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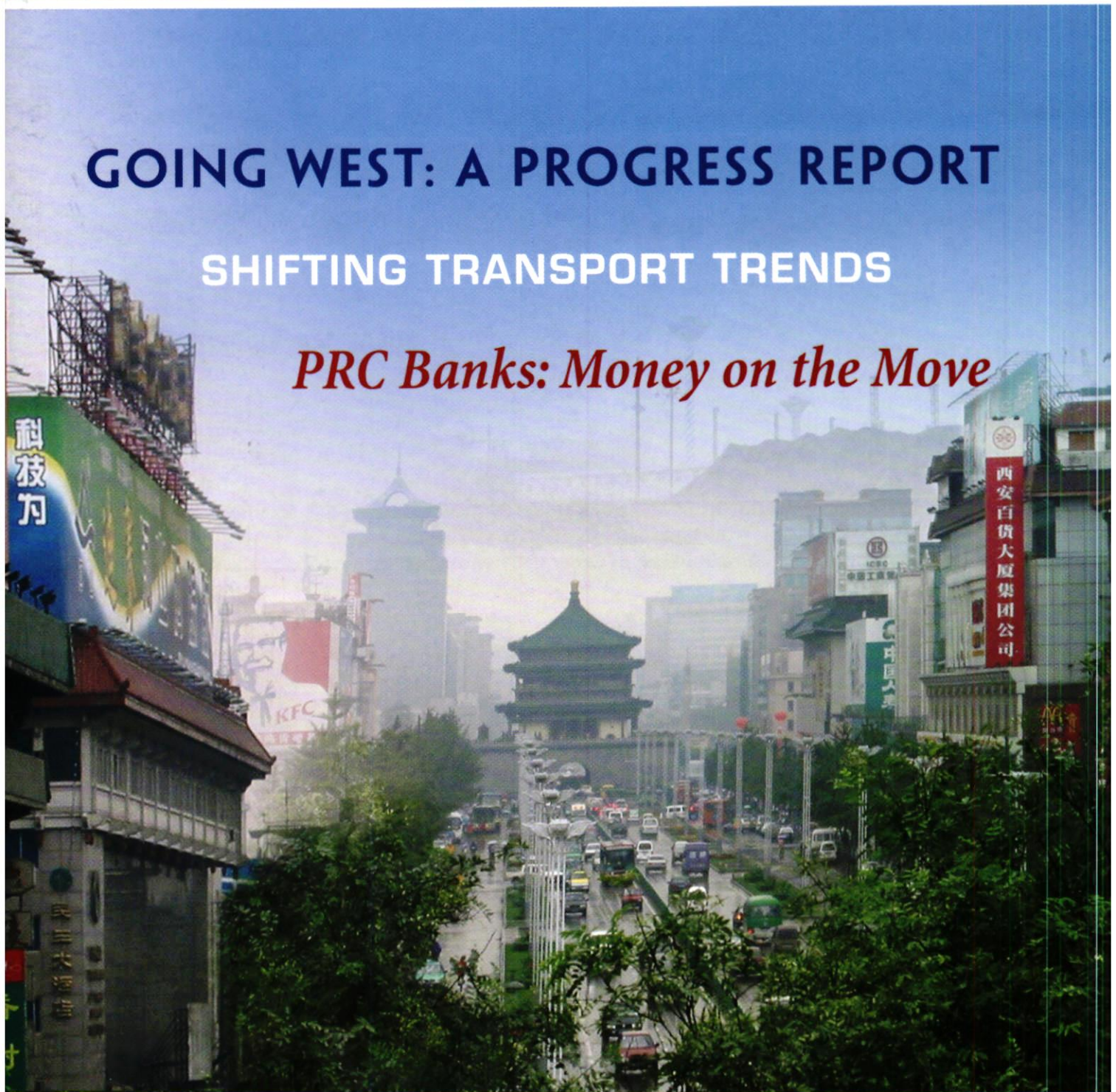
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SHIFTING TRANSPORT TRENDS

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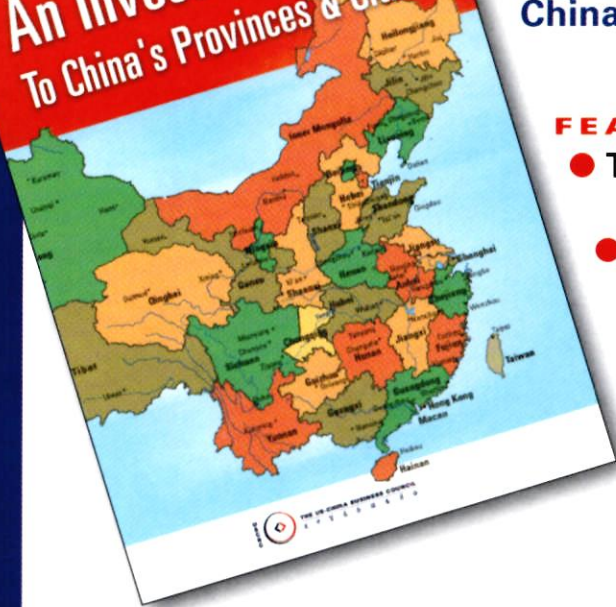
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**EVENT WRAP-UP****Washington****December 2003****Brown Bag Lunch**

Featured Ken Davies, senior economist at the Organisation for Economic Cooperation and Development

Reception and Dinner in Honor of PRC Premier Wen Jiabao (see p.5)

January 2004

US-China Logistics Conference Planning Meeting Featured Deputy Assistant Secretary of Commerce Henry A. Levine

Meeting on Intellectual Property Rights Featured Assistant US Trade Representative (USTR) James Mendenhall

January Issues Luncheon Featured Everett Eissenstat, chief international trade counsel, Senate Finance Committee; Brian Pomper, international trade counsel, Democratic Staff, Senate Finance Committee; and John Foarde, staff director, Congressional-Executive Commission on China

WTO Quarterly Group Briefing Featured Charles Freeman, deputy assistant USTR for the People's Republic of China, Taiwan, Hong Kong, Macau, and Mongolia

Forecast 2004 (see right)

February

February Issues Luncheon Featured Richard C. Bush, senior fellow and director at the Brookings Institution's Center for Northeast Asia Policy Studies

New York**January**

China Business 2004: China Market Trends and Opportunities in Financial Services The interactive workshop featured USCBC's senior staff and New York company representatives in a discussion of China's financial services sector. Sponsored by Citigroup Inc.

Minneapolis**February**

China Business 2004: China Market Trends and Opportunities for US Businesses Featured USCBC's senior staff and Minnesota company representatives with interest in China business trends. Sponsored by Cargill, Inc.

UPCOMING EVENTS

The Mainland and Hong Kong Closer Economic Partnership Arrangement: What It Is and What It Means for US Companies

Washington, DC, March 5, 2004

March Issues Luncheon

Washington, DC, March 18, 2004

April Issues Luncheon

Washington, DC, April 15, 2004

Biennial Gala and Annual Membership Meeting

Washington, DC, June 3 and 4, 2004

For more information, see p.41

Council Hosts Forecast 2004 Reception and Conference

USCBC President Robert A. Kapp and panelists at the Forecast 2004 conference.

The US-China Business Council launched its annual Forecast conference with an evening reception on January 28 that featured guests from the US government and the PRC embassy.

The conference began the next morning with a discussion on China and the global economic climate led by William Belchere of JP Morgan Chase & Co. (HK) and Pieter Bottelier of the Johns Hopkins University, Paul H. Nitze School of Advanced International Studies. Scott Kennedy of Indiana University, Fu Li of Tektronix, Inc., and Matthew McConkey of Coudert Brothers then spoke on Chinese trade associations and interest groups. Jonathan Pollack of the Naval War College and Evan Medeiros of RAND Corp. discussed China's foreign relations in 2004 and implications for US-China engagement. The luncheon program featured the Honorable James Sasser, former ambassador to the PRC and US Senator from Tennessee, and Clyde Prestowitz, president of the Economic Strategy Institute, who exchanged views on current politics. The afternoon panel, which featured Steve Monaghan of UPS and Ira Smith of Scala North America, focused on China in the global supply chain. After the last panel, member company representatives met with USCBC staff for tailored, individual strategy sessions.

Reception and Dinner in Honor of PRC Premier Wen Jiabao



(Left to right) USCBC President Robert A. Kapp, PRC Premier Wen Jiabao, and Fluor Corp. Group President, Industrial Business Unit, Robert A. McNamara.



(Left to right) Kapp, Premier Wen, America China Forum Chair Henry A. Kissinger, and National Committee on United States-China Relations President John L. Holden.

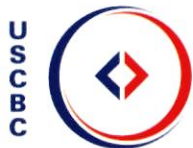


PRC Premier Wen Jiabao greets the audience.

The US-China Business Council and the National Committee on United States-China Relations in cooperation with the America-China Forum, Asia Society, Center for Strategic and International Studies, Committee of 100, Council on Foreign Relations, US Chamber of Commerce, and the United States-China Policy Foundation, hosted a reception and dinner in honor of PRC Premier Wen Jiabao in Washington, DC, on December 9, 2003. The Honorable Carla A. Hills, chair of the National Committee on United States-China Relations, presided over the event. US secretary of Agriculture Ann M. Veneman spoke on behalf of the US government. Christopher B. Galvin, former USCBC chair and former chair and CEO of Motorola Inc., introduced the premier. After delivering unscripted remarks on his US visit and his childhood to an audience of roughly 600 guests, Wen read from his prepared speech on US-China relations and mutual cooperation. The English translation and Chinese text of Wen's speech may be viewed on the USCBC website (www.uschina.org).



US-China Business Council members and guests.



THE US-CHINA BUSINESS COUNCIL

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Robert A. Kapp

PRESIDENT, THE US-CHINA BUSINESS COUNCIL



Welcome Aboard! But Keep Seat Belt Securely Fastened

The *China Business Review* (*CBR*)—which “impartial observers” like me consider hands-down to be the best publication for businesspeople and interested laypersons seeking to stay current on trade and investment with China—has scored a breakthrough. For the first time, in 2004, the *CBR* is reaching thousands of air travelers on key routes connecting the United States and China. We welcome to the *CBR* family our new readers moving in and out of China on two great US carriers: United Airlines and Northwest Airlines. They join travelers flying to China on selected Cathay Pacific and Malaysia Airlines routes. We are thrilled to have you and hope that you will want to make the *China Business Review* a part of your regular reading whether you’re in the air or in the office.

That the *China Business Review* is taking to the air so vigorously is just one of many signs of how robust US-China business relations now are. Two-way trade in 2003 reached \$191 billion, with American exports to China up more than 28 percent over 2002 (which registered a 15 percent increase over the same period in 2001). China’s massive exports to the United States continued to advance, rising 22.3 percent last year over 2002, leaving the PRC merchandise trade surplus with the United States (by American counting methods) at \$135 billion. (Veterans know that US and Chinese counting methods differ, with the United States over-counting Chinese exports to the United States and China under-assessing them.) By China’s numbers, total PRC trade in 2003 rose more than 37 percent year on year, even as China’s global merchandise trade surplus dropped by 16 percent, to \$25.5 billion.

The sizzle in US-China trade arises most importantly from China’s high growth rate in 2003, and it is not clear whether such rapid expansion can, or should, continue. But the 2003 trade numbers bear out an observation that we made during the struggle to pass Permanent Normal Trade Relations (PNTR) legislation in the US Congress four years ago: whether the Chinese economy grows at 10 percent a year or shrinks at 10 percent a year is likely to have a greater impact on US exports to the PRC than just about anything found in China’s World Trade Organization (WTO) commitments. Meanwhile, PRC exports to China’s largest overseas market—the United States—reflect not only China’s growing abilities to satisfy US market

demands but also the apparent resumption of strong overall economic growth in the States after a long stretch in the doldrums.

Among its member companies, the US-China Business Council finds optimism and the intention to grow. Indeed, the Council itself is growing, as companies of all sizes and from many US regions turn to China with a new intensity of interest. One small indicator of this interest is the number of sectoral trade associations now approaching the US-China Business Council for advice or for speaking appearances by top Council staff; we’re meeting people in sectors that formerly had little time to focus on China business prospects.

Contributing to the general optimism has been the remarkable absence of US-China fireworks over the past couple of years. Think back four years: we were in the middle of the all-out US political battle over PNTR, with fresh memories of the trauma over the “Cox Commission” allegations of PRC espionage; the US bombing of China’s embassy in Belgrade and the virulent response on Chinese city streets; and a nasty dust-up between Taiwan and the mainland over then-President Lee Teng-hui’s latest vision of the Taiwan-mainland relationship.

Few would disagree that US-China relations today are ordered and restrained, the public rhetoric measured even when critical, and the atmospherics much improved. US-China communication at the policy level is extensive and continues to expand. Visits by top leaders emphasize the positive. The Beijing talks on North Korea are back on the front burner. With weeks to go before the Taiwan presidential elec-

tion, close observers are holding their collective breath that the United States and China can avoid a collision that neither wishes.

Differences persist—some important ones in the trade sector, notably regarding WTO commitments, and others in human rights or other spheres—but they do not, for now, blow us off course.

At the US-China Business Council, however, our job is not just to turn on the autopilot but to scan the skies for signs of changes in the weather. The good news is that we're not looking at any typhoons heading straight for US-China relations. The more cautious news is that there are some clouds and that turbulence is possible. When seated, keep seat belt fastened!

What's in those clouds?

1 The possibility in the shorter term of a Chinese economic slowdown Experts differ, but many see slower growth as inevitable and even desirable. Few take the breakneck expansion of the last year or two as a given for the future, pointing instead to emergent supply bottlenecks, the downsides of profligate bank lending, and “irrational exuberance” in the building sector.

2 US legislative action to punish the PRC for the US trade deficit and China's rapidly expanding position in the US market I remain skeptical that China has sufficient “legs” in this US election year to become the focus of successful legislative attacks on US-China economic activity. But there are those on Capitol Hill who could try to “send China a message” that the United States doesn't like its currency practices or its trade surplus with us. The congressional legislative labyrinth offers the opportunity to send simple messages to multiple audiences (one of the audiences being US voters). Moreover, in some states with large electoral vote purses at stake, popular concern over manufacturing and service-sector job losses will resonate. Congress and the White House have been known to leap first and face the consequences later. Working to prevent that scenario is a Council priority shared by all of our member companies.

3 Escalation of tit-for-tat trade actions to restrict imports in the name of combating “market disruption” or fighting dumping Strong political pressures in the United States regularly demand tougher, more intense administration pursuit of such trade cases with China. Big issues impend on textiles and apparel, covered by those so-called “Textile Safeguard” clauses of China's final WTO accession package that the United States first negotiated with China in its earlier bilateral agreement of late 1999. High-visibility US antidumping cases, and even an effort to invoke US trade law to punish China's alleged currency manipulation, are under way. China has bristled at US measures taken or proposed, but has also invoked its own antidumping procedures with increasing frequency. No one talks about reciprocal retaliation, of course: each case is strictly “on the merits.” But hammering can become a way of life—and of making a living—and sooner or later the sound of the hammering can drown out normal conversation.

4 Longer term, the possibility of over-investment and overproduction in China, with implications for US commercial interests and the condition of the world economy Some US firms, seeking to define their opportunities in China

for the long haul and to plan their China investments in global long-term context, see such possibilities out on the horizon. China has known over-investment, glut, and shake-out before. What it can do to prevent it, especially as the government continues to loosen its grip on private economic decisions in the PRC, is a big question. With the transition from socialism to the market far from complete, the role of the state in preserving economic order competes with the necessity of relinquishing the state's grip on the economy in complex ways that every US company in China encounters sooner or later.

5 A lurking uncertainty about the longer-term distribution of global economic resources and economic power Even the most sanguine observers of China's rapid movement to the front ranks of the world's trading nations struggle to define the long-term impact of China's arrival upon the system it has entered so well in the space of a few years. China, for its part, has coined the term “Peaceful Rapid Emergence” and has acted in a manner designed to show that its entry creates benefits for all—neighboring states, trading nations able to penetrate China's large markets, and multilateral economic bodies benefiting from China's overall commitment to stable global institutions. But anxieties persist and grow, as in the sudden re-ignition of a hoary US debate over the future of the American manufacturing sector, or global speculation over the future of energy resources worldwide, or analysts' debates about the future of a global financial system in which the American economy is hopelessly in debt to foreign lenders like China and the Chinese economy remains burdened by behaviors and institutional weaknesses that it has found difficult to remedy.

In short, while September 11 has massively readjusted America's concerns in a dangerous world, pockets of concern persist in the United States about China's ultimate intentions and capabilities, both economic and military (for example, the US-China Economic and Security Review Commission, whose mandate from the US Congress is to clarify the links between US-China trade and economic relations on the one hand and US national security on the other, issues pronouncements that regularly veer toward pessimism).

Nevertheless, the bilateral relationship between our two great nations is operating far more smoothly, and the economic engagement of the United States and China has reached far more deeply, than we might have imagined only a few years ago.

As the two countries have expanded their engagement, including the economic and commercial activities that today practically join the United States and China “at the hip” (in the recent words of one senior US government official), keeping US-China relations—including trade and investment ties—on a stable trajectory is no less critical than it was when the trade and investment numbers were low. That makes it a top priority, always, at the US-China Business Council.

Some of the *China Business Review's* new airborne readers have been making the China trip for years, as our US-China Business Council's hundreds of corporate members have done. They know the need for vigilance, wide-ranging inquiry, and dependable research in a shifting economic and political environment. That's where the *CBR* and the Council come in. We hope our new friends will want, in turn, to come in to our magazine and to the US-China Business Council for the long haul. 完

GOING WEST:

A PROGRESS REPORT



Catherine Gelb and Dennis Chen

For the last four years, the PRC government has been touting its Great Western Development Strategy (GWDS), an effort to improve the living standards of the 367 million Chinese, more than one-quarter of China's population, who live far from prosperous coastal China. The strategy has included massive government funding of new infrastructure, efforts to improve the poor state of the region's environment, encouragement of local industrial growth based on local resources, development of local high-tech capabilities, and efforts to attract foreign investors.

The admittedly long-term strategy has nevertheless had decidedly mixed results so far from the perspective of the foreign investor looking at the region as a potential investment destination. Infrastructure construction has been significant and in many cases has successfully modernized parts of the region, but transportation costs are still high and transport networks are still unreliable. The environmental awareness of officials, according to foreign investors based there, has improved, at least in major cities, but varies from district to district. Industries based on the region's rich store of natural resources are growing, as are sectors such as autos, which have a long history in the

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WESTERN CHINA



AFTER FOUR YEARS OF CENTRAL GOVERNMENT ATTENTION AND FUNDS, CHINA'S INTERIOR HAS MADE SOME PROGRESS—BUT NOT ENOUGH TO LURE SUBSTANTIAL FOREIGN INVESTMENT

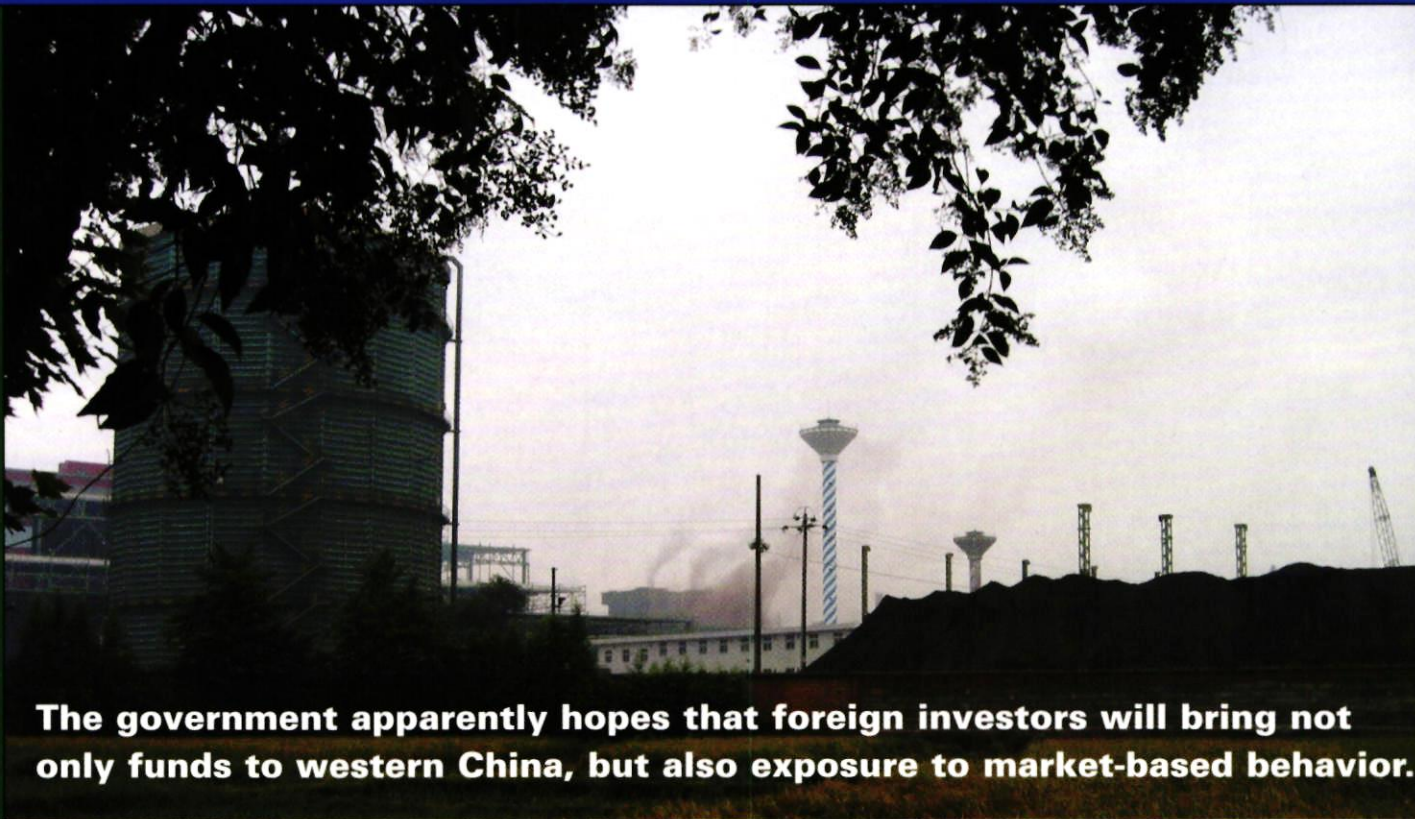
west, but attention to foreign investors' needs is uneven. Universities in major western cities, such as Xi'an, Shaanxi, and Chengdu, Sichuan, are established sources for engineering talent across China, but companies are still struggling to find and keep capable, bilingual staff. And although some high-profile, high-tech ventures were announced in 2003, foreign investment flows into western regions are still weak.

The western development story

Over the past two decades, China has gradually opened its economy to market-based commerce and foreign investment. Most of these efforts have focused on eastern China, particularly the coastal provinces. As a result, living standards of coastal residents have risen. But in China's hinterland, poor infrastructure, a much larger

rural population, and firmly entrenched government interests meant that the central government's economic liberalization policies did not extend to the residents of China's interior provinces. After many years during which the interior fell further and further behind, the PRC government realized that the imbalance in economic and social development posed a threat to the health of the overall economy and stability of the country and decided it was time to narrow the gap. The government's solution was the GWDS, covering one province-level municipality and 11 provinces and autonomous regions: Chongqing, Gansu, Guangxi, Guizhou, Inner Mongolia, Ningxia, Qinghai, Shaanxi, Sichuan, Tibet, Xinjiang, and Yunnan.

The overarching goal of the GWDS is to eliminate poverty in the western provinces and significantly reduce the development disparity between the east and the west



The government apparently hopes that foreign investors will bring not only funds to western China, but also exposure to market-based behavior.

by the middle of this century. The Tenth Five-Year Plan (FYP, 2001–05) official goals are to

- Invest heavily in infrastructure, from water resources, transportation, and energy to telecom.

- Reverse or at least halt environmental deterioration and prevent pollution in the upper reaches of the Yangzi River and Three Gorges area, as well as along other rivers located in the western provinces.

- Improve the competitiveness of agricultural products, mineral resource projects, tourism, and high-tech industries.

- Raise education levels and improve the quality of human resources.

- Make significant improvements in the infrastructure of provincial capitals and urban facilities of smaller cities and towns.

- Establish a modern corporate system in large and medium-sized state-owned enterprises (SOEs) and significantly reduce the proportion of state capital in these SOEs.

- Significantly raise the western provinces' proportion of national foreign investment and trade volumes.

- Supply rural residents with adequate food and clothing, ensure that the living standards of urban residents in the interior reach the "well off" (*xiao kang*) level, and prevent the east-west income gap from widening further.

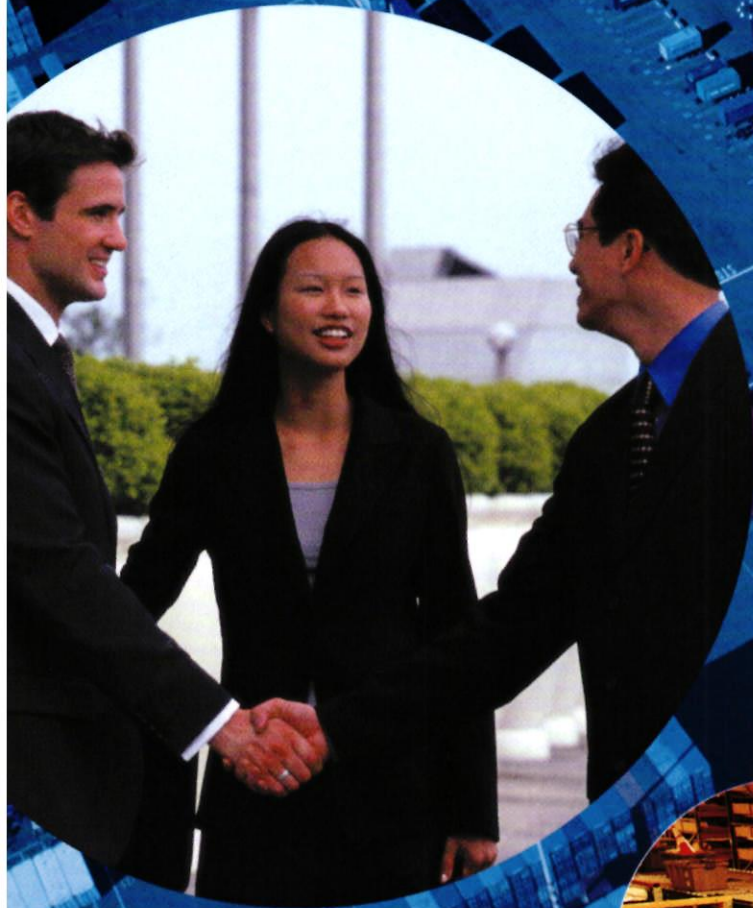
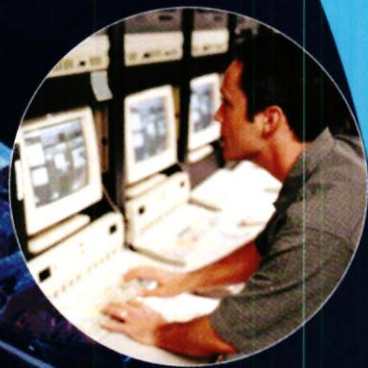
Separately, the government is maintaining the numerous incentive policies instituted in 2000 to attract investment to the interior. The government apparently hopes that foreign investors will bring not only funds but also

exposure to market-based behavior, exposure that might help government officials in the region appreciate the benefits of market-based, as opposed to government-promoted, economic growth.

First, the central government is increasing its budget for investment in key projects in the interior, disbursing more loans from state policy banks, and encouraging lending from international financial organizations and foreign governments for projects in western China. The government will also encourage PRC commercial banks to provide more loans (evaluated on their merits, the government is careful to note) for the construction of infrastructure projects like railways, trunk roads, and energy production and transmission.

Second, the central government is keeping a variety of tax breaks in place. Foreign-invested enterprises (FIEs) in sectors in which the government encourages foreign investment (according to the Catalogue Guiding Foreign Investment in Industry) benefit from a reduced income tax rate of 15 percent for the first three years after any existing tax break ends. With approval from the provincial government, enterprises in ethnic minority areas will be able to enjoy reduced income tax or be exempted altogether. New enterprises in the transportation, electricity, postal service, and radio and television sectors will be exempt from income tax for the first two years of operation and will pay only half of the normal income tax rate for the following three years. An enterprise in the western region that receives investment from an

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Western China used \$1.72 billion in FDI in 2003, a decline of 14 percent year on year; this total FDI figure accounted for only 3 percent of total utilized FDI in China.

existing FIE will enjoy all preferential policies for FIEs as long as the foreign investment stake in the new company is at least 25 percent. The government also issued the Catalogue of Encouraged Industries for Foreign Investment in Middle and Western Regions of China, which lists encouraged industries in 20 interior provinces and cities. Any FIE in an industry described in the catalogue will be exempt from tariffs and value-added taxes for equipment imported for its own use, as long as the value of the imports remains below the FIE's total investment amount.

Local governments and development zones also offer their own incentives; these vary from district to district and from project to project (see p.22).

The strategy in numbers

According to China's National Bureau of Statistics, from 1999 to 2002, the growth rates of GDP, per capita GDP, and fixed-asset investment in western China were slightly higher than the national rates, indicating that the western provinces are catching up in these areas, if slowly (see Tables, p.20). Between 1999 and 2002, China's GDP and per capita GDP increased by about 28 and 25 percent respectively, but the growth rates in the western regions are significantly higher than the national ones—about 31 and 30 percent, respectively. Only three western provinces (Gansu, Guangxi, and Yunnan) had growth rates of GDP and per capita GDP below the national growth rate—the rest exceeded the national rate. Of course, these figures must be taken with a grain of salt, as many economists have questioned the reliability of China's provincial GDP figures.

Even if the GDP and per capita GDP figures accurately reflect the massive infrastructure development that occurred between 1999 and 2002 in western China, this momentum has not

translated into a narrowing of the wealth gap between east and west. Urban per capita disposable income in the western region between 1999 and 2002 rose 26 percent, but this figure still lagged behind the national average urban income growth figure of 32 percent. (Rural incomes across the country grew only 12 percent during this period—one reason for the central government's recent focus on rural areas.)

The foreign direct investment (FDI) figures reflect the difficulties facing central and western local leaders in trying to convince foreign investors to take a chance on China's hinterland. Despite the incentives in place to lure foreign investment west, the share of China's total utilized FDI that flowed to western China actually declined in 2002, to 3.8 percent from 4.6 percent in 1999. This downward momentum continued in 2003. According to recent statistics from China's Ministry of Commerce (MOFCOM), the western regions used \$1.72 billion in FDI in 2003, a decline of 14 percent year on year; total FDI used by western regions accounted for only 3 percent of total utilized FDI in China. Gansu, Ningxia, Qinghai, Tibet, and Xinjiang received the least FDI in China in 2003 (Tibet has attracted no FDI in the past several years).

In contrast, foreign investors poured funds into China's coastal areas. In 2003, the five regions with the largest FDI inflows were Guangdong, Jiangsu, Shandong, Shanghai, and Zhejiang, all located along China's eastern coast. The total FDI used by these five regions accounted for nearly two-thirds of total utilized FDI in China last year.

A region in flux

To be sure, Chongqing and the western provinces and autonomous regions have some comparative advantages over the coast: a ready supply of educated workers who can be less expensive for some positions and proximity to abundant natural resources and second-tier consumer markets. Companies that are able to take advantage of these features and hold the attention of local officials can probably make a project work in western China (see p.14).

Indeed FDI, though still a small contributor to overall growth in western China, is increasingly visible in the major western cities, particularly in the high-tech and other industrial development zones. BP plc, Ford Motor Co., and foreign auto parts makers like Tenneco Automotive Inc. and Lear Corp. have set up in western China; Intel Corp. just announced a \$375 million chip testing and packaging facility in Chengdu; and Infineon Technologies AG

Continued on page 19



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Phase II : Apr.25-30, 2004

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» **Venue: CECF (Liuhua) Complex**

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Interview

Questions for a Venture Capitalist in Western China

A
businessman
working in
Chengdu talks
about the
opportunities
and pitfalls
of investing
in Sichuan

Scott Zheng (scott.zheng@wsif.net), a native of Fujian, received his MBA from Columbia University in the mid-1990s and after some time working as an investment banker in New York, found himself in western China in 2002. He is currently president and CEO of China Western SME Investment Corp., an offshore investment company that provides equity investment and investment consulting services to multinational and Chinese companies looking for cross-border transactions. Since founding the company in 2003, Zheng has invested in and founded Sichuan Top One Media & Culture Exchange Co., Ltd., a government and corporate event management company, and Chengdu Ice & Fire Technology Development Co., Ltd., an online chat and game company, and is in the process of helping prepare the overseas listing of a major Chengdu-based real estate company.

He was previously vice president at SEAF Sichuan SME Investment Fund, a Washington, DC-based, \$23 million venture capital fund with investment from New York Life International LLC and the International Finance Corp. At SEAF Sichuan he led the fund's first equity investment in Sichuan New Highway & Bridge Machinery Co., Ltd., and Chengdu Bangbangwa Foods. Before moving into venture capital, Zheng was an Asia-Pacific finance manager for Delphi Corp. in Shanghai.

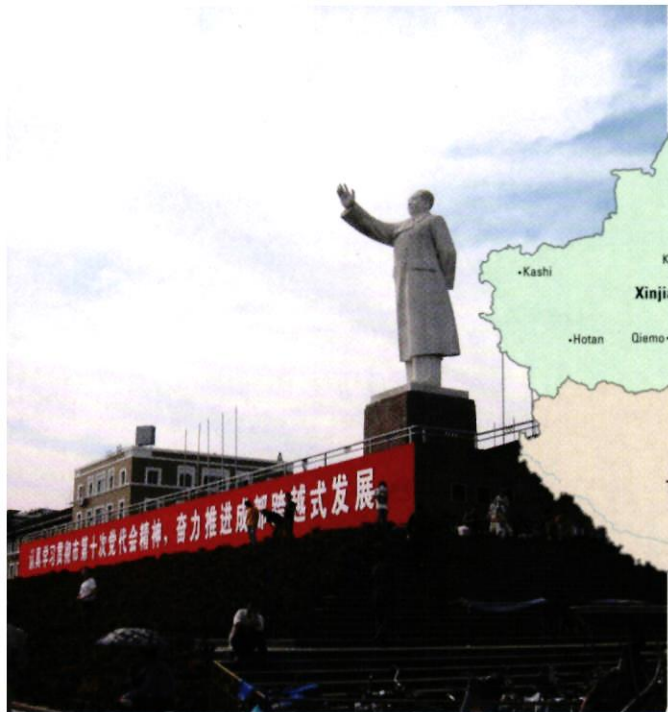
Zheng recently answered some questions posed by US-China Business Council Beijing-based Government Affairs Manager Dennis Chen and CBR Editor Catherine Gelb.

Q: How does the market in western China—specifically Sichuan—compare with the other parts of China in which you have worked? What are the most notable differences in the business environment there?

A: The market in the west is quickly catching up though it is still underdeveloped compared with other parts of China. This is partly because of the policy decision to open up the country to business gradually and partly because of a geographical barricade that had, in effect, "sealed" the region from the rest of China. This policy changed, however, when the Chinese government realized that the increasing divergence in economic development between the coast and the interior might plant the seeds of social instability.

The market in western China, and particularly in Sichuan, is somewhat unique. The province is endowed with abundant natural resources such as hydropower, various minerals, plants, and wild animals, plus good arable land and weather and so has historically been self-sufficient—and in fact ships much of its agricultural production and natural resources to other parts of China. I have seen businesses such as pharmaceuticals, mining, food processing, and processed agricultural products based on those resources flourish as a result of comparative advantage. The following aspects of the business environment differentiate Sichuan from the rest of China:

- An underdeveloped, large consumer market with potential purchasing power comparable to that of the Yangzi or Pearl river delta economic regions. In addition, consumerism and a relaxed lifestyle are deeply rooted among the population of 120 million people. This is particularly good news for indus-



tries such as consumer products, apparel and textiles, logistics and distribution, and tourism and leisure.

- Flourishing industries based on natural resource exploitation, rural and forest products, and pharmaceutical inputs extracted from plants or animals
- A lower-cost but well-educated and stable workforce
- A distinct Chinese cultural and historical heritage with great prospects for building tourism, museum, and art industries
- One of the largest transport infrastructure networks in China as a result of continuous investment in highway and bridges that link villages with cities
- A large base of ailing state-owned companies, and the legacy of the socialist “cold war syndrome” that “hides” key industries from the vulnerable eastern coast
- An improving legal and regulatory environment that still needs to catch up with more advanced regions elsewhere in China.

Q: What do you think are some of the region’s biggest challenges in attracting investors, both Chinese and foreign?

A: To compete with coastal regions for investment capital, Chengdu [Sichuan’s capital city] and Sichuan need to focus on their investment environments. Handing out lavish tax holidays and preferential treatment of all sorts is not sufficient to persuade serious investors to come, as other parts of China are offering the same. The government needs to think hard as an investor about how to reduce investment risk and increase investor returns.

In particular, the government needs to be concerned with the protection of investor interests.

Current legal and commercial regulations often confuse, and discourage rather than encourage, foreign and domestic private investment, though these hindrances may not be unique to Sichuan.

Second, the professional quality and working efficiency of government officialdom needs to improve in order to reduce investment risk. I have seen steady improvement in this regard.

Third, the government needs to create a level playing field for all businesses, Chinese and foreign.

Fourth, an area that is often neglected, the province needs to create a comparable living environment for expatriates and their families. Often, I have heard expatriates complain that there is no international high school for their teenage children.

Q: Over the past several years, the government has invested huge amounts of money into building highways in western China, and yet the media have reported that there is no traffic on some of these newly built highways. Do you think Sichuan still needs more highways to facilitate local economic development?

A: I think this is a classic case of misunderstanding the Chinese economy. The central and provincial governments do pour huge amounts of money into infrastructure. Over the next decade, the Chinese government plans to build roughly 42,000 km of new roads in south-western China. This figure will include around 3,400 km of new expressways and 1,600 km of “grade one” highways (similar to UK “A” roads). The remainder will largely be made up of lesser roads that will link smaller towns and villages to the main road networks. If the region is to catch up, highways and efficient logistics to move peo-

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ple, products, and machinery in and out are essential. As the province is currently characterized by its largely rural economy, it will take time for the self-sufficient economy to build its support networks up to a level able to offer business opportunities to outsiders.

Of course, there are problems with corruption and spending sprees in government-financed projects. And in fact as recently as two years ago, two consecutive provincial highway commissioners were charged with corruption and mishandling of construction funds.

Q: What are some promising industries, if any, that western governments should promote?

A: The industries that may be interesting to foreign businesses are forestry, consumer products, auto parts, energy (hydraulic power and natural gas), beverages, food processing, electronics, high-quality electronic components and products, pharmaceutical products and distribution, specialty packaging, leading local branded products including food, leisure business, and transportation, logistics, and distribution.

Q: Human resources are critical for economic development. How do you think the western provinces can stop the brain drain to the coast?

A: In the long term, I am not worried about this. Sichuan, especially the city of Chengdu, provides a low-cost but high-quality lifestyle that is competitive with the economically advanced coastal and major cities in eastern China. For example, rent for the same 60 m² studio apartment would probably be two to three times higher in Shanghai or up to four times more in Beijing than in Chengdu. But the salary of an educated white-collar worker in these coastal cities is only twice as high as that of a Chengdu white-collar worker. There is no shortage of qualified workers in Sichuan, as this province is home to a population of 130 million.

If there is a brain drain, the only way to stop it is through the creation of an efficient, competitive environment through which the growth of business will create demand for quality professionals who will come to western China—and stay there—to work for what they worth.

Q: Can you offer an example of a successful investment in the region, and why it was successful? Can you give an example of an unsuccessful investment?

A: Back when I was with the US venture capital fund, I led and participated in the fund's investments in two Chinese private companies. One was a highway infrastructure component maker and the other, a food processing company. Both companies are operating well and as planned in the investment memoranda.

An investor should look for companies with the following three primary characteristics: strong and honest managers, strong growth potential, and attractive entry multiples.

To be successful, an investor should never reduce screening criteria simply because of the fact that the companies under evaluation are located in inland provinces. Similar to any equity investment undertaken in the United States, an investor should look for companies with the following three primary characteristics: strong and honest managers, strong growth potential, and attractive entry multiples. (Entry multiples relate to how expensive the investment is to the investor. The higher the multiple, the more expensive and more risky to an investor.)

Our search emphasized especially companies with managers who were open, honest, and successful, and who recognized that they could profit from advice about aspects of their business in which they needed to improve their skills to grow, such as financial controls, marketing skills, cost accounting, and human resources management. It was hard work negotiating the deals but in the end, after screening out hundreds of companies, we were relieved and encouraged to find that there are good companies out there looking for smart equity capital and quality growth.

In contrast, the issue of control toppled an investment company with investors from Taiwan and the United States three months ago. The investors failed to hire the right person to lead the company to begin with, and probably chose the wrong local partners too, and then failed to install checks and balances in the investment company to prevent mismanagement. The investor should have adhered to the same rigorous investment practices typically adopted elsewhere.

Q: What approach or specific preparation is necessary before investing in the region in comparison with investing in coastal China?

A: Always, caution, attention to detail, and serious due diligence work are essential before making an investment, as respect for rule of law has not been completely established and law enforcement may take forever to implement. We have seen progress in this regard but thorough homework, including due diligence, is necessary. As a sophisticated investor, there is no excuse for not doing homework correctly. Often, people say: "Hey! This is

Often, people say: “Hey! This is China, things are handled differently here.” From my experience, this is not true.

China, things are handled differently here.” From my experience, this is not true.

It would be especially helpful in the due diligence process to find or team up with a trustworthy local advisor or seek help from established foreign chambers of commerce, or trading and investment representatives who are present in the region. As professionalism in Chinese CPA firms has significantly increased over the last two years, one of our approaches is to “borrow” the expertise of a reputable local CPA firm to conduct due diligence on a prospective company’s accounting books.

Compared with investing in companies in eastern China, a region that is more structured and documented, a vast number of western PRC companies function with short-sighted vision, meaning they operate without a business plan, without good business intelligence and market information, and under-invest in technology and people. And even what could be seen as basics, such as various corporate policies, are not in place. Therefore, quite often investors need to guide the western Chinese entrepreneur through number-gathering and business plan sessions in order to get as much information as needed.

Getting government help can be a double-edged sword. On one hand, administrative measures or personal gestures can be really effective and efficient. On the other hand, government may try to influence the decisionmaking process, which the equity investor may consider off-limits. In actuality, however, I prefer some level of government relationship and even personal friendship, as this can send a psychological signal to the investee: Do not mess with me. We have not used this tool for fire-fighting, but in status-conscious China, establishing

senior contacts and a wide relationship network could prove to be useful.

At the same time, abiding by government regulations and laws is important for foreign business survival. “Do the right thing rather than do things right all the time” needs to be remembered.

Other suggestions: Check on, and take advantage of, the various preferential treatment policies offered locally, such as tax holidays, export rebates, and tariff breaks, and even be prepared to apply for government funds when investing in the government’s “encouraged investment sectors.” These are some areas in which investors can strike bargains.

Q: You might have more career opportunities in China’s large, prosperous cities like Beijing and Shanghai. What made you decide to develop your career in Chengdu?

A: As the central government continues to reform itself and its management apparatus, the country is getting closer to a market economy. As a result, the opportunities for doing business are everywhere, so there is no lack of opportunities—but rather, a lack of people who can not only spot the opportunities but also make them reality.

Of course, Beijing and Shanghai are popular destinations for Chinese returning from overseas. There are many choices in life to make, and I like the opportunity to work in a less-developed region of China that promises greater growth and a better chance of making a real impact. Within my first working year in Chengdu, in September 2003 *West China Daily*, one of the two major local newspapers, awarded me “Excellence” status out of 41 West-China-based businesspeople nominated in its ranking of the “Top Ten Entrepreneurs,” in recognition of my investment work in Chengdu. I cannot imagine being awarded such an honor in a city like Shanghai or Beijing within a year of coming back.

Besides, Chengdu is a growing, fashionable city with distinct ancient Chinese culture and heritage. Within two hours’ drive of the city center, there are lots of historical landmarks and recreational activities. The government is currently broadcasting a tourism ad for Chengdu on TV directed by the renowned Chinese film director, Zhang Yimou. The ad’s slogan is: Chengdu is a city you would never want to leave, if you should ever come to visit. For me, this is true. 完

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Going West: A Progress Report

Continued from page 12

announced it was establishing an integrated circuit design center in Xi'an's high-tech park. Liberty Mutual Insurance Group also just launched its operation in Chongqing to sell property and casualty insurance. Many of these and other large-scale or high-profile foreign investors that have set up in western China have received the special treatment that comes with being a major local employer. Such strategic investments may yet yield benefits for these companies beyond the goodwill they establish with leaders in Beijing by setting up in a less desirable location.

But the GWDS has so far failed to make progress in many of the areas of greatest importance to investors, both foreign and Chinese:

● **Transport infrastructure** Despite advances in transport infrastructure, investors in the west acknowledge that transportation still accounts for a larger share of operating costs in the interior than it does on the coast, and that transport links still tend to be unreliable (see p.24). This may be less of a concern for manufacturers or service providers sourcing from, and selling in, local western markets, but higher-end goods like autos still must travel to the wealthier consumer markets on the coast. Transportation is also a problem for manufacturers who aim to export their products or who must source inputs from the coast or overseas.

Infrastructure improvements may accelerate in the medium term, though, as the Three Gorges Dam becomes fully operational, making inland shipping more efficient. New airports and eventually new air routes could benefit the western region as well.

A thornier issue is the development of efficient multimodal shipping options for inland-based companies. Multimodal transport requires cooperation among ministries and local governments that tend to resist such cooperation. It also requires consolidation of inefficient and protected industries like trucking, which has thousands of tiny fleets scattered around the country.

● **The environment** The central government's push to clean up the PRC environment has been espoused by local officials in major western cities. But as in eastern cities, the tendency is to relocate polluting industries outside of the city center—and then forget about them. That is, enforcement of the government's pollution laws runs headlong into local districts' desire for the tax revenue and employment that large SOEs in steel, chemicals, and other polluting industries offer. A foreign company that sets up a world-class facility with state-of-the-art wastewater treatment facilities may find that its

Transportation still accounts for a larger share of operating costs in the interior than it does on the coast, and transport links still tend to be unreliable.

neighbors are politically protected, polluting SOEs.

● **Government capabilities** Government officials in the western regions are much less familiar with the workings of a market economy than are their coastal counterparts. The slow or even nonexistent change in the mindsets of many local officials toward foreign investors may be the GWDS's most noticeable failure thus far. A recent Asian Development Bank report, *PRC: Attracting FDI to Western China* notes, "Many local officials are not only not convinced of the benefits of FDI, but are outright suspicious of it and view FDI as a zero-sum game—if the investor is gaining something then China must be losing."

The central government acknowledged the problem as far back as the 1980s, when it initiated a cadre-swap program in which some cadres from coastal areas were sent to help the interior areas for a couple of years, and officials in the western regions took jobs on the coast. The program has benefited some officials in western China, but the small scale of the program has limited its effect. How to train all the interior officials to be open-minded and forward-thinking is still a challenge for the GWDS.

Some foreign companies in western China praise the local officials with whom they deal as flexible and accommodating. Yet these companies tend to be the larger investors with the most tax revenue and employment prospects to offer local economies. Smaller foreign investors, or those without plans to expand their investment anytime soon, may suffer from the short-term focus of local government officials and their preoccupation with the largest taxpayers.

This short-sightedness has translated into a relatively weak set of investment incentives on offer for foreign investors in western China

beyond the national incentives offered to all foreign investors. Land costs remain relatively high, for example, and the focus is mainly on tax breaks rather than on providing services that meet investors' needs. Officials in some of western China's high-tech development zones and investment promotion bureaus appear to be showing greater flexibility toward potential investors, though they are only just learning about the full range of services they must offer investors to win their business.

The central government's plans to unify domestic and foreign corporate income tax treatment, moreover, could spell the end of the practice of offering special tax breaks to foreign investors. This makes the quality of government actions—from streamlining approval procedures to adopting policies that promote competition—all the more important.

● **Human resources** In western China, most colleges and universities are located in Sichuan and Shaanxi provinces, specifically in Chengdu and Xi'an. But many graduates seek jobs in Beijing, Shanghai, and other big coastal cities. At the same time, secondary education in the western regions has not yet adapted to meet the market's demands for skilled workers. The result is that the qualified managers or technicians willing to work in western China are in high demand among foreign investors, and problems with retention can be just as intense as on the coast. Training demands are also significant both for high- and low-skilled workers. And human resource issues can take up much of a foreign investor's time. Thus, though labor costs may be lower for some foreign firms in the interior, many others find few labor cost savings overall.

Western China in Numbers

GDP (RMB billion)

Year	Chongqing	Sichuan	Guizhou	Yunnan	Tibet	Shaanxi	Gansu	Qinghai	Ningxia	Xinjiang
2002	197.13	487.51	118.50	223.20	16.14	203.60	116.14	34.11	32.93	159.83
1999	147.97	371.16	91.19	185.57	10.56	148.76	93.20	23.84	24.15	116.86

Per Capita GDP (RMB)

Year	Chongqing	Sichuan	Guizhou	Yunnan	Tibet	Shaanxi	Gansu	Qinghai	Ningxia	Xinjiang
2002	6,347	5,766	3,153	5,179	6,093	5,523	4,493	6,426	5,804	8,382
1999	4,826	4,452	2,475	4,452	4,262	4,101	3,668	4,662	4,473	6,470

Fixed Asset Investment (RMB billion)

Year	Chongqing	Sichuan	Guizhou	Yunnan	Tibet	Shaanxi	Gansu	Qinghai	Ningxia	Xinjiang
2002	89.93	190.27	63.30	81.46	10.66	91.53	52.62	23.24	22.70	80.00
1999	52.53	122.44	31.19	66.40	5.36	58.78	35.55	11.72	12.81	52.67

Foreign Direct Investment (\$ million)

Year	Chongqing	Sichuan	Guizhou	Yunnan	Tibet	Shaanxi	Gansu	Qinghai	Ningxia	Xinjiang
2002	195.76	555.83	38.21	111.69	0	360.05	61.21	47.26	22.00	18.99
1999	238.93	341.01	40.90	153.85	0	241.97	41.04	4.59	51.34	24.04

Per Capita Disposable Income—Urban (RMB)

Year	Chongqing	Sichuan	Guizhou	Yunnan	Tibet	Shaanxi	Gansu	Qinghai	Ningxia	Xinjiang
2002	7,238	6,611	5,945	7,241	8,079	6,331	6,151	6,171	6,067	6,900
1999	5,896	5,478	4,934	6,179	6,909	4,654	4,475	4,703	4,473	5,320

Per Capita Disposable Income—Rural (RMB)

Year	Chongqing	Sichuan	Guizhou	Yunnan	Tibet	Shaanxi	Gansu	Qinghai	Ningxia	Xinjiang
2002	2,098	2,108	1,490	1,609	1,462	1,596	1,590	1,669	1,917	1,863
1999	1,737	1,843	1,363	1,438	1,309	1,456	1,357	1,467	1,754	1,473

Source: National Bureau of Statistics, *China Statistical Yearbook*, 2000, 2003

For expatriates, a western China position can be a significant hardship, particularly because of the lack of support services, such as international schools and expatriate-friendly healthcare facilities. This is starting to change, however, in the bigger western provincial capitals.

Slow and steady?

The GWDS is neither the first nor the last of the PRC government's efforts to direct economic and commercial development. Past efforts—even the government's first foray into “opening” China to commerce in 1980, the Shenzhen Special Economic Zone—have met with similarly lukewarm initial responses from investors until commercial circumstances made the investment location a compelling one or until the government sweetened the

incentive pot to make the new location more attractive.

The interior may yet, over the long term, come to benefit from the coast's success. For one thing, production costs on the coast are starting to rise, driving many manufacturers out of the major cities. Progress in infrastructure development, too, should improve transport and communication links, power sources, and other key support networks. And consumer markets in second-tier cities around China are becoming more appealing—and more accessible—to foreign companies as World Trade Organization commitments are phased in. In the short term, the income gap may remain wide, however. And the development of “softer” skills among the employment pool and bureaucracy may take time. The key may well be sustained government financial support for

Guangxi	Inner Mongolia	Western China Total	National Total	Western Growth Rate, 1999–2002	National Growth Rate, 1999–2002	Western China's Share of National GDP
245.54	173.43	2,008.09	10,479.06	30.79%	27.69%	19.16%
195.33	126.82	1,535.41	8,206.80			18.71%
Guangxi	Inner Mongolia	Average in Western China	National Average	Western Growth Rate, 1999–2002	National Growth Rate, 1999–2002	Western China's Percentage of National Average
5,099	7,241	5,792	8,184	30.30%	24.93%	70.77%
4,148	5,350	4,445	6,551			67.85%
Guangxi	Inner Mongolia	Western China Total	National Total	Western Growth Rate, 1999–2002	National Growth Rate, 1999–2002	Western China's Share of PRC Total
75.03	70.79	851.53	4,349.99	57.07%	45.71%	19.58%
57.88	34.82	542.15	2,985.47			18.16%
Guangxi	Inner Mongolia	Western China Total	National Total	Western Growth Rate, 1999–2002	National Growth Rate, 1999–2002	Western China's Share of PRC Total
417.26	177.01	2,005.27	46,877.59	9.14%	16.27%	4.28%
635.12	64.56	1,837.35	40,318.71			4.56%
Guangxi	Inner Mongolia	Average in Western China	National Average	Western Growth Rate, 1999–2002	National Growth Rate, 1999–2002	Western China's Percentage of National Average
7,315	6,051	6,675	7,703	26.32%	31.58%	86.66%
5,620	4,771	5,284	5,854			90.27%
Guangxi	Inner Mongolia	Average in Western China	National Average	Western Growth Rate, 1999–2002	National Growth Rate, 1999–2002	Western China's Percentage of National Average
2,013	2,086	1,792	2,476	11.70%	12.00%	72.37%
2,048	2,003	1,604	2,210			72.57%

concrete efforts to improve the interior's investment environment.

But the Chinese government is saddled with many other, arguably more urgent priorities—reforming the financial sector and shoring up the nation's frail social safety net are among the most pressing—and it is unclear whether the

government's commitment to western development will remain firm as reform of these and other weak sections of the economy intensifies (though an early 2004 plan to train farmers for off-farm jobs is encouraging).

Meanwhile, in late 2003, the Chinese government launched yet another regional develop-

Western High-Tech Zones

One example of the central government's effort to develop the west—the establishment of high-tech development zones in major cities—points out how far western officials have come, but also how much farther they must travel to catch up to their counterparts on the coast. The high-tech zones in Xi'an, Shaanxi, and Chengdu, Sichuan, for example, have both recently won major investments from foreign semiconductor manufacturers, but much of the foreign investment participation in these zones is in technology that is far from cutting-edge. The size of most investments has been relatively modest. And the number of foreign-invested enterprises (FIEs) within the zones remains far smaller than the number of Chinese entities.

The Yangling State Demonstration Zone of Agricultural High-Tech Industries

Yangling lies in the middle of the Guanzhong Plain in Shaanxi, 82 km from the provincial capital of Xi'an. The high-tech zone was established in 1997 in part to take advantage of the high concentration of academic resources in the area, including several agricultural universities and research institutes, which together employ about 5,000 research staff.

Yangling's "mission," according to zone officials, is to put agriculture-related scientific and technological resources to industrial use and to advance sustainable development of arid and semi-arid areas to help restructure the local agricultural sector and raise farmers' incomes. The overarching goal appears to be to create a self-sustaining local agricultural economy in western China.

The zone may well be more interested in this mission than in fashioning itself as an ideal location for foreign agriculture-related investment. Though officials are extremely helpful, and the zone offers the increasingly ubiquitous "one-stop shop" for investors, the large growth in output that the zone has achieved has been accomplished with little foreign involvement. Examples of foreign participation in the zone include Israeli technology at one Chinese-run firm that manufactures specialized sprinkler systems and imported American seedlings cultivated by one zone

enterprise that works to aid reforestation efforts across China.

Yangling is busy experimenting with new ideas and business models. One of these, called "Company + Experts + Farmers," has been used successfully by some local companies. Under this model, a company engaged in the raising of livestock hires experts to provide advice on scientific methods and also lends baby livestock to interested farmers to raise at the farmers' own barns. The farmers must follow the experts' instructions on how to raise the livestock. Once the livestock mature, the company takes them back and pays the farmers for "babysitting." This model seems to keep everyone happy, as the company can cut its overhead costs because it does not need to pay for any animal maintenance, the farmers don't need to worry about whether they can afford to buy their own stock and whether they can sell the adult livestock later for a good price, and the experts are paid for their expertise.

Enterprise and zone performance

- The zone is home to 600 enterprises with total registered capital of ¥3.5 billion (\$423 million). Of these, 15 are FIEs.
- Nineteen enterprises in the zone had registered capital of more than ¥50 million (\$6.04 million) each in 2002; 18 enterprises had annual revenue of more than ¥10 million (\$1.21 million).
- The zone's output has increased by around 20 percent on average per year, from ¥309 million (\$37.4 million) in 1997 to ¥805 million (\$73.6 million) in 2002. By the end of 2002, zone exports reached \$15 million.

Selected preferential policies

Yangling offers the national-level incentives for high-tech zones as well as a number of others, including

- An enterprise development fund, which will be used to subsidize FIEs in the zone for any income tax that exceeds 10 percent of their revenue after their first profitable year.
- A 20 percent business tax refund until 2005 for tourism and information consulting enterprises in the zone that have paid more than ¥500,000 (\$60,386) in business tax a year.
- Exemption from business tax for company or individual income obtained from technolo-

gy transfer, technology development, or services.

- Exemption from land-use tax for land used for agriculture, forestry, stockbreeding, and fishing.

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Xi'an High-Tech Industry Development Zone

Xi'an High-Tech Industry Development Zone (XHIDZ) was founded in May 1988 and was approved by the State Council in March 1991 as a national-level zone. XHIDZ is located in the southern suburb of Xi'an, home to numerous academic and research institutions. The zone, which has plans to double in size, is divided into sub-zones focusing on aviation science and technology, telecom, software, and startups by returned overseas Chinese, among others.

XHIDZ officials are keenly aware that they have tough competition for foreign investment. During a recent visit, they were open about the fact that Intel Corp. had chosen the Chengdu High-Tech Zone for its facility in western China. But they were proud of the Infineon Technologies AG project they had won and asserted that it was a better project, because it was bringing more sophisticated technology into China.

Some Chinese-run enterprises in the zone that have received foreign investment include Kaimi Co., Ltd., an environmentally friendly detergent manufacturer that also produces shower gels and other cosmetic soap products and that has started to export to Japan and South Korea (also the source of some of Kaimi's initial investment). And Xi'an Kong Hong Information Technology Ltd., an electronics enterprise that produces piezoelectric ionizers for air purification and piezoelectric ceramic transformers for use in consumer electronics, reports that it has received investment from the International Finance

ment effort, this one to "Revive the Northeast," China's rust belt, which is suffering from severe unemployment and rising social discontent. Government efforts to lure foreign investors to this troubled region may come at the expense of western China, especially because of the essential role of government funding in these pro-

jects and campaigns. The government's exhortations to investors to "Go West," then, if not backed by more substantial incentives and measurable improvement in the commercial environment, will not be enough to jumpstart western China's market for foreign goods and services. 完

Corp. and the Carlyle Group. The patented technology Kong Hong uses was developed at Qinghua University in Beijing.

Zone performance

- By the end of 2002, the zone had invested ¥14.75 billion (\$1.78 billion) in infrastructure.
- In 2002, revenue rose by a quarter, to ¥48.1 billion (\$5.8 billion) and GDP reached ¥11.9 billion (\$242 million), a 22.2 percent growth rate.
- The zone was home to 4,991 enterprises in 2002, of which 541 were foreign-invested.
- The top five foreign investment sources were Hong Kong (35 percent), the United States (24 percent), Taiwan (9 percent), the United Kingdom (9 percent), and Japan (6 percent).
- Leading foreign investors include Honeywell, NEC Corp., Fujitsu, Toyota Motor Corp., Dakin, Brother Industries, Ltd., Royal Philips Electronics NV, Robert Bosch GmbH, and Shangri-La Hotels and Resorts.
- Infineon Technologies announced in 2003 that it would set up an integrated circuit design center in the zone.

Selected preferential policies

In addition to central-government policies common to all high-tech zones, CHIDZ offers a number of other incentives, including

- An intellectual property rights fund to support patent, trademark, and copyright registration both domestically and abroad.
- A one-time award of ¥500,000 (\$60,386) for the establishment of a research and development center in the zone by one of the 500 largest enterprises in the world or top 10 enterprises global industry leaders.
- For investors in certain industries and at certain funding levels, preferential land prices. (Investors that commit more than \$100 million to the zone can obtain land for free.)
- Loan facilitation for small and medium-sized enterprises.

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Chengdu High-Tech Industry Development Zone

The Chengdu High-tech Industry Development Zone (CHIDZ) was established in 1991, like its fellow zones, to take advantage of the local educational resources, in this case those of Sichuan's capital. The zone received little support from the central government until the launch of the Great Western Development Strategy (GWDS)—yet the central government allowed all the national-level zones to offer the same incentives. The zone then had to distinguish itself from its rivals around western China.

Covering 67 km², the southern two-thirds of the zone consists of an R&D and business area, while the western section (about 20 km²) is a manufacturing base, mainly for information technology (IT) and modern Chinese pharmaceutical industries. Most of the companies in CHIDZ are in the IT and biomedical sectors. The zone has an incubator with 289 enterprises and "startup parks" for returned overseas Chinese and PhD holders. By 2002, 313 Chinese returnees and doctorate holders had launched 100 startup companies in the two parks. The first state-level export-processing zone in western China was set up in CHIDZ in 2000.

When asked what challenges the zone enterprises faced, officials noted that transportation infrastructure—distance from major markets—was a competitive disadvantage. But they added that many companies in the zone benefit from its relatively transparent services. Once the companies grow, they want to branch out, but often find it hard to get used to the "conservative mentality" of officials outside the zone.

Interestingly, the zone officials tout the leanness of their management (like several of its counterparts, CHIDZ provides a "one-stop shop" investors) and show flexibility that is not considered common among western PRC government officials. But paradoxically, they exhibit a minimal understanding of the kind of outreach necessary to lure foreign companies west, even as they express interest in marketing themselves to foreign investors.

Zone performance

- CHIDZ had attracted 4,200 enterprises with more than \$1.4 billion in investment from for-

foreign investors by the end of 2002, including Motorola Inc., Sumitomo Corp., Mitsubishi Corp., Corning Inc., and Compagnie Financière Alcatel.

- At the end of 2002, the zone had 480 FIEs. In 2002 alone, 51 FIEs signed contracts and 15 actually set up operations in the zone. In 2003, the zone won Intel Corp.'s coveted \$375 million semiconductor packaging and assembly project, reportedly the largest foreign investment project in western China, over Xi'an, Shenzhen, and Shanghai.
- Before the GWDS, the zone took in \$30 million in foreign direct investment (FDI) per year. In the years since then, the zone has taken in \$60 million—by mid-2003, the zone had contracted \$50 million in FDI.
- In 2002, the zone's value-added industrial output reached ¥16.8 billion (\$2.03 billion), up 25 percent, and total revenue was ¥47.2 billion (\$5.7 billion), an increase of 27 percent. CHIDZ was tenth in total output in 2002 out of 53 national high-tech zones.
- CHIDZ is the first high-tech zone in western China to have passed ISO 14001 and UKAS certifications.

Preferential policies

- Commercial banks in the zone are encouraged to give priority consideration to enterprises in the zone when providing loans.
- In 2003, the zone waived its application fee.
- The zone will cover or subsidize land-use fees for foreign companies that invest above certain levels and in certain sectors.
- According to zone officials, in addition to the preferential policies posted on the website, other preferential treatment can be discussed on a project-by-project basis.

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—Dennis Chen and Catherine Gelb



China's rapidly changing transport needs call for new strategies

CHINA'S Evolving

Transportation Sector

Alberto Nogales and Graham Smith

Transportation will be increasingly vital in China as the nation's economy continues to change from a planned, centralized system to one that is market-based and decentralized. To satisfy the rapidly changing needs of transport users, provide the necessary conditions for economic growth, improve access and mobility among the poor, and protect the environment, China will need to design and fund appropriate transport strategies.

China must address several key issues to reduce risks and bottlenecks in its transport sector.

Government and administration

China's government bodies need to adapt to their new roles as regulators. Because the central government has only limited powers over provinces and China lacks a single, national ministry responsible for all transport modes, the pace of administrative reform varies from province to province. And because government bodies have maintained a strong cultural reluctance to cross jurisdictional boundaries, services that require cooperation across such boundaries have developed slowly.

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The views expressed in this article are those of the authors, based on previous work at the World Bank's East Asia and Pacific Region Transport Sector Unit, and do not necessarily reflect the views of the World Bank.

China needs to introduce more efficient and sustainable modes of financing, such as a surcharge on auto fuel.

Regional disparities

Provinces along China's eastern seaboard have benefited from logistical accessibility and well-developed infrastructure, and have grown more quickly than their western counterparts. Current PRC government efforts aim to narrow the widening wealth and income disparities between the two regions by attracting more domestic and foreign investment to the interior (*see p.8*).

Shifting market needs

Shippers and passengers have more options now than ever before and are requiring faster and higher-quality services. Currently, however, some shippers resort to expensive and inefficient measures, such as operating their own truck fleets, to ensure quality service. As users demand better services, not only will infrastructure and other assets have to improve, but so will the capacity of operating companies to integrate services across transport modes and jurisdictions.

Specifically, road and waterway freight transport will take market share from rail—road transport because it can provide better door-to-door service and waterway transport because it is potentially cheaper for bulk products. Rail and buses' share of the passenger transport market will also shrink, as private car ownership and passenger air services grow.

Demand for container transport services will rise, since containers and multimodal transport reduce transport costs, facilitate global supply chains, and provide the reliable services and delivery that exporters and foreign investors depend on.

Road transport

The PRC government faces many new challenges concerning the nation's highways. While continuing to expand the expressway system, China would do well to focus on overall road network management and maintenance. Other key cross-jurisdictional coordination issues include improving the transport standards of western provinces and the management of entries and exits to cities, road safety, logistics, and land use.

China's road investment in 2002, including construction and maintenance, totaled roughly \$45 billion. These high levels of investment, which represent about 3.5 percent of the nation's GDP and have been maintained during the last five years, are exceptional (few countries ever spend more than 2

percent of their GDP on transportation). Yet funding for maintenance and construction of the secondary and tertiary networks remains inadequate. Additionally, the private sector's share of highway financing is unlikely to increase in the future. China, therefore, needs to introduce more efficient and sustainable modes of financing, such as a surcharge on auto fuel. (The State Council approved the gas surcharge concept in principle in 1999, but implementing legislation has yet

to be passed because of strong objections from many stakeholders. This reform will entail a far-reaching restructuring of several major tax revenue sources, public spending powers, and the balance between national and provincial mandates.)

Railways

The performance of China's rail system is, by international standards, very good, but the system needs to expand its capacity further, keep raising the quality of services, and acquire modern technology to remain competitive in the future. In the past, PRC rail management has tended to emphasize maximizing volumes carried rather than generating revenue or improving the value of services. But attitudes are changing.

The PRC government may find it useful to address these longer-term strategic questions: How much competition should be allowed among companies offering rail transport services (private or otherwise)? Can pricing be made flexible enough so that it reflects costs more accurately, permits fees on a service-by-service basis, and allows carriers and customers to enter into contracts that cover price and service quality? And what is the best way to handle surplus labor as information technology eliminates the need for many jobs? China opened its rail freight market to new private and joint ventures in specialized markets, such as container services, as part of its World Trade Organization entry. The playing field for such entrants would be more level if the state railway as an enterprise were legally separated from the ministry that regulates all operators.

Waterways

As China's economy matures and shifts toward manufacturing high-value intermediate and finished products, the primary sector (farming, fishing, forestry, and mining) and

construction will decline in relative importance, shrinking the market for inland water transport. The coastal provinces will feel this transition first. But inland water transport may continue to thrive for bulk cargoes, oversized loads, or dangerous cargo; it may even prosper in the coastal provinces—especially in river deltas—where no road or rail alternative is readily available. A niche market for containers may also develop in places where road and rail service is deficient. Taken together, the demand for transport on China's major rivers is likely to remain substantial for at least the next couple of decades.

To increase inland water transport efficiency, continuing channel upgrades and fleet modernization, including the use of separate barges and pusher units instead of self-powered small vessels, will be necessary.

Private funding may be crucial in meeting China's water transport demands, but further commercialization may be difficult because it implies an end to family-operated vessels, which are an important source of employment.

Air transport

Even though air transport makes up the smallest share of China's total freight transport, it is the fastest growing mode, with more than 2 million tons transported in 2002, compared with only 100,000 tons in 1980. And air freight is important for China's international trade since it allows quick access to China's two major markets—Europe and the United States. Chinese officials are aware that the rapid growth in air travel creates a need for strong infrastructure investment in the sector. Most government resources have been allocated to finance new runways. But as runway use and aircraft size increase, medium- and long-term investments will shift toward passenger terminals. In the past, most funding has been allocated to finance new airports, terminals, and other facilities to serve large cities in coastal provinces. Since the Great Western Development Strategy began in 2000, the government's attention has shifted to the needs of China's interior.

China's Recent and Planned Transportation Investments

The PRC government has actively stepped up its transport sector development to strengthen the country's economic growth and improve living standards.

Roads

China has, in the past, underinvested in roads; its road network still ranks among the sparsest in the world relative to geographic area and population. China's road network in 2002 extended roughly 1.76 million km, with some 25,130 km of expressways and about 27,468 km of other high-grade highways in operation.

Yet in recent years, governments at all levels have embarked on major highway investment programs. At the core of this program is the National Trunk Highway System (NTHS), a 35,000 km network composed of 12 major highways (five north-south corridors: Beijing-Fuzhou, Beijing-Zhuhai, Chongqing-Zhanjiang, Erliahaote-Hekou, and Tongjiang-Sanya; and seven east-west corridors: Dandong-Lhasa, Hengyang-Kunming, Lianyungang-Huoguoosi, Qingdao-Yinchuan, Shanghai-Chengdu, Shanghai-Ruili, and Suifenhe-Manzhouli) with an estimated cost of \$150 billion, connecting all provincial capitals and cities with populations exceeding 500,000 inhabitants (100 major cities). All sections of the NTHS will match US Interstate or European motorway standards.

By 2002 roughly 27,000 km, or 77 percent, had been completed. About 5,000 km are under construction now, while the remaining 3,000 km are yet to be built. The original target completion date for this program was 2020, but the government has since decided to push up the deadline to 2007.

Traditional funding resources are inadequate to meet the increasing demands that a growing economy places on road infrastructure. Financing for NTHS construction relies heavily on tolls to repay loans. The government's cash contribution has been raised from three earmarked road-user charges: the vehicle purchase tax (\$4.5 billion in 2002), the road maintenance fee (\$10 billion), and the highway transport management fee (\$2.5 billion). But altogether the charges only covered one-quarter of new construction expenditures in 2002. The road maintenance fee is inefficient, expensive to administer, easy to evade, and currently generates less than 40 percent of its potential. Of the revenue collected, only 60 percent is actually used for road maintenance; the remainder is spent on new construction. The 1999 authorization of a fuel tax has yet to be implemented.

Relative to most other countries in the world, private sector participation in the growth of China's highway system is extensive. Over the last decade, some 80 joint venture transactions between Hong Kong and mainland

developers and their mainland-counterpart highway agencies in 14 provinces have raised an additional \$9 billion from private sources. Further, asset securitization (the sale of highway equity through initial public offerings and private placements, as a substitute for long-term debt financing) raised another \$2 billion through 19 transactions by 2001. Altogether, though, private financing has contributed less than 10 percent of China's total commitment to new construction since the early 1980s.

Railways

By the end of 2000, China's rail system reached 68,000 km. The nation constructed 5,600 km of new rail during the Ninth Five-Year Plan (FYP, 1996–2000), an 8 percent increase over the five-year period. During this time, \$29 billion was invested in railway infrastructure construction—28 percent more than during the Eighth FYP (1991–95), which itself had set records for railway investment.

The nation's Tenth FYP (2001–05) proposes to expand the size of the rail network, speeding up railway construction in western China and adding capacity in the main corridors of the eastern network—notably to link Beijing and Shanghai. By 2005, the length of the national railway is expected to reach 75,000 km, extending the rail network in western regions by more than 2,000 km. The projects

Modernization of air traffic control in the coastal air corridors has begun in earnest. The next step will be expanding air routes as the demand for internal flights increases.

Urban transport infrastructure

Population growth and increased vehicle use are severely straining China's urban transport infrastructure. The last decade has thus seen a decline in mobility for most types of urban transport—especially bicycling and walking. As fast as ring roads are built, traffic expands to fill them. And the urban infrastructure planning process is neither comprehensive nor systematic. Traffic management and provisions for nonmotorized traffic are hampered by difficulties in cooperation between the police, who are responsible for road safety and traffic law enforcement, and highway departments.

China's urbanization and motorization growth rates have skyrocketed. The central government's current policies support both trends, which are expected to continue into the foreseeable future.

The World Bank's Current Lending Program for China

The World Bank's operational strategy in China is to support the nation while it makes two historic transitions: from a rural, agricultural society to an urban, industrialized society; and from a centrally planned economy to a more globally integrated market economy. The World Bank's lending program has evolved over time and is constantly adapting to fit the changing needs of China's transportation users.

The World Bank's portfolio for the transport sector in China is the single largest program in any sector worldwide. As of December 2003, the Bank had approved 61 projects (34 closed and 27 active) that totaled \$10.7 billion in the last two decades—an average of more than \$500 million per year. The World Bank invested in all transport modes except aviation. More than half of the total lending has been in highways (54 percent); more than one-fifth in railways (22 percent); more than one-tenth in inland waterways and ports (11 percent) and in urban transport; and the remaining 2 percent in mixed modes or container transport. The World Bank's Chinese transport clients have abundant access to other finance sources and borrow from the Bank mainly to enhance their access to international best practices in project management and transport operations.

—Alberto Nogales and Graham Smith

should create roughly 14,000 km of high-speed track—that is, with maximum speeds of 200–250 km per hour—across the national network, about 25,000 km of double-track lines, and 20,000 km of electrified lines.

After careful deliberation and analysis of international experience, the PRC government has adopted strategic goals for the national railway system, aiming to make it more responsive to market needs. The railway is spinning off nontransport subsidiaries as independent companies, and in certain regions has initiated pilot operations where passenger services are set up as profit centers separate from freight.

Waterways

China has large navigable rivers—especially in central and southern China—that link many of its major cities. Moreover, China's geography and the location of its population are exceptionally favorable to inland water transport. These features create the potential for inland water transport to claim a larger share of China's inland transport market, which today makes up roughly 10 percent of freight in tons and, because of the more efficient use of existing waterways, makes up 27 percent of the freight ton-km. Many rivers carry large volumes of bulk cargo that are hauled from rural to urban areas for process-

ing. On the rivers' upper sections, limited water depth prevents safe year-round access by vessels with capacity of more than 100 tons. But for a relatively modest cost, the navigation channels on these rivers could be deepened enough to enable much larger vessels to reach far upstream. An added advantage is that inland water transport creates less of an impact on the environment than rail or road transport. Accordingly, to ease the pressure of demand for new roads and improved railways, the government has recently increased investment in waterways to deepen navigation channels and upgrade navigational aids.

Air transport

Although central responsibility for airport development remains with the General Administration of Civil Aviation of China (CAAC), China's provinces are increasingly involved in detailed planning, construction, operation, and financing. CAAC will support between 20 and 60 percent of the total airport development cost, depending on the airport's role in the national hierarchy.

Air navigation is still the exclusive domain of CAAC and is likely to remain so for the foreseeable future. Although a plan for the development of air navigation facilities exists, there is no overall strategy for airport development.

Instead, each proposal is considered on its own merits.

Multimodal transport and logistics

China has for years maintained a hierarchical culture that resists crossing jurisdictional boundaries. This culture makes it difficult to take advantage of opportunities that require "horizontal" interaction—such as multimodal transport. Multimodal transport requires cooperation between providers of road transport and railways, which come under separate ministries and rarely interact. This may help explain why in 1999 China's logistics costs were estimated at 18 percent of GDP, high in comparison with the US share of 9.5 percent in the mid-1990s, but about average for a transition economy.

Transactions that are lengthy and costly to complete, high interest charges, and inefficient transport systems have contributed to China's high logistics costs. In developed economies, transport costs account for roughly one-quarter of total logistic costs, while China's transport costs in 1999 totaled roughly one-half of its logistics costs. Since 1999, big improvements have been made in both transport infrastructure and services in the coastal provinces, but the inland provinces are still lagging.

—Alberto Nogales

According to United Nations forecasts, China's urban population will increase from 30.2 percent of the population (319 million) in 1995 to 49.1 percent (712 million) in 2020. Car ownership is projected to increase tenfold from an average of 10 cars per 1,000 residents to 100 cars per 1,000 residents during the same period.

The road to success?

In the short term, if the government improves coordination between China's transport modes by creating a Ministry of Transport, develops an effective institutional and regulatory capacity, and creates a sustainable financing source (including a

China's Passenger and Freight Transportation Trends

Passenger traffic

China's highway passenger traffic surpassed railway passenger traffic beginning in 1990 when both modes experienced roughly the same traffic volume. Highway traffic grew more aggressively primarily because of its flexible networks and faster construction growth rates. If this trend continues, which is very likely, the 1980 modal split of railways and highways will reverse before 2005—the share of highways will reach 60 percent and the share of railways will fall below 32 percent.

Passenger traffic on waterways and aviation face opposite projections. While waterway transport volumes are shrinking, the aviation sector is increasing its share substantially.

Figure 1: China's Passenger Transport Evolution (100 million passenger-km)

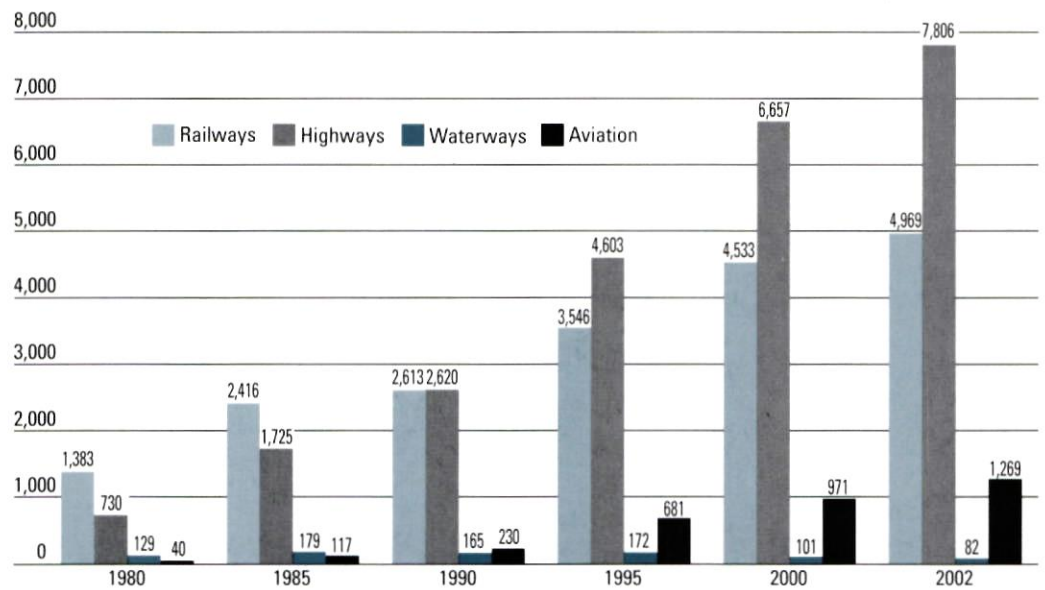
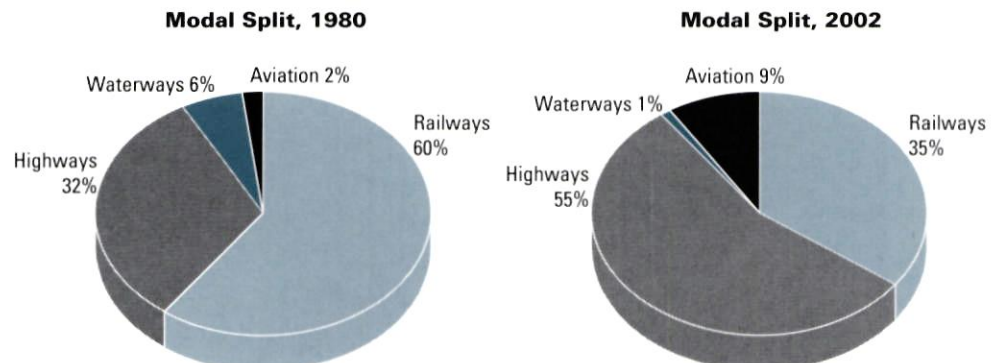


Figure 2: Passenger Modal Split, 1980 and 2002 (passenger-km)



Source: China Statistical Yearbook, 2003

fuel tax), it will achieve the ambitious goals defined in its current transportation plans. In the medium term, if China succeeds in maintaining high levels of investment in transport infrastructure and selects investments that will improve accessibility for lagging provinces, it will reduce the regional disparities between eastern and west-

ern China. But in the long term, only through improved transport logistics and trade facilitation, and directly supporting market-based initiatives for the provision of infrastructure and services, will China create a more favorable environment for private sector investments and be able to take full advantage of globalization. 完

Freight traffic

China's rail system has dominated the nation's freight transport market for years and will likely continue to do so given the size of its operations and lower costs. The nation's rail freight in ton-km almost tripled from 1980 to 2002. But the railways' share of the market has consistently dropped in favor of highways and waterways, which increased their shares by 12 percent and 8 percent, respectively, over the last two decades. This trend is partly explained by China's rapidly growing road network, which carried about six times more freight in 2002 than in 1980, and by more efficient use of existing inland waterways, which carried more than five times 1980's volume in 2002. The aviation sector, even though it has dramatically increased its volume, carries less than 1 percent of China's total freight.

Figure 3: China's Freight Evolution (100 million ton-km)

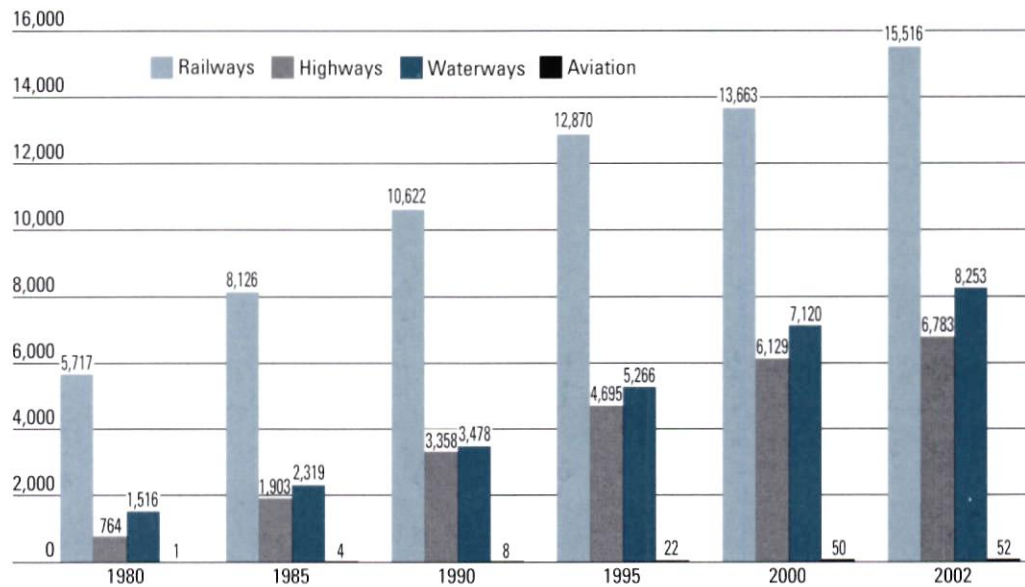
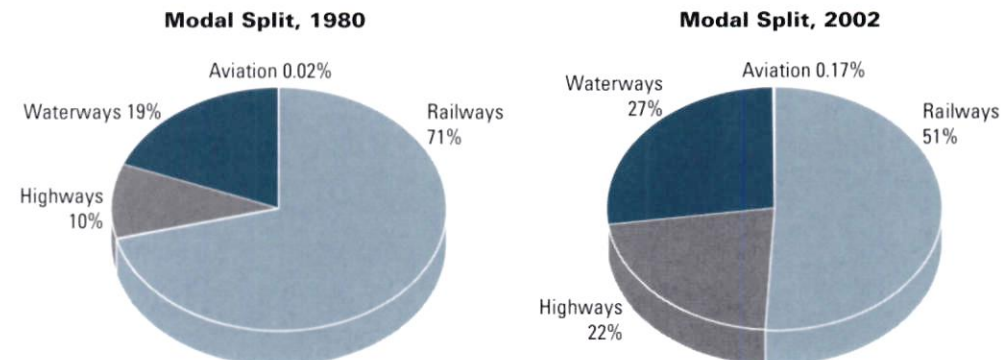


Figure 4: Freight Modal Split, 1980 and 2002 (ton-km)



Notes: Data excludes petroleum and gas pipelines; waterways data excludes ocean shipping. Domestic waterways freight estimated as 30 percent of total waterways freight.

Source: *China Statistical Yearbook, 2003*



BANK REFORM

How much time does China have?

Chi Lo

China launched an aggressive bank recapitalization program on January 5 by injecting \$45 billion from its \$400 billion-strong foreign exchange reserves into the Bank of China (BOC) and China Construction Bank (CCB), two state-owned banks preparing to list on foreign stock markets next year. The move is the first step of a strategy to spend more than \$100 billion in government funds to strengthen the big four state-owned commercial banks (the Big Four). The other two of the Big Four, the Industrial and Commercial Bank of China (ICBC) and the Agricultural Bank of China (ABC), are expected to be next in line to receive similar bailouts. The recapitalization is also part of the bank reform package that Beijing announced last December, which included raising the individual foreign ownership limit on local banks from 15 percent to 20 percent of total assets.



Chi Lo is author of the book *When Asia Meets China in the New Millennium*.



The continuing need for bailouts clearly indicates that bailout programs by themselves are not sufficient to reform the banks fully.

The continuing need for bailouts clearly indicates that bailout programs by themselves are not sufficient to reform the banks fully. Beijing is opening another round of financial reform, but the pressing concern is whether this round will work and whether China has enough time to fix its state-owned banks.

We can probably get a clue from its public debt picture. The situation at first glance looks grim: Government debt has surged in recent years—by 250 percent since 1997, from ¥550 billion (\$66.4 billion) to ¥1.9 trillion (\$229.5 billion) in 2002 (see Figure 1). This raises the fear that rising indebtedness will soon bring about a fiscal crisis and derail bank reform. The assumption is that Beijing's high debt load will block reorganization of China's insolvent banks because such a program will revolve around government borrowing. Such a view is wrong on two fronts.

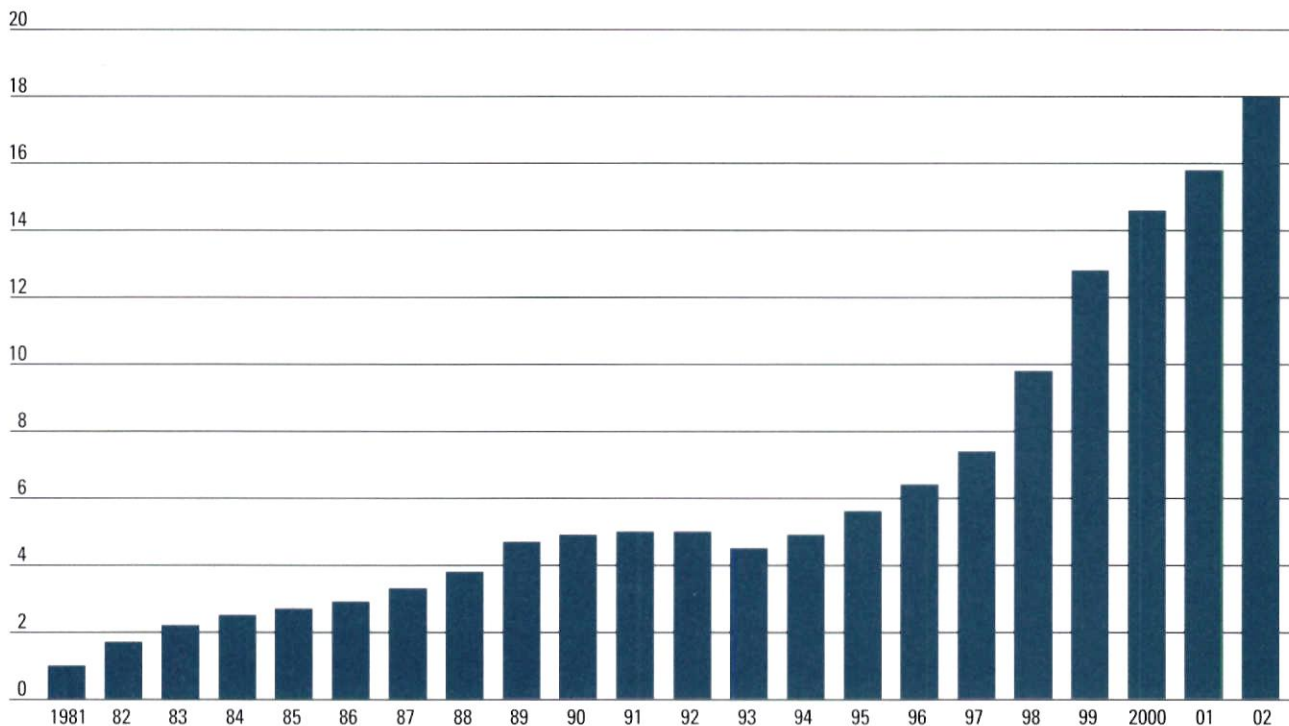
Recapitalization alone is not enough

First, China has already tried massive bank recapitalization, without success. That is why the government has been more hesitant this time around. Back in 1998, Beijing issued ¥270 billion (\$33 billion) in special bonds to recapitalize the Big Four. Then in 1999, it created four asset-management companies (AMCs)—Xinda for CCB, Huarong for ICBC, Dongfang for BOC, and Changcheng for ABC. The AMCs received ¥400 billion (\$48 billion) in seed capital from the Ministry of Finance (MOF) and issued ¥1 trillion (\$121 billion) worth of MOF-guaranteed bonds. They then used these funds to buy ¥1.4 trillion (\$170 billion) of bad loans from the state banks at face value.

But the program has failed to cure the banks' woes. Since 1998, the percentage of bad loans on the banks' books has not

Figure 1:
Public Debt Has Risen Sharply

Percentage of GDP



Source: Center for Electronic Information of China (CEIC)



China's public debt will remain stable for another three to four years, giving Beijing that much time to recapitalize and reform the banks without interruption from market volatility.

fallen much, and the AMC's have had limited success in recovering or selling off the bad assets. Meanwhile, corporate governance, transparency, and risk management at the Big Four have only shown slight improvement. Giving banks more money after they have piled up losses through imprudent practices thus risks creating a moral hazard situation in which they are encouraged to keep on lending recklessly.

Deeper pockets than you might think

Second, China's government debt levels are still low enough to afford further bank recapitalization. The 250 percent jump in government debt from 1997 to 2002 may seem horrifying, but the total debt-to-GDP ratio, as of 2002, was only 18 percent. Even with today's estimated total debt at about 25 percent of GDP, China's public debt is still far below the 60 percent threshold that the international community deems unsustainable for a healthy economy.

Further, despite the surge in debt, the cost of debt-servicing has plunged thanks to falling interest rates (see Figure 2). The government paid an average 9.4 percent coupon on domestic Treasury bonds issued in 1997 (it was above 10 percent before that). But the average interest rate on government debt dropped to only 2.4 percent in 2002.

Beijing now spends less on interest payments as a percent of total government spending than it did six years ago. It paid an estimated ¥65 billion (\$7.9 billion) in interest on domestic debt in 1997 and ¥100 billion (\$12.1

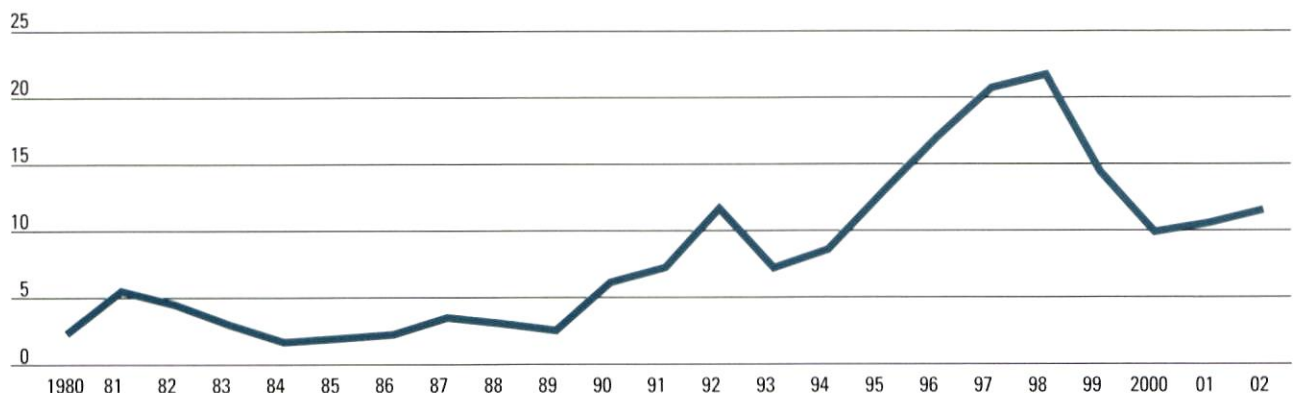
billion) in 2002. Granted, this is a 54 percent rise. But distributed over five years, the rise is not excessive, especially with strong economic growth averaging 8 percent each year. Furthermore, annual interest payments have been stable since 1998, ranging between ¥91 billion (\$11 billion) and ¥100 billion (\$12.1 billion), despite the surge in total debt. As a percentage of total government spending, total interest payments on domestic and foreign debts dropped from 7.6 percent in 1997 to 5.5 percent in 2002.

Critics fret that an eventual upturn in the interest rate cycle will crush Beijing's finances, as rising interest rates will raise the debt-service burden swiftly. But the impact of interest rate volatility on debt-servicing costs will be limited because of the recent changes in the term structure of China's public debt. The average maturity of Chinese T-bonds lengthened from 3.4 years in 1997 to 6.7 years in 2002, and most of these bonds carry an interest coupon of less than 4 percent. By extending the term structure, Beijing has effectively locked in three to four years of interest payments at less than 4 percent a year.

Hence, China's public debt will remain stable for another three to four years, giving Beijing that much time to recapitalize and reform the banks without interruption from market volatility. Incidentally, this time-frame coincides with China's promise to open up the banking sector to full foreign competition under its World Trade Organization agreement. But that also means that the government is racing against time. Four years is not a lot of time to complete the daunting task of bank reform.

Figure 2:
Total Debt and Interest Payments

Percentage of government expenditures



Source: CEIC

Strong medicine needed

The new bank reforms that Beijing unveiled on December 1, 2003, opening the sector further to foreign competition, are still too mild and limited in scope to fix the system within the timeframe imposed by the public debt constraint. The decision to put only two state banks in a pilot reform program indicates either complacency or reluctance to shake up the system.

It is also unclear how successful the new method of recapitalization will be. Rather than directly injecting funds, Beijing has established the Central Huijin Investment Co., Ltd. to effect the fund transfer and supervise the investment in the state banks. The central bank transferred foreign exchange to Huijin, which then used the funds to purchase equity stakes in the two banks. Huijin will recruit officials from MOF, the State Administration of Foreign Exchange, and the central bank for its board of directors. But it is hard to see how Huijin will be more effective than these entities, which already have full regulatory and supervisory responsibilities for the banks. To be effective, Beijing should appoint independent experts from both inside and outside China to Huijin's board to guide the recapitalization process.

Nevertheless, the bailouts are sorely needed. The Big Four, which account for almost 70 percent of total PRC bank assets, are technically insolvent. Their bad debts are estimated at 25 percent of total loans by the government, but private sector estimates put them at double that amount. Even under some optimistic private-sector estimates of a bad-asset recovery rate of 25 percent, a reduction of the bad-loan ratio to 12 percent within a few years, and a low capital-asset ratio of 3 percent (well below the Bank of International Settlements guideline of 8 percent, because state banks are underwritten by Beijing), the cost of bailing out the Big Four would exceed ¥2 trillion (\$241.5 billion), or almost 25 percent of China's 2003 GDP.

Given the depth of the problem, just repackaging the bad loans without addressing their root causes—lax accounting, policy lending bias, and poor corporate governance standards—will not work. Further recapitalization and the 5 percent increase in the individual foreign ownership limit of Chinese banks to 20 percent are also insufficient to fix state-bank woes without accompanying reform in the domestic capital market.

Without an efficient capital market, Chinese banks, as the primary source of capital for the economy, will continue to face policy lending pressure. And the stock and bond markets are currently both dysfunctional. The domestic stock market is rife with speculators and distorted by the government through its quota system on initial public offerings. Officials tend to favor the listing of loss-making state firms while keeping the jewels for the government, leading to an adverse selection problem in which only bad firms are selected for listing. The corporate bond market, on the other hand, suffers from thin trading, heavy bureaucratic control, and irrational pricing.

Solving insolvency

Control is the thorniest issue in banking reform, as the Big Four are fully government-owned. Even if the

banks are listed publicly, regulations dictate that the government maintain 75 percent ownership, making it difficult to establish a truly commercial culture at the Big Four. Their strategic importance as lenders to the state firms, which employ 85 million workers, also means politics and lending will remain entwined. Meanwhile, the state banks themselves are huge, with a workforce of 1.4 million and 116,000 branches nationwide.

The state banks' long history as the government's lending arm has also established the primacy of policy objectives such as social stability and equal income distribution over commercial objectives. As a result, the state banks have little experience with commercial practices such as managing risk and pricing capital. As a stopgap measure for financial reform, the banks are outsourcing the modern risk assessment process to foreign experts. But the system is still changing at a glacial pace.

Simply listing the banks in the domestic stock market will not solve this ownership problem. Unless capital can be allocated by market forces, particularly by freely adjusting interest rates, banks will be unable to make their own lending decisions based on proper risk analysis. But the government still sets bank interest rates, though it is slowly widening the band of allowable rates. Stock market reform is also necessary so that company performance can be adequately reflected in stock market valuations, which would lead to efficient capital allocation.

Greater foreign ownership may not necessarily improve banks' performance either, because the legal, institutional, and cultural infrastructure of the local system matter more to bank operation than foreign management. Beijing must ultimately end state control of the banks. But this, in turn, depends very much on stock market reform to inject market discipline into the system.

Don't forget the bonds

Capital market reform should also be extended to the Chinese corporate bond market. Beijing has so far used bond issues to help manage the macroeconomy, for instance, to soak up excess liquidity in the economy. But the corporate bond market, which provides fuel for the growth of the private sector, has remained minuscule and largely closed to foreign investors.

Corporate bond issuance peaked in 1992, with ¥681 billion (\$82.2 billion) issued. Last year, only ¥32.5 billion (\$3.9 billion) worth of corporate papers were issued. Though outstanding corporate bonds have risen from ¥52 billion (\$6.3 billion) in 1997 to ¥133 billion (\$16.1 billion) in 2002, they pale in comparison with the total ¥13 trillion (\$1.6 trillion) in outstanding loans in the banking system. The share of corporate bonds in the larger bond market is also dwindling, falling to 4.3 percent of all outstanding bonds last year from almost 7 percent in 1997.

Beijing has curbed the growth of the corporate bond market because of the high-profile scandals in the 1990s, most notably Guangdong International Trust & Investment Corp. (GITIC), which defaulted on \$4.7 billion in debts in 1998. The incident led to international

Continued on page 41

CASH Management for Foreign Investors

Shannon Cheung

Cash and treasury management in China has never been easy, even for top-tier multinational corporations (MNCs). Complex regulations, foreign exchange controls, a lack of tax and treasury consolidation mechanisms, limited investment products, unique operating conditions, and a developing banking and clearing infrastructure all inhibit the implementation of effective cash management techniques that are widely used in other countries.



Ways to make your cash management structure more effective in China

Nevertheless, China's financial system has developed significantly over the past few years, and many techniques that were once considered infeasible or difficult to implement are now possible. For example, until about two years ago, the prohibition of intercompany loans made cash concentration impossible in China and caused many MNCs to have massively inefficient cash management structures because excess cash in one group entity could not be utilized by another. But the introduction of renminbi (RMB) entrusted loans has now made intercompany loans possible and quasi-pooling arrangements feasible. (Entrusted loans are indirect intercompany loans, using banks as intermediaries. The entrusted loan does not sit on the balance sheet of the bank, and in return the bank levies a fee for the service.) Furthermore, in mid-2002 local banks were permitted to offer RMB overdrafts. By 2003, selected foreign banks, including HSBC, were also allowed to offer RMB overdrafts.

Further developments to China's banking infrastructure and regulatory framework are expected that will certainly make the job of a corporate CFO or treasurer easier.

Investment vehicles in China

In China, cash management cannot be looked at in isolation, but instead should always be considered along with other legal and tax issues, in particular the MNC's corporate structure. For foreign investors looking to establish an operating presence in China, three main forms of investment vehicles are available.

- **Equity joint ventures (EJVs):** EJVs were the earliest form of investment structure and have been available to foreign investors since 1979, when China opened its doors to foreign investment. A foreign-invested EJV is a limited liability company (with legal person status) established by at least one Chinese and one foreign investor. EJV partners appoint directors to the board and share

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profits according to the share of capital contributed by the respective investors.

● **Cooperative joint ventures (CJVs):** Compared with EJV, CJVs give investors greater flexibility in structuring their investments and in the distribution of profits. In contrast to an EJV, the method of profit sharing under a CJV can be prescribed in the CJV contract. CJVs can be either legal person or nonlegal person CJVs. The main difference is that nonlegal person CJVs are not limited liability companies and investors do not enjoy limited liability protection.

● **Wholly foreign-owned enterprises (WFOEs):** Since the Wholly Foreign-Owned Enterprise Law took effect in 1986, WFOEs have become an increasingly popular form of investment for foreign investors. A WFOE's registered capital is contributed solely by the foreign investor. WFOEs are generally more attractive in businesses that involve intellectual property rights and trade secrets.

How corporate structure affects cash management

For many MNCs with sizable operations in China, the need to form separate joint ventures (JVs) with different partners at different locations, limited business scopes, and different requirements for local registration has caused many to take on a complicated corporate structure. In certain cases, some corporate groups have more than 50 separate legal entities, some in the form of majority- or minority-owned JVs, others as WFOEs. In addition, though some entities are held directly under a China holding company, others may be directly held by off-shore special purpose vehicles, which are often set up to hold a company's China investment for tax reasons.

This fragmented structure presents a massive challenge to a CFO attempting to centralize and coordinate finance and treasury management initiatives, as well as standardize practices across group entities. Furthermore, the duplication of most core business functions, such as marketing, finance, information technology (IT), procurement, and administration is costly and inefficient.

Under such a decentralized setup, each entity may have negotiated independently with separate banks for facilities and services, resulting in different pricing and varying standards of services provided, with no central coordination of cash management initiatives.

From a legal and tax perspective, a group's entities are also considered to be separate, and there are no arrangements for centralized invoicing and shared services. Transactions between group entities are considered external and subject to value-added tax or business tax.

Thus, a number of leading MNCs in China have explored alternative structures to consoli-

date management of their legal entities; many have established holding companies for this purpose.

Solution? A holding company

Foreign-invested investment companies (more commonly known as holding companies) refer to enterprises set up with limited liability status that can engage in direct investment activities in China. Unlike other manufacturing and trading foreign companies, which may only conduct business in the place of their business registration, holding companies are permitted to invest in projects all over China. The establishment of holding companies was permitted in 1995, and since then, more than 200 foreign-invested holding companies have been established in China, mostly in Beijing and Shanghai.

In 2003, the newly established Ministry of Commerce took up the governance and regulation of holding companies and in June 2003 issued its first regulation, the Provisions on the Establishment of Investment Companies by Foreign Investors. Essentially, this regulation is a consolidation of several earlier ones. Though the conditions for forming holding companies remain unchanged, the new regulations expanded the permissible business scope, and foreign investors may now establish holding companies in a broader range of industries.

The requirements for establishing a holding company in China are high. In addition to a number of conditions on financial strength and investment capital contributed, foreign investors also have to commit \$30 million in fresh capital, to be paid up within two years after receiving a business license. Under the new regulations, this \$30 million may be used to purchase stock rights of domestic companies in China.

Holding companies can also provide centralized management and shared services to investee companies with a stake of at least 10 percent. Holding companies may only provide these services, however, subject to the unanimous approval of the board of directors of the investee company. Based on these rights, a number of MNCs are looking to expand the scope of operation of their holding companies to include trading, as well as treasury and cash management activities.

For example, holding companies may now sell products manufactured by their investees in domestic and foreign markets and provide after-sales services for these products. By acting as a principal in selling investees' products, holding companies can now centralize sales and invoicing of group products, presenting a "single face" to customers. This also enables companies with the right structure to manage and centralize their cash at the holding company level through leading and lagging techniques (adjusting the

Holding companies can now centralize sales and invoicing of group products.

timing of payment or disbursement to reflect expectations about future currency movements). Other MNCs have also taken advantage of the right to export products (for goods that are not subject to export quota and licenses) to establish an export procurement center under their holding companies. On the import side, a holding company can import goods worth up to 35 percent of its capital for the purposes of system integration and trial sale.

On the financial services side, holding companies may also provide operating leases of machines and office equipment to their subsidiaries. And as mentioned earlier, upon consent from the relevant authorities, the holding company can conduct intragroup lending and balance foreign currency among investee companies. But in reality, it is often difficult to obtain approval from the People's Bank of China and the State Administration of Foreign Exchange for such intragroup lending and balancing transactions.

It should be noted that holding companies are usually taxed at the full statutory rate of 33 percent, whereas manufacturing foreign-invested enterprises (FIEs) are usually taxed at much lower rates. Because tax and cash management are intertwined in China, companies should consider tax rates when designing their cash flow and trading structures.

Better cash management via corporate restructuring

Although the holding company presents a number of benefits in terms of centralized management and services, it has limitations, including difficulties in conducting intercompany finance and treasury activities, as well as other tax issues. As a result, a number of MNCs, even those with holding companies, are exploring ways to improve their intragroup cash management activities by streamlining their legal structure and consolidating the number of legal entities.

Ideally, the objective of many MNCs is to merge their units into a single legal entity with underlying operating branches. With this structure, because the various branches and the main entity are within the same legal entity, funds can be pooled and moved freely within the structure. If the entity is located in an area such as Shanghai where foreign banks are permitted to offer RMB services, it is also possible to have a foreign bank as a full-service partner by consolidating loans and cash management services with the foreign bank. Merging different JVs with dif-

ferent local partners to form a new JV can be cumbersome and complex, however.

The FICLS option

As a result, some foreign companies have formed foreign-invested companies limited by shares (FICLS) as an alternative. The FICLS is an increasingly popular form of investment that is allowed to list on China's domestic stock market and issue corporate bonds, subject to the relevant regulatory approvals. A FICLS is an enterprise legal person established in accordance with the 1995 Interim Regulations on the Establishment of Foreign-Invested Companies Limited by Shares. In essence, a FICLS is a joint-stock company with its capital divided into shares of equal amount and its shareholders bearing liabilities to the extent of the shares they hold. A FICLS must have minimum paid-up registered capital of ¥30 million (\$3.63 million, though this does not need to be fresh capital) and a minimum of five promoters or shareholders, with at least one foreign shareholder holding at least 25 percent of the capital (to maintain its "foreign-invested" status in order to qualify for preferential tax rates). The establishment of any company limited by shares, regardless of the amount of registered capital or foreign investment, requires approval from the Ministry of Commerce.

Unlike other forms of limited liability company such as JVs, a CLS may provide improved corporate governance and control to investors. For example, in a JV, the minority investor has pre-emptive rights with respect to the transfer of shares by the other investor(s), and its consent is required for certain key decisions, such as the increase and assignment of registered capital, merger, and dissolution. Passing any of these measures would require unanimous approval by all directors present at a board meeting. But for a CLS, the body with the highest authority is the shareholders' general meeting, and no issues require unanimous approval—in fact, two-thirds of shareholders' votes will decide the increase or assignment of registered capital, merger, dissolution, and other issues. In reality, however, the protection of minority shareholder interests can be negotiated and contained within the FICLS's articles of association.

Therefore, for corporate groups with multiple JVs with multiple partners, merging the different JVs to form a FICLS is more appropriate than establishing a multiparty JV. Eastman Kodak Co. and Unilever plc were the first companies to establish FICLS with local partners in China.

Nevertheless, it should be mentioned that tax implications and obtaining the necessary approvals involving cross-provincial mergers are potential stumbling blocks. And US-based MNCs should note that a FICLS is not a flow-through vehicle for US tax reporting purposes.

Other alternatives for liquidity management

MNCs that are not prepared to undergo complex and time-consuming restructuring can use other liquidity management tools, such as the entrusted loan, to improve their cash management. Other products, variations based on the entrusted loan legal framework, have since been developed to offer MNCs even more convenience in the administration and management of their liquidity.

HSBC, for example, has developed a product named Group Entrusted Loan, which is an extension of a plain entrusted loan arrangement, under which the bank provides corporate groups with a single multilateral entrusted loan arrangement to cover all their intra-group entrusted loan arrangements. Customers still initiate entrusted loans, which are sent to the bank via electronic banking, fax, or paper draw-down notices. The benefit is to reduce both administrative workloads by doing away with the need to have separate entrusted loan legal agreements prepared each time a transaction is executed, as well as to consolidate the payment of stamp duty on the entrusted loan master agreement. In addition to group entrusted loans, MNCs have also executed US-dollar entrusted loans among their group entities in China.

Regional headquarters and shared service centers relocate to China

In a landmark move in 1999, Compagnie Financière Alcatel moved its regional headquarters (RHQ) for Asia from Sydney, Australia, to Shanghai. Following Alcatel's lead, a number of other MNCs have relocated their Greater China or Asia-Pacific headquarters to Shanghai.

To facilitate and encourage MNCs to establish RHQs, the Shanghai municipal government issued the Interim Regulations to Encourage the Establishment of Regional Headquarters by Foreign Multinational Companies in Shanghai in July 2002. This piece of legislation offered a number of financial incentives, support in establishing regional and global procurement and logistics centers, as well as possible expanded rights in cash and treasury management. At the time of writing, 53 MNCs, including Delphi Corp., Exxon Mobil Corp., GE Plastics, Honeywell, Kodak, Siemens Mobile, and other MNCs from the United States, Europe, Japan, Indonesia, Hong Kong, and Taiwan, have applied for and received this official RHQ status.

In March 2003, the Shanghai government released the Implementation Guidelines on the Interim Regulations, in which the Shanghai government encourages commercial banks in Shanghai to provide financial services such as

settlement and foreign exchange, and more important, actively seek ways to support the cash management requirements of RHQs.

Along with the relocation of RHQs and regional functions to China, a number of other MNCs have also relocated shared service centers (SSCs) to China. These centers support the payment, treasury management, and accounting operations for multiple countries in Asia. Locating other data processing and call centers in China is also becoming a trend among corporate groups. One US MNC, for example, set up an SSC in Shanghai to support the payments, financial reporting, and cost accounting work of its operations in 17 countries. Another MNC set up an accounting center in Tianjin that supports accounting and payments functions for its operations in 13 countries in Asia.

There are three main reasons behind the relocation of such functions to China. First, for a number of MNCs, their business in China already occupies a significant portion of their Asian or global sales. Some MNCs also see China as their most important growth market in the world, so relocating such regional functions to China allows them to be close to their key or strategic market. Second, the PRC government offers incentives to relocate RHQs or SSCs to China. Finally, whereas it was once challenging to find the right staff for such service centers, today skilled, multilingual labor (e.g. English-speaking staff in Shanghai, Japanese- and Korean-speaking staff in Dalian, Liaoning) are now available at comparatively low costs.

Corporations must consider business scope issues before setting up an SSC, as the State Administration of Industry and Commerce might query whether the entity housing the SSC is engaging in business outside of its permitted business scope. If they use holding companies, MNCs should bear in mind that services can only be provided to investee FIEs with at least 10 percent shareholding and that unanimous board approvals from investee companies are required.

Let the cash flow

China has been successful in attracting a large number of foreign investments in recent years. Previously, investors tended to set up manufacturing entities for export, but a growing number of investors has been investing to take advantage of the expansion and opening of domestic markets.

China's cash management market in the past was characterized by a dearth of innovative ideas and solutions, but is improving with steady deregulation and the introduction of new products. With the deadline for national treatment for all foreign banks looming in December 2006, the banking sector will see even more significant changes in the coming years. 完

One MNC set up an accounting center in Tianjin that supports accounting and payments functions for its operations in 13 countries in Asia.

Shanghai's Loan Syndication Market: **PAST AND PROSPECTS**



Shanghai's banks are taking on increasingly complex transactions

Zheng Yong

In recent years, the size of corporate and government borrowing in China has grown sharply, making it difficult for single banks to cover whole loans independently while maintaining adequate capital levels and risk profiles. As a result, syndicated loans have emerged as an important source of funding in China.

A syndicated loan is a loan facility provided under one loan agreement, with certain negotiated terms and conditions, by a group of financial institutions led by one or more arranging banks. Each of the participating banks commits part of the loan, and one agent, usually a lead arranger, takes charge of the loan operation. Not only does the syndicated loan simplify large-scale funding for borrowers by providing a single contract and point of contact, but it also enables the borrower to establish relationships with more banks.

Loan syndication is a core business in all of the large, international commercial banks. Loan syndication thus follows a process well-established internationally. This includes analyzing

the financial market, identifying customers, building customer relationships and offering advisory services to win the borrower's allegiance, launching the syndication, arranging the distribution, and if necessary, selling the loan in a secondary market. Meanwhile, banks constantly formulate new structures for syndicated loans to meet borrowers' diverse demands. This is particularly true of Chinese banks. Early syndicated loans in China had simple structures, but lending practices have evolved along with business requirements, with the result that larger PRC banks now offer limited recourse loans, loans structured for joint ventures, and even loans with custom-tailored features.

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This article expresses the author's own views and not necessarily those of CCB.



Loan syndication timeline

Loan syndication first burst onto the Shanghai scene in the late 1980s. In 1987, Sinopec Shanghai Petrochemical Co. Ltd. borrowed around \$250 million through international syndication to fund its 300,000-ton ethylene project.

International banks such as Citibank, NA and Industrial Bank of Japan (IBJ, now part of Mizuho Financial Group) were chosen as lead arrangers of the transaction on one side, and China Construction Bank (CCB, then known as People's Construction Bank of China) was the borrower bank on the other side. CCB signed loan agreements with the international banks and then, as the on-lending provider, signed the final loan agreement with Shanghai Petrochemical. This syndication not only gave the project the financial support it needed, but proved to be a milestone for PRC investment and finance systems.

Prior to the Shanghai Petrochemical deal, projects in China were financed by the PRC government according to government plans, with banks playing the role of cashier and accountant. This transaction, which involved more than 40 international banks, showed that Chinese commercial banks could coordinate with the international financial market—and laid the groundwork for further investment and finance reforms.

In the early 1990s, the demand for foreign currency in Shanghai real estate and government-sponsored manufacturing developments expanded the local loan syndication market greatly and spurred the participation of major banks, including CCB, Bank of China (BOC), and Industrial and Commercial Bank of China (ICBC) on the domestic side and Crédit Lyonnais SA, ABN-AMRO Holding NV, and others on the foreign side. An early example is the first Oriental Pearl Tower Project syndication in 1991, one of the few at that time to involve both renminbi (RMB) and foreign currency. Borrowing in both RMB and US dollars allowed domestic and international procurement, although with the PRC's

Major domestic banks and firms have become more familiar with syndication, while supervising agencies, commercial banks, and even some large-scale enterprises have started to make use of professional talent teams.

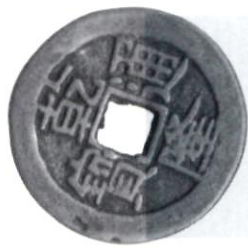
more recent liberalization of the current account and foreign exchange, the choice between RMB and US dollar denomination now hinges largely on movements in the exchange rate. The Oriental Pearl Tower transaction was guided by the central bank's Shanghai branch and co-arranged by CCB and ICBC acting as the RMB and foreign currency agents, respectively.

But pools of capital accumulated in large commercial banks and new financing channels opened via trust companies and China's B-share stock market, leading to a decline in the Shanghai loan syndication market from 1993 to 1996. While some international banks continued to set up syndicated loan facilities, such as those for the Shanghai Dachang Water Plant Project and the Shanghai Zhabei Power Plant Project, lead-arranged by Barclays plc and Standard Chartered plc, respectively, the domestic banks pursued RMB and US-dollar bilateral loans rather

than syndicated loans.

Two successful deals in the late 1990s breathed new life into the Shanghai loan syndication market. In 1997 and 1998, CCB successfully arranged two foreign-currency syndicated loans for Shanghai Petrochemical's ethylene expansion project. Participants, besides CCB, were all Chinese branches of foreign banks such as Chase Manhattan (now part of JP Morgan Chase & Co.), IBJ, Deutsche Bank AG, and Sumitomo Bank (now part of Sumitomo Mitsui Financial Group). The deals were CCB Shanghai's response to continuing market reforms. After Shanghai Petrochemical became an H-share company, it was able to borrow US dollar funds directly from international banks. CCB Shanghai thus changed its strategy to work together with international banks by way of syndication. The successful results of the two deals, together with continued changes in the market, renewed other domestic banks' interest in syndicated loans.

Local expertise also deepened as deals grew more complex. The Shanghai GM project was built in 1998 using limited-recourse project financing. Led by Citibank and co-planned



CCB and ICBC spearhead loan syndication among domestic banks while Citibank is the most active foreign bank in the local loan syndication market.

by the project sponsors, General Motors Corp. and Shanghai Automotive Industry Group Corp. (SAIC), this syndicated arrangement was classified into an RMB long-term loan facility, a US dollar long-term loan facility, and a working-capital revolving facility. ICBC, BOC, CCB, and other large domestic banks, together with SAIC's finance arm, Shanghai Automobile Finance Co., took active roles in the syndication arrangement, while the Shanghai branch of the State Administration of Foreign Exchange did much of the coordinating work. More than 40 financial institutions from China and abroad participated in this transaction.

A maturing industry

The pace of loan syndication has recently quickened.

- In January 2002, a \$1.8-billion syndicated-loan facility for a 900,000-ton ethylene project in Caojing, a petrochemical industry park in Shanghai, was established. The project, jointly sponsored by BP plc and Sinopec, is one of several important investments in this new industrial park. All the main local banks—Agricultural Bank of China (ABC), Bank of Communications, BOC, CCB, and ICBC—took part in both the RMB and US dollar transactions, while HSBC and IBJ, the only two foreign banks involved, covered a segment of the foreign-currency financing.
- Several other syndicated loans were completed in late 2002 and early 2003, including the Grace Semiconductor Project and the ¥7.5 billion (\$905.8 million) syndication for the Shanghai Deepwater Port Project, both lead-arranged by CCB, and syndication for the Krupp Stainless Steel Mill Project phase II.1, lead-arranged by Kreditanstalt für Wiederaufbau and ABC.
- In late 2003, ICBC, CCB, BOC, and three other local banks arranged a syndicated loan of 65 billion Japanese yen for Shanghai SVA-NEC Liquid Crystal Display Co. Ltd.'s TFT-LCD project.
- As the *CBR* goes to press, CCB Shanghai is arranging a syndicated loan facility for a power station project in Shanghai, which is expected to close in the first quarter of 2004.
- Some local banks also took part in syndicated loan transactions arranged in the Hong Kong market in 2003, which showed not only the

funding strength of these banks but also the marked improvement in PRC banking skills.

The Shanghai syndication market and its participants have begun to mature through these successful experiences. Major domestic banks and firms have become more familiar with syndication, while supervising agencies, commercial banks, and even some large-scale enterprises have started to make use of professional talent teams. Local law offices and some other agencies are also emerging as players and are learning to work together with their international counterparts. International banks of course play an important role in the market's development, bringing in new ideas and concepts and arranging numerous foreign investment projects in Shanghai with local banks' support and participation. CCB and ICBC spearhead loan syndication among domestic banks while Citibank is the most active foreign bank in the local loan syndication market.

Still room to grow

Compared with those of other financial centers, though, Shanghai's loan syndication market still falls short. One problem is that there is only a primary market for debt in Shanghai. A secondary market to allow banks to transfer or assign their lending portfolios is nonexistent, locking lenders into rigid capital terms, interest rates, and risk levels while market conditions continue to evolve.

Another problem is a lack of communication among banks. While Hong Kong has media dedicated to the Asian bond and loan market, such as the magazine *Basis Point*, Shanghai's banks have no equivalent publication and consider the price of *Basis Point* prohibitive. An open and transparent channel to publicize credit market information must be established to create a benchmark for the pricing and terms of lending.

Today, Shanghai is planning to build itself into an important financial center, first nationally and then internationally. Before this can happen, China's legal framework and banking practices need to be reformed. As for the syndication market, unreasonable rules and regulations need to be revised or improved, and banks' processes for syndication formation, setting of commissions, and roles in syndication should all be brought into line with international practices. 完

Bank Reform

Continued from page 33

criticism of GITIC for misleading creditors into believing the central government had guaranteed GITIC's debt when it had not.

More crucially, the central bank's strict control over interest rates makes it impossible to price corporate bonds according to market forces and credit risks. Other problems also include the lack of a strong bankruptcy law and huge default risk. And Chinese state firms (the largest borrowers of capital) have access to cheap money via the banking system and the domestic stock market, so they have no incentive to tap the bond market for funding.

The State Council has recently announced its intention to strengthen the corporate bond market—and capital markets in general—but implementation plans are not yet apparent. Beijing will need to liberalize the embryonic corporate bond market by cutting red tape (notably the seven agencies in charge of approving new bonds), relaxing interest rate controls, and strengthening independent credit rating agencies. Only when these

steps are taken effectively will a strong secondary bond market emerge.

Racing against time

China's window of opportunity for bank reform is closing rapidly. Recapitalizing the banks, identifying the bad loans, and spinning them off to the AMC's is the easy part of reform. But these moves are not sufficient to cure the banking sector's ills. As an exit strategy for recapitalizing the banks, Beijing must also act decisively to create an environment in which AMC's can sell off bad loans to recoup their losses. All this will involve fundamental reforms to the legal system, institutional framework, and corporate culture.

At the same time, China needs to reform the capital market both to fuel the growth of the private sector and resolve the political ownership of the banking sector. With less political intervention and more credible financial data, banks will have a better chance to run loan books on a commercial basis. Such market discipline is a prerequisite for the ultimate success of banking reform. 完

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MIGA in China

Political risk insurance helps investors push projects ahead

Angela Gentile and Philippe Valahu

Investing in a developing country can be a daunting experience. In addition to commercial risks faced by all projects, doing business in an emerging economy can bring added risks, real or perceived, of an undesirable political event that many investors are simply not prepared to deal with on their own. These issues have gained even more prominence in recent years, as concerns about borderless wars, financial crises, and terrorism dampen investors' appetite for risk-taking.

Reducing risk

Political risk insurance is an important instrument for equity investors and financiers concerned about mitigating noncommercial risks. A number of entities, both public and private, offer such insurance. Of these, the Multilateral Investment Guarantee Agency (MIGA), a member of the World Bank Group, offers a type of security unavailable anywhere else. MIGA may be of particular interest to US investors in China, as the Overseas Private Investment Corp., a US government agency that offers services similar to those of MIGA, is currently prohibited from operating in China.

Created in 1988 with \$1 billion in capital, MIGA now has nearly \$2 billion and 163 country members. The agency encourages the flow of private capital to developing countries to reduce poverty by offering insurance (or guarantees) to investors and lenders and by helping developing countries attract private investment. MIGA's insurance protects investments against the risks of currency transfer restriction or inconvertibility, expropriation, breach of contract, war, terrorism, and civil disturbance. By December 2003, MIGA had issued nearly 700 guarantees totaling more than \$12 billion in coverage, bringing the amount of foreign direct investment (FDI) facilitated to \$50 billion.

MIGA both supports and draws on the resources of the World Bank Group to offer clients in-depth knowledge of emerging economies. MIGA's unique structure, as an international organization whose shareholders include most countries in the world, also benefits clients. Because countries are shareholders in the agency, MIGA can help deter government actions that could disrupt investments and can help resolve potential disputes. For instance, in 1999, provincial government officials in China unilaterally reduced the prices paid to certain foreign electric power producers. MIGA had issued guarantees to one of the affected investors, providing protection against the risks of transfer restriction, expropriation, and war and civil disturbance. When the investor alerted MIGA to its difficulties, the agency stepped in. Negotiations with the investor and government representatives eventually yielded an agreement to resolve the problem and avoid a claim by the investor. This dispute was just one of some two dozen that erupted in China's power sector following the 1999 price change.

Insurance is particularly important for large, capital-intensive projects in the energy, mining, heavy industry, and infrastructure sectors. Financial institutions also often require political risk insurance for projects in developing countries, to provide not only protection against risks but also to enhance a project's credit profile while lowering the institution's country provisioning require-

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MIGA Contact Information

MIGA also provides free investment information on emerging economies through its online services: www.fdixchange.com, www.ipanet.net, and www.privatizationlink.com.

For more information on MIGA, see www.miga.org, or contact MIGA's corporate relations officer, Federica Dal Bono, by telephone at 202-473-9292 or by e-mail at fdalbono@worldbank.org.

ments. The agency's insurance has other benefits, such as allowing investors and lenders to venture into new markets with confidence and achieve investment-grade or higher ratings for emerging market securities, important considerations in today's tight markets.

Activities in China

China was one of the earliest members of MIGA, joining in 1991. Since then, MIGA has actively supported FDI into the country, providing \$333 million in investment guarantees. As of December 2003, MIGA's portfolio consisted of 14 contracts, with gross exposure of \$150 million, for projects in the manufacturing, power, and water sectors.

When the agency first started insuring projects in China, manufacturing projects were most popular. But there is a perception now that manufacturing no longer presents the kinds of noncommercial risks that concern investors. Rather, it is the larger, particularly infrastructure, projects that are perceived as risky by foreign investors, who are nevertheless tempted by these opportunities.

As China gears up for the 2008 Olympics in Beijing, and as the economy modernizes further, investment in infrastructure, particularly in the water, power, and transport sectors, has become a priority for the government. Because these and other infrastructure projects often involve local governments and long-term concessions, and therefore add what some perceive to be lesser-known elements to the mix, investors in this area typically seek out political risk insurance.

In the past six months alone, MIGA has issued guarantees for two water projects, in the Pudong District of Shanghai and in Deqing, Zhejiang, with a few more in the pipeline. One project for which MIGA provided a \$70 million guarantee involves the treatment, distribution, and sale of water; the maintenance and management of facilities; and water supply services in Pudong, home to more than 1.7 million residents. The guarantee covers the investment against the risk of expropriation for up to 15 years.

MIGA is also starting to see more PRC investment in Southeast Asia—particularly Indonesia, Thailand, and Vietnam—and investors have expressed interest in MIGA's coverage. The growing interest stems in part from a partnership launched by MIGA and the China Export and Import Corp. (Sinosure), China's official export credit insurance agency, in December 2001. (Sinosure was formed by a merger of the export credit insurance departments of the People's Insurance Company of China and the Export and Import Bank of China.) The partnership agreement calls for Sinosure and MIGA to increase cooperation and, in particular, to support PRC investment in developing countries.

MIGA is working closely with Sinosure, by co-hosting investment insurance seminars in Beijing, for example, and has provided training to its staff. Though primarily an export credit insurer, Sinosure is being drawn increasingly into the field of investment insurance and will likely work more closely with MIGA in the coming year on coinsurance and reinsurance of investments.

Eligibility

Projects eligible for MIGA-guarantee coverage include new, cross-border investments originating in any member country and destined for any developing member country. New investments associated with the expansion, modernization, or financial restructuring of existing projects, and acquisitions involving privatization of state enterprises, are also eligible. To qualify for coverage, projects must contribute to host country development needs, via job creation, technology transfer, or export generation, and be financially, economically, and environmentally sound.

Eligible forms of investment include equity, shareholder loans, and loan guarantees issued by equity holders, as well as technical assistance, management contracts, leases, and franchising and licensing agreements. The agency may also insure loans from unaffiliated financial institutions to the projects it guarantees, as well as shareholder loans from banks to their developing country subsidiaries.

Coverage

MIGA covers up to 90 percent of the value of equity investments, and up to 95 percent of debt, with coverage typically available for 15 years. The agency normally insures \$110 million per project, but can go up to \$200 million depending on country exposure and type of project. More can be arranged as needed. Pricing is determined according to project risk in the host country. The investor has the option to cancel a policy after three years; MIGA may not cancel the coverage other than for nonpayment of premium and breach of warranty.

In addition to its investment guarantee services, which complement those provided by other public and private entities, MIGA helps developing member countries attract investment by strengthening the capacity of investment intermediaries and equipping them with the tools, techniques, and know-how to target and win FDI. For example, MIGA is currently helping China's Sichuan Investment Promotion Bureau conduct a benchmarking exercise to determine the region's relative strengths, improvements in the investment climate, and changes in sector dynamics. 完

BEYOND CODES OF CONDUCT

Addressing Labor Rights Problems in China

ROBERT J. ROSOFF

The attraction of doing business in China is undeniable. The country's low labor costs, in particular, enable companies to manufacture apparel, footwear, toys, and many other products very cheaply. China is also emerging as a large consumer market for many goods. At the same time, terrible labor rights and human rights conditions persist even as China's economy develops. Foreign companies must address these conditions if they wish to operate in a socially responsible manner.

Some Western companies are already addressing the problem of labor rights violations in their Chinese factories. Their innovative strategies and programs to address labor law violations are best understood in the context of the requirements of Chinese labor law, typical violations, the types of factories operating in China, and the many codes of conduct that companies have crafted to establish minimum standards for suppliers.

PRC labor law

The 1995 PRC Labor Law is comprehensive, covering labor contracts, working hours, wages, worker safety, child labor, and labor disputes, among other subjects (see the *CBR*, January-February 2004, p.20). Government regulations provide additional detail and rights. For example, the law currently mandates a maximum workweek of 40 hours. Minimum wages are established locally, and wages cannot be deducted or delayed without reason. If employees must work more than 40 hours, overtime pay at fixed rates is mandatory. Workers are

guaranteed at least one day off every week. Working conditions are required to be safe and sanitary.

In practice, however, the rights of Chinese workers are routinely violated. Workers are often required to work far more than 40 hours a week, have few days off, are paid below the minimum wage, and are not paid required overtime. Improper deductions from wages are common. Some Chinese workers must pay a large sum of money as a "deposit" to their employer, and they may have to pay a "recruitment fee" in order to be hired. These payments can prevent workers from leaving jobs where their rights are violated. Physical abuse of workers, and dangerous working conditions, are also common.

Chinese factories

The types of labor rights violations found in a Chinese factory may depend, to a degree, on the nature of factory ownership and the size of the factory. Four broad types of enterprises exist in China today: private, state-

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A number of foreign companies are taking innovative steps to ensure good labor conditions in their PRC factories

owned, foreign-funded, and township-and-village enterprises. Before the mid-1990s there were clear differences between state-owned "socialist" factories, which offered lifetime employment, housing, and medical care, and private sector factories, which provided little job security, low wages, and no fringe benefits. Today, however, competition and a persistent government effort to privatize state-owned firms has led even these employers to offer less job security, fewer welfare benefits, and strict labor conditions.

Generalizations are difficult, but are possible based on evidence of labor rights abuse in PRC factories:

- Labor rights violations are so widespread in China that violations can be presumed to exist in every factory until proven otherwise.
- Factories fully owned and operated by foreign companies that implement good codes of conduct tend to have few violations.
- Large factories with direct investment from, and management by, Western companies also tend to have fewer violations, because Western companies often stress the importance of labor law compliance. Larger factories also tend to have enough orders to keep production lines going, enabling the factories to pay workers on time.
- A Western company with a good code of conduct will have greater success implementing the code in factories over which it controls a significant amount of the factory's output, because it will have more negotiating leverage over factory owners.
- If a Western company does not control a significant amount of a factory's output, it can act together with other companies that use the factory to demand acceptable treatment of workers.
- Factories owned by Hong Kong Chinese, Taiwan, and South Korean companies tend to have worse conditions, as do small, privately owned PRC factories.
- Large non-Western (usually Asian) foreign-funded factories tend to have better compliance than smaller factories.

Codes of conduct and inspections

To meet corporate social responsibility (CSR) obligations in countries like China that have

serious labor rights and environmental problems, companies are increasingly adopting codes of conduct that set forth labor rights, human rights, and social, ethical, and environmental requirements for suppliers. According to a recent estimate by the World Bank, there are about 1,000 different codes in existence today. They are issued by companies, multi-stakeholder groups such as the China Working Group, non-governmental organizations, and unions.

Although the language of the codes may differ, the substance is usually similar in codes adopted by apparel, footwear, and other light manufacturing companies, including: prohibitions on the use of forced labor and child labor; detailed provisions concerning wages, benefits, and terms of employment; limitations concerning hours of work; nondiscrimination guarantees; prohibitions of harassment, abuse, and

Labor Rights Resources

The Labor Law of the People's Republic of China

www.usmra.com/china/Labour%20Law.htm

Company Codes of Conduct and International Standards: An Analytical Comparison, Part I of II: Apparel, Footwear and Light Manufacturing; Agribusiness; Tourism

www.worldbank.org/privatesector/csr/doc/Company%20Codes%20of%20Conduct.pdf

Business Principles for Human Rights of Workers in China

www.amnestyusa.org/business/chinaprinciples.html

For information on Reebok and other companies' experiments with labor rights improvements in China, see

CECC Roundtable: Codes of Conduct: U.S. Corporate Compliance Programs and Working Conditions in Chinese Factories

www.cecc.gov/pages/roundtables/042803/index.php

www.cecc.gov/pages/roundtables/042803/cahn.php

www.cecc.gov/pages/roundtables/042803/niepold.php

www.cecc.gov/pages/roundtables/042803/vanHeerden.php

www.cecc.gov/pages/roundtables/042803/rosenbaum.php

Adidas-Solomon AG

www.adidas-solomon.com/en/sustainability/welcome.asp

Reebok Ltd.

www.reebok.com/x/us/humanRights/pdf/ReebokHR_SewingaSeam.pdf

Nike Corp.

www.nike.com/nikebiz/nikebiz.jhtml?page=25

types of disciplinary action; health and safety policies; and environmental standards.

Companies prefer to adopt one code to govern all their international operations, and some codes declare that workers must have the right to freedom of association and collective bargain-

Reebok believes that giving workers an independent voice in the operation of factories will reduce labor rights violations and lead to better working conditions, which, in turn, will strengthen the loyalty of workers and be good for business.

ing, although in practice these rights are denied to Chinese workers. In 1999, three companies and 21 organizations endorsed "Business Principles for Human Rights of Workers in China," a code drafted by the China Working Group specifically to address the human rights and labor rights violations common in China (see p.45).

Companies that manufacture in China using subcontractors have found that merely communicating the contents of their codes to subcontractors is insufficient. Inspections, either by the company's own inspectors or by professional monitoring companies, are necessary to determine the extent of compliance. Inspectors visit factories, determine compliance with the company code, and inform the company of results. After receiving a report of factory noncompliance, companies then approach factory owners to discuss changes in factory operation with the goal of achieving full compliance.

Codes of conduct and inspections are unquestionably useful. Codes establish higher standards than many subcontractors employ, while inspections ensure greater compliance than would otherwise exist. But in China this code-inspection regime has been only partially successful, for several reasons:

- Although China has an adequate labor law, it is poorly enforced.
- Codes imposed on factory owners raise costs, so owners have a financial incentive to ignore code requirements. Factory owners are becom-

ing increasingly adept at circumventing inspections, through practices such as double book-keeping and coaching of workers. As a result, inspectors are often deceived and "clean" audit reports often do not reflect reality.

- China has a virtually inexhaustible supply of migrant workers, most of whom are ignorant of their rights under Chinese law and are willing to work under any conditions without protest.
- The Chinese government prohibits the existence of independent trade unions, leaving workers without representatives who can discuss violations with management. Workers who have tried to form independent unions or lead labor protests have been imprisoned.
- Western companies' sourcing practices can contribute to the problem when, for example, large orders are made with short deadlines, the lowest possible prices are demanded, and orders are changed at the last minute. Factory owners are afraid to lose business if they refuse orders, even if they have to violate the law to complete an order.

In addition, companies manufacturing in China that seriously attempt to implement good codes of conduct have found the effort to be expensive and only partly successful. Therefore, some companies are seeking more creative strategies to ensure the protection of their subcontractors' employees in China.

New strategies

Faced with recurrent labor rights abuse in subcontractor factories despite code-inspection regimes, a few companies have been experimenting with more innovative strategies to address abuses. Such strategies include empowering Chinese workers through democratic factory elections of representatives; educating workers about their rights under Chinese labor law; seeking to protect the rights of labor activists; and working with the Chinese business community.

● **Democratic elections**

In 2001 and 2002, Reebok, Ltd. facilitated the democratic election of union representatives using secret ballots in one Hong Kong-invested factory and one Taiwan-invested factory to which it subcontracts. It was the first open election of its type in China, and it took place with the knowledge of provincial officials of the state-controlled All-China Federation of Trade Unions. Setting up the elections and educating the elected representatives about how to carry out the duties of trade union members has been challenging, but Reebok believes that giving workers an independent voice in the operation of factories will reduce labor rights violations and lead to better working conditions, which, in turn, will strengthen the loyalty of workers and be good for business.

● Educating workers about the PRC Labor Law

A number of companies, including Nike Corp., Adidas-Solomon AG, Reebok, and Sears, Roebuck & Co. have produced posters in Chinese that summarize the main provisions of China's Labor Law and include telephone numbers of PRC officials responsible for law enforcement. The posters also include the phone number of a call center established to provide information and advice to workers who believe their rights are being violated. In 2003, the posters were hung in factories used by these companies, and the call center has been receiving complaints and requests for advice. It is too early to determine whether this attempt at worker education has reduced labor rights violations in the targeted factories, but the more Chinese workers learn they have rights under Chinese law, the more they can be expected to seek to end violations of these rights.

● Protecting Chinese labor activists

Labor protests are increasing in China as a result of labor rights abuse, rising unemployment, lack of a social safety net, fraud by some factory owners, and lack of responsiveness by government officials. Often, when workers protest in large numbers, the Chinese government will arrest and imprison the protest leaders and pay off the workers. For many years, John Kamm has proved that Western businesspeople can effectively approach the PRC government and help to free these wrongfully imprisoned labor rights activists. Although most of his interventions have occurred during confidential meetings with PRC officials, Kamm began this work publicly in 1990 as vice president of Occidental Chemical and president of the American Chamber of Commerce in Hong Kong. At a public dinner he called on Beijing's senior representative in Hong Kong to release Yao Yongzhan, a student who had been detained and tortured shortly after the Tiananmen massacre. About three weeks later, Yao was released. Large companies have taken similar action. Reebok wrote a letter to the Indonesian president urging the release of imprisoned Indonesian labor rights activist, Dita Sari, who was also released. Chinese workers must be permitted to assert their rights under Chinese law. These examples indicate that Western companies can take beneficial actions on behalf of wrongfully imprisoned citizens without harming company business.

● Engaging the Chinese business community

Adidas, Nike, and Gap Inc. have agreed to participate in a project to engage Chinese small and medium-sized enterprises (SMEs) not currently manufacturing directly for Western companies. The primary goal will be to convince SMEs to comply with China's Labor Law and company codes of conduct, so Western companies can order from them directly. These SME

trainings are part of a larger project undertaken by the China Working Group to engage the Chinese business community concerning labor rights and CSR. With China's entry into the World Trade Organization, there is a growing awareness and interest within the Chinese busi-

A number of companies, including Nike Corp., Adidas-Solomon AG, Reebok, and Sears, Roebuck & Co. have produced posters in Chinese that summarize the main provisions of China's Labor Law and include telephone numbers of PRC officials responsible for law enforcement.

ness community concerning CSR. Efforts to build awareness of CSR within Chinese society should help improve labor conditions.

Ways to get started

Foreign companies can take a number of actions to address labor rights problems in China. First, they can own and operate Chinese factories directly. If this is not possible, they can significantly influence a factory's conditions by sharing the costs of upgrading labor standards, especially if they control a large percentage of the factory's output either alone or together with other companies. Second, they can, and should, adopt a detailed code of conduct and hire competent and experienced monitors to assess compliance, while ensuring their sourcing practices do not contribute to these problems. Third, since codes and monitoring are only partly effective in China, companies can, and should, seek to empower Chinese workers to act on their own behalf by educating them about their rights, by helping workers elect their own factory representatives, and by seeking to protect the right of workers to protest abuses. Fourth, companies can seek to engage the Chinese business community concerning the importance of CSR. Finally, companies can, and should, educate themselves about their options, through organizations such as the China Working Group and others. It is difficult to meet basic CSR requirements when manufacturing in China, but innovative techniques can help make this possible. 完

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.

Automotive

CHINA'S INVESTMENTS ABROAD

Beijing Jeep Corp. Ltd., a joint venture between DaimlerChrysler AG (Germany) and Beijing Automobile Industry Holdings Co.

Signed agreement with Adam Motor Co. (Pakistan) to begin assembly and sales of its BJ2020 model in Karachi. 11/03.

China National Bluestar (Group) Corp.

Will acquire Ssangyong Motor Co. (South Korea). 11/03.

INVESTMENTS IN CHINA

Cooper Tire & Rubber Co. (US)/Kenda Rubber Industrial Co. Ltd. (Taiwan)

Will build plant to produce radial passenger and light truck tires in Jiangsu. 12/03.

Delphi Corp. (US)

Will open WFOE to build and operate technical center, Delphi China Technical Center Co. Ltd., in Shanghai, to develop components and systems engineering. 12/03.

Hitachi Ltd. (Japan)/Shanghai Highly (Group) Co.

Signed agreement to set up car engine starter joint venture. (Japan:66.6%-PRC:33.3%). \$10.5 million. 11/03.

Ishikawajima-Harima Heavy Industries Co. Ltd., Itochu Corp. (Japan)/FAWER Automotive Parts Co. Ltd. (Jilin)

Established joint venture, Changchun FAWER-IHI Turbo Co. Ltd., to manufacture, sell, and provide after-delivery services for auto turbochargers. (Japan:55%-PRC:45%). \$14.9 million. 11/03.

Robert Bosch GmbH (Germany)/Wuxi Weifu Group Co. Ltd. (Jiangsu)

Formed joint venture to make diesel nozzles for cars and trucks. (Germany:67%-PRC:33%). \$189 million. 11/03.

Tenneco Automotive Inc. (US)/Chengdu Lingchuan Mechanical Plant (Sichuan)

Signed agreement to form joint venture, Chongqing Walker Exhaust System Co. Ltd., to supply emission control products and systems to Changan Ford Co. Ltd. (US:60%-PRC:40%). 11/03.

ZF Friedrichshafen AG (Germany)/FAWER Automotive Parts Co. Ltd. (Jilin)

Signed agreement to form joint venture, ZF FAWER Chassis Technology Co. Ltd., to produce chassis components and systems for passenger cars and commercial vehicles. 11/03.

OTHER

Continental AG (Germany)/Shanghai Automotive Industry Corp. (SAIC)

Agreed to merge Shanghai Automotive Brake Systems Co. Ltd. and Shanghai Automotive Brake Actuation Co. Ltd. to develop and manufacture brake systems. 12/03.

DaimlerChrysler AG (Germany), China Motor Corp. (Taiwan)/Fujian Motor Industry Group

Won approval from NDRC to establish auto joint venture to produce Mercedes-Benz vans in Fuzhou, Fujian. \$252.1 million. 12/03.

General Motors Corp. (US), Volkswagen AG (Germany), Toyota Motor Corp. (Japan)

Received initial CBRC approval to open auto finance WFOEs. 12/03.

Honeywell Transportation and Power Systems, a unit of Honeywell Inc. (US)

Signed agreement approving Beijing North American Shine Co. Ltd. to market Prestone-brand auto maintenance products in China. 12/03.

Aviation/Aerospace

CHINA'S IMPORTS

Sabre Airline Solutions (US)

Won contract from China Eastern Airlines Corp. Ltd. for software to manage its flight schedules and improve profitability. 12/03.

Sichuan Airlines Co. Ltd.

Signed contract with Airbus SAS for four A319s. 11/03.

Abbreviations used throughout text: ABC: Agricultural Bank of China; ADB: Asian Development Bank; ASEAN: Association of Southeast Asian Nations; AVIC I and II: China Aviation Industry Corp. I and II; BOC: Bank of China; CAAC: General Administration of Civil Aviation of China; CATV: cable television; CBRC: China Banking Regulatory Commission; CCB: China Construction Bank; CCTV: China Central Television; CDB: China Development Bank; CDMA: code division multiple access; CEIEC: China National Electronics Import and Export Corp.; China Mobile: China Mobile Communications Corp.; China Netcom: China Netcom Corp. Ltd.; China Railcom: China Railway Communications Co., Ltd.; China Telecom: China Telecommunications Group Corp.; China Unicom: China United Telecommunications Corp.; CIRC: China Insurance Regulatory Commission; CITIC: China International Trust and Investment Corp.; CITS: China International Travel Service; CNOOC: China National Offshore Oil Corp.; CNPC: China National Petroleum & Gas Corp.; COFCO: China National Cereals, Oils, and Foodstuffs Import and Export Corp.; COSCO: China Ocean Shipping Co.; CSRC: China Securities Regulatory Commission; DSL: Digital Subscriber Line; ETDZ: economic and technological development zone; GSM: Global System for Mobile Communication; ICBC: Industrial and Commercial Bank of China; IT: information technology; LNG: liquefied natural gas; MII: Ministry of Information Industry; MOFCOM: Ministry of Commerce; MOU: memorandum of understanding; NA: not available; NDRC: National Development and Reform Commission; NORINCO: China North Industries Corp.; PAS: personal access system; PBOC: People's Bank of China; PetroChina: PetroChina Co., Ltd.; RMB: renminbi; SARFT: State Administration of Radio, Film, and Television; SEZ: special economic zone; SINOPEC: China National Petrochemical Corp.; SINOTRANS: China National Foreign Trade Transportation Corp.; UNDP: United Nations Development Program; SME: small and medium-sized enterprise; WFOE: wholly foreign-owned enterprise



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OTHER**China Eastern Airlines Corp. Ltd. (Shanghai)**

Will halt Shanghai-Munich and Shanghai-Madrid routes and add Shanghai-London route starting April 2004. 12/03.

Eurocopter SA (France), Singapore Technologies Aerospace Ltd. (Singapore)/Harbin Aircraft Industry Group Corp., China National Aero-Technical Import-Export Corp.

Signed agreement to build assembly line to manufacture five-seat EC120 helicopters in Harbin, Heilongjiang. (France:61%-Singapore:15%-PRC:24%). 11/03.

Banking & Finance**CHINA'S IMPORTS****NCR Corp. (US)**

Won contract from Bank of China to provide ATMs and maintenance. \$36 million. 01/04.

INVESTMENTS IN CHINA**HSBC Holdings plc (Hong Kong)**

Bought 50% stake in Fujian Asia Bank Ltd.; China Ping An Trust & Investment Co. Ltd., a subsidiary of Ping An Insurance (Group) will purchase the remaining 50%. \$20 million. 12/03.

Kingsway Financial Services Group Ltd., a subsidiary of SW Kingsway Capital Holdings Ltd. (Hong Kong)/Shanxi Securities Co. Ltd., China Gaoxin Investment Group Corp.

Signed agreement to set up fund management joint venture in Shanghai. (Hong Kong:33%-PRC:67%). \$12 million. 11/03.

SHK Financial Group, a subsidiary of Sun Hung Kai & Co. Ltd. (Hong Kong)

Purchased 10% stake in Dalian City Commercial Bank. \$19.3 million. 11/03.

OTHER**Bank Indonesia/Bank of China**

Signed bilateral swap arrangement to bolster their foreign exchange reserves. \$1 billion. 12/03.

Merrill Lynch Investment Managers (US), BOC International Holdings (Hong Kong)/BOC International (China) Ltd. (Shanghai)

Won license from CSRC to establish a joint venture fund management company, BOC International Investment Managers. (US:16.5%- Hong Kong:16.5%-PRC:67%). 12/03.

All-Russian Regional Development Bank/ICBC

Signed letter of intent to expand their cooperation in export financing for metals and gold. 11/03.

Banque PSA Finance, a subsidiary of PSA Peugeot Citroën Group SA (France)

Approved by CBRC to open a representative office in Beijing. 11/03.

Mizuho Corp. Bank, Ltd. (Japan)/CDB

Signed contract to jointly finance industrial development projects in China. 11/03.

Chemicals, Petrochemicals & Related Equipment**CHINA'S IMPORTS****Aker Kvaerner ASA (Norway)**

Won contract from Yangtze River Acetyls Co. Ltd. for expansion of its acetic acid facility in Chongqing. \$17 million. 01/04.

Davy Process Technology Ltd. (UK)/Union Carbide Corp., a subsidiary of the Dow Chemical Co. (US)

Signed agreement to license and implement process technology for SINOPEC's oxo-alcohol plants in Jilin and Shandong. 12/03.

Fluor Corp. (US)

Won contract from BASF AG of Germany and US-based Huntsman International LLC to build chemical complex in Caojing, Shanghai. \$350 million. 11/03.

Shanghai Chemical Industry Park Industrial Gases Co., a joint venture of Praxair, Inc. (US) and Air Liquide SA (France)

Secured industrial gas pipeline supply contracts with Shanghai Lianheng Isocyanate Co. Ltd. and Shanghai BASF Polyurethane Co. Ltd. to supply them with hydrogen and carbon monoxide. \$120 million. 11/03.

INVESTMENTS IN CHINA**Hercules Inc. (US)**

Acquired carboxymethyl cellulose producer Quantum Hi-Tech in Guangdong. 12/03.

J.P. Morgan Chase & Co. (US)

Will invest in construction of a petrochemical storage wharf in Yangzhong, Jiangsu. \$130 million. 12/03.

Noveon, Inc. (US)

Will construct a thermoplastic polyurethane manufacturing facility in Shanghai. 12/03.

Consulting**CHINA'S IMPORTS****Korn/Ferry International (US)/Talent Shanghai Co. Ltd., an affiliate of the Shanghai Personnel Bureau**

Formed an executive search joint venture. 12/03.

Distribution, Logistics & Related Services**CHINA'S INVESTMENTS ABROAD****PSA Corp. Ltd. (Singapore)/COSCO Pacific Ltd., a unit of China Ocean Shipping (Group) Co. (Beijing)**

Formed joint venture, COSCO-PSA Terminal Pte Ltd., to manage and operate two berths at PSA's Pasir Panjang terminal in Singapore. (Singapore:51%-PRC:49%). 12/03.

INVESTMENTS IN CHINA

APM Terminals (Denmark)/Shanghai International Port Group

Formed joint venture, the Shanghai East Container Terminal Joint Venture Co., to operate a container terminal at Waigaoqiao IV. (Denmark:49%-PRC:51%). 12/03.

Dragados SPL (Spain)/Tangshan Port Investment/Beijing Jinzhou Engineering & Technology

Will construct and operate a terminal in the port of Jingtang, near Beijing. \$45.7 million. 11/03.

Kawasaki Kisen Kaisha, Ltd. (Japan)/China Shipping (Group) Co. (Shanghai)

Formed joint venture, Orient Sea Highway Services Co. Ltd., in Shanghai to provide marine transport for Chinese vehicles. (Japan:49%-PRC:51%). \$10 million. 11/03.

Education

CHINA'S IMPORTS

Dentsu Inc. (Japan)/Beijing University, Renmin University of China, Qinghua University, Beijing Broadcasting University, Fudan University, and Shanghai University

Signed contracts to establish Advertising and Communications Institute in Beijing. 11/03.

Electronics, Hardware & Software

CHINA'S IMPORTS

Ahnlab Inc. (South Korea)

Signed contract with SINA Corp. (sina.com) to provide security solutions. 01/04.

SAP AG (Germany)

Signed agreement with China Everbright Bank to streamline Everbright's operations with enterprise resource planning solutions and industry-specific applications for its banking portfolios. 12/03.

IFS UFSOFT, a joint venture between IFS AB (Sweden) and UFSOFT Co. Ltd. (Shanghai)

Signed contract with Shandong Rizhao SSYMB Pulp and Paper Co., Ltd. to implement supply chain and resource management applications. \$1 million. 11/03.

INVESTMENTS IN CHINA

Texas Instruments (US)/Skyworth (Group) Co. Ltd.

Signed contract to set up lab to develop semiconductor technology for high-definition televisions. 01/04.

Myson Century Inc., a subsidiary of Yulon Group (Taiwan)/Shanghai Belling Co. Ltd.

Formed joint venture to develop and produce chips used for broadband Internet access. \$3.5 million. 12/03.

CK Engineering Co. Ltd. (South Korea)/Harbin Huake Investment Development Co. Ltd.

Formed joint venture, Harbin High-tech Semiconductor Co. Ltd., to produce 5-inch and 6-inch semiconductor silicon chips. (South Korea:45.7%-PRC:54.3%). \$22 million. 11/03.

Royal Philips Electronics NV (the Netherlands)/Jilin Sino-Microelectronics Co. Ltd.

Formed joint venture, Philips Jilin Semiconductor Co. Ltd., to develop, design, and manufacture bipolar power products. 11/03.

OTHER

Miracle Linux Corp. (Japan)/Red Flag Software Co. Ltd. (Beijing)

Established partnership to develop low-cost Linux-based technology services. 01/04.

Taiwan Micro Display Corp./Henan Ancai CPT Glass Bulb Group

Signed contract to develop high-definition television optical engines. 01/04.

Altium Ltd. (Australia)

Set up representative office in Shanghai and appointed new Chinese distributors for its Windows-based electronics design software. 12/03.

Elpida Memory Inc. (Japan)/Semiconductor Manufacturing International Corp. (Shanghai)

Signed agreement to produce Elpida's dynamic random access memory chips in Shanghai. 12/03.

Cedara Software Corp. (Canada), IBM China, a unit of IBM Corp. (US)

Signed MOU to develop joint channel strategy for healthcare information systems using Cedara software and IBM hardware. 11/03.

Energy & Electric Power

CHINA'S IMPORTS

Voith Siemens Hydro Power Generation Inc., a joint venture between J.M. Voith AG and Siemens AG (Germany)

Won contract from Hubei Shuibuya Construction Co. for mechanical equipment and design for four Francis turbines and auxiliaries for turbines on the Qingjiang River in Hubei. \$30 million. 01/04.

ABB Ltd. (Switzerland)

Won order from Shandong Luneng Material and Goods M&G Group for transformers, breakers, and other power products to join Shandong and North China power grids. \$13 million. 11/03.

ABB Xiamen Switchgear Co. Ltd., a unit of ABB Ltd. (Switzerland)

Awarded contract by Tianjin Metro Corp. to supply switchgear to Tianjin Metro Line 1 project. \$3.3 million. 11/03.

Shell Solar GmbH, a unit of Royal Dutch/Shell Group (the Netherlands)

Won contract to provide solar-powered electricity to 26 remote villages in Yunnan and Xinjiang. \$3.4 million. 11/03.

CHINA'S INVESTMENTS ABROAD

CNPC

Will buy 60% stake in Russian energy firm ZAO Stimul, acquiring rights to the Orenburg oil and gas field in Russia. \$180-200 million. 12/03.

INVESTMENTS IN CHINA

CITIC Pacific Ltd. (Hong Kong)/Inner Mongolia Electric Power Group Co., Ltd., China Huaneng Group Corp. (Beijing), Shenhua Group Co., Ltd.

Signed cooperative agreement to form large, coal-based thermal power joint venture in Hohhot, Inner Mongolia. (Hong Kong:20%-PRC:80%). \$1.2 billion. 11/03.

CLP Power Hong Kong Ltd.

Will build a water power station in Sichuan. \$240 million. 11/03.

Sunspark Power Investment Co. Ltd., a subsidiary of CITIC Pacific Ltd. (Hong Kong)/Wuxi Municipal Electric Power Co. (Jiangsu)

Formed joint venture to construct pumped storage hydraulic power plant. (Hong Kong:70%-PRC:30%). \$28 million. 11/03.

Environmental Equipment & Technology

CHINA'S IMPORTS

VA Tech Water Systems Division, a unit of VA Technologie AG (Austria)

Won contract to provide the sludge treatment system for Xiaohongmen Wastewater Treatment Plant in Daxing, Beijing. \$17.4 million. 12/03.

INVESTMENTS IN CHINA

Hong Tong Holdings Ltd. (Hong Kong)/China Science Enterprises Group (Holdings) Corp.

Entered agreement to establish joint venture in Dongguan to incinerate and process waste. (Hong Kong:90%-PRC:10%). \$12.1 million. 12/03.

Onyx, a unit of Veolia Environnement SA (France), Citic Pacific Ltd. (Hong Kong)/Shanghai Chengtong Environment Industry Development Co.

Signed 20-year agreement with the Shanghai Urban Appearance and Environmental Sanitation Bureau and Shanghai Urban Construction Investment Development Corp. for the construction, operation, and transfer of the Laogang Municipal Waste Landfill near Shanghai. (France:60%-PRC:40%). 12/03.

Veolia Water, a unit of Veolia Environnement SA (France)/Beijing Capital VW Investment Co. Ltd.

Signed contract to purchase 45% stake of Shenzhen Water Group Co. Ltd. and manage its production and distribution of water, customer relations, and collection and treatment of wastewater for 50 years. (France:25%-PRC:75%). \$400 million. 12/03.

Sercel, a unit of Compagnie Générale de Géophysique (France)

Acquired 51% stake in Hebei Junfeng Geophysical Co. Ltd., the main provider of geophones and seismic cables for the Chinese market. 11/03.

Food & Food Processing

INVESTMENTS IN CHINA

AI China Breweries Co. Ltd., a joint venture between Itochu Corp. and Asahi Breweries Ltd. (Japan)/Tingyi (Cayman Islands) Holding Co.

Will form beverage joint venture Tingyi-Asahi-Itochu Beverages. (Japan:50%-PRC:50%). \$950 million. 01/04.

Calcol Inc. (US)

Purchased 20% stake from local joint venture partner China National Food Industry Corp. to assume full ownership of its soft drink manufacturing joint venture, Sanhe Meile Soft Drinks Co. 01/04.

Dingyi International Food Corp. Ltd., a subsidiary of Master Kong (Taiwan)/Hebei Zhongwang Group

Formed instant-noodle joint venture, Hebei Santaizi Co. Ltd. (Taiwan:50%-PRC:50%). \$72 million. 12/03.

Danone Asia Pte, a subsidiary of Groupe Danone (France)

Purchased 3.6% stake in Bright Dairy & Food Co. from Shanghai government, raising Danone's holdings to 7.7%. \$14.6 million. 11/03.

OTHER

Heineken NV (the Netherlands)/Asia Pacific Breweries Ltd., an affiliate of Heineken

Will merge operations and make Heineken Asia Pacific Breweries China the sole producer and marketer of Heineken beer in China. 01/04.

Imperial Tobacco (UK)/Hongta Group (Yunnan)

Signed 10-year cooperation agreement for Hongta to sell Imperial's West cigarette brand and for Imperial to market Hongta's brands overseas. 01/04.

Forestry, Timber & Paper

CHINA'S IMPORTS

Voith AG (Germany)

Won contracts from two unnamed domestic companies and one foreign venture to supply papermaking equipment. \$495 million. 11/03.

CHINA'S INVESTMENTS ABROAD

Nippon Paper Industries Co. Ltd. (Japan)/Chengde Dixian Textile Co. Ltd. (Hebei)

Formed paper manufacturing joint venture in Hebei. (Japan:55%-PRC:45%). \$56.5 million. 12/03.

OTHER

Nippon Paper-Pak Co. Ltd., a subsidiary of Nippon Paper Industries Co. Ltd. (Japan)/Elopak A/S (Norway)

Formed joint venture, Elopak China Ltd., in Shanghai to manufacture and sell beverage cartons. (Japan:25%-Norway:75%). \$18 million. 12/03.

Insurance

INVESTMENTS IN CHINA

Liberty Mutual Insurance Group (US)

Opened its first Chinese branch in Chongqing to offer property and casualty insurance to overseas-funded ventures in the municipality. 01/04.

Internet/E-Commerce

INVESTMENTS IN CHINA

Tiger Technology Fund (US)

Bought 18% stake in Dangdang.com, China's largest online book seller. \$11 million. 12/03.

FreeStar Technology Corp., Xinhua Financial Network (Hong Kong)

Agreed to form joint venture with offices in Shanghai, Beijing, and Hong Kong to distribute FreeStar's Internet credit card payment processing products in Asia. 11/03.

OTHER

IBM Corp. (US)/Asia United Telecom and Network Co. Ltd. (Beijing)

Signed MOU to cooperate in Internet cafe chain business in China, with first center in Wangfujing, Beijing. 11/03.

Machinery & Machine Tools

CHINA'S IMPORTS

Orbotech Ltd. (Israel)

Will supply automated optical inspection systems for LCD-TFT production line for Shanghai SVA-NEC Liquid Crystal Display Co. Ltd. 11/03.

OTHER

Mitsubishi Heavy Industries Ltd., and Sumitomo Corp. (Japan)/Shanghai Diesel Engine Co. Ltd.

Established joint venture, Shanghai MHI Turbocharger Co. Ltd., to manufacture and market turbochargers. (Japan:60%-PRC:40%). 12/03.

Media, Publishing & Entertainment

INVESTMENTS IN CHINA

Warner Bros. International Cinemas, a unit of Time Warner Inc. (US)/Dalian Wanda Group Co. Ltd. (Shanghai)

Signed agreement to form cinema joint venture to operate 30 Warner Wanda multiplex cinemas throughout China. 01/04.

Warner Bros. International Cinemas, a unit of Time Warner Inc. (US)

Signed agreement with Guangzhou Performance Co. to build eight to ten cinemas in southern China. 01/04.

Bertelsmann China Holding GmbH, a division of Bertelsmann AG (Germany)

Acquired 40% share of Beijing 21st Century Book Chain. 12/03.

OTHER

Matsushita Electric Industrial Co., Ltd. (Japan)/CCTV, Dayang Technology Development Inc.

Will jointly develop TV broadcast production system based on Matsushita's technology to integrate work processes for the news and documentaries on CCTV. 12/03.

Win Win Gaming Inc. (US)

Signed agreement with the Shanghai China Welfare Lottery to develop new Instant Ticket lottery games and a new TV lottery game show to be marketed throughout the Shanghai region. 12/03.

Metals, Minerals & Mining

CHINA'S EXPORTS

Baosteel International Economic & Trading Corp. Ltd., a subsidiary of Shanghai Baosteel Group Corp.

Signed iron ore transport contracts with Nippon Yusen Kaisha and Mitsui OSK Lines Ltd., both of Japan. 11/03.

CHINA'S IMPORTS

Voest-Alpine Industrieanlagenbau, a subsidiary of VA Technologie AG

Won contracts from Jiangsu Shagang Group for the construction of a heavy-plate rolling mill and the Benxi Iron & Steel (Group) Co. Ltd. for two new hot-dip galvanizing lines. \$163.9 million. 12/03.

Mitsui Engineering & Shipbuilding Co. (Japan)

Received order for a furnace blower from Shanghai Baosteel Group Corp. \$16 million. 11/03.

CHINA'S INVESTMENTS ABROAD

China Huaneng Group Corp. (Beijing)

Acquired 50% equity in coal power operator OzGen, a subsidiary of InterGen, a joint venture between Royal Dutch/Shell Group and Bechtel Enterprises Holdings Inc. \$226.9 million. 12/03.

INVESTMENTS IN CHINA

Orogen Holdings (BVI) Ltd., a subsidiary of Gold Fields Australasia Pty. Ltd. (Australia)

Bought 5.7% share in gold exploration and development company Fujian Zijin Mining Industry Co. Ltd. and will form separate 60-40 joint venture with Zijin Mining. 01/04.

Arcelor SA (Luxembourg), Nippon Steel Corp. (Japan)/Baoshan Iron & Steel Corp., a subsidiary of Shanghai Baosteel Group Corp.

Signed agreement to form joint venture, Shanghai Baosteel-NSC/Arcelor Automotive Steel Sheets Co. Ltd., to manufacture and sell high-grade cold-rolled sheets and hot-dip galvanized sheets. (Japan:38%-Luxembourg:12%-PRC:50%). \$362 million. 12/03.

SPX Corp. (US)

Established WFOE Tianjin Steel Cooling Technology Co. to produce advanced single-row aircooled condensers. \$4.2 million. 12/03.

Blackwatch Resources Ltd., a subsidiary of Caledon Resources plc (United Kingdom)

Signed letter of intent with Mojiang Mining Limited Co. (Yunnan) allowing a 70% equity stake as well as a 90% interest on exploration ground to be acquired in southern Yunnan. 11/03.

OTHER

TVI Pacific Inc. (Canada)

Won government license to establish its subsidiary, Hunan Pacific Geological Exploration Inc., the first mineral exploration WFOE in China. 01/04.

Kanematsu Corp. and Nippon Steel Corp. (Japan)/Tianjin Tiantie Coking and Chemical Co.

Formed coke production joint venture, Tianjin Tiesong Coking Co. (Japan:35%-PRC:65%). 12/03.

Erasteel, a subsidiary of Eramet (France)/Tiangong Co. Ltd. (Jiangsu)

Formed joint venture, Tiangong Erasteel Co. Ltd., to produce high-speed steel for manufacture of cutting tools. (France:60%-PRC:40%). 11/03.

Petroleum, Natural Gas & Related Equipment

CHINA'S IMPORTS

Honeywell International (US)

Won contract from CNOOC and ChevronTexaco's joint venture to automate processes and provide fire and gas safety systems to the Bozhong oilfield in Bohai Bay. \$4 million. 11/03.

INVESTMENTS IN CHINA

Panva Gas Holdings Ltd. (Hong Kong)

Bought a 45% stake in Foshan Gas in Guangdong and full equity in Dayi Gas Co. in Sichuan, with 50-year contracts for piped gas in Foshan city and Dayi county. 01/04.

Titan Oil, a subsidiary of Titan Oil (Hong Kong) Co. Ltd./Zhenrong International Petroleum Co. Ltd., a subsidiary of Zhuhai Zhen Rong Corp.

Formed joint venture to procure crude oil transportation contracts. (Hong Kong:90.01%-PRC:9.99%). 12/03.

Sunwing, a subsidiary of Ivanhoe Energy (Canada)/CITIC (Beijing)

Signed agreement to jointly develop Dagang oil project. 11/03.

Pharmaceuticals

INVESTMENTS IN CHINA

Hutchison Chinese Medicine Investment Ltd., a subsidiary of Hutchison Whampoa (Hong Kong)/China Beijing Tongrentang (Group) Co. Ltd.

Formed joint venture, Beijing Tongrentang Hutchinson Pharmaceutical Investment Co. Ltd., to develop and invest in traditional Chinese medicine and health-related projects and enterprises. (Hong Kong:49%-PRC:49%-Other:2%). \$239 million. 12/03.

Meiji Seika Kaisha Ltd. (Japan)/Shandong Lukang Pharmaceutical Co. Ltd.

Will form a pharmaceutical joint venture. (Japan:50%-PRC:30%-Other:20%). \$20 million. 11/03.

Ports & Shipping

CHINA'S EXPORTS

China State Shipbuilding Corp.

Won contract from Nippon Yusen Kaisha of Japan to build two 175,000-deadweight-ton bulk carriers in the Waigaoqiao Shipyard in Shanghai. 12/03.

INVESTMENTS IN CHINA

Wallem & Co., Ltd./China Ocean Shipping Agency Co. Ltd.

Signed agreement to start foreign shipping joint venture, Pen-Wallem Shipping Services Co. Ltd. with offices in Beijing, Dalian, Ningbo, Qingdao, Shanghai, Tianjin, and Xiamen. 01/04.

Wärtsilä Propulsion, a subsidiary of Waertsilae Oyj (Finland)/Zhenjiang CME Co. Ltd. (Jiangsu)

Formed joint venture, Wärtsilä-CME Zhenjiang Propeller Co. Ltd., to manufacture ship propellers. (Finland:55%-PRC:45%). 12/03.

Raw Materials

CHINA'S IMPORTS

Sherwin Alumina Co. (US)

Signed three-year contract to provide 160,000 metric tons of smelter grade alumina annually to China. \$96 million. 12/03.

CHINA'S INVESTMENTS ABROAD

Lafarge Group (France)

Will build second production line to more than double output at its Chongqing cement factory. \$40 million. 01/04.

Retail/Wholesale

INVESTMENTS IN CHINA

L'Oreal Group (France)

Signed agreements to acquire skin-care brand Mininurse and associated manufacturing facilities in Hubei. 12/03.

Bulgari SpA (Italy)

Will open two single-brand luxury jewelry and watch stores in Beijing and Shanghai. 11/03.

The International Finance Corp., the private sector arm of the World Bank

Agreed to invest \$6.5 million in retail chain store Wumart Stores, Inc. of Beijing. 11/03.

Nesh Cosmetics Ltd. (Israel)/Chindex International, Inc. (US)

Formed joint venture, Natural Formula Asia, Ltd., to distribute the Nesh brand of Natural Formula cosmetics to retail pharmacies in China. 11/03.

OTHER

Seven-Eleven Japan Co., Ltd., a subsidiary of 7-Eleven, Inc. (US)/Beijing Shoulian Commercial Group Co. Ltd., China National Sugar & Alcohol Group Corp.

Received approval from MOFCOM to form joint venture to develop 7-Eleven stores in Beijing and surrounding provinces. 01/04.

Telecommunications

CHINA'S EXPORTS

Huawei Technologies Co. Ltd. (Shenzhen)

Won contract from Sunday Communications of Hong Kong to build its WCDMA 3G network. \$116 million. 12/03.

Huawei Technologies Co. Ltd. (Shenzhen)

Signed contract with Ethiopian Telecommunications Corp. to replace existing analogue switches and outdated legacy digital switches. \$20 million. 12/03.

Huawei Technologies Co. Ltd. (Shenzhen)

Selected by Indonesia-based PT Bakrie Telecom to build its CDMA2000 1X wireless local loop network. 12/03.

Huawei Technologies Co. Ltd. (Shenzhen)

Signed contract with Telemar Norte Leste SA to build its 10G optical backbone in Rio de Janeiro. 12/03.

CHINA'S IMPORTS

Alcatel Shanghai Bell, a joint venture of Compagnie Financière Alcatel SA (France) and MII

Won contract from China Mobile to expand its GSM network in Gansu. \$14 million. 01/04.

LM Ericsson AB (Sweden)

Signed contract with China Unicom for phase III CDMA2000 infrastructure expansions for core and radio network equipment, including training, network rollout, and technical support. \$93 million. 01/04.

Lucent Technologies (US)

Signed agreements with China Telecom and China Unicom, including expansion of China Unicom's CDMA network, MPLS switching solutions for China Unicom's data backbone, and optical systems and switches for China Telecom. \$350 million. 01/04.

Motorola Inc. (US)

Won contract from China Mobile to expand and upgrade its GSM network in Beijing. \$510 million. 01/04.

Motorola Inc. (US)

Won contract from China Unicom to expand its CDMA2000 network and upgrade its GSM network in Beijing and 12 provinces. \$556 million. 01/04.

UTStarcom, Inc. (US)

Signed contract with China Telecom for deployment of its PAS infrastructure equipment. \$200 million. 01/04.

UTStarcom, Inc. (US)

Won contract from China Telecom to deploy 220,000 lines of its IP-based network. 01/04.

Alcatel Shanghai Bell, a joint venture of Compagnie Financière Alcatel SA (France) and MII

Won contract from Beijing Communications Corp., a subsidiary of China Netcom Corp. Ltd., to build an optical network to improve information infrastructure in Beijing. \$20 million. 12/03.

Nokia Corp. (Finland)

Signed contract with China Mobile to expand its GSM network in Henan to 10 million users. \$125 million. 12/03.

UTStarcom, Inc. (US)

Awarded contract by China Netcom to expand existing IP-based PAS networks in Yunnan. \$23 million. 12/03.

Heilongjiang Province International Economic & Trade Corp.

Purchased 200,000 units of CDMA 2000 1X camera phones from Telson Electronics Co. Ltd. of South Korea. \$53 million. 11/03.

LM Ericsson AB (Sweden)

Won contract from Guangxi Mobile Communications Co. Ltd. to expand GSM network in Guangxi. \$56 million. 11/03.

Rectifier Technologies Pacific Ltd., a subsidiary of ICE Corp. Ltd. (Australia)

Signed two license agreements with Wuhan Putian Telecom Equipment Co. Ltd. to manufacture and distribute telecom power supply systems. 11/03.

UTStarcom, Inc. (US)

Signed contract with China Netcom for PAS handsets in Liaoning. \$31 million. 11/03.

UTStarcom, Inc. (US)

Signed contract with Shanxi China Netcom to expand and upgrade existing IP-based PAS networks in Shanxi. \$30 million. 11/03.

INVESTMENTS IN CHINA

IBM China, a unit of IBM Corp., Intel China, a unit of Intel Corp. (US)/Tianhong Group

Signed agreement to deploy a wireless local area network in Xingfucun residential district of Beijing. 12/03.

NEC Corp. (Japan)/TechFaith Holding Ltd. (Beijing)

Formed joint venture, STEP Technologies (Beijing) Co. Ltd., to design and develop 2.5G and 3G mobile terminals. (Japan:30%-PRC:70%). \$6.5 million. 12/03.

Coding Technologies AB (Sweden)/Beijing E-World Technology

Formed joint venture, Beijing Media Works, to create and license a new audio compression/decompressions device. 11/03.

OTHER

Yahoo! Inc. (US)/SINA Corp. (Shanghai)

Signed agreement to form joint venture that will provide auction-based e-commerce service. 01/04.

Eastman Kodak Co. (US)/Shanghai Mobile, a unit of China Mobile

Signed agreement to form strategic partnership to jointly expand share in the mobile digital imaging market. 12/03.

IC Star MMS, a subsidiary of Telecom Communications, Inc. (Hong Kong)/3721 Inter China Network Software Co. Ltd. (Beijing)

Formed partnership to develop short messaging service, multimedia messaging service, and other wireless services. 12/03.

Subex Systems Ltd. (India)/BOCO Inter-Telecom (Beijing)

Entered partnership to promote fraud management solution to Chinese telecom companies. 12/03.

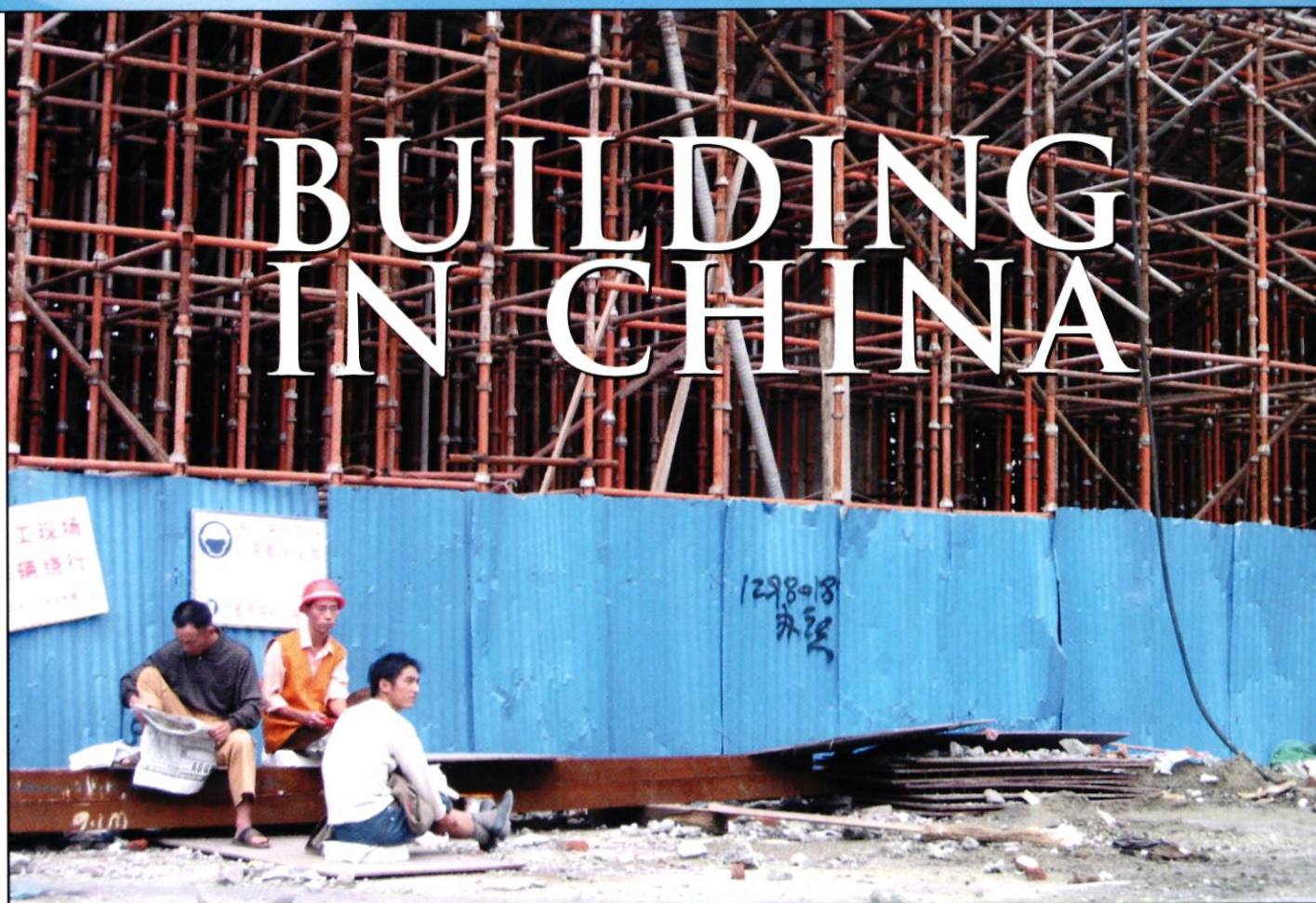
Codan Ltd. (Australia)

Set up representative office in Beijing to establish a national sales network for its satellite, high frequency radio, and microwave radio communication solutions. 11/03.

Sierra Wireless (Canada)/Putian Eastern Communications Group Co., Ltd.

Signed agreement to distribute AirCard 555 wireless PC card in China. 11/03.

BUILDING IN CHINA



Some essential tips for MNCs building facilities in China

JAY HOENIG

China continues to attract record levels of foreign direct investment as multinational companies (MNCs) from all industry sectors either expand their existing business operations or contemplate new investments there. And unlike the “gold rush” years of the mid-1990s, when foreign companies rushed blindly to China to form joint ventures (JVs), many companies now have a greater understanding of the market-entry problems they will encounter and assess the market by analyzing the lessons learned by pioneers. Today, this more thorough due diligence process applies not only to structuring business models, understanding customers, developing marketing plans, and adapting products and services to the Chinese market, but also to implementing capital building programs—which includes selecting qualified engineering and construction firms.

JAY HOENIG
works for Fluor Corp.
in China.

Do not compromise on your company's fundamental risk management practices just because you are in China.

On the contrary, apply them rigidly.

The expression "you get what you pay for" is nowhere more true than in China, particularly regarding construction projects. Over the last decade, numerous foreign MNC project heads in China have succumbed to local pressure to design and construct facilities without the involvement of foreign engineering and construction firms. At the urging of municipal officials, special economic and development zone sales representatives, and local design institutes, these MNCs accepted "great deals" only to discover that the resulting facilities did not meet quality, cost, schedule, and safety expectations. Many facilities required significant retrofits or post-project modifications to meet international standards. In many cases, these extra costs and delays negated any cost savings, and cost the company more than if the project had been structured and implemented effectively from the beginning.

Building a facility that meets international standards in China is a high-risk endeavor for any company—and is particularly unpredictable for a company that decides to "go local." It can be done and has been done, but not without project and construction management. City and development zone officials, design institutes, and even the company's own Chinese JV partners can make it difficult for foreign MNCs to exercise sound judgment and to approach a capital investment that meets international standards in a transparent and predictable way. These well-meaning officials lack an understanding of international project delivery requirements, international quality standards, and the effective role that foreign engineering and construction firms play in the China market. Naturally, no shortage of problems will occur when MNCs are unaware of local realities and are quick to accept a deal that is too good to be true.

China's building environment

Over the last decade, the facilities market in China has improved significantly in terms of

- The availability of equipment and construction materials in China that meet international standards
- The availability of experienced foreign engineering and construction firms in China
- The awareness of, and demand for, international quality among foreign MNCs and their JV stakeholders
- Construction safety programs in major cities
- Qualifications of Chinese design institutes and contractors

China is still classified as a high-risk engineering and construction environment, however. Such risk is determined by evaluating transparent tendering practices, license and permit approvals, labor quality, costs, predictability of construction quality and schedules, and arbitration and legal recourse. According to an *Engineering News Record* survey, China ranked third in global capital spending in 1999 but just above India in "construction risk." (The United States ranked first in global capital spending and held the lowest five-year construction

risk score—4.7; China and India, on the other hand, scored construction risk scores above 42). As such, foreign MNCs entering China must be aware that the same project management and implementation fundamentals that apply in their home countries also apply in China, if not more so.

Thus in China, MNCs must not ignore the basic risk assessments they perform elsewhere in the world, though they should of course adapt project and implementation plans to fit China's work environment and processes. Foreign companies must rigidly apply implementation fundamentals such as scope of work, scope of services, division of responsibilities, credible budgets and schedules, material management, and organizational structures. Without an effective project management plan, the cost benefit from the mandatory use of local design institutes; the widely available, qualified local and JV suppliers and vendors; and relatively inexpensive local construction contractors may be lost. Such project management planning, organization, and implementation is how foreign design and construction firms add value for their MNC customers in China.

What to expect

MNCs that construct facilities in China, particularly for the first time, will likely encounter these issues:

- Exaggerated cost and schedule claims, yet insufficient knowledge of the MNC's quality expectations
- Exaggerated claims of infrastructure quality and availability
- Extensive and unpredictable license and permit requirements—particularly outside major metropolitan areas
- Pressure to support the government's drive to develop western China
- Claims by development zones that full-service capabilities are available to plan, design, and construct facilities through their existing network of relationships
- An insistence on the part of local offices (possibly for unspoken reasons of protection, face, or even corruption) that there is "no need for foreign engineering and construction service providers."

The last item is a growing and visible phenomenon in China. Unfortunately, Chinese JV partners often echo this assertion because they fail to understand the value that foreign engineering and construction firms bring to China projects. Although Chinese firms may accomplish more than 90 percent of the actual construction work, international-standard professional risk and quality management is still lacking in China. Many JV partners (and some MNCs) fail to recognize the importance of professional project management and thus do not budget for it. The owners must either provide this planning and oversight themselves or hire foreign firms that have experience working in China.

Continued on page 61




Underwriters
Laboratories opens
its first joint venture
in China

UL-CCIC's testing facility in Suzhou, Jiangsu. Photo courtesy of UL-CCIC

STANDARD BEARER

Virginia A. Hulme

Turn over nearly any electrical appliance or tool sold in the United States, and on the back you will see . This familiar mark means that the product has passed the tests and inspections of Underwriters Laboratories Inc. (UL) and should be safe to use. Roughly 9,000 manufacturers in China, both Chinese and foreign-invested, are authorized to apply the UL mark. UL expects this number to more than double over the next five years, in part because companies are not just manufacturing in China these days. According to Doug Johnson, general manager of UL's joint venture (JV) in China, companies are beginning to develop advanced products in China, as shown by the fact that UL has received applications for such products.

Established in 1894 and headquartered in Northbrook, Illinois, UL develops safety standards and ensures that products destined for US stores, and ultimately US homes, meet these standards. The leading product safety testing and certification organization for the United States and Canada, UL has obtained American National Standards Institute acceptance for 65 percent of its 876 safety standards. For the last 20 years, UL has also offered management system certifications, such as ISO 9000 certification.

The UL process is relatively simple: UL engineers test products according to UL and international safety and performance standards and evaluate the results using a pass/fail system. Products that meet requirements are authorized to use the corresponding certification mark. When products fail, UL alerts the manufacturers about which specific tests the products failed. This helps the manufacturer identify and correct the problem.

Virginia A. Hulme
(vhulme@uschina.org)
is associate editor of
the *CBR*.



(Left) The lobby of UL-CCIC's testing facility in Suzhou, Jiangsu.
Photo courtesy of UL-CCIC

(Below, top to bottom) UL-CCIC General Manager Douglas Johnson.
Photo courtesy of UL-CCIC

UL-CCIC tests products for the different voltages found around the world.
Photo courtesy of Virginia Hulme

Testing a light fixture.
Photo courtesy of Virginia Hulme

UL-CCIC performs many electrical tests on special testing benches.
Photo courtesy of Virginia Hulme

The Suzhou testing facility currently performs tests in the most popular product categories, including small home appliances such as lights, fans, rice cookers, toasters, and electric tools.

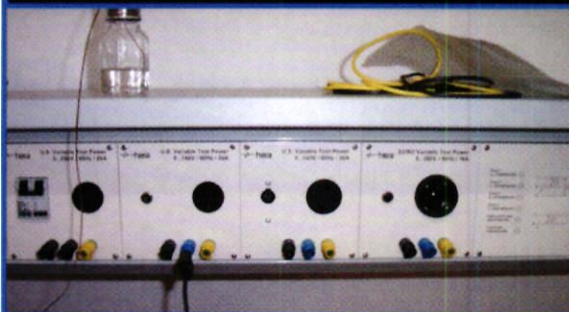
In 2003, 68,713 manufacturers had been authorized to apply the UL mark to their products. Once UL has authorized a product to carry a certification mark, UL inspects the factory that makes it to determine that the product still complies with the standard's requirements. If not, UL re-evaluates the product. UL conducts these "follow-up" inspections at least four times a year, though there are exceptions for products not manufactured year-round, such as Christmas lights. Though technically "unannounced," UL asks manufacturers to identify manufacturing "windows," during which UL conducts inspections.

UL in China: A long history of cooperation

UL is not just a US-based organization; since the 1920s UL has been active internationally and now has customers in 99 countries, affiliates and representative offices in 21 countries, and 127 inspection centers in 65 countries.

UL first came to China in 1980, when it established a cooperative relationship with China Certification & Inspection (Group) Co., Ltd. (CCIC), formerly the China National Import & Export Commodities Inspection Corp., to conduct follow-up inspections of Chinese factories. Authorized by the State Council and accredited by the State Administration of Quality Supervision, Inspection, and Quarantine and the China National Certification and Accreditation Administration (CNCA), CCIC performs commodity inspection, accreditation, testing, and certification, as well as inspection of containers and transport tools that contain imports and exports. Like UL, CCIC offers management system certifications, but does not test products for the China Compulsory Certification (CCC) mark (see the CBR, May-June 2003, p.32).

Under the cooperation agreement, UL tests products made in China at its nearest testing facility capable of performing the necessary tests for that particular product, usually UL facilities located in Hong Kong or Taiwan. Once a product passes the tests and receives the UL mark, CCIC conducts the quarterly follow up inspections.



In 2001, growing demand for product safety testing and certification services prompted UL and CCIC to begin negotiations to set up a JV. UL had already opened two representative offices in China, in the manufacturing areas of Guangzhou (1994) and Shanghai (1997), to answer procedural and technical questions and provide better service to customers in China. Still, having a testing facility in China would bring UL closer to its customers and would save customers time and money because they could pay in renminbi and wouldn't have to ship their products abroad.

The partners signed their JV contract in June 2002. Johnson attributes the brevity of negotiations to the fact that the two partners have worked together for more than 20 years and know each other well.

The new JV

The venture, UL-CCIC Company Limited, is a 50-50 JV with total investment of \$15 million. Set up in January 2003, UL-CCIC is headquartered in Shanghai, with branches in Beijing, Guangzhou, Suzhou, and Shanghai. (Parent company UL still maintains a representative office in Guangzhou; the old UL Shanghai representative office became a UL-CCIC branch.) UL expects its share in the JV to rise to 70 percent in early 2004, as under China's World Trade Organization (WTO) commitments majority foreign ownership was to be allowed in this sector by December 11, 2003. Equipment, training, processes, and systems are all based on UL requirements; CCIC invests in the JV and provides it with 25 percent of its senior managers. Factory follow-up inspections remain outside the purview of UL-CCIC; UL still contracts those out to CCIC.

UL also offers management system certification, commercial inspection and testing, and electromagnetic compatibility services, as well as related training programs. And in May 2003, CNCA authorized UL-CCIC as a registered agent to assist domestic and overseas customers with the CCC application process, allowing UL to serve not only companies producing for export, but also those producing for the domestic market or importing into China.

UL chose to locate its testing facility in Suzhou because of the city's central location on China's east coast, within the Yangzi River Delta, where manufacturing is heavily concentrated. The heart of the JV, the Suzhou testing facility currently performs tests in the most popular product categories, including small home appliances such as lights, fans, rice cookers, toasters, and electric tools. The facility's capabilities will gradually expand to perform tests on just about anything exported from China.

In fact, UL-CCIC is looking to become a "one-stop" test site, not just for goods destined for the US market, but for goods exported around the globe—and aims to have a share of the European safety certification market by 2005. But UL-CCIC is not the only testing company with this idea; some of its competitors, such as TUV Rheinland Group, also

hope to become a test site for China's exports to the rest of the world. Because UL is less well known in China than it is in the States, the company is raising its profile by providing training programs for existing and potential customers, and is working with trade associations, in addition to traditional advertising and trade-show participation efforts.

UL-CCIC is held to the same high standards as any other UL affiliate. UL-CCIC managers report not only to General Manager Johnson, but also to managers at UL's regional headquarters in Hong Kong. UL-CCIC employees also access the same company systems, such as intranet and e-mail, as other UL employees worldwide. And of course, the JV shares the same public safety mission. Johnson estimates that the venture will turn a profit in 2005 and break even on the total investment in 2006 or 2007.

Ramping up capacity

UL is rapidly expanding capacity, especially at the Suzhou test facility. In October 2003, UL-CCIC had 155 employees, of which nearly 100 were hired in the last year. Just over 70 of the new employees are located in Suzhou. By 2009, the venture expects to employ around 400 people, most of whom will work at the Suzhou facility. The testing facility is currently 4,400 m², but will double in size by the end of 2005. UL-CCIC has no immediate plans to set up more test centers in the near future, but may consider branches in other cities, particularly in western China.

UL-CCIC has had no problem finding qualified engineers for its testing facility, but they still must be trained, usually in cooperation with UL facilities in Hong Kong, Taiwan, and the United States. Each engineer learns the standards, tests, and how to evaluate test results for a number of products. Training can take time; some engineers go to UL's Hong Kong facility for six to eight weeks to learn a particular standard, and any related substandards. For instance, an engineer may be qualified to evaluate tests for the information technology equipment (ITE) standard, but within ITE are numerous substandards. Experienced engineers often acquire standards expertise in a variety of product categories.

Johnson explains that as the engineers in the Suzhou facility get up to speed, they will take over most of the work currently being sent to UL testing facilities in Hong Kong and Taiwan.

Customers already have high expectations, and UL has had to explain that the Suzhou facility cannot perform every test right away. Eventually, the organization plans to be able to meet more than 80 percent of the demand for UL testing services in China. Fortunately, UL-CCIC has a board of directors that understands that quality is just as important as speed in this business, and that integrity is everything. Thus UL-CCIC is improving the quality and timeliness of its services quickly—without cutting corners or compromising integrity. 完

Building in China

Continued from page 57

Elements of successful construction projects

Five key performance factors affect the success of capital building projects in China.

1 Concept and preliminary designs

Concept and preliminary designs, usually developed either on- or offshore by foreign firms, must incorporate international standards, comply with Chinese codes and standards, and match the availability of materials and equipment. Without these initial steps, the foreign firm may need to redesign the project or import materials, thus increasing the project's cost and causing delays.

2 Design institute management

China's design institutes offer a wide range of capabilities, yet many are unfamiliar with the quality expectations of foreign MNCs. Typically the institutes provide minimal interdisciplinary coordination, no fast-track drawing release procedures, poor schedule control, pre-determined equipment specifications and vendors (some of whom receive commissions), little understanding of international quality standards, and a minimal regard for intellectual property protection.

MNCs will need to supervise the design process closely before construction begins. This is particularly true with process; manufacturing; and mechanical, electrical, and instrumentation systems.

3 The permit process

Obtaining permits is a complex process that occurs throughout the project's life. Developing relationships with relevant officials is important to streamline the process. It is necessary to have a full-time permit engineer on the team to ensure that design and construction approvals are obtained in a timely manner.

4 Procurement

Key material and equipment decisions must be made early in the project to determine whether they will be sourced on- or offshore. Because China's manufacturing sector is expanding rapidly, most equipment and materials can be sourced in China—but MNCs must be aware that counterfeiting is widespread. In addition, contractors do not create "shop drawings," so equipment details must be incorporated into the design drawings.

5 Construction

Construction contractors are schedule-driven—many times at the expense of quality and safety. The

focus of any internationally experienced site team should be quality and safety. The liberal use of craft certification and testing, mockups, and sample boards is strongly recommended.

Simple rules

Spurred by both domestic and foreign spending, capital construction in China is booming. Many projects have been successful and have met all of the owners' cost, schedule, quality, and safety expectations. But implementation in China is difficult, and these projects were not successful by accident.

When considering a capital facility investment in China, MNCs must not compromise on the engineering and construction industry fundamentals of sound planning, thorough risk assessment and management, effective staffing, a clear and documented scope of work, and the division of responsibilities among all members involved.

The following simple rules and common-sense principles apply to capital facility investments in China, as elsewhere:

- Avoid basing plans only on claims by overzealous city and development zone officials and design institutes.
- Realize that capital cost and schedule savings can be achieved *only* if the project is effectively organized, planned, and implemented by people who are knowledgeable about China.
- Do not compromise on your company's fundamental risk management practices just because you are in China. On the contrary, apply them rigidly.
- On your first project, consider using foreign firms that have a China presence and experience.
- If you are the majority shareholder and your JV partner refuses to understand, accept, and cooperate, or undermines your efforts to use foreign project management, do not compromise. Make sure your corporate executives understand this position before deals are made.
- If you are an equal or minority shareholder, use a project management firm to protect your interest and pay for it through "Corporate." It's good insurance. When your team is seasoned, you can go local on the next project.
- Do your homework. Check with manufacturing companies that have built similar facilities, the US-China Business Council, the US Commercial Service, the American Chamber of Commerce, and other organizations to validate the information provided by city officials, development zones, and design institutes.
- Temper your project expectations; implementation is difficult.

China offers US manufacturers unique opportunities to profit from domestic and international markets. But to meet the demands of your customers, your China manufacturing facility must produce "saleable" products as soon as possible, so building your facility well, and on schedule, must be your priority. 完

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Short Takes

Red Light for Chinese Businesses

China has among the highest capital requirements in the world for starting a business, according to the World Bank's recently released report, *Doing Business in 2004*. Starting a business in China requires an average of 11 procedures and 46 days, compared to an average of eight procedures and 66 days for East Asia as a whole. And while the average cost of incorporation (\$134.69) is a bargain, China suffers from the world's second-highest capital requirement at \$36,230—more than 38 times the per capita national income.

Setting up a business in Australia, the country most conducive to startups, requires only two days, two procedural steps, and a sum of \$402. Canada ranks second in the world with three days and two procedures; incorporation there costs only \$127. Neither has minimum capital requirements, according to the report.

US-China Arbitration Center to Open in September

The New York-based CPR Institute for Dispute Resolution (CPR Institute) and the Beijing-based China Council for the Promotion of International Trade (CCPIT) signed an agreement on January 29 to launch a new business dispute-resolution center. The US-China Business Mediation Center—which will have offices in New York and Beijing—was created to provide US and PRC companies in need of dispute resolution with a faster and less-expensive alternative to China's judicial system and binding arbitration. The two organizations plan to open the center by September and to select and train 48 professional mediators by the end of the year.

NPC Deputy Harvests Proposals from the Airwaves

Inspired by suggestions from friends overseas, Zhou Xiaoguang became the first National People's Congress (NPC) deputy to canvass her Zhejiang constituents for ideas and opinions using TV advertising. The advertisement, which cost \$2,400 and received support from the local NPC Standing Committee, ran from January 18 to February 8 on the Yiwu television station.

Zhou received hundreds of proposals and is preparing the best of them as motions for the upcoming NPC session in March. She also set up a hotline, which has received more than 300 phone calls, and a five-member panel to review the proposals. Zhou noted that many of the proposals focus on agricultural and farming issues, environmental problems, or punishment of corruption.

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