THE CHINA BUSINESS REVIEW

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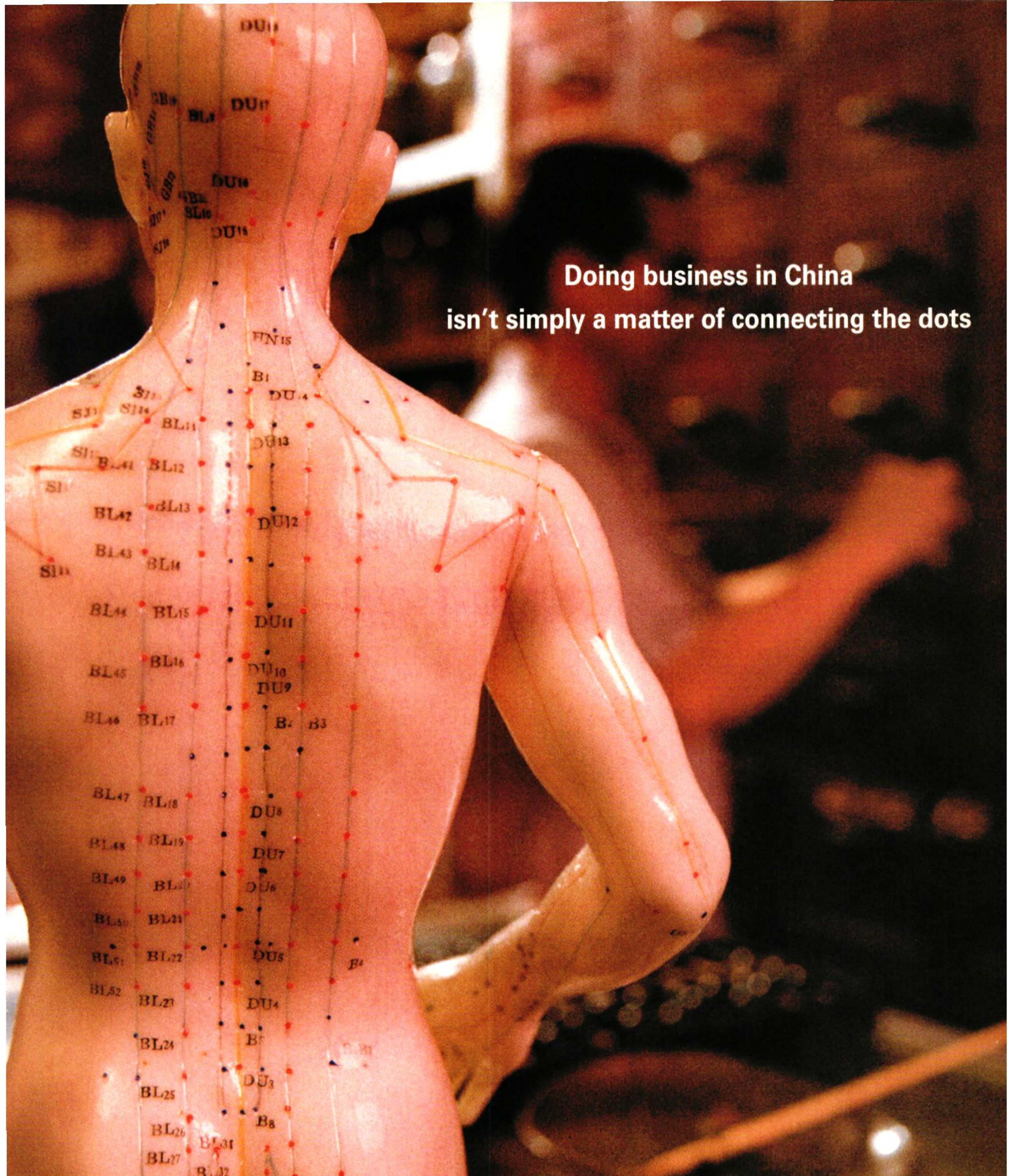
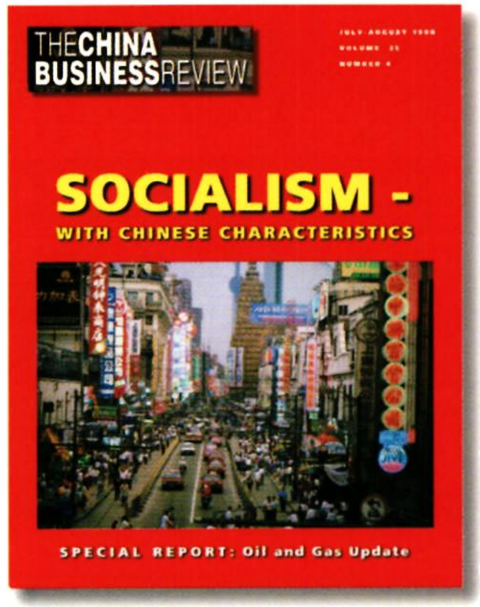
SOCIALISM -

WITH CHINESE CHARACTERISTICS

SPECIAL REPORT: Oil and Gas Update


Doing business in China
isn't simply a matter of connecting the dots

1998 JULY AUGUST



Cover design by Greg Berger

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HONG KONG ELECTION SETS PRECEDENT

Voters in the Hong Kong Special Administrative Region (SAR) made history by participating in the election of the Legislative Council (LegCo) on May 24. The election marked the first time that any part of the People's Republic of China has held multiparty elections for the upper levels of government. A record 53 percent of the electorate braved torrential thunderstorms and flooding to cast ballots, returning to the legislature 18 pro-democracy advocates elected in 1995 and ousted last year when China installed the provisional legislature. The LegCo election was nothing if not unique. The electorate was given inducements to vote, including election souvenir cards, which could be redeemed for a discount at a local clothing store.

A convoluted and confusing electoral system determined the composition of the new body. Forty seats, or two-thirds, of the new legislature were elected by small numbers of voters grouped mainly along business lines. As predicted, these seats went primarily to candidates likely to support the status quo, some of whom were unopposed or elected by fewer than 100 voters. The remaining third of the legislature was elected directly, by geographically based constituencies. Of those 20 seats, the democratic camp won 14, while the pro-Beijing Democratic Alliance for the Betterment of Hong Kong (DAB) garnered five. The remaining seat went to an independent candidate. The pro-business Liberal Party fared poorly in the geographical constituencies, winning no seats, but nevertheless secured the second-largest representation in LegCo with 10 seats. The Democratic Party, with 14 seats, now constitutes the largest bloc in the legislature.

There is no doubt that the new LegCo will be more assertive than its predecessor, the unpopular provisional legislature. Many analysts interpret the results as a rejection of Hong Kong's traditional, elitist, pro-business style of politics, and a mandate for greater popular say in the running of the territory. Already the democratic forces, who occupy about a third of the legislature despite winning roughly 60 percent of the popular vote, are urging the government to speed up the pace of democratization in the territory. Democracy aside, analysts believe the government will have a harder time persuading the populist DAB and Democrats to back its economic and social welfare policies. It could then find itself in the awkward position of relying on members elected by a handful of people to overrule those elected by the majority.

Notably, Hong Kong-China politics played a smaller role in this LegCo election than in the pre-handover LegCo vote in 1995. Most of the electorate has been preoccupied with Hong Kong's troubled economy, which is facing its highest unemployment rate in 15 years, and predictions that things will get worse. Voters seem to be counting on the new legislature to keep an eye on the government and jolt it out of what many perceive to be inaction in dealing with the economic downturn. If anything about the election is clear, it is that the Hong Kong public, by turning out in such great numbers to vote in an election in which its voice was minimized, has dispelled the myth that it is politically apathetic.

—Pam Baldinger

Pam Baldinger is director of the US-China Business Council's Hong Kong Office.

EU DUMPS PRC "NON-MARKET" CLASSIFICATION

In a move welcomed by the PRC government, the Foreign Ministerial Council of the European Union (EU) decided in April to accept the EU Commission's December 1997 proposal to remove China's "non-market economy" designation in dumping cases against the country. With the April 27 decision, the European Union, one of the top initiators of antidumping investigations against China, now permits PRC price information to be used in cases for which the presence of market economy conditions can be demonstrated.

In general, members of the World Trade Organization (WTO) compare alleged antidumping prices for products from non-market economies with prices calculated using data collected from a market-oriented surrogate country at a similar level of economic development. The United States generally uses India as a surrogate country in its dumping cases against China. This practice tends to put China at a disadvantage, as surrogate-country prices are often higher than PRC prices.

The decision should improve China's bilateral trade relationship with the European Union, as antidumping quotas and licensing requirements drop along with the overall number of investigations that find PRC imports in violation of EU dumping thresholds. Over the years, EU antidumping investigations have imposed a number of restrictions on PRC exports of textiles, silk products, and other light industrial goods. In 1996 alone, China was the target of 39, or roughly one-fifth, of all antidumping cases filed by WTO member countries.

The EU decision could put pressure on the United States to make similar changes in its antidumping policy toward China. Beijing has repeatedly insisted that PRC market conditions meet US qualifications for "market-economy" status, arguing that more than 90 percent of product prices in China are set by the market, that the *renminbi* is convertible for current-account transactions, and that foreign investment is welcome. But the United States contends that China's progress in eliminating subsidies for product inputs, and reducing government control over distribution and production of resources, has been inadequate. In short, US policymakers believe that China's economy contains too many socialist remnants to change the "non-market economy" classification.

US law does contain provisions that permit antidumping investigations to be conducted in accordance with guidelines for market economies for industries that operate under market conditions but within a non-market economy. Nonetheless, few, if any, US complaints against China have used these market-economy provisions. Since 1980, the United States has filed 68 dumping complaints against China.

—Ann M. Weeks

Letter from the Editor

Socialism with Chinese characteristics—the PRC's unique mix of centrally planned economics and free market activity—could well describe the theme of any number of past *China Business Review* issues. In this issue, however, we consider several distinct aspects of the "destatization" of China's economy—the shrinking State sector and expanding non-State sector—and what this means for foreign firms. As the World Bank's Richard Newfarmer and Dana Liu detail in their piece (p.8), reform of the State-owned sector is now center stage in China's unfolding economic transition, and a successful performance is hardly assured. The decision made at last September's 15th Party Congress to redefine public (State) ownership to include stock ownership officially sanctioned this move toward reducing State control over assets. As Cole R. Capener writes in his article on mergers and acquisitions (p.14), the decision stands to provide foreign investors with new strategic opportunities. But practically speaking, in what form will investors find the books of Chinese enterprises in which they hope to invest? This is the question that Coopers & Lybrand manager Martin Foley addresses in his review of China's shift to a system of accounting based not on allocated inputs but on profits and losses (p.22).

In addition to the Focus, you'll find articles on China's new leadership line-up, by University of Washington China specialist David Bachman (p.25); and on recently enacted capital controls, by Hong Kong attorney T.K. Chang (p.31). Our special report on oil (p.34) and gas (p.40) updates developments in this sector, including important changes announced at the March National People's Congress, and outlines prospects for further foreign investment.

We at *The CBR* hope this issue provides some food for thought, and informative summer reading as well!

Best regards,

Kirsten Sylvester

Kirsten Sylvester

A Rising Tide of Offshore Trade

The Hong Kong Special Administrative Region (SAR)'s position as a regional trade hub has served as a buffer against the effects of the Asian financial crisis, according to the Hong Kong Trade Development Council (HKTDC). According to HKTDC, in 1997 offshore trade—goods and services of overseas Hong Kong companies exported directly to their destination markets—totaled $134.6 billion, or roughly 80 percent of Hong Kong's Gross Domestic Product. Such trade, which is not included in official government statistics, has grown in proportion to total Hong Kong exports over the years, from 50 percent in 1988 to 85 percent in 1997. Thus, even as Hong Kong's export growth has fallen over the last decade, the territory's trade capacity has expanded.

Overall, goods manufactured outside the SAR made up 28 percent of exports by Hong Kong companies last year. And Hong Kong continues to serve as an entrepot for mainland China. The SAR handled 40 percent of the total value of mainland exports in 1997. Mainland-sourced goods, in turn, made up 63 percent of Hong Kong exports.

—Darlene M. Liao

Short Take

Asian Job Bank?

In a recent Deloitte & Touche LLP survey of 400 executives of US-based firms with revenues above $1 billion, more than one-fifth of the respondents said that China would be a significant growth market for their business. But short-term employment prospects in Asia may not be so rosy. The Economist Intelligence Unit predicts that China will slip to fifth place this year in the ranking of fastest-growing countries, and that Asia's overall growth rate will fall to 2.4 percent.

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Letter FROM THE PRESIDENT

Robert A. Kapp

Again the Crossroads

Stability and forward momentum in US-China relations are at the foundation of this country's long-term interests

As predicted (by me, anyway), the United States is again at the crossroads on relations with China. At least, inside the Beltway we are. The gloomy springtime pattern has reappeared: sensational leaks to the press of unproven allegations, followed by media frenzy mixing separate stories into a single heady brew, followed by political furor over the media stories, followed by a rush to legislate new sanctions and prohibitions aimed both at China and US economic relations with the PRC.

The high point for me of this year's eruption: a press release from one political organization, containing a bitter diatribe against American engagement policy toward China, which closed by saying, "For more information, contact____. *For sound bites, contact____*" (emphasis added).

The media tell me that the average sound bite has dropped from 21 seconds to 7 seconds in recent years. So if a broadcaster needs 7—or 10 or 15—seconds of "sound" on US-China policy, he or she need only call the listed phone number to get the right bite, and Voilà! If you like "talk radio," you'll *love* "talk foreign policy"!

And yet, for all the excitement, there is surprisingly little that is new and fresh in all this. Structurally, at least, it's mostly replay, and when the dust settles it will be seen as such. The unique elements of the 1998 situation, perhaps, are that the President of the United States is paying a visit to China (the first in nine years, following the positive visit of the Chinese president to the United States last fall), and that a close congressional election looms in the autumn.

So again, as expected, we're at the crossroads. Will China's Most Favored Nation (MFN) status go down? Will the upcoming summit "fail," i.e., end in mutual disappointment and recrimination? Will decades of broadly continuous US policy, across four administrations, abruptly shift, taking down with them any prospects of further improvement in American-Chinese cooperation after a couple of years of hard-won progress? Will another round of internal demon hunting bring down a policy or even an Administration?

Don't bet on it. Here's why:

■ Knocking off $80 billion in trade and crippling $25 billion in US investment by axing MFN is not kid stuff, and everyone knows it. To their great credit, the Speaker of the House and the chairmen of the House Ways & Means Committee and its Trade Subcommittee pledged to work with the President to uphold MFN, on the very day that the President announced his intention to renew it. Heated rhetoric there will be, but the signs

The breadth of American interests with China will resurface in all but the most tightly sealed minds.

at mid-June are increasingly positive, at least on the narrow issue of MFN.

On MFN, we must again work very, very hard to make our message heard: that stability and forward momentum in US-China relations are at the foundation of this country's long-term interests, and that maintaining normal trade relations is simply a pit stop, a routine but essential prerequisite to successful pursuit of vital long-term national goals.

■ Opening salvoes aside, there are many in Congress, in the general public, and in the media who prefer to know before they act and to act on the basis of their knowledge. The month of May witnessed a deluge of allegations and accusations related to American engagement with China and to China's own conduct. Legislative measures bloomed like desert flowers after a squall.

Investigations into sensitive matters are now under way. Findings of fact are required. Public disclosure of the findings—in detail, and not simply in politicized, second-hand interpretations—is essential. While some advocates in the media have long since formed and published their conclusions, most interested Americans await a clearer understanding of the truth. Legally constituted US institutions will function as they are designed to function, and knowledge will finally replace allegation and rumor. Policymakers, in the end, will wait for that truth to emerge—and to emerge publicly—before deciding whether to turn US relations with China upside down.

■ The futility of the "shut the door and turn off the lights" approach to China has always been clear, and is as clear as ever. Only the uninformed or the opportunistic can maintain that a long-term war of political and economic attrition against China will force China to act as Americans might wish to see it act. Does anyone seriously believe that denying entry visas to Chinese officials, or putting tariffs on Chinese products up from 5-6 percent to 70-80 percent, is the way to encourage China to act with greater regard for American preferences?

■ The breadth of American interests with China will resurface in all but the most tightly sealed minds. US-China relations are not one-dimensional. US interests with China include Asia's regional economic stability; management of the volatile Korean Peninsula situation; further responsible PRC participation in rules-based global systems such as the World Trade Organization; intensified cooperation on nonproliferation; further convergence of views on human rights and related issues; strengthened cooperation on globe-threatening environmental problems; and swift and effective communication on sensitive and urgent global concerns. The economic benefits of rapidly expanding trade with China are found in every US state, county, city, and town. The flow of scholarship and ideas, artistic trends, and educational relationships between American and Chinese colleagues is massive and important.

Finally, the instinct of most Americans, in this open and broadly based society, is to get acquainted with others, not to slam the door in others' faces. Domestic social strains notwithstanding, Americans on the coasts and in the heartland look outward with a greater sense of interest and of opportunity than they are sometimes given credit for doing. Perhaps that is one reason that, in election after election, the linked themes of foreign threat and domestic treachery haven't pulled decisive weight since the height of the early Cold War.

So, in spite of this year's China flap; of the tubs of ink again pouring from the attack media; of the fuzzy logic and the overheated rhetoric; and of the seductions of the sound bite, we should be optimistic at the crossroads. We should work for, and expect, the best from our government and ourselves. We should fight for, and try to ensure, stability and civility in the long-term American encounter with China. Our Chinese friends, in turn, should bet on the best in the United States as well, recognizing that they, too, bear responsibility for the choices ahead: progress, stagnation, or an unnecessary retreat into disillusionment. If the chips fall as I expect them to, we will look back on mid-1998 as a stormy moment, not as a time when the international climate changed for good and the glaciers of a new Cold War began to advance. 完

China's Race with Globalization

China's State-owned enterprises must prepare for the country's integration into the world economy

Richard Newfarmer and Dana M. Liu

As the East Asian economies stagger under the pressures of capital outflows, recession, and contracting imports, the PRC economy has—so far—escaped the worst of the crisis. With huge foreign currency reserves, comparatively low short-term debt, and a semi-closed capital account, China has been partially insulated from market pressures to match regional currency depreciations (*see The CBR*, March-April 1998, p.44). Yet the regional crisis has lent a new urgency to the PRC's domestic reform efforts, especially those affecting its 300,000 State enterprises. Long before the crisis, China became locked in a race pitting the pace of its own reform process against the pace of its integration with global markets. The East Asian crisis casts a spotlight on this drama. At center stage is the challenge of State-enterprise reform.

The Pressures of Globalization

China is not yet exposed to the full pressures of globalization. Its currency has been convertible for current account transactions only since 1996, and remains non-convertible on the capital account. With the expansion of trade and the integration of Hong Kong, however, associated inflows and outflows of capital will gradually pry open the capital account. In fact, already substantial amounts of capital move across the border unrecorded. In 1995-96, while capital inflows far exceeded outflows, gross outflows of short-term capital—recorded in part as "errors and omissions" in the balance of payments—averaged $18 billion. Though policy can slow this process somewhat, market forces are powerful and cannot be suppressed indefinitely (*see* p.31).

The first task required for such a transition is to create a market-based system of financing the State sector before most households and firms gain access to international financial assets. In the early 1990s, State-owned enterprises (SOEs) routinely required some 9 percent of Gross Domestic Product (GDP) to finance their investment programs. The government has been able to finance both its own deficit, and the borrowings of its State enterprises, mainly by printing money that its citizens have been willing to hold in ever-larger amounts. This seigniorage has provided the government, over the past decade, with roughly 4 percent of GDP in resources with which to finance State-sector investment. International experience has shown that such a situation cannot last indefinitely. Eventually, households and firms learn that they can earn higher returns by holding assets other than currency and demand deposits. The demand for cash will significantly diminish as foreign

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and domestic financial assets become attractive, and as people begin to use credit cards rather than cash for purchases. At that point, printing money to finance the public sector would risk inflation. SOEs and the PRC government thus must prepare to adjust to these new conditions, through improving public finance as well as reducing SOEs' overall need for funds.

China's second challenge in preparing for globalization is to establish a viable financial system before capital becomes fully mobile across its boundaries. The dramatic events that exposed structural weaknesses among the Asian economies have served as a wake-up call to China. The crisis has underscored for PRC leaders the urgent need for both enterprise- and financial-sector reforms to end the buildup of bad debt that creates pressures which, in turn, could erupt as a systemic crisis.

The State-enterprise problem

Once the key drivers of China's industrial sector, SOEs have increasingly become a drag on the PRC economy (*see The CBR*, March-April 1996, p.19). As Andrew Walder discusses in his 1996 book *Communist Neo-Traditionalism: Work and Authority in Chinese Industry*, the State enterprise—a legacy of the command economy—has traditionally provided for all the needs of employees and their families. SOEs provided employees with privileged access to housing, health care, education, and pensions, and still constitute the only safety net for urban workers, albeit frayed. Many of these welfare responsibilities are gradually being shifted to municipal governments. Today, State enterprises employ about 75 million workers, of which about 43 million work in industrial enterprises; they dominate the urban labor market landscape, employing two-thirds of the workers in cities. This makes them an important urban political constituency.

Other SOE characteristics that shape reform options include:

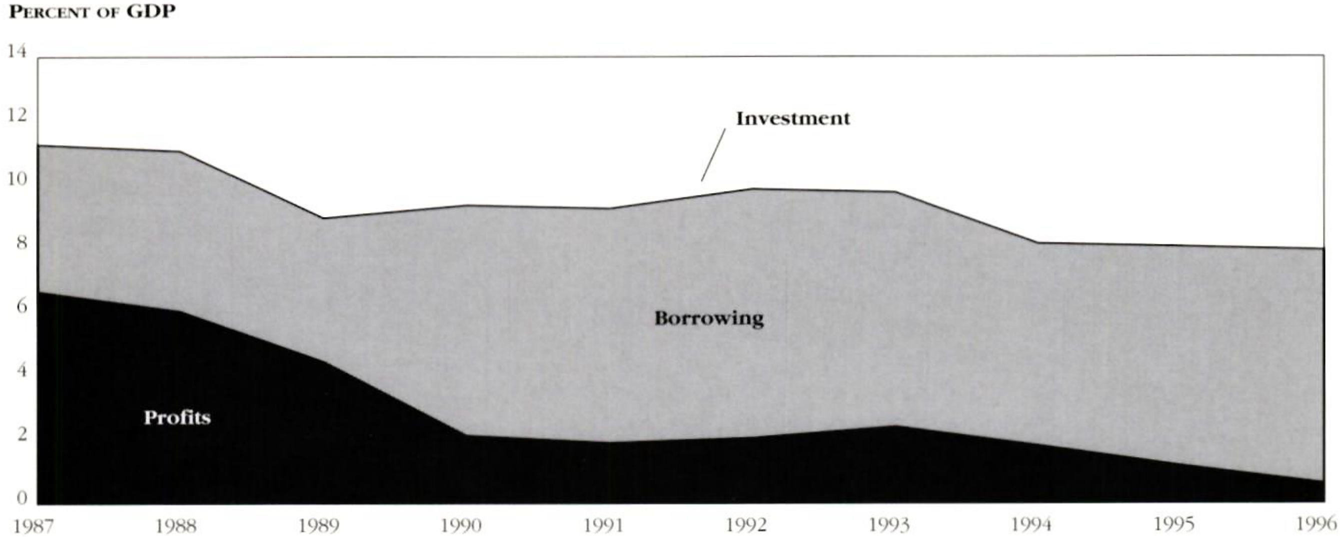
■ **Concentrated industrial ownership** The largest 5 percent of industrial companies in the mid-1990s accounted for 57 percent of output, 43 percent of employment, and 62 percent of net fixed assets. This aggregate concentration is not particularly high by Western standards. But it highlights the importance of the government's decision to focus reform efforts on the largest 1,000 companies.

■ **Lack of economies of scale** Industrial companies operate at considerably smaller scales of production than international standards. Most operate primarily in one province and therefore do not benefit from economies of scale or multi-plant economies. Many have had only partial access to international technologies, and thus are far from the frontier of modern technology. Exposing industry to the shock treatment of international trade competition, however, implies significant labor dislocation, and explains why PRC policy regarding reform to date has been gradualist.

Local governments may be resistant to reforms that generate unemployment and remove social welfare provisions before replacement institutions are ready to take over.

■ **Local government ownership and control** About 75 percent of State enterprises, mainly the smaller ones, are under the ownership or control of major municipalities. Thus, much of China's reform effort will have to be implemented at the provincial and municipal levels. Yet local governments may be resistant to reforms that generate unemployment and remove social welfare provisions before replacement institutions are ready to take over these key functions.

TABLE 1
State-owned Enterprise Profits, Borrowing, and Investment as a Share of GDP



SOURCE: *China Statistical Yearbook*, various issues
NOTE: As a share of GDP, profits have fallen faster than investment, so State enterprises' overall borrowing has increased, burdening the banks.

With a combination of superior quality products and lower costs, non-State firms have steadily expanded their market share at the expense of SOEs.

■ **Highly leveraged companies** Beginning in the mid-1980s, the central government sought to reduce transfers from the budget by encouraging State enterprises to borrow from banks. This had adverse consequences for the banks, but also left companies with debt-to-registered capital ratios of nearly 3:1. Much like the problem encountered by corporations in South Korea last year, this situation exposed SOEs to the rise in interest rates that took place in 1993-95.

■ **Lower productivity and deteriorating performance** Since the beginning of China's economic reform initiatives in the late 1970s and early 1980s, State-owned industrial enterprises have been caught between competition in the marketplace, and government mandates to provide cradle-to-grave security for employees and undertake specific investments. A bureaucratized system of management and production also has resulted in poor internal incentives. Management has lacked full autonomy in wage setting, hiring, pricing, input sourcing, and investment. Wages have not reflected productivity, and non-cash benefits in the form of housing, education, and other social welfare services have nearly equaled the value of monetary wages. On the other hand, managers have had no accountability to State owners.

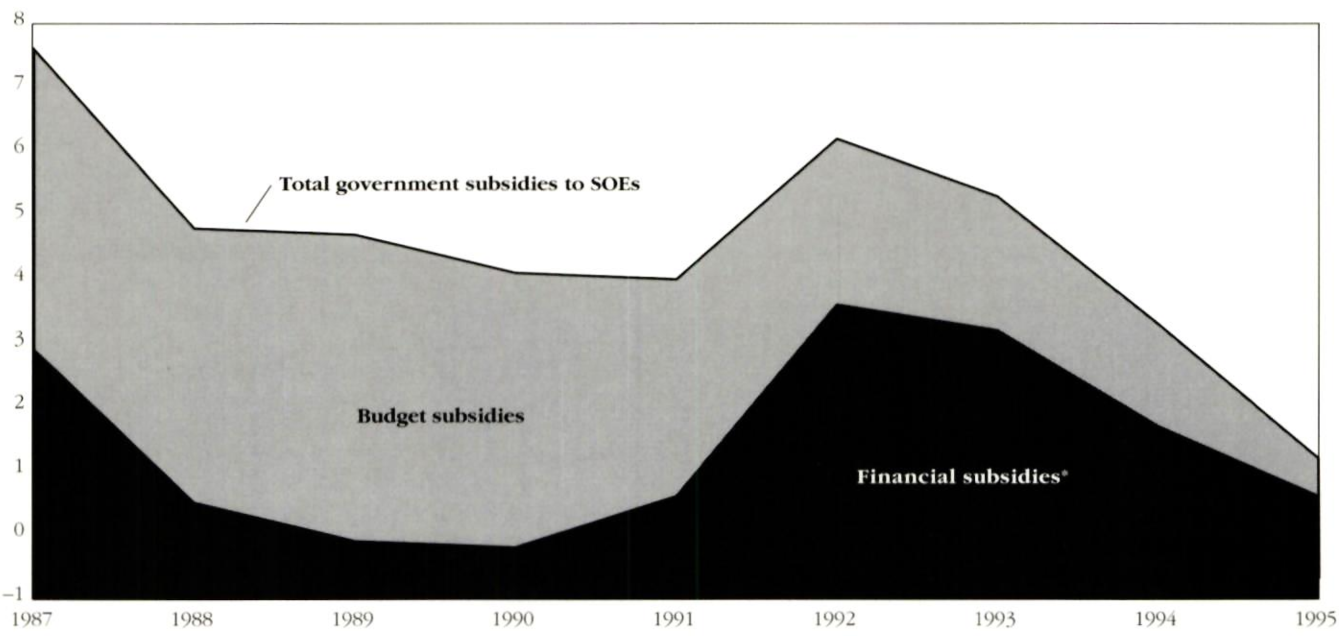
Similarly, the lack of a bankruptcy threat and easy access to finance through the directed credit system have provided weak external incentives to improve profitability. The investment and credit plan, the weak financial system, and pricing distortions combined to channel State-enterprise investment into activities with lower productivity. Several studies by economists Gary Jefferson, Thomas Rawski, and Yuxin Zheng show that State enterprises have had total factor productivity growth of only 50-75 percent of that of the non-State sector.

At the same time, the government has facilitated the rapid growth of non-State enterprises, at first in the rural sector to create off-farm employment, and more recently in the emerging private sector. In the 1980s, rural township and village enterprises transformed the economy, reporting annual growth rates of nearly 22 percent from 1980-95 and claiming a 25 percent share of industrial output by 1995. With the 1990s came the rise of the "private" sector, comprised of individual enterprises, joint stock companies, domestic joint ventures, and foreign-invested enterprises.

With a combination of superior quality products and lower costs, these non-State firms have steadily expanded their market share at the expense of SOEs. The State share of industrial output has fallen from 78 percent in 1978 to 34 percent in 1996. As market share fell, so did State-enterprise profits. The rate of return on fixed assets has dropped from over 20 percent to about 5 percent, well below the 8.4 percent for collectives and the 9.9 percent for joint ventures. And as profits have declined and the State share of output has withered, SOE

TABLE 2
Subsidies to SOEs as a Share of GDP

Percent of GDP



SOURCE: *China Statistical Yearbook*, various issues
* Financial subsidies are estimated to equal the SOE share of net lending from the central bank to the banking system, adjusted for interest rate subsidies and estimated debt losses.

profits in industry as a share of GDP have fallen by more than 70 percent (*see* Table 1).

The deterioration of SOEs became acute in 1996-97 as profits continued to shrink. The reasons for the most recent declines, however, include some important changes that stand to benefit the economy in the long run. For example, Beijing increased depreciation allowances to more economically reasonable rates; reduced subsidies on energy, cotton, and other inputs; and improved social security accounting methods. Aggregate profits dipped below 1 percent of GDP in 1996-97, the lowest in the reform period. The percentage of SOEs losing money rose from about 25 percent in 1992 to nearly 40 percent in 1996, according to one recent study on China's privatization by Beijing economist Cao Yuanzheng and Stanford University professors Yingyi Qian and Barry Weingast. By 1996, profits of the State-enterprise sector were only two-thirds of their level the previous year. Factory capacity utilization rates had dipped to below 60 percent for half of all State plants.

State enterprises also have more frequently fallen behind in their debt service, putting pressure on the banks. Some 20-30 percent of loans in the banking system are thought to be nonperforming, and most of these are to State companies. SOE investment, too, has fallen, if at a slower pace. Both the credit plan and local authorities continued to direct bank resources to State enterprises. As a consequence, retained profits have financed a declining share of total investments, and debt held by the banks has increased, undermining the quality of the banks' portfolios. State enterprises still command some 70 percent of credit, nearly twice their share of output.

Emerging pressures to reform

The steady drumbeat of State-enterprise reform that for years could be heard in the distance is now intensifying. The 15th Party Congress in September 1997 declared SOE reform a strategic priority, a consensual shift among the top leadership that was later ratified during the March 1998 Ninth National People's Congress (NPC). Zhu Rongji, the new premier, announced ambitious objectives to complete State-enterprise reforms within the next three years.

These announcements come against a backdrop of earlier reforms. Most important has been the gradual diminution of preferential access to subsidized financial resources for State enterprises—what economists call applying a "hard budget constraint" to State enterprises. Subsidies through the budget, and implicit subsidies through the financial system, have fallen from more than 7 percent of GDP in 1987 to less than 2 percent in 1995 and perhaps half that today (*see* Table 2). This, together with tighter regulatory control over the nation's banks, provided the single greatest impetus to restructuring.

The government's reduction of subsidies reflected improvements in the legal basis for administering public finances. The national budget law, which took effect in 1995, prohibited the central government from receiving financing from the People's Bank of China (PBOC), the central bank. Local governments had to balance their budgets, and the law strictly regulated local borrowing. District branches of the central bank and commercial banks were no longer allowed to follow the dictates of mayors and governors to finance favored SOEs, and PBOC branches' power to extend loans to State bank branches was revoked. Net credit to the financial system was reduced drastically after 1994.

State enterprises still command some 70 percent of credit, nearly twice their share of output.

As the reductions in subsidies have begun to bite, the government has offset the pain somewhat by granting tax exemptions and preferential tax rates on income, value-added taxes, and even customs duties. These exemptions are unlikely to endure, however, because the hard budget constraints are being applied to the national and sub-national governments alike, and tax revenues are still low.

Three major initiatives coming out of the NPC are particularly noteworthy. Beijing has recognized, first, that the State-enterprise sector must shrink

Progress on reforming China's small enterprises has probably been more profound than has generally been recognized in the international press.

further, and that this reduction must occur through ownership reforms; second, that layoffs must occur; and third, that financial reforms must move in tandem with SOE reforms, and at an accelerated pace.

New forms of ownership

Ownership reforms date back to November 1993, when the government issued its pilot blueprint for reform in the 10/100/1,000/10,000 program, later reaffirmed in the "grasping the large and letting go the small" program (*zhuada fangxiao*). According to a report by Albert Keidel of the World Bank's Resident Mission in China, of the 100 large enterprises chosen in 1994 for incorporation, 93 have now been incorporated and 84 have boards of directors. Incorporation, which involves the development of a clear corporate governance structure and transparent accounting procedures, is a prerequisite for more independent firm behavior, discipline in investment and pricing strategies, and at least some asset divestitures. Meanwhile, the original list of 100 has expanded to 512 companies. These 512 firms account for 55 percent of all SOE assets, most of the gross profits of the industrial sector, and 85 percent of collected taxes. To these should be added the 2,500 large municipally controlled enterprises undergoing similar incorporation. By June 1997, 1,989 of these firms had been similarly converted, and 63 percent had boards of directors.

The government also began in 1993 to encourage the mergers of SOEs, to increase the average size of firms, achieve some scale and multi-plant economies, and provide an alternative to bankruptcy for money-losing companies. To date, China has created 120 group enterprises, 47 of which are under the direct control of the State Council. Experience around the world, however, suggests that these group companies have rarely proven to be a viable way to restructure State enterprises. But it was not until the recent stumble of South Korea's *chaebol* conglomerates that a serious debate resonated in China about the wisdom of this course, and recent reports suggest that mergers among medium- and large-scale enterprises have slowed significantly. Ownership reforms for medium and large companies are likely to proceed more slowly and with a greater variety of outcomes in the near term.

Progress on reforming China's small enterprises has probably been more profound than has generally been recognized in the international press. Local governments began taking the initiative for reform in 1994, and the pace appears to have intensified. As the banking system started to reduce subsidies to SOEs, many local governments began to seek to sidestep fiscal responsibility for the enterprises. The program of "grasping the large and letting go the small" allowed local governments to convert companies into worker cooperatives, set up management contracts with outside firms, divest whole or part of the equity of an SOE to new investors, or even sell companies outright to foreign firms.

Three forms account for more than half of ownership changes: sales to domestic or foreign investors (11 percent); corporatization into a limited liability or joint stock company (8 percent); and stock cooperatives (35 percent) (*see* p.14). The result, in Shandong Province alone, has been that 50 percent of small SOEs are now stock cooperatives; in Jiangsu Province, more than 80 percent have converted to such structures; in Henan Province, 33 percent; and in Jilin Province, 40 percent. Low capitalization has made it both easy and attractive to convert small State enterprises into employee-owned companies. Employees can afford to purchase the enterprises with their own savings. In some cases, governments have ceded ownership at zero cost, provided that the new owners service their debt.

Labor reform

A second major outcome of the NPC was the official recognition that layoffs will be necessary. Labor Minister Li Boyong announced that SOEs are expected to let go 8-10 million workers in the next 3 years, not including layoffs in other sectors. With as much as 30 percent of the SOE labor force unproductively employed, release into the labor force of large numbers of workers during restructuring must occur. Though rapid layoffs could cause social unrest, the process is already in motion. In 1997, 12 million workers were furloughed (*xiagang*), an increasingly common vehicle for releasing labor. Academic surveys show that 14 percent of SOE workers in Shanghai are already on furlough, 23 percent in Shenyang, Liaoning Province, and 28 percent in Fuzhou, Fujian Province. Four million workers have been reemployed in other enterprises—both State and private—and another 2 million were released and registered as unemployed.

For many workers, the impact of layoffs has been cushioned somewhat by their ability to retain their housing. In addition, the government has set up income-maintenance programs in 300 cities in China, which guarantee jobless urban workers a minimum income. The government plans to expand the programs to 600 cities. In Beijing, support amounts to ¥200 ($24) per month. Former Minister of Finance Liu Zhongli announced at the NPC that the central budget had allocated ¥9.4 billion ($1.1 billion) in 1998 to subsidize losses incurred by SOEs, a slight increase over the 1997 figure. Government-organized projects will assist laid-off workers in finding employment and ensure a minimum standard of living through funds from enterprises, the government, and social security. Financial departments will increase expenditures to relocate employees to jobs in other cities and provide loans to enterprises having trouble meeting payrolls.

Labor unrest is nonetheless a real concern for senior policymakers. With reforms, the erosion of the labor rules tying workers to a particular work unit (*danwei*) has augmented the problem of an urban "floating" population. Enterprise reform underscores the crucial need to create a new social safety net to replace the *danwei* system. Reports of worker demonstrations surface sporadically in Chinese newspapers. In spring 1997, workers in Nanchong, Sichuan Province took over the city center for more than a day to demand back pay. Eventually, special bank credits were arranged. Earlier in the year, street demonstrations occurred in

Wuhan, Hubei Province, to protest enterprise closings.

Debt restructuring

In addition to reducing SOEs' labor forces, the government has allocated about ¥40 billion ($4.8 billion) to reduce SOE liabilities on top of the ¥9.4 billion ($1.1 billion) already earmarked for SOE losses. While this has taken various forms—financing bankruptcies, allowing mergers and layoffs, or reducing interest charges—the majority of the funds were used to convert bank debt to equity.

At the same time, the government has begun a program to recapitalize the banks, which will include a ¥270 billion ($33 billion) special issue of Treasury bonds to strengthen the capital base of the four State-owned commercial banks—the Agricultural Bank of China, the Bank of China, China Construction Bank, and the Industrial and Commercial Bank of China. The proceeds will be used to increase the banks' capital adequacy ratios. This is linked to a reduction in reserve requirements, and, to guard against shocks to the monetary system, a repayment of commercial bank loans to the central bank. At the end of June 1997, total reserves (required reserves plus excess reserves) held by the four State commercial banks amounted to ¥1 trillion ($133 billion), or 15 percent of their total assets.

Of perhaps greater importance to the banks' health, however, is the adoption of a new loan classification system. This will allow the central bank to classify bank loans by risk. The new system divides loans into five categories: normal, special-mentioned, sub-standard, doubtful, and loss-to-be-written-off. Proper loan classification and provisioning will help pave the way for a modern system of prudential regulation. The formal abandonment of the credit plan on January 1 of this year, and the current development of a capacity to supervise banks, are the final pieces in the mosaic of bank supervision.

Winning the race with globalization

The road ahead will not be easy. Ownership reform, especially of the large enterprises, involves the thorny economic problems of reconciling conflicting mandates and conflicting stakeholder interests (among government organs, State-enterprise managers, banks, and labor). Making changes without losing valuable assets to insiders will be difficult. Labor reform will also be challenging: renegotiation of lifetime employment contracts and redesign of social welfare institutions must be handled with care as well as resoluteness. All of this must be coordinated with a complex reform of a weak financial system ill-prepared for the pressures of a market economy fast integrating with global finance.

Meanwhile, the economy has cooled from its overheated rates of more than 10 percent in the early 1990s to 8.8 percent last year. Growth in the first quarter of 1998 was 7.2 percent. The economy must maintain a growth rate of 4-5 percent annually simply to absorb the natural increase in the labor force—to say nothing of the workers that reforms in the SOE sector will release. If the economy should slow much more, the favorable conditions in labor markets to absorb transitional layoffs from State enterprises could easily disappear and dampen reform.

Sluggish domestic demand and a steadily worsening outlook in Japan, one of China's main trading partners, have put macroeconomic policy on a collision course with medium-term reform objectives. Some macroeconomic stimulation is necessary to prevent the economy from falling through the floor of an acceptable growth band. But loosening macroeconomic policy may provide resources to the very SOEs that the government has starved to induce reform. Looser credit channeled through a banking system halfway between plan and market and not yet capable of evaluating credit risk is likely to end up in the same poorly performing SOEs of the past. Fiscal policy would be a better choice, but years of investment restraint have dried up the pipeline of good public projects, and, in any case, may involve unacceptable lags. Using the exchange rate to stimulate is the least effective instrument because it would only undermine the confidence of households in their *renminbi* savings, exposing the already vulnerable banks to unnecessary risks and international pressures sure to come from mounting trade surpluses.

Loosening macroeconomic policy may provide resources to the very SOEs that the government has starved to induce reform.

Winning the race with globalization will put to the test all the considerable skill the Chinese economic leadership can muster. The race is likely to be long, with unpredictable twists and turns. 完

M&A in China Comes of Age

A variety of structures exists for foreign investors interested in mergers and acquisitions in China

Cole R. Capener

The recently announced mega-mergers of Daimler-Benz with Chrysler, Citicorp/Citibank with the Travelers Group Inc., and BankAmerica Corp. with NationsBank, have driven worldwide merger-and-acquisition (M&A) activity to new heights. These and other announced M&A transactions are certain to push this year far beyond 1997's record-breaking level of $1.6 trillion in aggregate value of such transactions. China has not been left out of this M&A frenzy, and it should come as no surprise that "M&A" has become a buzzword there as well. Indeed, the PRC has emerged as a key participant in, if recent arrival to, the international M&A field.

A popular target for foreign direct investment over the past decade and a half, China's investment environment is undergoing a gradual transformation. With the PRC investment climate maturing, both foreign and domestic investors' needs and strategic plans are changing. The rules governing business relationships have become both more settled and somewhat more sophisticated, and are coming to resemble their counterparts in other countries.

It is within this evolving investment environment that China's M&A activity has begun to grow. Last September's 15th Communist Party Congress, with its emphasis on State-sector reform, and the selection of Zhu Rongji as premier at the March 1998 National People's Congress, suggest a new openness and pragmatism, and a promise of even greater flexibility for foreign investment in China. The reality, unfortunately, is somewhat less clear cut; no panacea is likely to appear to transform China overnight into an easy country in which to do business. But certain systemic changes nonetheless promise greater M&A opportunities.

Back to Basics

What exactly is M&A and does it really exist in China? While the term "M&A" refers generically to any combination of two or more business enterprises, a "merger" and an "acquisition" are two distinctly different legal transactions in many jurisdictions, including the United States—and China. An "acquisition" (*shougou*) can be defined as the purchase by one economic entity of all or part of the shares or assets of another economic entity. Both economic entities survive after the purchase. A "merger" (*hebing* or *jianbing*), on the other hand, is the legal combination of two discrete economic entities in which only one entity survives and assumes, by operation of law, all the assets and liabilities of both entities.

In developed economies like those of the United States and some European and Asian countries, M&A transactions can assume myriad forms. In the United States, for example, an acquisition could take the form of a purchase of a target company's assets with either cash or shares; a cash purchase of shares in the target; a purchase of shares in the target

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with the purchaser's shares; or some combination of these forms. Mergers, like acquisitions, can be effected with shares or cash. The transaction can leave the purchaser in place, in the case of a forward merger; leave the target in place, in the case of a reverse merger; or involve a subsidiary of the purchaser merging with the target, in the case of a triangular merger.

China in 1998 does not yet permit all of these M&A structures, but as its market sector matures, all of these forms inevitably will become more familiar to M&A participants in the PRC. Indeed, over the past several years, foreign investment in China has taken a number of M&A forms, including the acquisition, by a foreign-invested enterprise (FIE), of all of the assets of a going concern (usually a State-owned, township, or collective enterprise); the purchase of shares in a listed or unlisted PRC company; and the purchase from other foreign investors of existing interests in PRC entities.

M&A's recent history in China

The first foreign investment deals in China tended to be greenfield projects in which the parties funded a joint-venture company and built a new factory, usually furnished with imported machinery and equipment. Today, foreign investment is more likely to consist of a takeover of a PRC business by a newly established joint venture, in which the foreign partner has majority control, or by a wholly foreign-owned enterprise (WFOE).

Share purchases have also surfaced in the 1990s as another option for foreigners seeking to acquire an interest in a PRC company. Share-purchase transactions are not entirely new to China: foreign investors have long been permitted to acquire B shares in PRC-listed companies. In the last few years, however, an avenue has emerged for private equity deals in which foreigners can purchase shares through a private placement in an unlisted company, and for strategic investment by share acquisitions in listed companies.

The 15th Party Congress officially blessed the increased use of a Western-style, share-issuing corporate vehicle, known as a joint stock limited company (*gufen youxian gongsi*, also translated as company limited by shares) to hold State-owned assets (*see* p.18). Many non-share issuing State-owned enterprises (SOEs) are likely to convert into joint stock limited companies, providing foreign investors with opportunities to buy directly the shares of a going concern. Although it appears, from PRC and Hong Kong press reports, that Zhu Rongji may not share PRC President Jiang Zemin's enthusiasm for allowing State-owned assets greater autonomy through the use of this form, such deals are likely to proliferate.

The last few years also have witnessed the emergence of a secondary market for investments in existing FIEs established by early investors in China. Some take the form of the purchase of an interest by one foreign party from another, or by the foreign party from the original Chinese party; or a sale from a foreign party back to either the Chinese party or a third party. Increasingly, the purchase and sale of such interests take place through transactions involving the transfer of shares held by a Hong Kong or other "offshore" holding company. The experienced M&A participant will find such transactions largely indistinguishable from cross-border acquisitions anywhere in the world.

Like acquisitions, mergers among domestic PRC companies have become commonplace. Such mergers attempt both to rescue failing SOEs by combining them with healthy enterprises, and to create Korean *chaebol*-like conglomerates, which Chinese policymakers believe will enable them to compete more effectively against foreign competitors both at home and abroad. Mergers directly involving foreign companies are still not possible in China, but as foreign investors seek to restructure their existing PRC holdings, there have been a growing number of mergers of FIEs. The flurry of mega-mergers outside of China, moreover, dictates some consolidation of the merger parties' entities within China.

Building the legal and regulatory framework

The array of laws and Chinese regulations governing M&A transactions is expanding rapidly. The applicable laws for a given deal will depend on how the deal is structured. In general, acquisitions common in the Chinese M&A market today take one of two forms. In the "direct acquisition" structure, a foreign investor either purchases assets through a company registered in China, or directly purchases shares (or an interest in the registered capital) in a listed or unlisted company registered in China. In an "indirect acquisition" structure, a foreign purchaser acquires the shares in a non-PRC offshore holding company, the assets of which include an interest in a company or companies registered in China. The various M&A scenarios possible in China include the following:

Over the past several years, foreign investment in China has taken a number of M&A forms.

■ **Asset purchase** PRC law generally does not permit the acquisition of a domestic company's assets by a foreign entity unless the foreign acquirer has established (or concurrently establishes) a registered presence in China, in the form of either an equity or cooperative joint venture, a WFOE or, more recently, a joint stock limited company. In addition to the respective pieces of legislation that apply to joint ventures and WFOEs, these entities are theoretically subject to the relevant provisions of the Company Law, which also govern the establishment and operation of joint stock limited companies. The Company Law stipulates, however, that where the provisions of legislation governing each type of FIE are different from those of the Company Law, the laws and regulations specifically relating to the FIE will prevail.

Generally, asset acquisitions of Chinese targets must be made through a PRC-registered FIE in which the foreign investor owns at least a 25 percent interest. But in late 1997, the Shanghai municipal government issued the Several Opinions on Promoting Opening to the Outside World and Extending the Use of Foreign Investment, which permit foreign investors to acquire assets of a domestic enterprise through an investment vehicle in which they hold less than 25 percent. Though this policy applies only in Shanghai, it may eventually be extended throughout the country.

All direct acquisition transactions are subject to PRC government approval, either local or central. The establishment of the acquisition vehicle and the acquisition project must be approved by foreign-investment and planning authorities, respectively. Whether an acquisition of the assets of (or merger with) a Chinese target is permissible will depend in large part on State policies for industrial development and the direction of foreign investment. PRC regulations classify all foreign investment projects into four categories: en-

Compelled by financial or strategic imperatives, foreign investors with previously established FIEs in China are increasingly pursuing exit strategies.

couraged, permitted, restricted, and prohibited. The Guiding Catalogue for Foreign Investment in Industry (the Catalogue), first issued in 1995 and recently amended and effective January 1, lists the various industries in which foreign investment is encouraged, restricted, or prohibited (*see The CBR*, March-April 1998, p.4).

■ **Purchase of registered capital in an FIE** Compelled by financial or strategic imperatives, foreign investors with previously established FIEs in China are increasingly pursuing exit strategies. In most cases, the sole option is to sell the registered capital in the entity, either to one of the other equity holders in the joint venture (if the investment is through a joint venture) or to a third party.

The Several Regulations of the Ministry of Foreign Trade and Economic Cooperation [MOFTEC] and the State Administration for Industry and Commerce [SAIC] Concerning Changes in Equity Interest of Investors in Foreign Investment Enterprises (the Equity Change Regulations), adopted in May 1997, represent the PRC government's attempt to address this type of M&A transaction. In fact, much of the content of the Equity Change Regulations is not new, but offers more specific guidance on the approval process and requirements, as well as additional restrictions. For example, the Equity Change Regulations stipulate that MOFTEC must approve the equity sale from the Chinese party to a foreign party in a joint venture if, as a consequence of the foreign party's purchase, the joint venture would be converted into a WFOE in an industry in which the establishment of a WFOE is restricted. The Equity Change Regulations clearly prohibit the aggregate equity share held by foreign investors to fall below 25 percent of registered capital through such an acquisition, unless all of the foreign party's interest is to be acquired by the Chinese party. Of particular importance to foreign investors acquiring an interest in an FIE through an offshore merger is a provision that if the other parties (such as the Chinese party for whom this right is obviously intended) object, the FIE may have to be liquidated. The Equity Change Regulations do not apply to joint stock limited companies.

■ **Share purchase transaction** With MOFTEC's 1995 Provisional Regulations on Several Issues Concerning the Establishment of Joint Stock Limited Companies with Foreign Investment (the Provisional Regulations), Chinese law now explicitly allows foreign investors to acquire shares in a PRC company (other than as a passive B shareholder). In a share purchase transaction, the target company may be a listed or an unlisted joint stock limited company. A foreign investor may either acquire the shares from existing shareholders, typically a holding company set up to hold State-owned shares or another Chinese legal person holding legal person shares, or acquire newly issued shares directly from the joint stock limited company.

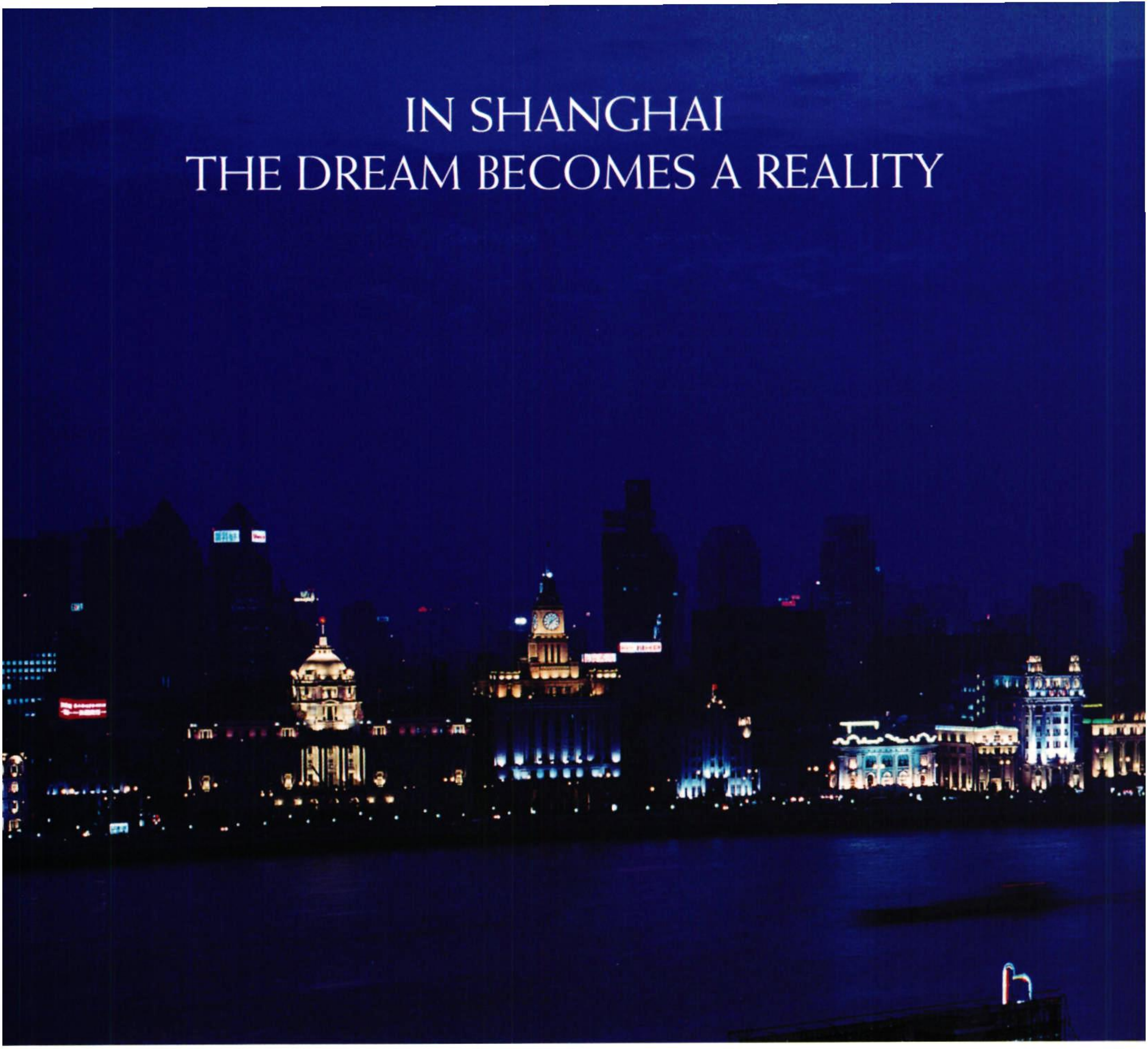
According to official PRC statistics, China has almost 8 million industrial enterprises, of which 9,000-13,000 had been organized as, or converted into, share-issuing joint stock limited companies by the end of 1996. Of these, only 745 have issued A shares on one of the two major PRC stock exchanges, 101 have issued B shares, and 42 are currently listed on an overseas exchange (including Hong Kong). Even though the 15th Party Congress may have implicitly encouraged the conversion of SOEs into joint stock limited companies, and the number of such companies is expected to grow, the total number of potential share purchase targets is still quite small. The number of completed direct share deals is even more limited (*see* Table).

Part of the reason for the slow growth of share purchase transactions lies with the Beijing Light Bus acquisition in 1995. Shares of the listed bus company that were intended for Chinese legal persons were sold to Isuzu Motors Corp. and Itochu Trading Co. Upset with this attempt by foreign companies to acquire shares not proper for them to hold, in September 1995 the State Council issued the Notice from the State Council on the Suspension of the Transfer of State-owned Shares and Legal Person Shares of Listed Companies to Foreign Investors (the Notice). The Notice imposed a moratorium on similar purchases of State-owned shares or legal person shares in any listed company until regulations were formulated to govern such transactions. No specific regulations have yet been promulgated. But certain subsequent decrees provide that a holder of State-owned shares may transfer its shares to a PRC legal or natural person inside or outside China, which, by implication, permits sales to foreigners. These decrees include the March 1997 Opinion on Standardization of the Exercise of Share Rights by Holders of State-owned Shares in Joint Stock Limited Companies (the State-owned Shares Opinion), issued by the State-owned Assets Bureau and the State Commission for Restructuring the Economy. An explicit repeal of the moratorium, however, would certainly serve China's policy interests as well as the interests of the foreign M&A community.

In the meantime, foreign investors can pursue share-purchase transactions through private placement transactions with unlisted companies. The State-owned Shares Opinion appears to rescind an unfortunate policy codified in earlier regulations in which the holder of State-owned shares is required to have a controlling interest in a joint stock limited company. The State-owned Shares Opinion instead provides that any requirement for State control must be determined with reference to relevant regulations. Current regulations do not otherwise prescribe State control except in a few identified industries.

■ **Indirect acquisitions** Many early investors in China were Hong Kong or overseas Chinese entrepreneurs who set up their investments in FIEs in China through Hong Kong or other offshore corporations, such as those located in the British Virgin Islands. As these businesses have developed, many investors have sought to realize profit by selling all or part of their business to multinational corporations. In this type of investment, the foreign investor acquires the shares in the target company either directly from the shareholder or from the offshore company in the form of newly issued shares.

PRC law need not govern the sale and purchase of shares of investments with offshore structures—including those in Hong Kong, since the Special Administrative Region maintains its own legal system. Typically, the parties designate Hong Kong law, English law, or New York law. The documentation for such transactions is therefore consistent with any international M&A deal, and both reliable courts and international arbitration are available to ensure effective remedies—unlike many direct transactions, in which PRC law must govern and ultimate enforcement of any remedies rests with the People's Courts.


IN SHANGHAI
THE DREAM BECOMES A REALITY

■ **Mergers** Mergers in China are governed by specific provisions of the Company Law. Two forms of merger are identified: first, merger by absorption, in which one company absorbs one or more other companies and the absorbed companies are dissolved; and second, merger by establishment, in which two or more companies are merged into a newly created company and the parties to the merger are dissolved. (The Equity Joint Venture Law also mentions mergers, but only in the context of a requirement that the board of directors unanimously consent to any merger involving the joint venture.) The Company Law requires the parties to enter into a merger agreement and to prepare balance sheets and asset lists prior to any merger. There are detailed procedures for notifying the merging parties' creditors and a requirement that the debts be either repaid or "guaranteed" by the parties. In fact, this latter provision seems unnecessary because the Company Law stipulates that the surviving company succeeds to the claims and debts of each party to a merger.

The Mechanics of an M&A Transaction

An important step in the acquisition of PRC shares or assets is thorough financial and legal due diligence. Where the acqui-

A New Investment Vehicle

A desire both to tap into the nascent capital markets and to gain greater autonomy from intrusive government supervisory organs has prompted many State-owned enterprises (SOEs) to convert into joint stock limited companies (also translated as companies limited by shares) over the past six years. To many PRC policymakers this "corporatizaton" was a natural step in the evolution of reforming the State sector. Late last year, the 15th Party Congress suggested that the "joint stock limited company" should replace the "State-owned enterprise" (*guoyou qiye*) as the preferred State asset vehicle and that the government could even be satisfied with a minority position in such companies.

Since the 1994 Company Law, which governs the formation of joint stock limited companies, contains few specific provisions relating to foreign investment in such companies, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) supplemented it by promulgating the Provisional Regulations on Several Issues Concerning the Establishment of Joint Stock Limited Companies with Foreign Investment in January 1995 (the Provisional Regulations). The Provisional Regulations created a new foreign investment vehicle: the Sino-foreign joint stock limited company. Unlike equity and cooperative joint ventures and wholly foreign-owned enterprises, the Sino-foreign joint stock limited company is a share-issuing vehicle more akin to its Western counterparts.

Under the Company Law and Provisional Regulations, domestic or foreign-invested joint stock limited companies can be established either by "sponsorship" or by "share offer." If by sponsorship, all shares must be subscribed for by the company sponsors (of which more than half must be domiciled in China) and no shares may be issued to the public. If by share offer, shares must be issued to the public, but the sponsors must subscribe to a minimum of 35 percent of the total share issue. Foreign-invested enterprises (FIEs)—but not holding companies—may act as either sponsors or shareholders subject to certain limitations. Unlike FIE legislation, the law governing joint stock limited companies grants fewer minority shareholder protections, such as power to block corporate actions and share transfers. The Provisional Regulations also permit the conversion of an FIE into a joint stock limited company. The minimum registered capital requirement for the establishment of a foreign-invested joint stock limited company is ¥30 million ($3.6 million). Significantly, however, all foreign-invested joint stock companies must be approved by MOFTEC in Beijing regardless of the size of the total investment.

The transfer of shares in a joint stock limited company nonetheless requires clearer legislative guidance. Under the Company Law, shareholders are permitted to transfer their shares "according to law." But there are few laws that explicitly deal with transfers, particularly those involving foreigners. Moreover, the policy issue of whether it is permissible to sell foreigners shares previously reserved for SOEs and Chinese legal persons has not been finally resolved. As China moves toward eliminating differences between domestic-invested and foreign-invested entities, it may eliminate the troublesome classification of shares based on the identity of the shareholder. Investors also hope that the cumbersome provisions of Article 144 of the Company Law that require the transfer of shares "at securities trading places established by law" will be clarified. Such a provision may make sense for transactions involving the transfer of shares listed on a stock exchange, but is inappropriate for unlisted companies and seems, in practice, to be ignored. Indeed, China Securities Regulatory Commission officials have informally opined that Article 144 does not apply to the transfer of unlisted shares.

Instead of establishing an FIE to acquire the assets of a PRC target, it is now possible to establish a foreign-invested joint stock limited company as the acquiring entity. According to press reports, Eastman Kodak Co.'s recently announced $1 billion investment in China was effected in part through the use of a foreign-invested joint stock limited company, the shares of which are owned by Kodak and two SOEs whose assets have been acquired by the new entity.

The growing prevalence of joint stock limited companies may translate into more share transactions overall. Under MOFTEC's regulations, domestic enterprises may also convert into joint stock limited companies with foreign investment. This is possible either by listing B shares on the Shanghai or Shenzhen stock exchanges, or by a private placement sale to foreign investors. In either case, the foreign party is required to purchase the shares with freely convertible currency and take a stake of at least 25 percent in the company. The target company must also have been established with official State approval and have been profitable for the last three years. This avenue of investment may be particularly interesting for foreign portfolio investors, as it offers an exit strategy compatible with their short-term objectives.

—Cole R. Capener

sition involves the purchase of an interest held by a foreign company, the due diligence process may be routine, since the parties and their advisers tend to have had experience in such matters. But due diligence is still a relatively new process to SOEs and other domestic PRC entities, and may meet with some resistance. Only a few years ago, allowing foreign lawyers, accountants, and investment bankers liberal access to financial and operating records and documents of an SOE would have constituted a violation of the PRC's State secrets regime and could have subjected the offenders to severe punishment. Even today, the culture of secrecy continues to survive in some parts of the country, and especially among certain industries. As a result, M&A participants and their advisers must begin early in the transaction to explain the due diligence process to the Chinese target's senior management, and to enlist its active participation and cooperation. Due diligence questionnaires in Chinese are a necessary initial step in the process and, at a minimum, should cover licenses and approvals; financial statements; land-use rights; title to assets; taxes; foreign exchange; labor; environment; operating agreements; litigation and arbitration; and any special circumstances.

To assuage the concern of an apprehensive Chinese target, it is useful (and often necessary) to sign a non-binding letter of intent containing a confidentiality undertaking. Onsite visits by accountants, lawyers, environmental auditors, and structural engineers, and extensive follow-up are usually part of a due diligence exercise. Nonetheless, the dearth of accurate documentation of many PRC intra-group transactions, the near absence of publicly filed documents, and Chinese companies' traditional aversion to revealing internal information, may make it difficult to understand fully the target's operations. Thus, the inclusion of suitable representations, warranties, and indemnifications is crucial.

Together with due diligence, valuation is a critical component in the M&A process. The price paid for assets or shares in China may not be determined solely by the parties, unlike in other jurisdictions. PRC law requires appraisals where a transaction involves either State-owned assets or the interest in an FIE held by an SOE. In a direct-share purchase, Chinese law also imposes certain restrictions on the price the parties may negotiate.

Beijing is particularly concerned about undervaluation of State-owned assets sold or contributed to FIEs. Thus, prior to any transfer of such assets, a State-authorized appraiser must appraise the assets, and the State Asset Appraisal Administration must confirm the assessment. A recurring problem with these asset evaluations is that the Chinese appraisers, who typically base their valuation on replacement value less depreciation, often grossly overvalue the assets to be acquired. Since the asset appraisal largely determines how much the foreign investor must pay for its acquisition, the importance of becoming involved in the appraisal process as early as possible cannot be overemphasized. Typically, once the appraisal has been confirmed, the parties may only agree to a price that differs no more than 10 percent from the appraised price. Under the newly enacted Equity Change Regulations, any sale of the Chinese party's interest in an FIE, where the Chinese party had invested State-owned assets, must also be appraised in the same manner.

Discretion to determine the price in the sale and purchase of shares in a joint stock limited company is also subject to certain limitations. New shares must be issued at or above par. The issue of shares above par is subject to approval by the China Securities Regulatory Commission. Under the Company Law, the same price should be paid for each of the shares subscribed for by any unit or individual. But the government has exercised its right to grant waivers under this rule. If the seller is a holder of State-owned shares, the State-owned Shares Opinion stipulates that the price not be lower than net asset value per share and should also take into account such factors as net asset yield ratio, actual price of investment, reasonable price/earnings ratio, and market price, if any.

Because the pricing of shares in an indirect structure takes place beyond the reach of PRC restrictions, it is determined by negotiation between the parties. Multinational investors often determine a suitable purchase price through the discounted cash flow method of valuation, adopting an internationally appropriate multiple for the particular industry.

Another concern in Chinese M&A transactions is financing, whether for acquisition of a target or for operation of the target after completion of the transaction. Acquisition financing in China is limited. Banks typically are not prepared to lend without parent corporate guaranties. The Equity Change Regulations address the prospect of a pledge of the equity investment to a lender under the Security Law of the PRC, provided all the other equity holders consent. The pledge is limited to paid-up capital only and must receive government approval. Notwithstanding the availability of financing methods, including the possibility of listing on a PRC or foreign stock exchange or issuing bonds, financing for the operating needs of the target typically still takes the form of foreign shareholder loans or bank loans secured by foreign investor guaranties.

The documentation required for an M&A transaction in China depends on the structure of the deal. If an FIE is established to acquire assets of the Chinese target, the relevant documentation for FIEs must be used. In contrast, if the foreign investor is buying shares in an existing joint stock limited company (or setting up one), the documentation more resembles any international M&A transaction and would include a share purchase or subscription agreement and shareholders agreement with articles of association.

After successful negotiations that culminate in the signing of the M&A documentation, obtaining the necessary government approvals usually marks the final stage in the M&A process. Typically, the Chinese target's representatives will take the lead in obtaining any required approval, but this should not occur without close consultation with the foreign investor. Both the approval process and approval authority differ depending on the type and structure of the transaction. In a direct transaction, in which the Chinese target's assets are purchased through an FIE, approvals must come from the State Council, MOFTEC, or MOFTEC's provincial, municipal, or county-level counterparts, depending on the project's level of total investment and use of State-allocated resources. The approval may be issued subject to changes made to the transaction documents, but the smart foreign investor will seek to discuss beforehand with MOFTEC any changes they may request, and will seek clarification of, or alternatives to, the changes requested.

After receiving approval, the foreign investor must register with the local SAIC and obtain a business license. A direct acquisition involving the purchase of an existing interest in an FIE also requires approval, usually from the "original examination approval authority"—MOFTEC or the local counterpart that approved the FIE's creation, and SAIC. In a transaction involving a purchase of shares in a joint stock limited company, MOFTEC must approve the purchase if the acquisition involves shares constituting 25 percent or more of the total issued and outstanding shares of the company. If the purchaser is acquiring less than 25 percent, the State Economic and Trade Commission's local counterpart (and perhaps other departments as well) must approve the transaction. If the target is a financial institution, including an insurance operation, the Peoples' Bank of China (PBOC) must approve any share transfer of 10 percent or more. In practice, PBOC asserts approval jurisdiction over all share transfers involving financial institutions. Other government ministries may be involved in the approval process if the target is within that ministry's jurisdiction. Though the Company Law requires that any share transfers be effected at an established stock exchange irrespective of whether the company is listed, in practice, this requirement is largely ignored.

The acquisition documents of an indirect acquisition may not need PRC government approval, as they tend to be executed outside of China and governed by non-PRC law. But a purchaser with an interest in an FIE in China may wish to have the FIE's constituent documents amended before closing. The amendment process usually requires approval of the original examination and approval authority and an amended SAIC business registration.

Selected Foreign Purchases of Listed and Unlisted Shares of PRC Companies

Date	Industry	Company	Transaction
1998	Home appliances	Sanyo Electric Group Co.	Acquired a 10 percent stake in Dalian Freezer Co. by buying 33 percent of a 100 million B share issue for ¥124.9 million ($15 million).
1996	Airlines	American Aviation Investment Fund	Acquired 25 percent of Hainan Airlines.
1996	Oil refining	Atlantic Richfield Co. (ARCO)	Purchased 64 percent of convertible bond offering by Zhenhai Refining and Chemical Co. (ZRCC) for $128 million. Upon conversion in 2003, ARCO will own a 20 percent interest in ZRCC. (In 1994, ARCO acquired 237.6 million of ZRCC's H shares for $70 million, representing 9.9 percent of its total shares.)
1995	Automotive	Ford Motor Co.	Acquired 20 percent of Jiangling Motors for $40 million, representing 80 percent of the available B shares.
1995	Automotive	Isuzu Motors, Itochu Corp.	Jointly acquired 25 percent of Beijing Light Bus (Isuzu: 15 percent; Itochu: 10 percent).
1995	Chemicals	Nimrod Group	Acquired 25.4 percent of Sichuan Guanghua Chemical Fibre Co., Ltd. through purchase of State-owned shares.
1994	Power plant equipment	Asea Brown Boveri (ABB)	Acquired 5 percent of Harbin Power Equipment's H shares for $7.2 million.
1993	Beer	Anheuser-Busch International Holdings Inc.	Acquired 13 percent of Tsingtao Brewery Co., Ltd.'s H shares (5 percent of the total shares) for $16.3 million.
1993	Diesel engines	Hong Leong Technology Systems (BVI) Ltd.; Cathay Clemente Diesel Holdings Ltd.; Goldman Sachs Guangxi Holdings (BVI) Ltd.; Tsang & Ong Nominees (BVI) Ltd.; Youngstar Holdings Ltd.	Acquired 51 percent of the outstanding shares of Guangxi Yuchai Machinery Co. Ltd.

SOURCE: Cole R. Capener

Strategic Considerations

As elsewhere, representations and warranties play a critical part in M&A documentation in China, particularly because foreign lawyers often do not have access to government records that confirm title to real estate or existence of liens, and because of dubious tax avoidance structures and questionable accounting practices.

In addition to facing restrictions imposed by the Catalogue on obtaining a controlling interest, foreign investors must deal with Chinese statutes that confer important powers on minority equity holders in FIEs. Unanimous consent of the board of directors is necessary for all major actions of a company, such as increasing capital, amending the articles of association, assigning registered capital, merging with another firm, or dissolving the firm. (Joint stock limited companies are not subject to the same unanimity requirements.) The foreign shareholder should therefore be aware that a Chinese partner is able to exert influence far beyond that which its minority shareholding would suggest.

Parties in an M&A transaction may be concerned that the shareholders from which they are purchasing shares, or other shareholders of the target company, intend to compete with the target company. In such a case, parties can formulate covenants not to compete, and not to solicit employees. These covenants are generally enforceable under PRC law if reasonably limited in time and scope. Restrictive covenants with individual employees may not exceed three years and require separate consideration. And when a foreign investor buys into an existing PRC entity, or when an FIE acquires all of the assets of an SOE (and intends to hire its employees), careful consideration must be given to the pre-existing legal obligations owed to such employees.

Another strategic issue is that of exit options for investors. The objectives of financial investors usually differ from those of operating companies making strategic investments in China. Financial investors envision a shorter term of involvement and seek some type of exit strategy exercisable within three to five years of making the investment. Financial investors will want to include exit provisions in the acquisition documents. This may take the form of a put option allowing the investor to sell its equity back to the seller, or an obligation to cause the holding vehicle to undertake a public offering so the financial seller can dispose of its shares. In an indirect structure, a financial investor buying shares in an offshore holding company should be free to incorporate such obligations. In direct structures not involving joint stock limited companies, the statutory preemptive and veto rights of each equity holder and the non-share issuing nature of the enterprises pose potential obstacles for an exit strategy. Such transactions might be restructured to allow the financial investor to hold its interest in a single-purpose, offshore holding company, to facilitate both the exercise of a put option (relating to the shares of the offshore company rather than the PRC-based company) without being subject to preemptive or veto rights as well as a possible future listing. If a listing is not contemplated, the financial investor may want to try to arrange waivers of preemptive rights and consents in advance (although enforceability is uncertain under PRC law). Any assignment of an interest in an FIE is further subject to government approval.

Overseas investors should also be aware of the tax implications of their M&A transactions in China. PRC tax authorities recently issued regulations covering M&A deals to provide guidance on the tax consequences of mergers (*see The CBR*, November-December 1997, p.26). Mergers are treated as a non-taxable event; in general, the parties' premerger tax treatment is preserved after the merger. As before, an enterprise's income tax must be paid on gains resulting from asset assignment or an FIE restructuring. Other tax considerations include value-added tax on the sale of machinery and equipment, and business tax assessed on intangible property rights. A stamp tax is also imposed on the transfer of shares in a Chinese joint stock limited company and on a contract for the assignment of registered capital in an FIE.

The Start of a New Era

M&A transactions in China will continue to increase as China attempts to reform its State sector and foreign investors ply China's investment waters. The well-worn path of asset acquisitions through FIEs remains the favored and most predictable structure for investors, but the future promises more options for share purchases in both listed and unlisted Chinese entities. A secondary market for interests in FIEs in China in which early foreign (mainly Hong Kong and overseas Chinese) investors are eager to sell, often at a healthy premium, now exists. Despite China's progress over the past 17 years, M&A participants are sure to encounter pitfalls, including a complicated legal system that is hardly a steady foundation for M&A deals. Thorough due diligence, well-crafted documents, and proper government approvals are essential. Regardless of such difficulties, however, China promises to be near the forefront of the continuing wave of global M&A transactions. 完

> *The well-worn path of asset acquisitions through FIEs remains the favored and most predictable structure for investors, but the future promises more options.*

Accounting Adjustments

Changes are in the works to adapt China's accounting profession to international standards

Martin Foley

Few countries in the world have witnessed economic growth and change on a scale as large as China has over the last five years. This growth could not have taken place without fundamental economic changes that began in 1979 and are continuing. At the 15th Communist Party Congress held last September, PRC President Jiang Zemin identified a range of initiatives of the new five-year government. Among these goals are lifting troubled large- and medium-sized State-owned enterprises (SOEs) out of difficulty and developing a modern corporate system for them; transforming the financial sector by strengthening central bank supervision and commercializing State banks; and reforming the systems of taxation, investment, and fundraising.

Underlying all of these reforms are planned improvements in accounting regulations and enterprise transparency, particularly as they relate to the recording or transfer of reliable financial information. Efforts, in the form of undergraduate accounting programs and on-the-job training with international and domestic accounting firms, also are under way to increase the number of PRC accountants qualified to prepare internationally standardized financial statements.

Government institutions and domestic and foreign firms support these efforts and agree that a strong PRC accounting profession would encourage capital investment in China. Meeting the needs of these investors is important, especially if they are to provide the capital that will aid SOE restructuring, strengthen domestic companies to compete globally, help reform the banking system, and expand the country's infrastructure. In the past, much of this capital has been in the form of foreign direct investment and government subsidies. But for domestic and international equity markets to become significant providers of capital in China in the future, the country will have to continue its move toward implementing a sophisticated, transparent accounting system.

A TRANSFORMATION IN THE WORKS

For the first 30-odd years of the PRC's existence, all of the country's productive resources were owned by the State. In effect, the only economic entity was the SOE. The accounting framework used during this era, known as fund accounting, was intended primarily to establish an information and reporting system for State economic policies and maintain administrative control over State assets. To a great

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extent, these rigid and uniform accounting rules also served as a tool to strengthen the financial discipline of enterprises and safeguard State property.

Accounting in China has shifted significantly in recent years, away from a system that facilitated central planning, to one better suited for a market economy. In the early 1980s, the government inaugurated changes to the PRC accounting profession that are ongoing. The first Chinese certified public accountant (CPA) firm was formed in 1981, at which time international accounting firms received permission to open representative offices in China. Such moves reflected a growing awareness that the PRC should align its practices more closely with internationally accepted standards.

The PRC accounting system has continued in the 1990s to take on a more cosmopolitan form. Early in the decade, an accounting system for Sino-foreign joint ventures was developed and implemented, marking the country's first step away from the fund accounting concept. To enable PRC enterprises to attract foreign investment or list stocks on overseas markets, the Ministry of Finance (MOF) issued in January 1992 a separate set of accounting regulations for selected joint stock companies that conform more closely to international accounting and disclosure practices than the general PRC standards. In 1994, the PRC Company Law took effect, providing a regulatory framework on which new accounting and auditing standards could be based. Prior to the release of the Company Law, formulation of other finance regulations, such as the National Securities Law and Listing Regulations, was more difficult and time consuming.

In the last five years, MOF has issued or revised three sets of accounting regulations applicable to all enterprises in the PRC, including joint stock limited companies and foreign-invested enterprises (FIEs). Since all three sets of accounting regulations were prepared and issued at roughly the same time, they differ mainly in the degree of detail and disclosure required rather than in the principles employed. These regulations, however, are prescriptive in nature, setting out specific accounting treatments for different types of enterprises in different industries, and therefore are still rather rigid compared with International Accounting Standards (IAS). In addition to passing new accounting laws and regulations, China joined the International Accounting Standards Committee (IASC) in July 1997. Membership in IASC will help PRC accountants better understand international accounting practices and give them a voice in the international accounting community.

Despite these developments, areas of the PRC accounting profession still need improvement. For example, China has yet to establish an independent accounting standards regulatory body. In the absence of an independent authority, MOF is responsible for formulating, issuing, and administering accounting regulations in China. The Accounting Society of China (ASC) and the Chinese Institute of Certified Public Accountants (CICPA), both branches of MOF, are responsible for regulating, governing, and monitoring the reform and development of the accounting profession. CICPA also assumes administrative authority, delegated by MOF, to serve as a bridge between the government and practicing accountants.

Comparing ledgers

Foreign players in the PRC are hoping that IASC membership will help align Chinese practices with international standards. The multinational companies and individual entrepreneurs that have invested billions of dollars in China since 1992 have financial reporting needs as diverse as the many countries they represent. Though PRC accounting standards gradually are coming into line with IAS, they continue to serve first the requirements of the Chinese central and local government tax authorities. Consequently, foreign investors likely will continue to find it difficult to compare the financial merits of a PRC investment target with investment prospects elsewhere. The PRC's new form of enterprise, the joint stock limited company (*see* p.18), is the one exception—such enterprises typically use accounting standards that approximate IAS.

Nonetheless, both the multinational corporation with several China investments and the entrepreneur with a single joint venture need to understand financial statements prepared in accordance with PRC accounting standards in order to prepare financial statements in line with IAS or other mature, widely accepted accounting standards, such as US Generally Accepted Accounting Principles (GAAP). Some general distinctions between IAS and PRC FIE accounting standards that investors should take into consideration include:

Though PRC accounting standards gradually are coming into line with IAS, they continue to serve first the requirements of the Chinese tax authorities.

■ **Selecting a method** A framework of accounting principles and conventions, IAS enables individual enterprises to select appropriate accounting policies so that their financial statements accurately reflect the enterprise's financial condition. PRC regulations, on the other hand, do not include alternatives that would allow a degree of flexibility. Adherence to PRC regulations is mandatory.

■ **Accounts receivable** Provisions for doubtful accounts receivable are required by IAS under the prudence concept, which calls for determinations based on judgement. The PRC regulations stipulate that general provisions for accounts receivable are only to be made in accordance with the percentage prescribed by tax authorities. The prescribed rate for joint stock companies is 0.3 percent of the accounts receivable balance as of the date of the financial statements.

■ **Stock value** Under IAS inventory provisions for net realizable value, stock should be carried at the lower of cost or net realizable value. PRC standards, however, permit inventory provisions for net realizable value only in accordance with FIE regulations. To be tax deductible, such provisions must be approved by PRC tax authorities.

■ **Depreciation** Depreciation charges required by IAS are based on the economic useful lives of assets. In the PRC, however, depreciation charges are based on measures of assets' useful

PRC leaders recognize the urgent need for the country's accounting profession to keep up with domestic reforms and foreign commercial involvement.

lives that are established by tax authorities. For example, PRC regulations specify that buildings must be depreciated over 20 years, or another approved term. Under IAS, depending on its economic useful life, that same building may be depreciated between 30-40 years. Thus, there may be a significant difference between the depreciation charges determined in accordance with IAS and those calculated according to PRC accounting standards.

■ **Asset valuation** Assets contributed as capital or State-owned assets sold to an investor must be valued by a licensed valuation professional and approved by the State-owned Assets Bureau. PRC regulations require that assets be recorded in a company's PRC financial statements based on the valuation, which can be different from the original cost or market value of the assets. Under IAS, the market value of an asset is used.

■ **Income taxes** PRC regulations provide no guidance on accounting for income taxes, particularly deferred income taxes. According to IAS, either the deferral or liability method should be used for tax accounting.

■ **Contingencies** For purposes of IAS or US GAAP, contingencies are defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise, which ultimately will be resolved when a future event or set of events occurs or fails to occur. PRC regulations contain no provisions for contingencies. Under IAS, probable and estimable contingent losses should be accrued, and all other such contingencies require disclosure unless deemed "remote" (a slight change in future events).

Beyond the Books

In addition to noting differences in accounting standards, investors should become familiar with China's business environment and its impact on a company's financial statements. One important element of the PRC business environment is the handling of related-party transactions, which can include loans, loan guarantees, and raw material purchases. MOF released in June 1997 the Accounting Standard for Business Enterprises: Disclosure of Related Party Relationships and Transactions. Based on IAS, the standard requires listed companies, and encourages unlisted firms, to disclose related-party relationships and transactions. Nonetheless, investors should gain a thorough understanding of significant related-party transactions and the processes and internal controls over such transactions.

Foreign investors also should be aware of the "triangular debt" situation in China that has resulted from companies obtaining loan guarantees from third parties to cover their debt obligations. Until recently, the fact that companies were not required to disclose such information in their financial statements made it difficult for financial institutions and investors to assess the risk of investing debt or capital in a PRC company. Under MOF's June 1997 pronouncement, however, companies now may be required to disclose information about loan guarantees obtained through third parties.

Also over the last several years, local authorities have attempted to encourage foreign investment by providing various tax incentives that may have been inconsistent with central government policy. In March, the State Council issued a notice indicating that local authorities do not have the right to arbitrarily interpret national tax laws, or grant tax exemptions or reductions that are contrary to the central government's tax regulations.

Preparing for the Future

PRC leaders recognize the urgent need for the country's accounting profession to keep up with domestic reforms and foreign commercial involvement. After introducing national accounting examinations in 1991, China had 124,000 CPAs, including 58,000 practicing in 6,700 CPA firms by year-end 1996. To meet the needs of the market, CICPA aims to increase its membership to 350,000, including 200,000 practicing CPAs by 2000, and to 500,000—including 300,000 practicing CPAs—by 2010.

Large international accounting firms also are playing a part in training Chinese CPAs. They are helping to improve Chinese universities' accounting programs by assisting in the development of core curricula; funding both scholarships and professorial chairs in accounting and auditing; and providing computers, textbooks, and other technical training material. In addition, these firms are training post-graduate students who work in their PRC offices and in other Chinese CPA firms. This training includes formal classroom and on-the-job training as well as overseas study in countries that have more developed accounting and auditing systems, including Australia, the United Kingdom, and the United States.

CICPA also intends to implement a formal quality control review program and promote the merger of Chinese accounting firms. Such mergers will allow CICPA to better monitor the profession. Consolidation of the industry will also enable accounting firms to utilize economies of scale in developing policy, monitoring quality, and training professional staff.

In addition to the recently issued related-party transaction standard and another on cash flow statements, MOF has finished drafting 31 standards on such issues as accounting for cash and cash equivalents, consolidated financial statements, contingencies and commitments, and futures. These regulations are expected to be released sometime this year, with priority given to disclosure standards. Adherence to these standards will be mandatory for joint stock limited companies, and will be recommended for other enterprises.

The PRC has made great strides over the last five years, and continues to make significant efforts to improve its accounting profession. Despite recent and imminent regulatory developments, however, foreign investors should demand that PRC regulators and accounting officials continue introducing enhanced standards that will help protect investments in China. And investors must insist—with a degree of patience—that the PRC accounting profession take an active role in the evolution of China's equity market. 完

A New Triumvirate

The Ninth National People's Congress puts its stamp of approval on officials who will lead China into the next century

David Bachman

The results of China's Ninth National People's Congress (NPC) in March marked a major transition in the PRC leadership at a time of great uncertainty in the Asia-Pacific region. The appointment of Zhu Rongji as premier and his powerful performance at the news conference at the closing of the congress raised great expectations—at home and abroad—about an accelerated pace of reform, even though China and the rest of East Asia must cope with the region's financial crisis.

But Zhu faces a daunting economic reform agenda. Indeed, an irony of that agenda is that although success would help create common ground between China and World Trade Organization (WTO) members, especially the United States, it would also make China much more vulnerable to the types of problems associated with the Asian "flu." Zhu will lead the State Council in dealing with many of the issues associated with globalization, particularly borders open to capital flows, at the end of the twentieth century. China could hardly find a better champion in such efforts, but whether domestic reform will accelerate, in light of its potential social consequences, remains uncertain. Even less clear is who would come out on top if a split within the elite occurred over these difficult issues.

Zhu's Mission

Many of the difficulties confronting Zhu stem from the incompatibility of the issues at hand. As premier, his principal charge for 1998 is to maintain a rate of economic growth of at least 8 percent. At the same time, he expects, and is expected, to deal with the problems of State-owned enterprise (SOE) reform over the next three years (*see* p.8), but SOE reform is breeding unrest. Over the last two years, protests and demonstrations have occurred widely, if sporadically, in urban centers.

A similar set of expectations exists with regard to the banking system, which is being reformed to function according to commercial principles. One goal of the current reforms is to write off or recover at least a substantial portion of the banking system's nonperforming loans, which now equal 20-30 percent of State banks' total loans. Yet, to keep China's growth rate relatively high—the highest in Asia—Beijing intends for the domestic banking sector to provide much of the funds for ambitious infrastructure investment and housing reform plans over the next three years. Given the long pay-off periods associated with infrastructure projects, it remains unclear how banks will fund such government projects or how funding these projects will help their balance sheets. The government has reportedly foresworn the use of bank pump priming. But its urging of banks to lend to

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In his move from the State Council to the NPC, Li Peng has lost a major base of power in the form of his ability to control the agenda of the State administration.

stimulate the economy may also rekindle inflation, which peaked in 1994.

Meanwhile, Zhu has conceded that, though technical upgrading of Chinese industry has long been on Beijing's agenda, until recently, funds had been diverted to other uses at the expense of China's educational and technical base. At his post-NPC press conference, Zhu stated that the restructuring of the ministries of education and science and technology will finally enable more money to go to education and technological modernization, thus enhancing China's long-term competitiveness. Newly appointed Minister of Science and Technology Zhu Lilan has long played a critical role in China's "863" program to develop its high-technology base. The program, which was approved by Deng Xiaoping in March 1986, supports high-tech research and development projects with industrial spinoffs. Upgrading the Commission on Science and Technology for National Defense from a unit under the People's Liberation Army to a ministry also will enhance the State's ability to coordinate science and technology promotion, as the defense industry has been a key driver of most PRC high-tech endeavors.

But the redistribution of budgetary funds among government agencies—always a divisive political process—has yet to occur. To the extent that Zhu can limit the hemorrhaging of State funds to support the SOEs, he should be able to expand gradually the funds for high-tech research and development. Major results from such efforts could take many years to emerge, however. Finally, Zhu must try to manage all of these issues in an international environment in which China's exports will find fewer Asian buyers, and the number of Asian investors—China's largest source of foreign investment to date—will shrink.

Balancing power

Also complicating Zhu's tasks is the fact that in the current political alignment he is only one of three linchpins—and perhaps the weakest politically. President Jiang Zemin has created a tri-polar political line-up consisting of Li Peng, Zhu Rongji, and himself as the fulcrum. Neither Li nor Zhu alone is likely to be able to challenge Jiang, and institutional rivalry, among other reasons, may prevent Zhu and Li from acting in concert. Jiang, skilled politician that he is, appears to have created such a "divide and rule" arrangement precisely because it makes collusion between Li and Zhu difficult and requires both to appeal to him for support.

In his move from the State Council to the NPC, Li Peng has lost a major base of power in the form of his ability to control the agenda of the State administration, but his political staying power should not be underestimated. Many of his protégés remain in important positions within the State Council, and Li, now NPC chairman, retains his number-two position in the Communist Party. Conventional wisdom holds that Li's conservative tendencies will make the NPC, and especially its Standing Committee, a less independent lawmaking body than it was under Qiao Shi. But this may be a misperception (*see The CBR*, January-February 1998, p.8), as Li must strengthen the NPC institutionally to remain in power. In time, Li and Zhu may find themselves at loggerheads, particularly if the NPC tries to oversee the affairs of the State Council or if the State Council expects the NPC led by Li to be no more interventionist than now. Even without a new institutional base to support him, Li Peng has demonstrated considerable political staying power since 1989.

Though Zhu currently is riding a wave of popularity, due largely to his success in bringing about the soft landing for the economy, this acclamation may be fleeting. Zhu's support has waxed and waned with the results of the fight against inflation. Presumably, other macroeconomic variables could also affect his standing. Zhu, whose intellectual powers are widely acknowledged, is recognized as a very demanding superior. If he ignores or pushes aside those officials whom he considers to be less capable, Zhu risks provoking bureaucratic resistance.

Finally, it appears that economic management is Zhu's cross to bear. Should accelerated reform succeed, it will redound to his credit. But should there be problems—and it is all but guaranteed that there will be—Zhu will be in a vulnerable position. Inflation could fuel a rush to withdraw deposits from the banking system, which in turn would deal a severe blow to the State's ability to guide the economy. Zhu would be the first to take the blame if layoffs or inflation (rekindled by pump priming) resulted in growing protests in China's urban areas. If social unrest spreads or intensifies rapidly, and the benefits of accelerated reform fail to manifest themselves quickly, Zhu's position would suffer. Again, this positioning of Zhu appears to be the strategy of Jiang Zemin, who has distanced himself from China's economic problems, and thus from the bulk of the blame if the recessionary economy lapses further.

Accent on international experience

Jiang and the rest of the leadership appear to have installed figures with extensive international experience in key posts. Officials who can perform comfortably in multilateral and bilateral forums now make up the majority of the State Council leadership. Qian Qichen, more than anyone else, has been responsible for China's generally successful foreign policy over the last few years. He retained his position on the Politburo and his post as a State Council vice premier, despite pressure from the military in 1995-96.

Also among those versed in international affairs are Zhu Rongji and his associate Wang Zhongyu, former State Economic and Trade Commission chairman and now a State councilor. Successive former Ministry of Foreign Trade and Economic Relations (MOFTEC) heads Li Lanqing and Wu Yi have moved up the ranks as well. Li served as vice premier responsible for foreign economic relations from 1993 until this past March when he succeeded Zhu Rongji as executive vice premier. Li Lanqing, in cooperation with Zhu, is now in charge of running the PRC economy. Thus Li has emerged as Zhu's principal subordinate. Wu Yi's promotion to the State Council as a result of her demonstrated competence and professionalism should be interpreted as a positive sign for overlapping PRC and US interests. Wu presumably is taking over the broader management of foreign economic relations. Because Wu's personal connections are not readily identifiable, however, gaining insight on her is difficult.

Sticking to the Rules

Underlying all political developments among the top echelon is the emerging norm of retirement at age 70 (unless one is the preeminent leader). According to Hong Kong reports, the age limit was used to force Qiao Shi out of the Politburo and the NPC. Zhu got in under the wire; he turns 70 this year. Whether Zhu will be retained for a second five-year term at the next NPC in 2003, or whether he will be regarded as a lame duck, remains uncertain. The same questions apply to Jiang Zemin. Nonetheless, both Zhu and Jiang must now perform their duties as if they intend to continue serving beyond 2002-03, if only to ensure effective policy development and implementation. Strict adherence to the retirement age also stands to affect the career prospects of officials such as 66-year-old Li Lanqing (who may hope to become the next premier) and others born before 1932, or even 1937. This may dishearten older officials who have their sights set on top leadership posts and intensify competition among the younger generation of leaders.

Further Down the Line

China's political and economic evolution since 1978, and especially since 1989, suggests that the composition of the leadership at the apex of the political system matters less and less. But the process by which officials arrive at the top matters a great deal, since smooth succession obviously supports stability. Contentious succession struggles, whatever the outcome, introduce uncertainty about government policy and overall direction. The way that Jiang and Zhu are likely to rule will probably add to the uncertainty, since their political effectiveness requires ambiguity about another five-year term.

Hu Jintao's ascension to the vice presidency of the PRC, meanwhile, confirms the view that he is Jiang's likely successor. At 55, Hu is the youngest among the top leaders. He sits on the Politburo Standing Committee with Jiang, Li, and Zhu and also serves as the president of the Party school of the Communist Party Central Committee. A hardliner when he was Party secretary in Tibet in the late 1980s, Hu has taken moderate or reform-inclined stances in recent years. Vice Premier Wen Jiabao and several ministers in the new State Council, most importantly Minister of Public Security Jia Chunwang, are seen by knowledgeable Hong Kong observers as having good ties with Hu. Despite support from conservatives and fellow technocrats, Hu's position is not unassailable.

Within the State Council leadership, there has been little change in the power alignment. Three of the four vice premiers and three of the five State councilors are incumbents. Considerable turnover at the ministerial level, however, has made clear factional or personal affiliations difficult to determine. Because 11 of the 22 new ministers clearly were promoted from within their respective ministries, competence and professionalism appear to have been key criteria in deciding the appointments.

But personal connections have played a role in some appointments, according to Hong Kong press reports and other sources. Zhu Rongji's associates dominate the banking, finance, economy, and trade portfolios, while Jiang Zemin's command the planning, education, culture, health, and agriculture portfolios. Other ministers and State Council officials are affiliated with Li Peng, Hu Jintao, and Wei Jianxing, secretary of the Central Discipline Inspection Commission and Politburo Standing Committee member.

Both Zhu and Jiang must now perform their duties as if they intend to continue serving beyond 2002-03, if only to ensure effective policy development and implementation.

Associating State Council figures with top leaders, however, often involves sorting out personal ties and overlapping tenures. And even though the State Council and its constituent ministries have been the scene of much bureaucratic battling, rarely have ministers played key roles in elite conflict. Politburo members and the top leaders of the State Council have been the participants in such conflicts in the past. Whatever happens at the apex of the State Council, foreign businesses in China should not expect immediate changes. It will take some time for the ideas and policies of the new leadership to percolate through the system. Moreover, the bureaucratic restructuring will keep

CHINA'S GOVERNMENT STRUCTURE

PRESIDENT
Jiang Zemin

VICE PRESIDENT
Hu Jintao

NATIONAL PEOPLE'S CONGRESS

STANDING COMMITTEE
Chairman: Li Peng

Vice Chairmen:

Tian Jiyun
Xie Fei
Zou Jiahua
Pagbalha Geleg Namgyai
Wang Guangying
Cheng Siyuan
Buhe
Tomur Dawamat
Wu Jieping
Peng Peiyun
He Luli
Zhou Guangzhao
Cheng Kejie
Cao Zhi
Ding Shisun
Cheng Siwei
Xu Jialu
Jiang Zhenghua
Jiang Chunyun

Secretary General: He Chunlin

Supreme People's Court
President: Xiao Yang

Supreme People's Procuratorate
President: Han Zhubin

NPC COMMITTEES
Financial and Economic
Chen Guangyi
Ethnic Affairs
Wang Chaowen
Law
Wang Weicheng
Internal and Judicial Affairs
Hou Zongbin
Education, Science, Culture, and Health
Zhu Kaixuan
Foreign Affairs
Zeng Jianhui
Overseas Chinese Affairs
Gan Ziyu
Environment and Resources Protection
Qu Geping
Agriculture and Rural Affairs
Gao Dezhan

Commission for Legislative Affairs
Gu Angran

Credentials Committee
Wang Weichang

Central Military Commission
Chairman: Jiang Zemin
Vice Chairmen:
Chi Haotian, Zhang Wannian

STATE COUNCIL

Premier:
Zhu Rongji
Executive Vice Premier:
Li Lanqing
Vice Premiers: Qian Qichen, Wen Jiabao, Wu Bangguo
State Councilors: Chi Haotian, Luo Gan, Ismail Amat, Wang Zhongyu, Wu Yi
Secretary General: Wang Zhongyu

Commission for Science, Technology, and Industry for National Defense
Liu Jibin
State Development Planning Commission
Zeng Peiyan
State Ethnic Affairs Commission
Li Dezhu

State Economic and Trade Commission
Sheng Huaren

China National Offshore Oil Corp. (CNOOC) Wang Yan
State Bureau for Coal Industry Zhang Baoming
State Bureau for Internal Trade Yang Shude
State Bureau for Light Industry Cheng Shineng
State Bureau for Machine-Building Industry Shao Qihui
State Building Materials Bureau Zhang Renwei
State Bureau for Metallurgical Industry Wang Wanbin
State Bureau for Nonferrous Metals Industry Zhang Wule
State Administration of Petroleum and Chemical Industries Li Yongwu
State Bureau for Textile Industry Dou Juezhou
State Power Industrial Corp. Gan Yan
State Tobacco Administration Ni Yijin

MINISTRIES AND MINISTRY-LEVEL ORGANIZATIONS

Ministry of Agriculture
Chen Yaobang

Ministry of Foreign Trade and Economic Cooperation
Shi Guangsheng

Ministry of Public Security
Jia Chunwang

OTHER KEY GOVERNMENT AGENCIES*

Bureau of Religious Affairs
Ye Xiaowen

State Administration of Foreign Exchange
Wu Xiaoling

State Forestry Bureau
Wang Zhibao

STATE-LEVEL CORPORATIONS*

Aviation Industries of China
Zhu Yuli

China National Automotive Industry Corp.
Gu Yaotian

China National Star Petroleum Corp.
Zhu Jiazhen

Ministry of Civil Affairs Doje Cering	**Ministry of Information Industry** Wu Jichuan	**Ministry of Railways** Fu Zhihuan	**China Securities Regulatory Commission** Zhou Zhengqing	**State Administration of Industry and Commerce** Wang Zhangfu	**State Intellectual Property Bureau** Gao Lulin	**China Aerospace Industry Corp.** Liu Jiyuan	**China National Chemicals Import and Export Corp. (SINOCHEM)** Liu Deshu	**China North Industries Group** Min De
Ministry of Communications Huang Zhendong	**Ministry of Justice** Gao Changli	**Ministry of Science and Technology** Zhu Lilan	**Foreign Affairs Office** Liu Huaqiu	**State Administration for Inspection of Import and Export Commodities** Tian Runzhi	**State Pharmaceutical Administration** Zheng Xiaoyu	**China Cereals, Oils, and Foodstuffs Import and Export Corp.** Zhou Mingchen	**China National Development and Investment Corp.** Wang Wenze	**China Ocean Shipping Co.** Chen Zhongbiao
Ministry of Construction Yu Zhengsheng	**Ministry of Labor and Social Security** Zhang Zuoji	**Ministry of State Security** Xu Yongyue	**General Administration of Civil Aviation (CAAC)** Chen Guangyi	**State Administration of Taxation** Jin Renqing	**State Radio, Film, and Television Bureau** Tian Congming	**China Everbright Group Ltd.** Zhu Xiaohua	**China National Minerals and Metals Import and Export Corp.** Miao Gengshu	**China Resources (Holdings) Co.** Gu Yongjiang
Ministry of Culture Sun Jiazheng	**Ministry of Land and Natural Resources** Zhou Yongkang	**Ministry of Supervision** He Yong	**General Administration of Customs** Qian Guanlian	**State Copyright Administration** Yu Youxian	**State Sports Administration** Wu Shaozu	**China Great Wall Industry Corp.** Zhang Xinxia	**China National Nuclear Corp.** Jiang Xinxiong	**China State Shipbuilding Corp.** Xu Penghang
Ministry of Education Chen Zhili	**Ministry of National Defense** Chi Haotian	**Ministry of Water Resources** Niu Maosheng	**Hong Kong and Macao Affairs Office** Liao Hui	**State Environmental Protection Administration** Xie Zhenhua	**State Statistical Bureau** Liu Hong	**China Huaneng Enterprise Group** Liu Jinlong	**China National Petrochemical Corp. (SINOPEC)** Li Yizhong**	**China United Telecom (Unicom)** Li Huifen
Ministry of Finance Xiang Huaicheng	**Ministry of Personnel** Song Defu	**National Audit Office** Li Jinhua	**National Tourism Administration** He Guangwei	**State Family Planning Commission** Zhang Weiqing	**State Technology Supervision Bureau** Li Chuanqing	**China International Trust and Investment Corp.** Wang Jun	**China National Petroleum and Gas Corp. (CNPC)** Ma Fucai**	**People's Insurance (Group) Corp.** Ma Yongwei
Ministry of Foreign Affairs Tang Jiaxuan	**Ministry of Public Health** Zhang Wenkang	**People's Bank of China** Dai Xianglong	**Office for Restructuring the Economy** Liu Zhongli		**Xinhua News Agency** Guo Chaoren			

SOURCE: US-China Business Council files, FBIS, China Directory 1997

*These listings are not meant to be comprehensive

**Acting general manager

The military and many of the large SOEs affiliated with the defense industry will continue to draw inordinate support and protection.

many cadres preoccupied with trying to hold onto their jobs rather than dramatically altering policies.

Faces, not issues, change

Despite extensive personnel changes, the issues before the government remain the same. At the post-NPC news conference, Zhu deferred to Li Lanqing to discuss WTO issues. Li commented that China was still pushing for developing-country status within WTO. Whether this was a pro forma statement or an indication that China intends to adopt a hard line on sector-specific negotiations is difficult to say. By most other accounts, the negotiations seem aimed at reaching compromises between the developing-country argument of China and the developed-country position of the United States, the European Union, and Japan. Most recently, revelations about US satellite-waiver and technology-transfer decisions have made it unlikely that Congress would approve China's accession on anything other than stringent commercial terms. Even then, Congress may still be unwilling to grant China permanent Most Favored Nation status. Under such circumstances, it is not clear that China would be willing to join WTO.

The short-term economic challenges facing China could prompt PRC officials to take a harder line in its WTO negotiations. On the other hand, the fact that Taiwan's negotiations for WTO accession are all but complete may spur progress on China's negotiations, since the PRC leadership deems a Taiwan entry before China to be unacceptable. By concluding accession negotiations this year, China could participate fully in negotiations within the WTO, set to begin in 1999 and 2000, respectively, on service industry and agricultural trade liberalization.

Indeed, WTO accession could also benefit the SOE and banking reform processes. As a WTO member, China could be required to reduce government support for failing enterprises, exposing them to competition. China's international competitiveness, in turn, would likely increase, as resources would be allocated more efficiently under a liberalized trade regime.

Proceeding with caution

In China, as elsewhere, rarely are plans and programs fully carried out as designed. Unintended consequences, changing circumstances, and unexpected developments always alter the execution of programs. Nevertheless, housing reform and increased investment in education, science, and technology should proceed as scheduled. The military and many of the large SOEs affiliated with the defense industry will continue to draw inordinate support and protection as well. Given China's stated commitment to military modernization, its growing defense budget, and the greater technical capabilities of potential adversaries, modernization of the defense industry is considered essential. Regarding SOEs, Zhu apparently sees the problems of the big companies differently than many outside observers. He has stated that of the 500 largest SOEs, which provide 85 percent of industrial taxes, only 50 are in the red and must be "overhauled"; most observers believe far more than this are unprofitable.

The realities of the Asian crisis, meanwhile, may encourage the PRC leadership to carry out other reforms more carefully and slowly than originally planned. Despite Zhu's bold rhetoric regarding structural economic reform, he and his colleagues do not want the problems that have afflicted Southeast Asia, South Korea, and Japan to infect China. One of the key lessons of the crisis was that a country must have in place strong regulatory institutions to survive the vagaries of international markets and capital flows. But China has far to go to build an effective regulatory system. Under such circumstances, full liberalization of the banking and financial sectors is probably among the last items on the agenda.

There are, therefore, good reasons to believe that the problems of China's SOEs and the banking system will not be fully resolved within the next three years. Though a general consensus exists within the PRC leadership that these two sectors are core problems that must be addressed immediately, the strength of this consensus remains unclear. If social unrest erupts, the economy falters, or benefits fail to appear soon, opinion among the elite will start to diverge. How severe the divide will be, what forms it might take, and whether the Chinese people will participate in any ensuing political confrontation are beyond anyone's ability to predict. But given the stark and difficult choices confronting the leadership, some fragmenting of the current consensus is all but guaranteed. How Jiang Zemin and Zhu Rongji handle this eventuality will be the central political issue during their current terms in office.

Surrounding Zhu's premiership is the question of how well and how quickly he can address the country's critical economic challenges. Should he manage banking and SOE reform successfully, he will make a lasting contribution to China's development, and China will emerge from the process well positioned for several decades of solid growth. But if Zhu's efforts falter, outcomes become much less clear. The next three years will reveal much about China's prospects for the next two decades. 完

SAFE and Sound

Beijing tightens foreign-debt controls and encourages foreign direct investment in the face of the Asian financial crisis

T.K. Chang

A conspicuous irony of the Asian financial crisis for China investors is that the general non-convertibility of the *renminbi* (RMB), about which foreign investors have long complained, has in fact enabled China to escape the regional turmoil relatively unscathed. Moreover, Beijing's past policy of strict foreign-exchange controls, and its dogged insistence that Sino-foreign joint ventures balance their foreign exchange and meet export quotas or targets, have helped China amass one of the world's largest reserves of foreign exchange. World leaders now look to China, and PRC Premier Zhu Rongji, to help lift Asia out of its economic doldrums.

In the aftermath of the Asian financial crisis, the PRC leadership has responded by adjusting China's policies on foreign debt and foreign direct investment (FDI), as well as its timetable for full convertibility of the RMB. Since mid-1997, Beijing has passed a number of regulations that further tighten government controls over foreign-currency debt obligations and that grant incentives aimed at attracting FDI. Among these are regulations issued by the State Administration of Foreign Exchange (SAFE) that strengthen its control over international commercial borrowings, the issuance of foreign-currency bonds, and the overall foreign-debt exposure of Chinese entities; and that tighten restrictions over collateral security provided to foreign lenders and the establishment by PRC entities of overseas foreign-exchange accounts.

Rather than take on short-term foreign debt, a primary cause of the crises in other Asian countries, China is promoting FDI. Beijing restored the tax exemption revoked in 1996 for the import by foreign-invested enterprises (FIEs) of certain types of capital equipment (*see The CBR*, March-April 1998, p.4). Unlike foreign debt or portfolio investment, FDI cannot be defaulted upon or accelerated, and is generally illiquid and difficult to shift quickly out of the country. PRC leaders finally seem to be realizing the increasing indispensability of FDI to China's future economic growth, and the significant role that it has already played in China's modernization.

Postponed Convertibility

Prior to Asia's financial implosion in 1997, China's leaders appeared to be targeting an aggressive timetable for making the RMB a fully convertible currency. To that end, the PRC government declared in 1996, several years ahead of the original target date, that the country's currency was convertible for current-account transactions, making the RMB officially convertible for profit repatriation and trade in goods and services. PRC officials also have offered to abolish foreign-exchange balancing requirements and export quotas for FIEs in connection with the country's bid to join the World Trade Organization (WTO). Combined with the PRC's rapidly growing foreign-exchange reserves, which topped $140

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A number of analysts and international organizations believe that official PRC statistics underreport the country's true level of foreign indebtedness.

billion in 1997, these moves suggested that convertibility of the RMB for capital account transactions was perhaps a realistic goal by the year 2000.

But the financial crisis halted progress on full RMB convertibility. Despite mounting bad debts and an ailing banking sector, the non-convertibility of the RMB shielded the currency from speculative attacks by world financial markets. As a result, Beijing is likely to enforce tighter foreign-exchange controls, making full convertibility of the RMB a more distant prospect.

SAFE tightens debt controls

The financial problems in Indonesia, Thailand, and South Korea illustrated the dangers of uncontrolled borrowing of foreign currencies by non-sovereign borrowers. For example, Indonesia's more than $65 billion in outstanding private-sector debt—a level much higher than ever previously suspected—remained hidden until more than five months after the outbreak of the financial crisis. China, on the other hand, has generally exercised caution in restricting enterprises and local entities from incurring foreign debt, primarily by requiring government approval for foreign-exchange transactions.

But a number of analysts and international organizations believe that official PRC statistics underreport the country's true level of foreign indebtedness. Official PRC statistics show utilized foreign bank commercial loans in the first 11 months of 1997 of only $904 million. Records of the Bank of International Settlements, however, indicate a debt load of $86 billion in June 1997, up from $75 billion in June 1996. According to some analysts, offshore accounts of PRC entities may also have significant foreign-debt obligations that are not reflected in official figures.

To keep a lid on China's foreign indebtedness, SAFE issued the following regulations: the Procedures for the Administration of the Borrowing of International Commercial Loans by Domestic Institutions (the International Loans Procedures), Procedures for the Administration of Foreign Currency Bonds by Domestic Institutions (the Foreign Bonds Procedures), Implementing Rules for the Statistical Monitoring of Foreign Debts (the Debt Monitoring Implementing Rules), Implementing Rules to the Procedures for the Administration of the Provision of Security to Foreign Entities by Domestic Institutions (the Foreign Security Implementing Rules), and Provisions on the Administration of Overseas Foreign Exchange Accounts (the Forex Accounts Provisions). These regulations, which took effect January 1, supersede or supplement previous regulations, and increase government control over foreign-exchange transactions, either by tightening the requirements for such transactions or by extending the coverage of the regulations over previously unregulated transactions.

■ **International Loan Procedures** The International Loan Procedures replace the 1991 Loan Procedures issued by the State Administration of Exchange Control (SAEC), SAFE's former English name. The new procedures require all PRC enterprises to obtain central- or local-level SAFE approval before securing any international commercial loan that constitutes an obligation to a foreign financial institution or individual either inside or outside the PRC.

Compared to the 1991 Loan Procedures, the International Loan Procedures are considerably broader in scope and more restrictive. For example, the definition of "international commercial loans" now includes export financing, financing leases, foreign-exchange payments in connection with compensation trade, overseas foreign-exchange deposits (except with approved offshore banking departments of PRC banks), project finance, and trade-related finance with terms exceeding 90 days. The International Loan Procedures also set forth stringent criteria for approving requests by non-financial PRC institutions to secure international commercial loans. Such criteria include the requirements that the borrower be profitable for three years prior to seeking a loan, and that its total international loans and provision of foreign security not exceed 50 percent of its net assets or its total foreign-exchange revenues for the previous year.

Many provisions of the International Loan Procedures apply to FIEs, unlike the 1991 regulations. For example, under the 1991 procedures, a PRC company with more than 25 percent of its registered capital in the form of B shares (the type of tradable share available to foreigners) qualified as an FIE and thus could secure international commercial loans without SAFE approval. But the International Loan Procedures could be interpreted to require SAFE approval for certain international loans to FIEs that relate to project finance. It remains uncertain how many of such provisions actually can apply, in practice, to FIEs, as most of them are directed at domestic PRC enterprises. Foreign investors will need to await further interpretation by SAFE before gauging the impact of the International Loan Procedures on their China ventures.

■ **Foreign Bonds Procedures** The Foreign Bonds Procedures override the Procedures for the Administration of Bond Issues Outside the PRC by Domestic Institutions, promulgated by the People's Bank of China (PBOC) on September 28, 1987. Under the new procedures, SAFE approval is required for the issuance of all securities denominated in a foreign currency, including convertible bonds, large-denomination transferable certificates of deposit, and commercial paper. All the provisions of the Foreign Bonds Procedures apply to FIEs. Thus, FIEs and PRC companies with more than 25 percent foreign equity cannot issue any type of foreign currency bond or other security without SAFE approval, even floating-rate notes or other securities that resemble loans. The Foreign Bonds Procedures also prohibit local governments from issuing bonds outside the PRC, or applying for a credit rating issued by a foreign agency.

■ **Debt Monitoring Implementing Rules** The Debt Monitoring Implementing Rules supersede the Implementing Rules for Foreign Debt Registration, issued by SAEC on November 10, 1989. These monitoring rules detail the legal framework for registering and tracking the total national foreign-debt exposure, including the foreign debt of enterprises and government ministries. Although most FIEs do not need SAFE approval for international commercial loans, these monitoring rules require all FIEs to report such loans to SAFE. Rigorous enforcement of the Debt Monitoring Implementing Rules will help China avoid the problems experienced by the governments of South

Korea, Thailand, and Indonesia, which had vastly underestimated the foreign-exchange obligations of their private-sector companies.

■ **Foreign Security Implementing Rules** The Foreign Security Implementing Rules supplement the Administrative Procedures for the Provision of Security to Foreign Entities by Domestic Institutions (the Security Procedures), which PBOC issued on September 25, 1996. The Securities Procedures and the Foreign Securities Implementing Rules aim to curtail indiscriminate guarantees and other abuses that already have resulted in the closure of a number of provincial and ministerial trust and investment corporations in the PRC (*see The CBR*, January-February 1997, p.16). These implementing rules, in 52 detailed articles, reinforce SAFE's authority over all types of security provided to foreign entities, including guarantees, mortgages, and pledges. The provision of such security represents a contingent foreign-exchange obligation, and requires SAFE approval. Under the Foreign Security Implementing Rules, however, the provision of security by wholly foreign-owned enterprises does not require SAFE approval.

■ **Foreign Exchange Accounts Provisions** The Foreign Exchange Accounts Provisions replace the Provisions on the Administration of Overseas Foreign Exchange Accounts of FIEs, issued by SAEC on January 7, 1989, which applied only to FIEs. Under the Foreign Exchange Accounts Provisions, SAFE must approve the establishment of any overseas foreign-exchange accounts by domestic institutions. Because of the still-imperfect legal framework in the PRC for taking security interests, such as a lien or mortgage over assets, foreign lenders in China have often had to resort to taking security over the overseas bank accounts of PRC borrowers. Under the Foreign Exchange Accounts Provisions, the establishment of overseas foreign-exchange accounts, and any change to the scope of receipts and expenditures, the maximum account balance, or the duration of such accounts, are subject to SAFE approval.

REVITALIZING FOREIGN INVESTMENT

Beijing has also sought to bolster declining foreign investment levels by reinstating the tariff and tax exemptions in conjunction with the issuing of a revised Guiding Catalogue for Foreign Investment in Industry. China's falling FDI receipts stem, in part, from continuing economic problems in other Asian countries, which traditionally accounted for a significant portion of China's foreign-investment inflows, and the removal of foreign-investment incentives. Beijing had revoked the tariff exemptions enjoyed by FIEs because Chinese economists had argued that excessive FDI was, in part, responsible for the high inflation in the early 1990s, and that such exemptions gave FIEs an unfair advantage over PRC enterprises. The FIE exemptions prompted many PRC enterprises to cycle funds through their overseas subsidiaries and establish false FIEs to make "round-trip" investments, taking advantage of the FIE tariff exemptions.

Such arguments prompted Beijing to revoke tariff and duty exemptions for all capital imports of FIEs approved on or after April 1, 1996. Ironically, PRC officials claimed the move represented the government's commitment to honor requests by the United States and other Western members of the WTO to provide FIEs "national treatment," that is, treatment equal to that given to PRC domestic enterprises.

The effects of removing the tariff exemptions on foreign investment in China were not readily apparent in 1996, in part because foreign companies had accelerated their capital import timetables to beat the various deadline phases. But the precipitous drop—by more than a quarter—in China's contracted FDI in 1997 caught Beijing's attention. PRC leaders, realizing that already slowing foreign-investment inflows would likely drop further as a result of the Asian financial crisis, responded by restoring the tariff exemptions, effective January 1, 1998.

Although China has so far avoided the worst ravages of the Asian financial crisis, it shares many of the systemic ills of its Asian neighbors, including massive nonperforming bank portfolios, fragile financial institutions, and an overbuilt property sector. China faces potentially massive layoffs resulting from the reform of the State-owned enterprise sector. China's post-Deng leadership will perhaps need to implement more fundamental reforms to both the Chinese economy and the Chinese political system—beyond just controls on foreign debt and incentives for direct investment—to stem the tide of recession and deflation, and the accompanying societal pressures, that seem to be sweeping across Asia. 完

Fuel for the Next Century

China appears to be opening its oil and gas sector to greater foreign involvement

David Blumental and Gray Sasser

Strategic business alliances have replaced self-sufficiency as the centerpiece of China's plan to meet its increasing consumer and industrial demand for petroleum products. The recent reorganization of the petrochemical and oil and gas ministries, part of a nationwide program to revamp and revive ailing State-run industries, could have an important impact on foreign investment opportunities in the PRC oil and gas sector (*see The CBR*, May-June 1998, p.36).

China's spectacular economic growth has made it the second-largest energy consuming nation in the world, trailing only the United States. This rapid rise in consumption, however, has outstripped domestic oil production, forcing a greater reliance on imported fuel. China has been a net oil importer since 1993. In 1997, imported petroleum accounted for 15 percent of the PRC's total consumption of more than 170 million tons, and crude oil imports increased 55 percent over 1996, to 35 million tons. Most experts, and many PRC officials, believe that China will remain a net importer well into the next century.

With explosive energy growth rates expected to continue, press reports estimate that oil imports could account for 40 percent of PRC oil use by 2020. By 2015, China may be importing 4 million barrels of oil per day, about half of Saudi Arabia's total current production. At home, Chinese onshore oil production reached record levels in 1997, topping 1996 output by more than 1.8 million tons, according to PRC officials. Nevertheless, stagnating output at many of China's aging, inefficient oil fields, and the closing of many such facilities prompted by recent rapid declines in global oil prices, make continued exploration and development of new areas a necessity.

Reaching out

The days of "Learn from Daqing" self-reliance are indeed over. The nearly 40-year-old Daqing oil field in northern Heilongjiang Province was China's primary source of oil, and for years supplied half of the nation's oil needs. Since the 1980s, however, the PRC has been forced to import foreign technology and equipment to boost dwindling domestic production and keep the oil flowing at Daqing and other traditional oil-producing sites in northeastern China. But these efforts have not met burgeoning demand. As a result, the PRC has begun to look outward to procure dependable, affordable energy, including entering into several agreements to explore for oil outside China.

Prior to its recent reorganization, China National Petroleum and Gas Corp. (CNPC), China's largest oil production company, had stepped up its investment in overseas projects. In 1997, CNPC purchased a 60

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percent stake in western Kazakhstan's Aktybinsk oil field for $365 million, beating out a consortium led by Amoco Corp. CNPC has also pledged to invest $3.5 billion over the next 20 years to construct a pipeline linking the rich oil fields of Central Asia with China's industrializing Pacific coast. Elsewhere, CNPC agreed to pay $385 million to develop two Venezuelan fields, and pledged $1.3 billion to develop the Al Ahdab field in Iraq as soon as the United Nations lifts the sanctions in place against the country.

Meanwhile, China's heavy investment in domestic petroleum projects during the first six months of 1997 represented a 15.8 percent increase over the same period in 1996. According to the most up-to-date figures available, Beijing pumped ¥110.1 billion ($13.7 billion) into the energy sector in the first half of 1997 alone, an increase of 18.2 percent over the previous year. As a result, China was the fifth-largest oil-producing nation in 1997 at 160 million tons, and officials estimate domestic production will top 200 million tons by 2010.

Given the advanced age of many Chinese fields, new areas, especially the recent find in the Xinjiang Uygur Autonomous Region, must come on line if China hopes to reduce reliance on imported oil significantly. Gao Ruiqi, chief of the exploration bureau of CNPC, reported that China has verified total onshore reserves of more than 17.3 billion tons of crude oil and 1.2 trillion cubic meters (cu m) of natural gas. In addition to Xinjiang, where officials, according to PRC press reports, claim to have identified a reserve of 13 billion tons, more than 100 million tons have been discovered in the northwestern provinces of Shaanxi, Gansu, and Ningxia.

But weak transportation infrastructure hampers exploitation of major new finds. PRC officials also realize that domestic investment, on its own, will be insufficient to develop the country's vast resources. In a major policy statement published in the Communist Party journal *Seeking Truth* last year, then-Premier Li Peng emphasized the importance of utilizing both domestic and foreign capital to tap China's abundant mineral resources. The revised Guiding Catalogue for Foreign Investment in Industry, which took effect January 1, 1998, officially encourages foreign participation in certain petroleum, petrochemical, and chemical projects. These include new technology for tertiary oil recovery, and construction and management of oil pipelines and depots. At the end of 1997, oil-refining capacity exceeded domestic production by 70 million tons. To limit further proliferation of small refineries, and encourage economies of scale, construction of refineries with a capacity of less than 5 million tons is "restricted" under the Catalogue. Although these and other important restrictions on foreign oil exploration and exploitation activities within China remain, recent developments demonstrate that the government is taking bold initiatives to meet the country's energy needs into the next millennium.

FROM PLAN TO MARKET

At the March session of the National People's Congress, delegates approved a merger between China National Petrochemical Corp. (SINOPEC), the State-owned refining monopoly, and CNPC. The congress also passed an aggressive bureaucratic restructuring plan that slashed the number of ministries from 40 to 29 (*see The CBR*, May-June 1998, p.36). As part of this plan, administrative regulation of the petroleum industry was transferred to a new body, the State Administration of the Petroleum and Chemical Industries (SAPCI). SAPCI will take over the regulatory and administrative functions from the disbanded Ministry of Geology and Mineral Resources, as well as from CNPC and SINOPEC. SAPCI itself will come under the jurisdiction of the State Economic and Trade Commission (SETC), which now also controls the disbanded ministries of power, coal, machine-building, metallurgy, chemicals, and internal trade—the traditional State-owned sectors.

According to PRC government officials and published reports, SAPCI will be made up of 70 employees from the Ministry of Geology and Mineral Resources and 40 each from SINOPEC and CNPC, respectively. SINOPEC will assume control from CNPC of 10 fields and 750,000 workers, while CNPC will take over 15 SINOPEC subsidiary corporations with 150,000 workers. The plan also calls for the dissolution of China Eastern Petrochemical Co., with its member companies reverting to SINOPEC control. Any foreign companies that have already initiated negotiations with China Eastern can continue to negotiate with SINOPEC.

PRC officials realize that domestic investment, on its own, will be insufficient to develop the country's vast mineral resources.

China National Offshore Oil Corp. (CNOOC), meanwhile, is now also under the formal control of SETC, though the State Council will likely continue to exert authority over the organization.

The ultimate goal of this corporate restructuring is to form two large, specialized enterprise groups (*qiye jituan*) with control over oil and gas exploration and production in different regions, accelerating the demise of entrenched bureaucratic interests, and improving the sector's lackluster performance. In May, PRC officials announced that CNPC will concentrate on upstream oil and gas exploration and production in northern and western China, while SINOPEC will focus on downstream projects, specifically petrochemical production in southern and eastern coastal China. This regional division corresponds to the location of resources and markets. Significant challenges and opportunities for investment lie in the integration of upstream production and downstream demand.

Market economic principles appear to have prevailed in the restructuring. According to one SINOPEC source, China will deregulate domestic oil prices by the end of the year. Falling international petroleum prices, and the resulting spike in imports and rampant smuggling, have disrupted domestic production. SINOPEC has limited production at eight key oil fields. Overall onshore production was down 590,000 tons in the first quarter of this year, according to SINOPEC. Prices for petroleum products have dropped as much as 26 percent, and domestic producers are forced either to hold on to their inventory or sell below cost. The *Economic Daily* noted that the current problems underscore China's vulnerability to sudden market changes, and the need to develop strategic oil re-

China Star is developing both onshore and offshore oil and gas resources, with an emphasis on natural gas.

serves. Some at SINOPEC believe that adopting a market-based pricing system is the best way to overcome the current difficulties.

This year's bureaucratic reshuffling continues the market-oriented reforms that first shook China's petroleum industry in January 1997, when 8 oil-exploration bureaus and 10 research institutes under the now-defunct Ministry of Geology and Mineral Resources established China Star National Petroleum Corp. (China Star) with registered capital of ¥3.1 billion ($373 million), 31,000 employees, and 150 production units. Like CNPC, China Star is authorized to enter relationships with foreign companies. Unlike CNPC, however, China Star is developing both onshore and offshore oil and gas resources, with an emphasis on natural gas. It will also invest in downstream industries and diversify production to reach a projected total annual output of ¥10 billion ($1.2 billion) by 2000. In its first year of production, China Star boasted an output of 1.57 million metric tons of natural gas and had reportedly engaged in discussions with a major multinational to form a chemical fertilizer joint venture in Sichuan Province, which would utilize natural gas as a raw material. This year China Star estimates its total output will reach 2 million metric tons.

Sources in Beijing say that CNPC and its offshore counterpart, CNOOC, had strongly opposed the creation of the new company. Their failure to prevent China Star's formation reflected Beijing's dissatisfaction with the industry structure, and the government's desire to marketize the sector through increased competition. At the ceremony marking the new company's inception, Zou Jiahua, then vice premier in charge of industry, heralded China Star's establishment as a "significant step in the reform of [China's] oil industry." Notwithstanding such political support and China Star's good showing in its first year of operation, the merger of CNPC and SINOPEC and resulting economies of scale could eliminate China Star's competitive edge. On the other hand, China Star's small size and close ties with high-ranking officials at SAPCI, some of whom formerly served in the Ministry of Geology and Mineral Resources, may give it the flexibility to survive and even flourish in the market. The recent restructuring and transfer of administrative authority to SAPCI highlights the leadership's commitment to operate by market principles, which will work to China Star's advantage.

It is still too early to predict exactly what effect the restructuring will have on foreign investment, but recent ministerial appointments indicate that the Chinese government is taking a more pro-business, no-nonsense approach to market reforms. Sheng Huaren, former head of SINOPEC, has been tapped to head SETC, while Zhou Yongkang, head of CNPC since late 1996, will take charge of the new Ministry of Land and Natural Resources. Both men represent the new breed of pragmatic, market-oriented technocrats elevated to high positions in Premier Zhu Rongji's government.

The regulatory structure

Despite Beijing's professed commitment to market reform, foreign companies seeking to invest in PRC oil and gas projects still face a complex body of regulations. Whether the ministerial restructuring will lead to an overhaul of these regulations remains unclear. In the meantime, foreign investors can expect the regulatory regime to continue to follow the procedures already in place, if with minor modifications.

The regulatory structure governing foreign parties exploring and developing Chinese onshore oil reserves is detailed in the Regulations of the PRC on the Exploitation of Onshore Petroleum Resources in Cooperation with Foreign Enterprises (the Onshore Regulations), promulgated by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) in October 1993. Also important are the Provisional Measures Governing Control of Registration of Oil and Natural Gas Exploration and Exploitation (the Provisional Measures), promulgated over a decade ago by the Ministry of Petroleum Industry. After that ministry was disbanded, CNPC assumed many of its administrative and regulatory functions. A substantially similar regulatory framework governs foreign cooperation in offshore oil exploration and exploitation.

Under the Onshore Regulations, foreign companies may engage in petroleum exploration and exploitation only within specific regions approved by the State Council. CNPC, which produced 90 percent of China's total crude oil in 1996, has been the sole department authorized by the State Council to cooperate with foreign firms in exploring approved areas. It remains unclear, however, how the advent of China Star will affect this monopoly. The regulatory structure will probably be revised to include China Star and reflect the shift of administrative function to SAPCI, but with little other substantive change.

The regulations state that foreign parties must perform all exploration work, bear all associated risk, and provide all necessary investment. Before beginning any exploration work, however, foreign parties must conclude a Cooperative Exploration Agreement (CEA) with CNPC or a CNPC-designated local entity. Under such an agreement, a foreign party and CNPC (or designated local body) negotiate exploration and exploitation fees to be paid to CNPC. Both fees must be fixed prior to the discovery of any exploitable oil reserves. The agreement also establishes the distribution percentage between the foreign and Chinese parties.

Prior to signing the CEA, however, the parties must submit it to MOFTEC for preliminary review and comment. MOFTEC reviews the agreement in accordance with the Notice Concerning the Publication and Distribution of the Examination and Approval Principles and Procedures for Foreign-invested Enterprises in Selected Industries (the Approval Notice), issued in late 1996. Terms of the CEA should conform to common international practice. During the review process, MOFTEC considers, in particular, the term of exploration, the term of the agreement, the region to be explored, and any signing fee. The agreement also must stipulate that the foreign party bears all risk. Finally, because the agreement cannot create a legal person under PRC law, it cannot alone create a joint-venture company. The parties must negotiate and sign a separate joint-venture contract. This process can sometimes be expedited, depending on the characteristics of a particular deal, by encouraging local Chinese partners to lobby central CNPC and MOFTEC officials to transfer approval authority to the provincial level.

The Onshore Regulations further require foreign partners to provide timely reports to CNPC on the progress of exploration, development, and production activities. These reports include current samples as well as associated technical, economic, financial, and administrative materials. Once submitted, all of these materials become the property of CNPC and their subsequent use, transfer, or grant is subject to strict governmental regulation.

Drilling for oil

Once the parties to a CEA can demonstrate proven reserves of oil or natural gas, CNPC and the foreign party must conclude a production-sharing contract (PSC) before full-scale production and extraction can begin. Foreign partners generally take on development and production activities for a stipulated time period. The foreign party customarily also establishes a branch or representative office in China to conduct technology training and personnel development, with the eventual goal of localizing operations. Once the foreign partner receives compensation as stipulated in the PSC, or at the end of an agreed-upon production phase, ownership of all assets with the exception of those leased from third parties reverts to CNPC.

The approval process for the PSC mirrors that for the CEA. CNPC's signing of the PSC, for example, symbolizes project approval. Often, in fact, the terms of the PSC—including the distribution of oil—are negotiated and agreed upon during the CEA approval process.

Unlike the approval process for the CEA, however, the parties to the PSC must jointly prepare a feasibility study for submission, along with the PSC, to MOFTEC for review and approval. The feasibility study must include a comprehensive utilization plan for any "symbiotic or accessory minerals" of industrial value discovered during petroleum exploration. MOFTEC will conduct a preliminary review of the contract before it is signed and then formally examine and approve the contract after the relevant parties have signed it, considering the same factors as those taken into account when reviewing the CEA.

Oil for sale

The Onshore Regulations permit a foreign party to sell oil domestically through CNPC or export the oil abroad. In practice, all oil is sold to CNPC, which markets it in-country at a State-determined price. Recovered investment, profits, depreciation, and all other legal earnings may be remitted abroad in accordance with the relevant PRC foreign-exchange regulations. In the past two years, China has taken significant steps toward greater convertibility of the *renminbi*. US dollars have also been readily attainable on the market, though certain restrictions on conversion remain.

PRC and foreign enterprises engaging in cooperative exploitation of onshore oil resources must pay royalties to the PRC government according to the Provisional Regulations on the Payment by Sino-Foreign Cooperative Joint Ventures of Royalties for the Exploitation of Onshore Oil Resources, promulgated by the Ministry of Finance in 1990. Royalties are calculated based on annual gross production and are payable in kind in advance by installments to the PRC tax authorities. In 1996, pursuant to the Approval Notice, MOFTEC raised the minimum amount of annual production under which enterprises are exempt from royalties from 50,000 tons to 500,000 tons, as an added incentive to foreign cooperation in oil exploitation.

With market reforms, the government has gradually removed price controls on most commodities, but has kept controls in place for crude and finished oil products, in part to maintain low inflation. These controls have created a two-tiered pricing system that requires CNPC to sell a large portion of its oil at lower prices to other State-run industries, and only a small portion of its products at higher market prices. An internal policy memorandum jointly submitted to the State Council by SETC and the State Planning Commission in 1994, Opinions Concerning the Restructuring of the Crude and Finished Oil Circulation System, set forth this general policy. Since 1994, reinforced market controls and central allocations have worked to stabilize the pricing system, curtail speculation on the domestic market, and provide ailing State-owned enterprises with continued access to de facto subsidized inputs.

The government has gradually removed price controls on most commodities, but has kept controls in place for crude and finished oil products.

However, continued marketization and plummeting international oil prices have put pressure on the government to dismantle this vestige of the planned economy. According to SINOPEC, Beijing plans to float domestic prices to international market levels by the end of 1998. Deregula-

Forcing the domestic oil and gas industry to live or die by the market is in line with Zhu Rongji's overall plan for reform of State-owned enterprises, and in fact may benefit State-owned enterprises in other sectors.

tion is sure to create economic stress for State-run producing and refining enterprises, but there seems to be a consensus that continuing to maintain artificially high prices is untenable. Forcing the domestic oil and gas industry to live or die by the market is also in line with Zhu Rongji's overall plan for reform of State-owned enterprises, and in fact may benefit State-owned enterprises in other sectors, by allowing them access to cheaper inputs.

Thirsty for foreign investment

The 1998 restructuring and the advent of China Star has raised important issues concerning a regulatory structure that controls foreign participation in oil projects as well as oil prices. Notably, current State Council regulations name CNPC as the only entity permitted to cooperate with foreign oil concerns. It is still unclear how or when the regulatory regime will be amended to reflect the establishment of SAPCI and China Star.

Despite the State's hold on prices, both the continued commercialization of the sector and the ongoing separation of administrative authority from corporate participation demonstrate the government's resolve to ensure reliable petroleum supplies. Political will also seems to exist to promote the further opening of domestic oil exploration and production opportunities to foreign investment and advanced technology. An agreement reached last year between CNPC and Japan National Oil Corp. represented a major breakthrough. For the first time, foreign interests gained access to some of the better blocks in Xinjiang's Tarim Basin. Prior to that agreement, many foreign companies had been abandoning exploration projects in that area because CNPC had withheld critical information and access to choice blocks. Meanwhile, China Star has also reportedly negotiated with several Western firms for the sale of data that would give those companies a clearer picture of the quality of blocks offered by CNPC. All of these are promising signs that foreign firms will have a role to play in China's oil sector in coming years.

China as a world player

Three thousand guests from 80 countries attended the Fifth World Petroleum Conference held in Beijing last fall. For China, hosting this conference could not have been more timely. China is coming into its own as a world power, and has already become an important player in an increasingly competitive international oil market. As CNPC and China Star develop their own international sources, continuing concern over dependence on foreign-sourced oil will mean greater emphasis on development and exploitation of China's own reserves, estimated at 94 billion tons of oil and 38 trillion cu m of natural gas (*see* p.40). Despite difficulties posed by the geographic distribution of resources, official sources predict that maximum annual oil production will probably reach 200 million tons by 2010. Government policy will encourage development mostly in western China and offshore, while stabilizing annual oil output of 53 million tons at Daqing oilfield. Offshore oil production is estimated to reach 10 million tons or more by 2010.

Sweeping changes in the petroleum industry should spell opportunities for foreign cooperation. New policies and administrative authorities will continue to guide the partial opening of this sector. Opportunities for foreign investment may well abound, but much depends on the outcome of the ongoing restructuring—and the technocrats behind it. 完

Oil and Gas Industry Forum

Among the components of the US-China Energy and Environment Initiative is the US-China Oil and Gas Industry Forum, which aims to engage US and Chinese government and business representatives on oil and gas issues. A tentative list of topics to be discussed at the first meeting of the forum, scheduled for November 2-4 in Beijing, includes China's recently restructured oil and gas administration; approval procedures for oil and gas exploration and production projects; energy transportation issues; US-PRC cooperation in third countries, particularly in the former Soviet Union and the Middle East; and a proposal to raise the equity limit for locally approved energy projects.

The US-China Energy and Environment Initiative was created by former US Energy Secretary Federico Peña and PRC State Development Planning Commission Minister Zeng Peiyan on October 29, 1997. Signed during PRC President Jiang Zemin's summit visit to the United States last year, the initiative is intended to foster bilateral technical cooperation and commercial projects in urban air quality, rural electrification, clean energy, and energy efficiency.

For more information about the Oil and Gas Industry Forum and its initial meeting in Beijing, contact:

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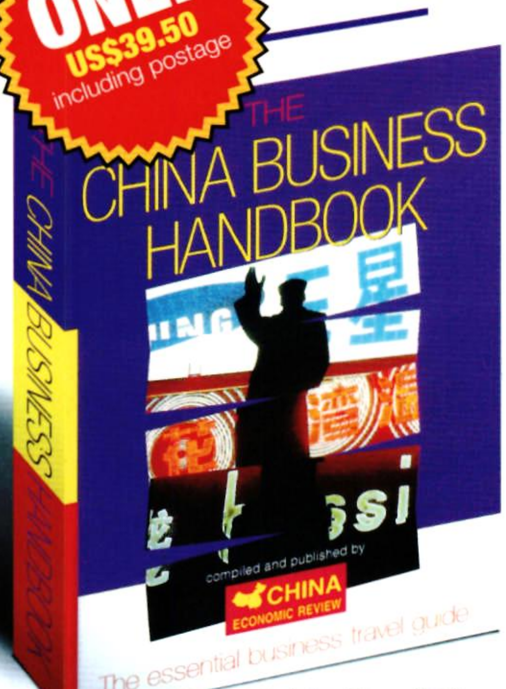

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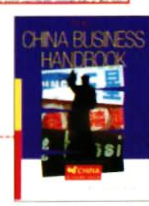

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Natural Gas Gains Momentum

To realize China's natural gas potential, Beijing should remove key barriers to foreign investment

Jeffrey Logan and William Chandler

Though coal still accounts for nearly three-quarters of its total energy needs, China stands on the brink of dramatically increasing its use of alternative energy sources, including natural gas. Chronic energy imbalances and shortages, the cost of rising petroleum imports, extensive environmental damage caused by coal combustion, and improved natural gas-based power-generation technologies all stand to expand the role of natural gas in China's energy structure.

Natural gas currently accounts for less than 2 percent of the PRC's primary energy consumption, but government planners project domestic production of natural gas to triple by 2010, rising from the current level of roughly 22 billion cubic meters (cu m) to 60 billion cu m per year (*see* Table). China's Ninth Five-Year Plan (9th FYP, 1996-2000) calls for natural gas production to rise to 25 billion cu m and for 70 percent of urban households to use gas fuel by 2000. By 2015, international forecasters expect PRC annual output of natural gas to reach approximately 113 billion cu m. And the US Department of Energy (DOE) estimates that natural gas will account for 4 percent of China's total primary energy use by then. Greater use of China's stores of coalbed methane (CBM), gas extracted from coal deposits, imported liquefied natural gas (LNG), and gas transported through international pipelines, could easily double or triple these projections.

Consumption rates, meanwhile, have risen steadily since the 1970s, and promise to accelerate. But a coordinated effort between Beijing and foreign firms to speed up the development of natural gas would go a long way toward spurring natural gas consumption in China. A number of impediments in China's natural gas sector have slowed foreign participation. Representatives from DOE, the Natural Resources Defense Council, and four multinational natural gas companies with deep commitments in China, participated in a workshop hosted by Pacific Northwest National Laboratory (PNNL) in Washington, DC, in mid-1997. With the goal of identifying barriers to foreign investment, the workshop recommended that the PRC raise natural gas prices closer to international market prices; permit foreign access to prime exploration plots; and improve transparency in the industry, among other measures.

Making a case for natural gas

Indeed, conditions in China—particularly its distribution of energy resources—call for rapid moves to expand the use of natural gas. Most of the country's high-quality, low-sulfur coal is situated in the north and

Jeffrey Logan is a research scientist in the Advanced International Studies Unit (AISU) of Pacific Northwest National Laboratory (PNNL) specializing in energy and environmental analysis of China. William Chandler, a senior staff scientist at PNNL and director of AISU, has worked on energy and environmental issues for more than 25 years.

must be transported by rail or ship to consumers in the east and south. Coal shipments currently take up more than half of China's railroad capacity, overloading an already outdated transportation infrastructure. China's abundant hydropower resources are concentrated in the southwest, also far from east-coast consumers. And wind and solar power generation facilities typically must be located in sparsely populated areas, making transmission to consumers costly.

Despite Beijing's efforts to conserve energy, dramatic economic growth and uneven resource distribution cause power shortages in many regions of the country. A combination of new energy supplies, efficiency improvements, and easing demand as a result of factory closings have helped reduce the frequency of power shortages. Nonetheless, continued economic growth of over 7 percent well into the next decade would require substantial quantities of energy. Beijing plans to add more than 16 gigawatts of annual electricity capacity through 2010.

Though coal and oil will continue to supply the bulk of China's energy needs, natural gas is targeted to become a larger source of energy, especially in the urban residential and industrial sectors and as a fuel source for vehicles. Rapid growth in the number of vehicles on China's roads, combined with stagnating oil production, forced China to become a net oil importer in the early 1990s (*see* p.34). Based on current growth rates, DOE analysts predict that by 2000 the PRC will import nearly 1 million barrels of oil daily. Such reliance on imports has made planners in Beijing receptive to domestic fuel alternatives, particularly for the transport sector. Natural gas-driven vehicles already are in use in Guangzhou and Shenzhen, Guangdong Province. The city of Haikou in Hainan Province also has pledged to invest ¥30 million ($3.6 million) to install a natural gas fuel-burning system in 5,400 buses and cars.

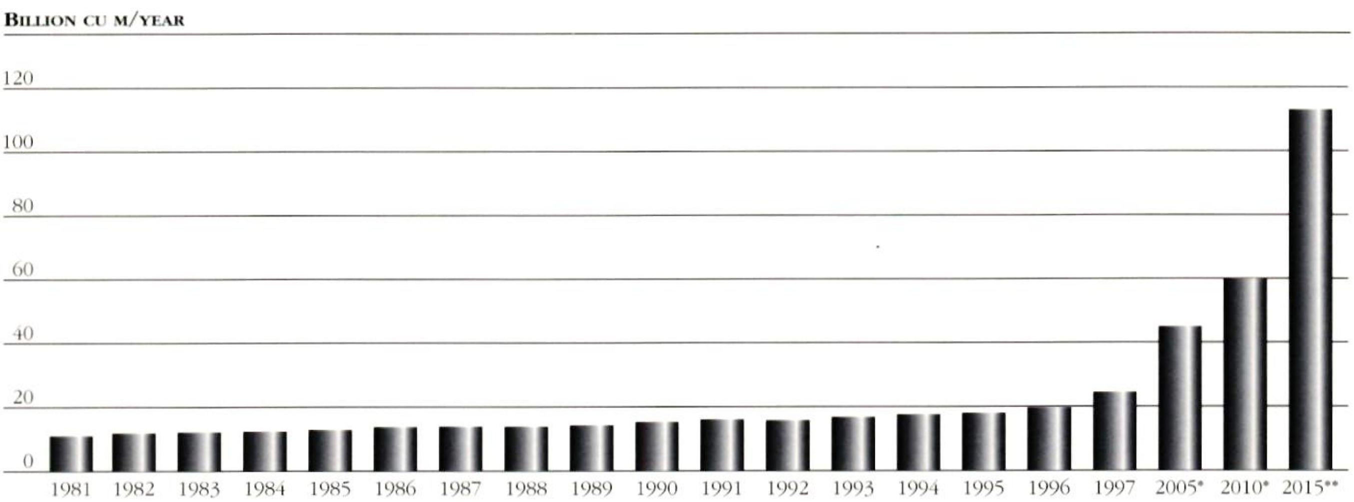
Promising new technologies, including the proton exchange membrane (PEM) fuel cell, also might be appropriate for China. PEM cells can operate on hydrogen, natural gas, gasified coal, CBM, methanol, gasoline, and other alcohol fuels. Scientists in Europe, Japan, and North America have made significant progress in this technology over the past five years. Vehicles equipped with PEM fuel cells are slated to enter industrialized markets by 2005. China, too, has expressed an interest in this technology, and has welcomed a United Nations Development Program project that will put a small number of PEM-operated buses on the country's streets.

A new generation of combined-cycle gas turbines, which use natural gas and steam turbines in combination to improve fuel-extraction efficiency, also offers advantages that coal-reliant China might find attractive. The cost of combined-cycle gas turbine technologies is about two-

Though coal and oil will continue to supply the bulk of China's energy needs, natural gas is targeted to become a larger source of energy.

thirds that of coal-based technologies in developed countries. A coal-fired power plant with sulfur-control equipment costs roughly $750 per kilowatt (kW) in China. The cost of an imported combined-cycle gas turbine is similar, but would decrease once production of the gas turbine elements shifted to China. In addition, combined-cycle gas turbine systems presently operate at over 50 percent thermal efficiency; the next generation of technologies will raise thermal efficiency to 60 percent, twice the level of China's current vintage of pulverized coal plants. Gas-fired plants, moreover, can be built in less than a year, half the time required for a similar coal-fired unit—an important consideration in power-hungry China. And switching from coal- to gas-generated power would free up rail capacity for the transportation of people and non-coal freight.

China's Natural Gas Production



SOURCES: *China Monthly Statistics*; *Zhongguo Nengyuan Fazhan Baogao* (China's Energy Development Report) 1997
* Projection from in "Energy Consumption and Prospects in China," World Bank, 1996
** Projection from *Enron Oil Outlook*, 1997

In addition to meeting China's power and industrial energy requirements, natural gas possesses a number of environmental advantages over coal-fired power stations.

Combined-cycle power plants fueled with natural gas also tend to be more cost-effective than nuclear power plants. Beijing plans to step up nuclear power's contribution to the country's overall energy structure (*see The CBR* March-April 1998, p.24), but such plants are more expensive and difficult to finance than those powered by natural gas. PNNL estimates suggest that the construction costs of gas-fired plants in the regions where nuclear plants are currently being planned would be lower. For example, a combined-cycle power plant fueled with LNG could bear a delivered price of up to roughly $4.50 per million British thermal units (Btus) before nuclear energy would be competitive. LNG currently costs less than $4 per million Btus in Japan, but China could most likely secure cheaper final LNG prices than Japan, in part because the labor costs incurred during terminal construction are significantly lower in China. Much of the cost of LNG stems from the need to build docking and re-gasification facilities in port cities.

In addition to meeting China's power and industrial energy requirements, natural gas possesses a number of environmental advantages over coal-fired power stations. Regardless of the combustion method, natural gas emits virtually no sulfur or particulates. Low-sulfur Chinese coal (1.1 percent sulfur), on the other hand, emits about 10 grams (g) of sulfur dioxide and almost 50 g of total suspended particulates (TSP) per kW hour of electricity generated. On an annual basis, an 800 MW steam-cycle coal plant using unwashed coal thus would produce roughly 220,000 and 45,000 tons of TSP and sulfur dioxide emissions, respectively. The same size combined-cycle gas turbine plant would generate almost none. Nitrogen oxide emissions in a natural gas plant also would decline by roughly three-quarters compared to a coal plant, from 25,000 tons to about 5,000 tons. Carbon dioxide emissions from combined-cycle gas turbines are less than half that of coal-fired plants. Each plant powered by natural gas would reduce annual carbon dioxide emissions by about 2.6 million tons and waste heat by 25 percent. And natural gas combined-cycle plant systems use roughly 25 percent less water than coal-based ones.

Assessing the drawbacks

Boosting natural gas production and consumption in China is not problem-free, however. Greater use of natural gas in China traditionally has been hindered by the absence of a strong supporter within the PRC leadership, an undeveloped pipeline infrastructure, and the priority placed on using natural gas in smaller-scale residential and industrial applications instead of the larger-scale power projects.

Constructing pipelines of the magnitudes necessary for gas transport, too, requires the resolution of a number of issues. For instance, construction of even a relatively short pipeline from Siberia would cost nearly $7 billion. And though transporting LNG by sea may be more practical than constructing pipelines, it requires capital-intensive liquefaction and re-gasification facilities, which require massive investment.

Resources at home

The remote locations of China's natural gas deposits have complicated efforts to survey accurately the amount of natural gas available from both proven reserves and estimated deposits. PRC and international measurements of China's proven natural gas reserves range from 1.2-5.3 trillion cu m, with 1.7 trillion cu m the most frequently cited figure. At China's current natural gas consumption rate of 22 billion cu m per year, these reserves would be able to meet the country's needs for more than 75 years.

Sichuan Province alone has accounted for over 40 percent of China's natural gas output, most of which has not been a byproduct of oil refining. Natural gas output in Shaanxi and Gansu provinces, and the Ningxia Hui and Xinjiang Uygur autonomous regions, on the other hand, typically is a byproduct of oil refining and makes up the bulk of China's remaining onshore production. Output from proven reserves in these provinces is expected to drive most of the future onshore growth. Offshore production in the South China Sea and Donghai regions accounts for most of the remainder of China's output. And offshore exploration endeavors are expected to boost output.

Reserve levels could change, however. Most geologists believe that significant natural gas deposits remain undiscovered in China. Because all three fossil fuels share a similar formation process, China's large coal and oil reserves suggest the presence of similarly large natural gas deposits. Advanced exploration technologies such as 3- and 4-dimensional seismic imaging, and new drilling processes, could uncover additional reserves.

Alternative supplies

China's natural gas reserves can be supplemented by CBM extraction, LNG imports, and natural gas imported through pipelines from other countries. Since the early 1990s, China has looked to CBM as another environmentally friendly source of energy. With abundant coal deposits, and the well-developed technology used in methane recovery, the PRC recovers roughly 500 million cu m of methane per year. The government has tallied potential reserves at a massive 35 trillion cu m. Texaco Inc. signed a $500 million contract with the China United Coalbed Methane Corp. in January 1998 to recover an additional 500 million cu m of methane per year from coal and gas fields in Anhui Province, which are thought to contain more than 60 billion cu m of methane reserves.

Methane recovery offers several added benefits. China's coal mines, in most cases, contain more than 15 cu m of methane per ton of coal. Unless the methane is tapped first, these gassy mines are vulnerable to explosion and pose risks to worker safety and productivity. In addition, engaging in recovery activities prior to mining the coal can prevent methane, a potent greenhouse gas, from escaping into the atmosphere. Methane has perhaps 20 times more heat-trapping potential than carbon dioxide on a molecular basis.

Along with CBM extraction, LNG imports could become a promising source of natural gas for China. Transporting natural gas in liquid form—chilled to -164 degrees Celsius, pressurized, and loaded onto a "thermal flask" ship—is cheaper than sending it through a pipeline. Japan accounts for 65 percent of the global LNG trade, and uses LNG to generate more than 25 percent of its own electricity. China, on the other hand, currently does not import LNG, despite potential demand in its relatively prosperous coastal regions. Situated far from the country's coal and hydropower resources, southeastern China is particularly well-suited for LNG imports to fuel power plants. In southern China, the cost of electricity from LNG-fired power plants is roughly equal to that of coal-fired power with desulfurization equipment. In recognition of LNG's potential, China's 9th FYP calls for the construction of three LNG terminals in southern China that are to begin operating between 2002-05.

Despite their higher costs, natural gas pipelines have received greater attention from Beijing in recent years. With proven reserves of over 56 trillion cu m, the neighboring countries of the former Soviet Union are logical suppliers. Russia's Irkutsk Basin gas fields, near Lake Baikal in Siberia, lie some 3,000 kilometers (km) from Beijing. In fact, Beijing signed a memorandum of understanding with Russia in late 1997 to build a $12 billion pipeline from Siberia to China's Pacific coast. Japan and South Korea reportedly hope to cooperate with China and Russia on extending this pipeline to their countries. If completed, the pipeline is expected to transport, over a 30-year period, 10 billion cu m of natural gas to China and another 10 billion cu m to Japan and South Korea.

Discussions also are under way to build a 6,000 km natural gas pipeline joining Kazakhstan with China's eastern coast. A 1996 World Bank study on natural gas trade estimated that fuel could be transported 6,000 km from Central Asia to China at the rate of 28 billion cu m per year, for $3 per million Btus. Over a distance of 7,600 km, the delivered price of natural gas would rise to $3.89 per million Btus.

Foreign investment obstacles

Though the arguments clearly favor greater natural gas use, a number of barriers prevent foreign firms from expanding their activities in natural gas exploration and development in China. Moves that would facilitate foreign involvement include:

■ **Raising gas prices to international market levels** Average prices for natural gas in China currently are around ¥500-¥600 per 1,000 cu m ($1.6-$1.9 per million Btus), far below the international level of ¥768-¥921 per 1,000 cu m ($2.50-$3.00 per million Btus). On an energy basis—the usable energy per volume or mass—natural gas is also priced far below crude oil, for which PRC prices currently are about $18 per barrel, or $3.10 per million Btus. The inability to cover production costs at such low prices discourages foreign exploration for natural gas deposits in China.

■ **Expanding the use of gas to industrial and power sectors** Almost 70 percent of natural gas consumption in China goes to produce fertilizer, to raise production at oil fields by injecting gas into oil wells, and to heat oil in various conversion processes. Only a small fraction of natural gas is consumed in industrial applications such as burners, furnaces, and power plants. If Beijing channeled more natural gas into these activities, US gas companies would likely consider raising their investment levels in China.

The highest value-added use for gas is in replacing coal where pollution is most damaging—in stoves, boilers, and furnaces in residences and small factories. Beijing has taken a first step toward substituting natural gas for such purposes by, for example, encouraging homes to replace coal with natural gas for cooking and heating. A natural gas pipeline from Shaanxi to Beijing opened last fall to deliver gas to over 300,000 users, and another pipeline delivers gas to residents of Xi'an, Shaanxi Province.

■ **Granting access to prime exploration areas** Many foreign companies have stated that PRC officials tend to offer them exploration rights for less attractive sites. Moreover, contracts currently tend to be awarded through sealed bids. Gas company representatives would like Beijing to allow international companies to vie for contracts through a more transparent, competitive bidding process.

Beijing signed a memorandum of understanding with Russia in late 1997 to build a $12 billion pipeline from Siberia to China's Pacific coast.

■ **Improving transparency** Currently, no single entity in China regulates and establishes policy for all natural gas-related activities. American businesses frequently cite poor legal and regulatory transparency as one of the most difficult aspects of doing business in China. Common problems include negotiating contract terms, prices, and arbitration procedures, and determining which government institution has final approval authority. China's gas industry is almost exclusively government-run, with the exception of a handful of joint ventures. Information about offshore oil and natural gas operations generally is more accessible than onshore projects, as coastal and offshore organizations have had more experience dealing with foreigners. Many companies report that information is harder to obtain further inland.

■ **Improving data accessibility** Companies familiar with field operations in the PRC have noted that gaining access to crucial field data often is either impossible or requires navigating near-impenetrable bureaucracies. Data from seismic and well logs and well test and production reports often are managed by a number of government agencies that do not routinely communicate with one another and can be possessive of their data. A centralized data repository, a standard in most countries, could solve some of these problems.

■ **Removing subsidies for fertilizer producers** Fertilizer manufacturers often receive subsidies in the form of artificially low prices for natural gas, one of their primary inputs. Of China's 915 nitrogen fertilizer manufacturing facilities, 832 are relatively small-scale operations. Roughly 94 percent of all fertilizer factories accounted for 50 percent of output in 1995. These small plants use outdated technology that consumes about twice the level of natural gas inputs as plants using more advanced technologies. By removing producer price subsidies, Beijing would force the outdated fertilizer manufacturers to modernize their facilities, and thus improve energy efficiency.

HIGH HOPES FOR NATURAL GAS IN CHINA

Unocal Corp., an international energy company founded in California in 1890, today has initiatives and operations in 31 countries around the world. The company specializes in "market-to-resource" energy projects with an emphasis on natural gas. During more than a quarter century of participation in Southeast Asia, Unocal has engaged in oil, natural gas, and geothermal energy production in Indonesia, the Philippines, and Thailand. Significant exploration successes and development investments will soon add natural gas production in Bangladesh, Myanmar, and Vietnam.

Unocal has been an active participant in the China market for 19 years. Chris Costelloe, executive vice president for Unocal East China Sea, Ltd. and manager of Unocal's newly opened Shanghai office, recently spoke with CBR *Editor Kirsten Sylvester about Unocal's China activities.*

CBR: When did Unocal first enter the China market? What are the company's main activities in the PRC?

COSTELLOE: Unocal first visited China in 1979 and later participated in the drilling of an offshore exploration well in the Pearl River delta area. In the 1970s and 1980s, as an integrated oil and gas company, Unocal was also involved in a number of downstream business opportunities, including the licensing of its "Unicracker" refining technology to SINOPEC [China National Petrochemical Corp.]. This technology, important to the Chinese refining industry, increases the production of middle distillates using heavy domestic crude oil.

Unocal's areas of focus are oil and gas resource exploration and development; liquid and gas-fired power generation plants; liquefied petroleum gas [LPG] terminals; fuel import terminals; fertilizer plants; ammonia and urea import facilities; and fuel supply and risk management services. Of top priority over the last five years has been the promotion of domestic natural gas projects in three focus areas: Shanghai and the provinces of Zhejiang and Jiangsu; Sichuan Province; and Guangxi Province.

In 1996, Unocal entered into a joint venture, Zhangjiagang Oriental Unocal Energy Company Ltd. (ZOUEC), with Oriental Petroleum (Yangtze) Ltd. (a subsidiary of China International Trust and Investment Corp.) and the Zhangjiagang Free Trade Zone Economic Development Co. The joint venture is currently constructing, and will operate, a refrigerated LPG terminal with an annual capacity of 500,000 metric tons, 150 kilometers west of Shanghai on the Yangtze River. The ZOUEC terminal is expected to commence operation in late 1998.

CBR: What are some of the challenges to foreign participation in China's oil and gas sector?

COSTELLOE: Billions of dollars are needed to develop China's remaining oil and gas resources, and there are a number of policy issues that affect the ability of the private sector to contribute to that investment. We at Unocal are hopeful that the Oil and Gas Forum, announced by presidents Clinton and Jiang last fall, will be the vehicle for ongoing discussions to resolve these issues, and we look forward to participating in the initial forum meetings in Beijing later this year (*see* p.36).

Unocal is primarily interested in offshore natural gas production. Issues of special interest to us include those surrounding the developing gas markets in key urban areas such as greater Shanghai, Beijing, and Guangdong Province. Another issue we see as important for China's energy decisionmakers is determining the mix of gas supplies: onshore, offshore, coalbed methane, and imports such as liquefied natural gas. Gas project investments require billions of dollars up front, so companies have to determine whether there is a firm commitment to developing a domestic gas market large enough to support these investments.

I have an optimistic outlook. Gas is a clean and efficient energy resource and has become the fuel of choice for electricity generation in Asia's fast-growing urban areas. Opening up China's offshore gas areas, especially in the East China Sea, would make the price of domestic gas fully competitive with imported LNG and pipeline gas from other countries. This would also create jobs, bring substantial foreign capital into play, and save billions of foreign exchange dollars that would otherwise pay for imported gas.

CBR: What is your outlook on the potential for increased use of natural gas in China?

COSTELLOE: I am very encouraged about the prospects for increased gas use. This is a natural progression similar to that which began in the United States and Europe in the 1960s when these economies moved away from a primary reliance on coal-based energy. As was the case with these governments, the Chinese government recognizes the economic, commercial, and environmental protection benefits of natural gas and is beginning to make the changes necessary to develop the market for gas in key urban areas. Natural gas infrastructure investment will be a challenge. Large sums will be required. Major strategic decisions must be made about committing market share to natural gas, and resources to transnational and domestic pipelines, gas distribution systems, and the like. In addition, the development of domestic resources will be a major challenge requiring technological innovation and substantial capital.

These are all challenges that can be met. I believe Unocal and other foreign companies will have many investment opportunities in the development of gas resources and markets in China, and we look forward to participating in the development of China's natural gas sector.

Another problem resulting from fertilizer subsidies, especially nitrogen-based fertilizer, is overuse. The Ministry of Agriculture has formulated, in accordance with agronomic requirements, an optimal nutrient ratio of 1.00/0.42/0.40 for nitrogen/phosphorus/potassium fertilizer production. But the actual fertilizer application ratio in 1994 was 1.00/0.27/0.08. Many Chinese farmers, unaware of the timing and ratio requirements of fertilizer applications, apply excessive amounts of the nitrogen fertilizer.

■ **Raising the permissible equity returns for power projects** There is currently a backlog of power plant projects that could use natural gas as a power source awaiting State Council approval. Though foreign natural gas companies would like to participate in such projects, they are discouraged by the government's tendency to limit the return on equity to 15 percent.

■ **Allowing foreign equity investments in the de facto pipeline monopoly** Even though foreign entities are not prohibited by PRC law from equity ownership in China's natural gas pipelines, Beijing has made it difficult for foreign investors to secure attractive contract terms. The risks associated with natural gas-related investments probably would be substantially reduced if foreign firms could gain at least partial equity ownership of transportation pipelines and local distribution networks. Many other international pipelines are supported by arrangements among transnational petroleum companies, local firms, and host governments.

■ **Clarifying transmission and distribution tariffs** Related to the pipeline monopoly issue, predictable determination of transmission and distribution tariffs could help reduce the risk and uncertainty of building new pipeline infrastructure. As in the electric power sector, some localities set tariffs to recover costs and provide a profit margin, while other areas set tariffs below actual costs, providing no incentive to foreign firms to help construct natural gas infrastructure.

■ **Accounting for coal's environmental externalities** Coal prices typically do not adequately reflect all costs, particularly the costs of pollution. Pollution caused by burning coal harms human health, ecosystems, land resources, and infrastructure. Chinese and international analysts estimate the cost of this pollution at 6-10 percent of China's Gross Domestic Product. Internalizing these externalities by imposing either sulfur caps or taxes on pollution would make natural gas more competitive and help reduce the risk of further upsetting the ecological balance. The United States, for example, has successfully implemented a tradable permits program to cap the amount of sulfur particles emitted nationwide.

Better enforcement of PRC air pollution laws, especially those pertaining to sulfur emissions, would also make coal a less attractive energy source than natural gas. The pollution levy system, for example, imposes fines on enterprises that exceed their sulfur emission allocations. Currently, these fines typically do not even begin to cover the cost of damages caused by excessive emissions. Enforcement of the rules has been inconsistent as well, not least because local economic bureaus are more powerful than their environmental counterparts.

■ **Providing greater incentives for CBM** Beijing should offer such incentives as tax holidays to CBM producers to raise methane's role in China's energy structure. Presently there is no incentive structure for CBM recovery.

■ **Increasing allocation of gas by the open market** Most natural gas is channeled by China National Petroleum and Gas Corp. into fertilizer production (about 35 percent) and oil field use (30 percent). Roughly 15 percent is allocated by the open market. The remaining 20 percent typically is allocated to other industries. If Beijing permitted more natural gas to trade on the open market, the share of natural gas allocated to industrial sectors presumably would rise.

■ **Focusing greater attention on gas-to-liquid conversion technology** Natural gas produced in remote areas often is burned off or flared because no pipeline exists to transport the gas to other consumption centers. If an inexpensive liquefaction technology existed, more gas could be put to productive use since such technology would permit land transport by truck or train. The US DOE is working to develop this technology and believes it has potential in China.

Imposing either sulfur caps or taxes on pollution would make natural gas more competitive and help reduce the risk of further upsetting the ecological balance.

Multinationals Gear Up

Though foreign involvement has been relatively limited, several major multinational oil firms have committed resources to the sector. Over the past five years, Unocal Corp. has undertaken several natural gas projects in Shanghai, and Zhejiang, Jiangsu, Sichuan, and Guangxi provinces (*see* p.44). Chevron Corp. signed a contract with China National Offshore Oil Corp. (CNOOC) in May 1996 to explore natural gas resources in a 2,000 sq km area in the western South China Sea. US-based Atlantic Richfield Corp. (ARCO) signed a cooperation agreement in October 1997 with CNOOC to jointly tap natural gas in the Ledong gas fields of the South China Sea. ARCO, in conjunction with CNOOC and Kuwait Foreign Petroleum Exploration Co., currently operates China's largest offshore natural gas field, Yacheng 13-1, also situated in the South China Sea. Enron Oil & Gas Co. signed a 30-year contract with CNOOC in late 1997 to explore for natural gas and crude oil in a 1.8 million acre plot in the Chuanzhong Block of China's Sichuan Basin.

China's gas reserves, and the promising potential for CBM recovery and natural gas imports, should propel Beijing toward raising the contribution of natural gas to the country's overall energy supply. The 9th FYP targets for the sector and recently inked deals with foreign firms and governments indicate that the PRC leadership is taking strides toward this end. But to maximize the potential of this resource, the government must accelerate market reforms, especially by lifting the cap on gas prices. This and other key incentives would improve the investment climate and move China's natural gas industry into the twenty-first century. 完

Council Celebrates its Silver Anniversary

Council Chairman and Eastman Kodak Co. Chairman and CEO George M.C. Fisher and Council President Robert A. Kapp welcomed nearly 700 member company representatives and special guests to the Council's 25th Anniversary Gala on June 2 in Washington.

Following US Treasury Secretary Robert Rubin's address, which was closed to the press, PRC Ambassador to the United States Li Zhaoxing read a congratulatory letter from PRC State Councilor Wu Yi. Wu praised the Council for its dedication to promoting bilateral trade and investment and improving overall US-China relations. Wu also expressed hope that President Clinton's trip to Beijing would build on the progress made at the October 1997 presidential summit. Li then offered his own congratulations to the Council, and commended the organization for its "vision, courage, and professional integrity."

China Council for the Promotion of International Trade (CCPIT) Chairman Yu Xiaosong was the Council's Chinese guest of honor. Yu congratulated the Council on its 25th anniversary, commenting that the Council has played a vital role in assisting the US business community with its China endeavors. Yu called the bilateral trade relationship among the most important issues between the two countries. Yu presented the Council with a framed congratulatory message in his own calligraphy.

Council President Robert A. Kapp concluded the evening by announcing the formation of the US-China Legal Cooperation Fund, which will operate under the China Business Forum (the Council's education and research arm). Ambassador Wendy Sherman, counselor to the Department of State and acting undersecretary of state for global affairs, congratulated the fund's founding sponsors for their commitment to a partnership with the US government on cooperation with China. Through resources pledged by Council members, the fund will support bilateral cooperative programs in the field of law. According to Sherman, this initiative should "strengthen China's economy and society, provide transparency and predictability for US businesses, and promote a range of other interests, including...human rights."

Members Gather in Washington, Elect Board

The Council held its 25th Annual Membership Meeting in Washington, DC, on June 3. Council Chairman and Eastman Kodak Co. Chairman and CEO George M.C. Fisher opened the meeting by stating that in the coming years the US-China relationship "will affect us more than any other on earth." He urged member companies to support the renewal of China's Most Favored Nation (MFN) trade status zealously. US companies have a stake in China's economic success, he said, and he encouraged the business community to help ensure the development of common understanding between the United States and China and the realization of a "shared vision."

In his remarks to Council members, Senator Frank Murkowski (R-AK), chairman of the US Senate Energy and Natural Resources Committee, described the current mood on Capitol Hill toward China. "Congress is on a collision course with the Administration on MFN," he said. Despite such sentiments, Murkowski reaffirmed his strong support for the Administration's policy of engagement with China, stressing its contribution to US competitiveness. Though Murkowski forecast a contentious MFN vote, he did not believe there would be enough votes to override a presidential veto of any attempts to withdraw China's MFN status. Murkowski urged Council firms to take the lead in educating members of Congress, and their own workers, about the PRC's importance to their firms.

US Institute of Peace President Richard Solomon followed, speculating about the future of US-China relations based on the relationship's progression over the past quarter century. China and the United States today stand at a crossroads in their attempts to maintain stable relations, said Solomon. The Clinton Administration has moved the country's China policy back to constructive engagement, away from the ineffective "punitive sanctions" approach. The question, according to Solomon, is whether the US government can sustain a stable relationship with China in the midst of vocal criticism of engagement.

Department of Commerce (DOC) Secretary William M. Daley, in his luncheon address, detailed the many commercial and strategic reasons for the Clinton Administration's engagement policy with China. Daley pointed out the importance to the United States of economic security, in the form of stable, reliable markets for US products—particularly high-technology products in which US firms excel. But Daley stressed that enforcement of US export-control policy remains as strict as ever. The secretary also noted recent DOC efforts to advance the concerns of US firms in China through Joint Commission on Commerce and Trade meetings at both working and higher levels, and praised the Council's efforts behind the US-China Legal Cooperation Fund as the "kind of public-private partnership that has made [US] China policy a success."

At the meeting, members also elected a new board of directors. Fisher was named the Council's chairman for a second year. Elected as vice chairmen were Michael R. Bonsignore, chairman and CEO, Honeywell Inc.; Carla A. Hills, chairman and CEO, Hills & Co.; and Frederick W. Smith, CEO, Federal Express Corp. Member companies also selected Edgar G. Hotard, president and chief operating officer, Praxair, Inc., to fill the board's secretary-treasurer position. Elizabeth R. Rindskopf, a partner with Bryan Cave LLP, will serve as the board's counsel.

In addition, Council members elected five new directors to initial three-year terms, and re-elected five current directors to new three-year terms. The new directors are William E. Bradford, chairman and CEO, Dresser Industries, Inc.; Roger A. Enrico, chairman and CEO, Pepsico, Inc.; Pierre Hochuli, executive vice president and chairman, International, Monsanto Europe SA; Karen Elliott House, president, International, Dow Jones & Co., Inc.; and Howard Pierce, CEO Americas, ABB Ltd. Elected to their second three-year terms were Fisher; Hills; Michael H. Jordan, chairman, Westinghouse Electric Corp.; Harry J. Longwell, senior vice president, Exxon Corp.; and George W. Sarney, chief operating officer, The Foxboro Co.

China BUSINESS

Julie Walton

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 rate quoted in the International Monetary Fund's *International Financial Statistics.*

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 editor.

SALES AND INVESTMENT *March 16 – May 15, 1998*

Foreign or Hong Kong party/Chinese party **Arrangement, value, and date reported**

Accounting and Insurance

OTHER

Colonial Ltd. (Australia)
Received license to sell life insurance policies in China. 4/98.

Royal & Sun Alliance (UK)
Received license to sell life insurance policies in China. 4/98.

Agricultural Commodities and Technology

CHINA'S IMPORTS

Government of Australia/Government of the PRC
Will export live cattle to China for slaughter. 4/98.

CHINA'S INVESTMENTS ABROAD

Agricultural Bank of the Ivory Coast/China First Tractor Group
Established joint venture in Abidjan, Ivory Coast, to manufacture tractors. (Ivory Coast:32%-PRC:68%). 4/98.

INVESTMENTS IN CHINA

The Great Wall Food Co. Ltd. (Taiwan), Marubeni Co. Ltd. (Japan)
Formed joint venture in Liaoning Province to process livestock products. $30 million. 5/98.

Tokyo Huayu Co. (Japan)/Henan Xinlin Tea Co. Ltd.
Created joint venture to cultivate Japanese-style green tea leaves. $3 million. 5/98.

Abbreviations used throughout text: ADB: Asian Development Bank; BOC: Bank of China; CAAC: Civil Aviation Administration of China; CNAIEC: China National Automotive Import-Export Corp.; CATIC: China National Aero-Technology Import-Export Corp.; CITIC: China International Trust and Investment Corp.; CITS: China International Travel Service; CNOOC: China National Offshore Oil Corp.; CNPC: China National Petroleum & Gas Corp. ETDZ: Economic and Technological Development Zone; ICBC: Industrial and Commercial Bank of China; MII: Ministry of Information Industry; NA: Not Available; NORINCO: China North Industries Corp.; P&T: Posts and Telecommunications; PBOC: People's Bank of China; SEZ: Special Economic Zone; SINOCHEM: China National Chemicals Import-Export Corp.; SINOPEC: China National Petrochemical Corp.; SINOTRANS: China National Foreign Trade Transportation Corp.; SPC: State Planning Commission; UNDP: United Nations Development Program; UNICOM: China United Telecommunications Corp.

Pioneer Hi-Bred International Inc. (US)
Received approval to establish a research center in Tieling, Liaoning Province, to develop corn hybrids. 4/98.

The World Bank
Approved loan to certain PRC State-owned farms to renovate facilities. $150 million. 4/98.

Banking and Finance

OTHER

Templeton China Resources, a subsidiary of Franklin Resources, Inc. (US)
Opened representative office in Shanghai. 5/98.

Czech Savings Bank (The Czech Republic)
Opened representative office in Shanghai. 4/98.

Chemicals, Petrochemicals, and Related Equipment

INVESTMENTS IN CHINA

Air Products & Chemicals (US)/Shanghai Hua Yi
Will establish a manufacturing and marketing joint venture in Shanghai to produce methylamines. 5/98.

Dead Sea Works (Israel)/Ministry of Land and Natural Resources
Will build a potash production facility in Qinghai Province with an annual capacity of 800,000 tons. (Israel:34%-PRC:66%). $450 million. 5/98.

Elf Autochem, a subsidiary of Elf Aquitaine (France)/Gaoyuan Organic Powder Plant (Shanghai)
Launched joint venture in Jiangsu Province to produce copolyamid powders. (France:80%-PRC:20%). 5/98.

BASF AG (Germany), Nippon Polyurethane (Japan)
Announced joint venture to build a 160,000 ton aniline and nitrobenzene production plant in Shanghai. 4/98.

Dainippon Ink and Chemicals Inc. (Japan)/NA
Formed joint venture in Guangdong Province to manufacture and market denatured rosin used in making ink. (Japan:70%-PRC:30%). $5.5 million. 4/98.

Hercules Inc. (US)/Beijing Yanhua High Technology Co. Ltd.
Established joint venture to manufacture hydrogenated hydrocarbon resins. 4/98.

Montell Polyolefins, a unit of Royal Dutch/Shell Group (Netherlands)/Maoming Petrochemical (Beijing)
Announced agreement to build and operate a polypropylene production and sales joint venture. 4/98.

Rohm and Haas Co. (US)/Shanghai Resin Plant
Formed joint venture to produce exchange resin, with an annual capacity of 14,000 tons. $18.8 million. 4/98.

Zeneca PLC (UK)/Jiangsu Agrochemical, Nantong Pesticide, Nantong Petrochemical (Jiangsu)
Received approval to form a joint-venture herbicide manufacturing plant in Nantong, Jiangsu Province. (UK:88%-PRC:12%). $85 million. 4/98.

The Dow Chemical Co. (US)/Zhejiang Chemical Factory
Will buy out Zhejiang Chemical to create a wholly owned Dow subsidiary in Ningbo, Zhejiang Province. 3/98.

Eastman Kodak Co. (US)/Shantou Era Photo Materials Industry Corp., Xiamen Fuda Photographic Materials Co. (Fujian)
Established joint stock limited company to produce and sell film and paper sensitizing materials. (US:80%-PRC:20%). 3/98.

Eastman Kodak Co. (US)/Wuxi Aermei Film & Chemical Corp. (Jiangsu)
Formed joint stock limited company to produce and sell sensitized photographic materials. (US:70%-PRC:30%). 3/98.

OTHER

British Petroleum Ltd. (BP) (UK)/SINOPEC
SINOPEC will transfer its 44% stake in its acetic acid joint venture with BP to CNPC. 3/98.

Consumer Goods

INVESTMENTS IN CHINA

Citicorp Everbright China Fund, a unit of Citicorp/Citibank (US)/Guangdong Kelon Electrical Holdings Co. Ltd.
Received approval to establish a joint-venture air conditioner manufacturing plant. (US:40%-PRC:60%). $50 million. 5/98.

Isaberg Rapid (Sweden)/Shanghai Stationery & Sports Goods Corp.
Formed joint venture in Shanghai to manufacture staplers and staples. (Sweden:51%-PRC:49%). $18 million. 5/98.

BASF AG (Germany), Interface Inc. (US)/China Worldbest Group (Shanghai)
Announced joint venture to manufacture carpet in Shanghai. (Germany:5%, US:70%-PRC:25%). $12 million. 4/98.

Dielle Furniture Manufacturing Group (Italy)
Set up wholly owned plant in Shanghai to manufacture Italian-style furniture. $1 million. 4/98.

Merloni Group (Italy)/Haier Group (Shandong)
Will build a plant to manufacture top-loading washing machines. 4/98.

OTHER

Unilever PLC (UK)
Opened regional headquarters in Shanghai. 5/98.

Electronics and Computer Software

CHINA'S IMPORTS

Computer Modeling Group Ltd. (Canada)
Won contract to install oil and gas modeling software for Tuha Petroleum Exploration and Development Bureau in Xinjiang Uygur Autonomous Region. 4/98.

IBM Corp. (US)
Will sell Lotus system licenses to PBOC. 4/98.

IBM Corp. (US)
Will provide online business services technology to China Telecom. 4/98.

NCR Corp. (US)
Received contract to provide intra-city automatic check-clearing and sorting system to PBOC. 4/98.

Honeywell Inc. (US)
Will furnish extra low-voltage automated control infrastructure systems to the China Resources Co. Ltd. building in Beijing. $4.8 million. 3/98.

NII Norsat International Inc. (Canada)
Won contract to supply digital chip sets and video encoders to Shantou Radio and TV Equipment Co. in Guangdong Province. $1.1 million. 3/98.

INVESTMENTS IN CHINA

Computer Associates International, Inc. (US)/Jinchen Security Technology Industry & Commerce Corp., an arm of the Ministry of Public Security
Agreed to jointly develop, market, and distribute computer antivirus software. 5/98.

Canon Inc. (Japan)/Beijing University
Established joint venture to develop software. (Japan:70%-PRC:30%). $800,000. 4/98.

Hewlett-Packard Co. (HP) (US)/Beijing J-Tech System Integration Co., China National Computer Software & Technology Service Corp., Nantian Electronic Information Group (Beijing)
Agreed to jointly develop and distribute HP's information-management and online business software. 4/98.

International Data Group (US)/Kejian Group (Guangdong)
Will form a systems integration and information technology joint venture in Shenzhen, Guangdong Province. 4/98.

Toko Inc. (Japan)
Announced formation of sales subsidiary in Shanghai to market coils, semiconductor parts, and chips for electronic products. $500,000. 4/98.

NEC Corp. (Japan)/Hua Hong Integrated Circuit Design Co. Ltd. (Beijing)
Formed joint venture to design and market microcomputers and related microchip products. (Japan:60%-PRC:40%). $30 million. 3/98.

OTHER

Cincom Systems, Inc. (US)
Will open a representative office in Shanghai. 5/98.

Intel Corp. (US)
Will open an Internet technology research center in Beijing. $50 million. 5/98.

Engineering and Construction

INVESTMENTS IN CHINA

Asia Pacific Concrete Inc. (Canada)/Guangxi Youjiang Water & Power Development Corp.
Formed joint venture in Guangxi Province to produce ready-mix concrete for the Bai Se dam project. (Canada:55%-PRC:45%). $656,000. 5/98.

Asia Pacific Concrete Inc. (Canada)/Taiyuan Lion Head Cement (Shanxi)
Will establish a joint venture in Shanxi Province to produce ready-mix concrete. (Canada:70%-PRC:30%). $2.4 million. 5/98.

Eaton Corp. (US)/Shanghai Pudong Valve Factory
Announced joint venture to manufacture and market automotive engine valves and hydraulic valve lifters for the PRC market. (US:55%-PRC:45%). $15 million. 4/98.

LaFarge Group (France)/Government of Sichuan Province
Will jointly build a cement production facility with an annual capacity of 1.2 million tons. $145 million. 4/98.

Powertrusion 2000 (US)/China National Machinery & Equipment Import-Export Corp.
Formed joint venture to manufacture and market composite utility poles. 4/98.

Siam Cement Group (Thailand)/Tianjin Building Materials General Corp.
Announced joint venture to manufacture pipes and PVC plastic for sanitation equipment. (Thailand:75%-PRC:25%). 4/98.

Cheung Kong Infrastructure Holdings (Hong Kong)/Government of Hubei Province
Entered into joint venture to construct and operate a bridge in Wuhan, Hubei Province. (Hong Kong:70%-PRC:30%). $63 million. 3/98.

OTHER

The World Bank
Approved loan to the Sichuan Gas Development and Conservation Project for purchase of a mobile hydraulic crane. 4/98.

Environmental Technology and Equipment

CHINA'S IMPORTS

Quanterra Co. (US)
Will provide air and soil testing equipment to the China Environmental Science Academy. 4/98.

INVESTMENTS IN CHINA

Earth Tech (US)/Qingdao Municipal Government (Shandong)
Will form a joint venture in Shandong Province to construct new water-supply plants. 4/98.

Sino-French Water Development, a joint venture between Suez Lyonnaise des Eaux SA (France) and New World Infrastructure Ltd. (Hong Kong)/Zhongshan Municipal Government (Guangdong)
Entered into two 22-year BOT contracts to take over existing water supply plants in Zhongshan municipality. (Hong Kong:66%-PRC:34%). 3/98.

OTHER

Lyonnaise des Eaux, a unit of Suez Lyonnaise des Eaux SA (France)/Qinghua University (Beijing), Shenyang Institute of Environmental Science (Liaoning)
Lyonnaise will finance and other partners will carry out a research project to identify and monitor sources of water pollution in Shenyang, Liaoning. 4/98.

Government of Hong Kong SAR
Will grant loan to Guangdong Province to build a closed aqueduct pumping system. $305 million. 3/98.

The World Bank Global Environment Facility
Granted loan for China's Energy Conservation Project to reduce carbon dioxide emissions. $85 million. 3/98.

Food and Food Processing

INVESTMENTS IN CHINA

Sapporo Breweries (Japan)/NA
Formed joint-venture brewery in Jiangsu Province. 4/98.

Chuang Ye Brewery Co. (Hong Kong)/Jilin Songyuan Food and Pharmaceutical Industrial Co.
Established a joint-venture brewing company in Jilin Province. (Hong Kong:90%-PRC:10%). 3/98.

Machinery and Machine Tools

INVESTMENTS IN CHINA

Phoenix AG (US)/NA
Formed joint venture in Shanxi Province to manufacture conveyor belts. (US:66%-PRC:34%). 4/98.

SKF AB (Sweden)/Wafangdian Bearing Co. (Liaoning)
Set up joint venture to manufacture and market spherical roller bearings for the mining, pulp, and transportation industries. (Sweden:51%-PRC:49%). $2 million. 4/98.

OTHER

Oakland Port Authority (US)/Zhenhua Port Machine Co. (ZPMC) (Shanghai)
Will purchase four Panamax-type container cranes from ZPMC. $24 million. 4/98.

Toshiba Corp. (Japan)
Received authorization to establish a wholly owned subsidiary in Shanghai to sell its machine tools and injection molders. $362,000. 3/98.

Medical Equipment and Devices

CHINA'S INVESTMENTS ABROAD

Government of Eritrea/Government of the PRC
Will build a 200-bed hospital in the Eritrean capital of Asmara. 4/98.

INVESTMENTS IN CHINA

Essilor International (France)/Songjiang Industrial Corp. (Shanghai)
Launched joint venture to manufacture contact lenses and related eyewear products. (France:95%-PRC:5%). $53 million. 4/98.

Metals, Minerals, and Mining

CHINA'S IMPORTS

BHP Minerals, a subsidiary of Broken Hill Proprietary Co. (Australia)
Will sell 40,000 tons of copper annually to the State Bureau for Nonferrous Metals Industry. $70 billion. 4/98.

INVESTMENTS IN CHINA

Geo2 Ltd. (Australia)/Shui Chuang Gold Refinery (Liaoning)
Received approval to launch a joint-venture gold recovery plant in Liaoning Province. (Australia:51%-PRC:49%). $1.3 million. 4/98.

Geo2 Ltd. (Australia)/Hulu Dao Mines (Liaoning)
Will establish a joint-venture ore refinery with a daily capacity of up to 100 tons of oxidized ore. (Australia:49%-PRC:51%). 4/98.

OTHER

The Export-Import Bank of Japan
Will finance the construction of a steel manufacturing facility in Hebei Province. $36.8 million. 4/98.

Geo2 Ltd. (Australia)
Opened representative office in Shenyang, Liaoning Province. 4/98.

Packaging, Pulp, and Paper

INVESTMENTS IN CHINA

Asian Paper Industrial Shareholding Co. (Singapore)/Ningbo Paper Industrial Investment Co., Ltd. (Zhejiang)
Received approval to launch a paperboard production joint venture with an annual capacity of 1 million tons. (Singapore:75%-PRC:25%). $1.5 billion. 5/98.

New Toyo Corrugated Products Pte. Ltd., a unit of New Toyo International Holdings Ltd. (Japan)/Jiangsu Lian Tong Group Corp., Jiangyin Sugar, Cigarettes & Wine Corp. (Jiangsu)
Established joint venture to manufacture and distribute corrugated boxes and paper products in China. (Japan:60%-PRC:40%). $3.5 million. 3/98.

Xerox Corp. (US)/EAS International Transportation Ltd. (Beijing)
Opened a joint printing center to provide document services in Beijing. 3/98.

Petroleum, Natural Gas, and Related Equipment

CHINA'S EXPORTS

Hyundai Oil Refinery Co. (S. Korea)/CNOOC
Hyundai will import 1.7 million barrels of crude oil annually from CNOOC. 4/98.

INVESTMENTS IN CHINA

Agip Petroli, a branch of ENI SpA (Italy), Haikou Refinery Ltd. (Hong Kong)
Received approval to establish an oil refinery in Hainan Province with an annual capacity of 6 million metric tons. (Italy:50%-Hong Kong:50%). $1.6 billion. 4/98.

Monde Group LLC (US)/SINOPEC
Signed 25 year-contract for cooperation in oil recovery programs within China. 3/98.

OTHER

Total SA (France)/SINOPEC
SINOPEC will transfer its 22.7% stake in a Dalian oil refinery joint venture with Total SA to CNPC. 3/98.

Pharmaceutical

INVESTMENTS IN CHINA

Nichimen Corp. (Japan)/North China Pharmaceutical Corp. (Hebei)
Opened joint venture to manufacture semi-synthetic antibiotics. (Japan:34%-PRC:46%). $20.4 million. 4/98.

Ports and Shipping

INVESTMENTS IN CHINA

Halter Maine Inc. (US)/Taisun Shipbuilding Co. Ltd. (Shandong), Yantai Shipyard Co. Ltd. (Shandong)
Formed joint venture to construct and market marine vessels ranging from tug boats to offshore drilling rigs. 5/98.

OTHER

PSA Corp. (Thailand)
Opened representative office in Dalian, Liaoning Province. 4/98.

Zim Israel Navigation Company (Hong Kong)/Shekou Container Terminal (Guangdong)
Received approval to conduct weekly shipping service from Shekou, Guangdong Province, to the Mediterranean. 4/98.

Power Generation Equipment

CHINA'S IMPORTS

Mitsui Babcock Energy Ltd., the British unit of Mitsui & Co. (Japan)/Shandong Zhonghua Power Co.
Awarded contract to install power boiler equipment in two coal-fired power stations in Shandong Province. $30 million. 5/98.

Korea Electric Power Corp. (S. Korea)/Qinshan Nuclear Reactor Plant (Hubei)
Will sell its nuclear reactor test operation technology to Qinshan plant. 4/98.

Westinghouse Electric Corp. (US)/China Electric Power Import-Export Corp., Henan Provincial Electric Power Corp.
Will install two 350 MW power generating units in Henan Province. $167 million. 4/98.

INVESTMENTS IN CHINA

Greenwich Natwest (UK), Industrial Bank of Japan, Société Générale SA (France)/Shandong Zhonghua Power Co.
Will jointly construct electric power plants in Shandong Province, each with an output capacity of 3 million kW. $1.5 billion. 5/98.

IDM Energy, a subsidiary of IDM Environmental Corp. (US)/Hebei Qingzhang Huada Heat & Power Corp.
Formed joint venture in Hebei Province to design, construct, and operate a 100 MW heat and power plant. $120 million. 5/98.

Alliant (US)/Tongxiang Juneng Heat and Power Co. Ltd. (Zhejiang)
Entered into joint-venture 24 MW electric and steam-generating power plant in Zhejiang Province. (US:50%-PRC:50%). $24 million. 4/98.

Electricité de France/China Light & Power Co. (Shandong), Shandong Electric Power Group Co., Shandong International Trust & Investment Corp.
Agreed to build two thermal electric power stations. (France:19.6%-PRC:84.4%). $2.2 billion. 4/98.

New World Development Co. Ltd. (Hong Kong)
Acquired controlling interest in the Caoyutan power plant in Sichuan Province. (Hong Kong:51%-PRC:49%). 4/98.

ABB AG (Switzerland)/Chongqing Transformer Works
Formed joint venture to manufacture power transformers for utilities and industrial customers. 3/98.

Environmental Power Co. Ltd. (Australia), Great Pacific Financial Group (Australia), Prosperous Corp. Ltd. (Australia)/Tianjin Environmental Engineering Design Institute
Agreed to build a power plant that generates electricity from garbage. $45 million. 3/98.

OTHER

ADB
Approved loan for the construction of a 720 MW electric power plant in Fujian Province. $567 million. 5/98.

The World Bank
Awarded loan to the Jiangsu Power Transmission Project for infrastructure development. $250 million. 3/98.

Property Management and Development

INVESTMENTS IN CHINA

Pan Australian International Investment (Australia)/ Zhonghuan Investment Development Group (Shanghai)
Set up joint venture to finance and construct a residential property development site in Shanghai. $866 million. 3/98.

Henderson Investment Ltd. (Hong Kong), Universal Studios, a unit of Joseph E. Seagram & Sons, Inc. (US)
Will build a family entertainment complex in Beijing. 3/98.

OTHER

LaSalle Partners Inc. (US)
Opened office in Shanghai to offer real estate and consulting services to multinational corporations. 4/98.

Telecommunications

CHINA'S IMPORTS

Motorola Inc. (US)
Will supply UNICOM with more than 100 nucleus transmitters. $1 million. 5/98.

Oy Nokia AB (Finland)
Will deliver analog and digital switching platforms to the Daqing Petroleum Administration Bureau. 5/98.

Glenayre Technologies Inc. (US)
Received contract to supply a province-wide, high-speed paging network in Heilongjiang Province. $13.5 million. 4/98.

LG Information and Communications, a unit of LG Group (S. Korea)
Will provide wireless local loop (WLL) relaying subsystems and control units to Guangdong Province. $1 million. 4/98.

LM Ericsson AB (Sweden)
Received contracts from the Heilongjiang P&T, Jiangsu P&T, Liaoning P&T, and Shanghai P&T administrations to expand existing GSM cellular networks. $756 million. 4/98.

LM Ericsson Telefon AB (Sweden), AB Volvo (Sweden)
Will supply five sets of telephone exchange equipment to MII. 4/98.

Motorola Inc. (US)
Awarded contract to expand the GSM digital cellular network in Jiangsu Province. $42 million. 4/98.

Motorola Inc. (US)
Will install M-cell base stations and expand the dual-band network in Hunan Province. $105 million. 4/98.

Oy Nokia AB (Finland)
Will deliver synchronous digital hierarchy systems to the Ji'an unit of China Telecom in Jiangxi Province. 4/98.

Oy Nokia AB (Finland)
Will provide the Shanghai P&T Administration with a dual-band GSM cellular telephone network. $60 million. 4/98.

Samsung Electronics Co. (S. Korea)
Will supply optic-fiber amplifiers to the Wuhan Institute in Hubei Province. $2 million. 4/98.

Samsung Electronics Co. (S. Korea)
Will provide Chongqing municipality with a wireless local loop system based on localized CDMA technology. 4/98.

Siemens AG (Germany)
Won contract to provide telecommunications switching exchanges to 22 cities in China. $50 million. 4/98.

WavePhore Inc. (US)
Will deliver variable bit rate, frequency agile data broadcast receivers to Shenzhen Securities Satellite Communications Co. in Guangdong Province. $1 million. 4/98.

Hybrid Networks, Inc. (Japan)
Received order from Guangzhou CATV in Guangdong Province to provide cable modems and head-end equipment. 3/98.

LM Ericsson AB (Sweden)
Will provide the Shanghai P&T Administration with a commercial GSM 1800 network. $64 million. 3/98.

Motorola Inc. (US)
Will install M-cell communications base stations in Tianjin municipality. $43 million. 3/98.

NEC (Japan)
Will sell digital optic-fiber transmission equipment to China Telecom to connect Hohhot, Inner Mongolia, and Beihai, Guangxi Province. $13.1 million. 3/98.

Nixxo Telecom (S. Korea)
Will supply MII with 20,000 two-way pagers. $3 million. 3/98.

NSI Communications Inc. (Canada)
Will sell satellite earth stations and related equipment to the China Instrument Import Export Co. for the expansion of long-distance telecommunications in Tibet. $6.3 million. 3/98.

Qualcomm Inc. (US)
Will supply the Beijing P&T Administration with infrastructure and subscriber equipment, and deployment services for a WLL network. 3/98.

Siemens AG (Germany)
Won contract to expand the GSM network in Anhui Province. $136 million. 3/98.

INVESTMENTS IN CHINA

Asia-Pacific Mobile Telecommunications (Singapore)/China Telecommunications Satellite Co.
Formed joint venture to provide telecommunications services for Asia. (Singapore:34%-PRC:66%). $95 million. 5/98.

EMCEE Broadcast Products, Inc. (US), Superior Group Inc. (US)
Launched joint-venture company in Chengdu, Sichuan Province, to manufacture wireless cable products. 5/98.

Brightpoint Inc. (US)/Guangdong Nanfang Communication Group Corp.
Established joint-venture distribution center and retail stores for wireless communication products. 3/98.

OTHER

Philips Consumption Communications (US)
Established offices in Fuzhou and Xiamen, Fujian Province. 4/98.

Oy Nokia AB (Finland)/China Post & Telecommunications Equipment Corp. (CPTEC)
Granted CPTEC wholesale and retail distribution rights for the sale of Nokia's products in China. 3/98.

Textiles and Apparel

INVESTMENTS IN CHINA

E.I. du Pont de Nemours & Co. (US)/Beijing Dayuan Non-woven Co.
Formed joint venture to produce spunlaced fabrics. (US:50%-PRC:50%). $15 million. 5/98.

Polymer Group Inc. (US)/Nanhai Nanxin Non-Woven Fabric Co. Ltd. (Guangdong)
Created joint venture to upgrade factory equipment and expand production of spun polymer textiles. 4/98.

E.I. du Pont de Nemours & Co. (US)/China Worldbest (Shanghai)
Opened joint venture in Shanghai to manufacture synthetic fibers. (US:86.5%-PRC:13.5%). $100 million. 3/98.

Kanebo Ltd. (Japan)/NA
Set up a joint-venture company in Taican, Jiangsu Province, to produce pantyhose. (Japan:70%-PRC:30%). $12.5 million. 3/98.

Transportation

CHINA'S EXPORTS

Canadian Aerospace Group/Harbin Aircraft Manufacturing Corp.
Will purchase 200 Y-12 IV aircraft over the next 10 years. 4/98.

CHINA'S INVESTMENTS ABROAD

Addis Ababa Road Authority (Ethiopia)/China Road and Bridge Corp.
Won contract to build a 33 km road around Addis Ababa. $67.2 million. 4/98.

Government of Iran/Government of the PRC
Will construct a public railway transit system in Tehran. $550 million. 4/98.

INVESTMENTS IN CHINA

Honda Motor Co. (Japan)/Dongfeng Motor Corp., Guangzhou Auto Group Corp. (Guangdong)
Signed agreements to set up passenger vehicle manufacturing and marketing facilities in Guangdong Province. $200 million. 5/98.

Kwoon Chung Bus Holdings (Hong Kong)/Shanghai Public Transportation Holding Co.
Formed joint venture in Shanghai to operate bus routes. (Hong Kong:53%-PRC:47%). $14.5 million. 5/98.

Iveco, a unit of Fiat SpA (Italy)/Changzhou Congjiang Bus Group (Jiangsu)
Will establish a joint venture in Jiangsu Province to manufacture buses. (Italy:50%-PRC:50%). $137 million. 4/98.

Rolls-Royce PLC (UK)/Beijing University of Aeronautics and Astronautics, Nanjing University of Aeronautics and Astronautics (Jiangsu), Shenyang Aeroengine Research Institute (Liaoning)
Established joint ventures to conduct research on lubricating oils, air-spray fuel injectors, and vane-pylon interactions with low-pressure compression systems. 4/98.

Siemens AG (Germany)/Zhuzhou Electric Locomotive Plant and Research Institute (Hunan)
Will form joint venture in Hunan Province to build alternating current transmission trains. $36 million. 4/98.

Tokico Ltd. (Japan)/First Auto Works Group Corp. (Jilin)
Will set up joint venture in Changchun, Jilin Province, to manufacture and market shock absorbers. (Japan:49%-PRC:51%). $7.2 million. 4/98.

TRW Inc. (US)/Ningbo Yongxing Automobile Parts Co. (Zhejiang)
Formed joint venture to manufacture automotive fasteners and injection-molded components. (US:70%-PRC:30%). 3/98.

OTHER

Austral Pacific Group Corp., a subsidiary of Clifford Corp. (Australia)/China National Heavy Duty Truck Co. (Shandong)
Announced deal to share coach and chassis-building technology, train engineers, and sell Australian buses in China. $127 million. 5/98.

Miscellaneous

CHINA'S EXPORTS

Government of Kuwait/Government of the PRC
Will purchase 155 mm artillery guns from the PRC. $186.5 million. 3/98.

CHINA'S INVESTMENTS ABROAD

Government of Cuba/Government of the PRC
Agreed to invest in rice production, education infrastructure, and hydroelectric projects in Cuba. $19 million. 3/98.

INVESTMENTS IN CHINA

Diethelm Co. (Switzerland)/China International Travel Service, Yunnan Travel Co. Ltd.
Received approval to establish a joint-venture travel company. (Switzerland:49%-PRC:51%). $1 million. 5/98.

Hearst Corp. (US)/Trends Publishing Co. (Shanghai)
Won license to publish *Cosmopolitan* magazine in China. 4/98.

OTHER

Illinois Institute of Technology/Shenyang Institute of Technology (Liaoning)
Will set up a joint educational program to train Chinese managers in marketing, consumer research, quality control, and administration. 4/98.

International Finance Corp., a unit of the World Bank/Orient Group Finance Co. (Heilongjiang)
Granted loan to Orient Group for investment in infrastructure development projects. $30 million. 3/98.

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What a Difference a Year Makes

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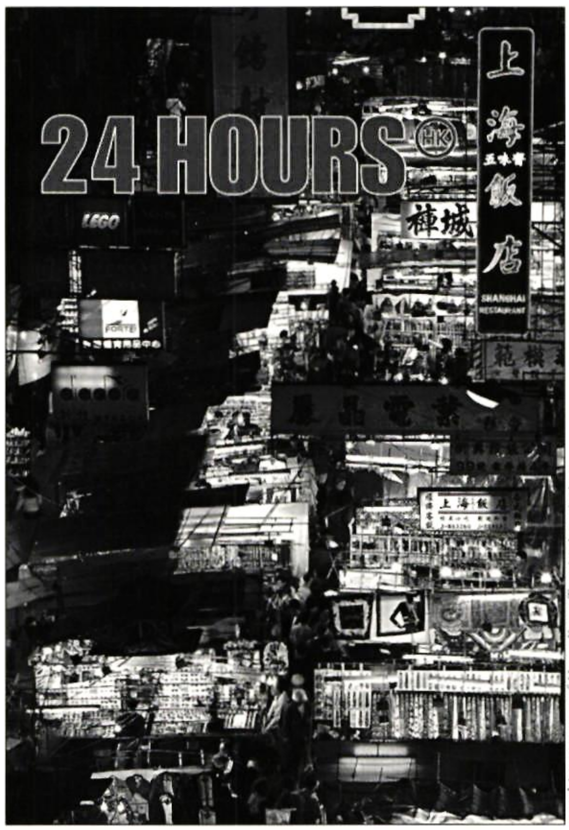
The one-year anniversary of the Hong Kong Special Administrative Region (SAR) is fast approaching, which means it's time for the inevitable question: What's changed?

For those of us who live here, quite a bit, actually. This time last year, in between debates over whether Beijing would truly respect Hong Kong's autonomy, Hong Kongers frantically tried to get their hands on 1,200 percent-oversubscribed red chips, cash in on the dizzying property market, and plan for five days of non-stop partying before the eyes of the world. No one saw the storm clouds forming over Thailand, Indonesia, and South Korea, and few forecast that the storm would become a typhoon engulfing virtually all of Asia. Now, the bear has chased the bull from the Hang Seng, the property market has crashed, tourists are staying away in droves, and you can't eat anything without reading in the next morning's paper that it was contaminated.



graphics courtesy of Hong Kong Tourist Association

Certainly, Hong Kong has fared quite well compared to the rest of the region. The currency is stable, in May the government successfully conducted the first multiparty election in PRC history, and banks are solvent. Nevertheless, unemployment is at a 15-year high and expected to get worse, the economy suffered negative growth in the first quarter (and probably the first half) of the year, and the public's once-lofty confidence in the civil service has been shaken dramatically by revelations of medical blunders, the chicken flu, and a perceived inability to turn the economy around. Hong Kong's "attitude," a confidence bordering on arrogance thanks to so many years of strong economic performance, is considerably humbler. Hong Kong, in short, has lost its swagger.

If the past year has been hard on the territory's human inhabitants, it's been even worse for the animal kingdom. Hong Kong's lax hygiene monitoring standards opened the door to the avian flu, which led to the mass slaughter of over a million chickens, ducks, and geese. More recently, a "red tide" of toxic algae, caused in part by appalling levels of pollution in the Sourth China Sea, killed thousands of tons of fish throughout the territory's fish farms. I imagine such events must make the Hong Kong Tourist Association's new "Hong Kong: City of Life" campaign a slightly harder sell.

One also can't help but wonder what the higher powers are thinking about Hong Kong these days. It seems every time there's a major political event in the territory, the heavens open and dump a month's worth of rain in a day. While the stoicism of Prince Charles and the Black Watch was impressive during the handover ceremonies (it can't be comfortable marching around in soaking bear fur), the sight of grannies wading through shin-high water to vote in the May Legislative Council election was downright inspiring. One can only hope they braved the elements to do their civic duty, not to get their souvenir election cards which could be redeemed for a discount at a local clothing store. Only in Hong Kong can an election turn into a shopping opportunity!

Even though Hong Kong has seen better days, and may be down, the SAR certainly is not out. A fascinating transformation is going on, both economically and politically. Many economists believe Hong Kong's economy is facing a paradigm shift, but there is no consensus as to what the new paradigm will be or how the government and citizens should respond to ensure the territory's long-term prosperity.

On the social and political front, opinion polls reveal that the majority of the populace is satisfied with China's handling of Hong Kong thus far, but is less content with its own policymakers. In late May, Hong Kong citizens elected a vocal minority of politicians who will be much more assertive in questioning government proposals and pressing for change, whether it be a faster pace of democratization or protecting workers rights, than the outgoing provisional legislature. The real test of the "one country, two systems" policy is just beginning, a year after the handover. For Hong Kong, these are indeed interesting times—but that can be a blessing as well as a curse.

—Pam Baldinger

Pam Baldinger is director of the US-China Business Council's Hong Kong Office.