunications Corp. (S. Korea)
Will increase sales of fiber optic equipment. 9/88.

Telecom (Australia)
Will build digital microwave system to link Shanghai and Beijing. 9/88.

Ericsson (Sweden)/Beijing Wire Communications Plant
Will jointly manufacture MD110 digital switching systems in China for six years. $40 million. 9/88.

NEC Corp. and Marubeni Corp. (Japan)/MPT
Will provide technology and equipment for large-scale microwave communications. 9/88.

Alcatel Standard Electrica SA (Spain)/CTIEC
Will provide digital exchange systems for Hubei Province. 10/88.

Investments in China

GEC Plessey Telecommunications, joint venture between GEC and Plessey (UK)
Signed 15-year contract establishing Shanghai Digital Telephone Equipment Co. to manufacture, sell, and distribute integrated digital exchange systems. $204 million. 9/88.

Elec & Eltek (HK)
Established wholly owned enterprise in Shenzhen to form electronics and telecommunications center. $9.7 million (HK$76 million). 9/88.

Other

Fuqing County, Fujian
Group of overseas Chinese bought Japanese program-controlled telephone exchange system for the county. $650,000. 8/88.

Nippon Electric Corp. (Japan)/Ministry of Machine Building and Electronics Industry
Signed cooperation agreement on integrated circuit and digital switching equipment production. 10/88.

International Development Agency (Canada)/MOC
Granted $3.6 million for purchase of telecommunications equipment from the Canadian firm, Spar Communications, and for general improvements to communications systems. $3.6 million (C$4.4 million). 10/88.

China's Investments Abroad

China Satellite Launch and Tracking Control General
Won five-year contract for tracking, telemetry and command services for Inmarsat-2 satellites in the Pacific region. $8 million. 9/88.

Textiles

China's Imports

Waltex (Italy)/Taishi Woolen Textile Mill, Shandong
Sold computerized fabric production system. 9/88.

Austral Insulation (Australia)/MOFERT
Will supply refrigerated room equipment for maintenance of silkworms. $1.9 million (A$1.5 million). 9/88.

Investments in China

Denison Resources and Deak Morgan (Australia)/Shenyang Textile Industry Bureau
Established Wool Cleaning Technologies to scour and process wool; one factory will be in Shenyang and one in Australia. (50-50). $50.4 million (A$40 million). 8/88.

Mitsui & Co. (Japan)/Nei Mongol
Will set up suit manufacturing joint venture. 9/88.

NA (Japan)/CHINATEX, Nanjing Silk Weaving Mill
Will produce blended silk-wool dress material. 10/88.

Other

Gunze Sangyo Q Inc. (Japan)/Hangzhou Honglei Silk Weaving Factory
Signed compensation trade agreement for Japanese to supply weaving equipment in exchange for silk. 10/88.

China's Investments Abroad

Industria Textil, S.A. (Costa Rica)/United Trading Corp., S.A.
Established joint venture in Costa Rica to export textiles to third markets. $3.6 million. (50-50). 8/88.

Transportation

China's Imports

Boeing Co. (US)/CAAC, Guangzhou
Will supply three 757-200 twin-engine jets. $125 million. 9/88.

McDonnell Douglas Corp. (US)/CAAC
Will supply four MD-11 tri-engine jets. $400 million. 9/88.

Daimler-Benz (FRG)/Guizhou Tire Factory
Will transfer tire production technology and supply equipment. 9/88.

Badische Masch Durlach (FRG)
Will supply air flow impact molding machine for The World Bank First Railway Project. $1.2 million. 9/88.

Marubeni (Japan)
Will supply 2,800 tonnes fishplates for 50 kg/m rails for The World Bank First Railway Project. $1.4 million. 9/88.

Marubeni (Japan)
Will supply 37 fault locators for The World Bank First Railway Project. $1.6 million. 9/88.

Airbus Industrie (France)/CAAC
Contracted for three A300-600R aircraft. 9/88.

Daewoo Motor Co. (S. Korea)
Sold 175 passenger cars. 9/88.

Pirelli (Italy)
Will supply optical fiber cable to The World Bank First Railway Project. $3.3 million. 10/88.

Ensco (US)
Will supply two sets track inspection cars to The World Bank First Railway Project. $2.3 million. 10/88.

Investments in China

General Motors Corp. (US) and Fuji Heavy Industrial Co. (Japan)/China No. 2 Automotive Factory
Will cooperatively establish car factory. $4 billion. 6/88.

Alsthom (France)/Ministry of Railways
Will supply 129 transformer sets to The World Bank Second Railway Project. $9 million. 8/88.

Asea Brown Boveri (Sweden)/Ministry of Railways
Will supply power equipment to The World Bank Second Railway Project. $11.8 million. 9/88.

Firestone Co. (US)/Guangzhou Tire Factory
Signed contract for 300,000 units per year tire production line. $34.9 million (¥130 million). 9/88.

Purolator Products Inc. (US)
Established Shanghai Purolator Filter Co. to produce and market automotive filters. 9/88.

Thomson Co. (US)/Beijing No. 2 Auto Works
Producing upgraded thermostats at Dongfeng-Thomson Co. Ltd. 9/88.

Other

USSR
Will provide 4% interest rate loan to finance completion of rail line along the two countries' central Asian border. $82.2 million (SwF130 million). 10/88.

American Aerospace Industries Inc. (US)/CATIC Industries Inc. USA
Signed agreement to generate avionic business opportunities. 9/88.

China's Investments Abroad

Pacific Sales & Development Corp. (US)/Hualin Rubber Plant, Heilongjiang
Named exclusive agent to market and distribute radial and nylon tires in North and South America. 9/88.

Targa International Inc., subs. of Dynamic Capital Corp. (Canada)/NA
Signed letters of intent to set up high-tech joint ventures in the car and banking industries in Canada. $6 million. 11/88.

Miscellaneous

Investments in China

NA (Taiwan)/Juzhou Chemical Industry Co., Zhejiang
Established Jubao Glass Mosaic Co. Ltd. to produce glass mosaic decorative materials. 9/88.

King Fook Holdings (HK)/China Merchants Steam Navigation
Will open a diamond polishing workshop in Shenzhen SEZ. 10/88.

Grumman Corp. (US), Godiva Ltd. (UK), Salva-Kronenburg (Netherlands), and Oy Bronto Skylift Ltd. (Finland)/China Fireprotection Equipment Corp. and Shanghai Fire Equipment General Plant
Formed Shanghai Grumman International Fire Equipment Co., a 30-year joint venture to produce fire-fighting equipment. 10/88.

Other

Mississippi (US)/Hainan
Signed cooperation agreement for technical exchange in agriculture, forestry, fertilizers, and transportation. 9/88.

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