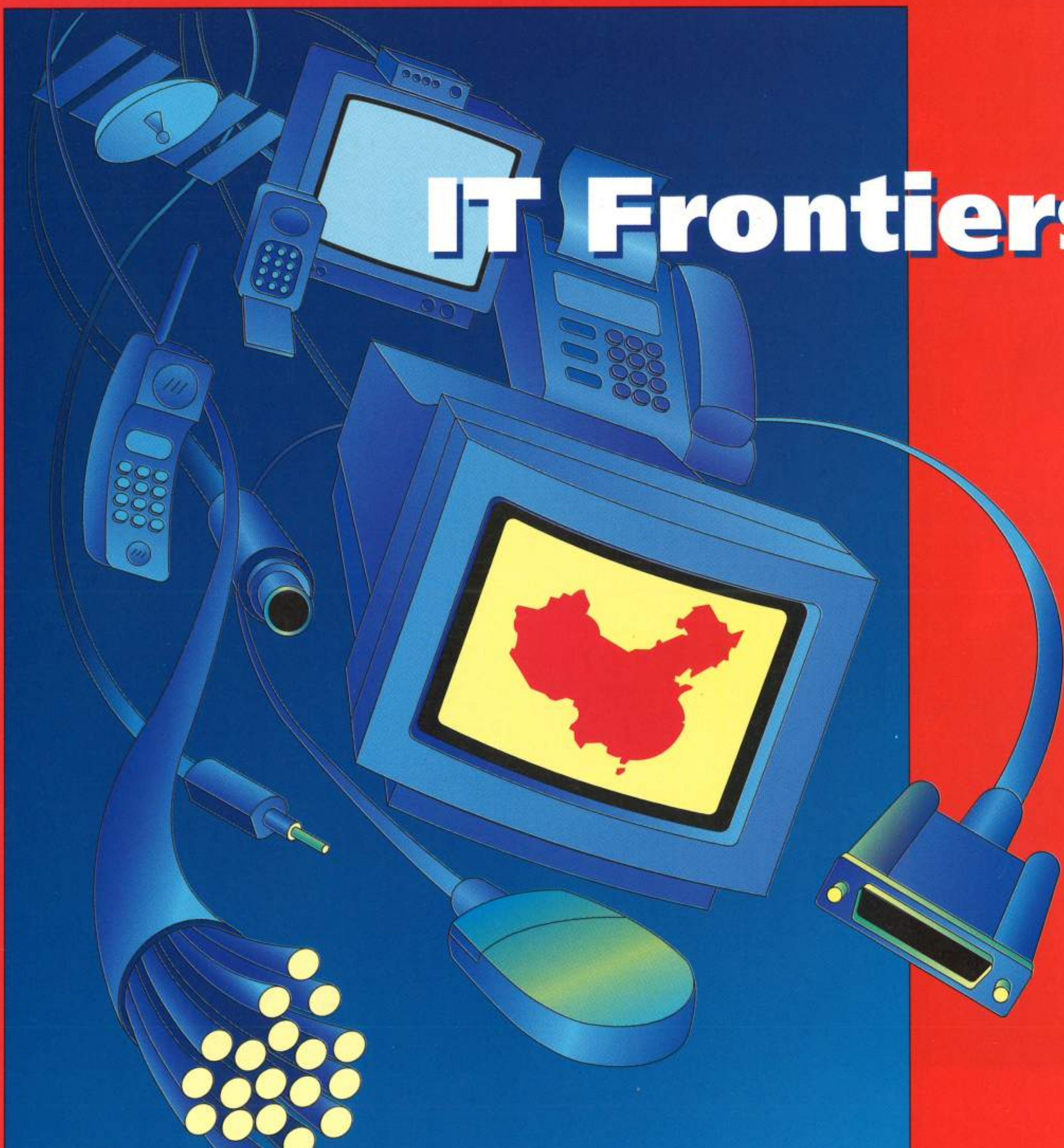
CELEBRATING 25 YEARS: 1974–1999

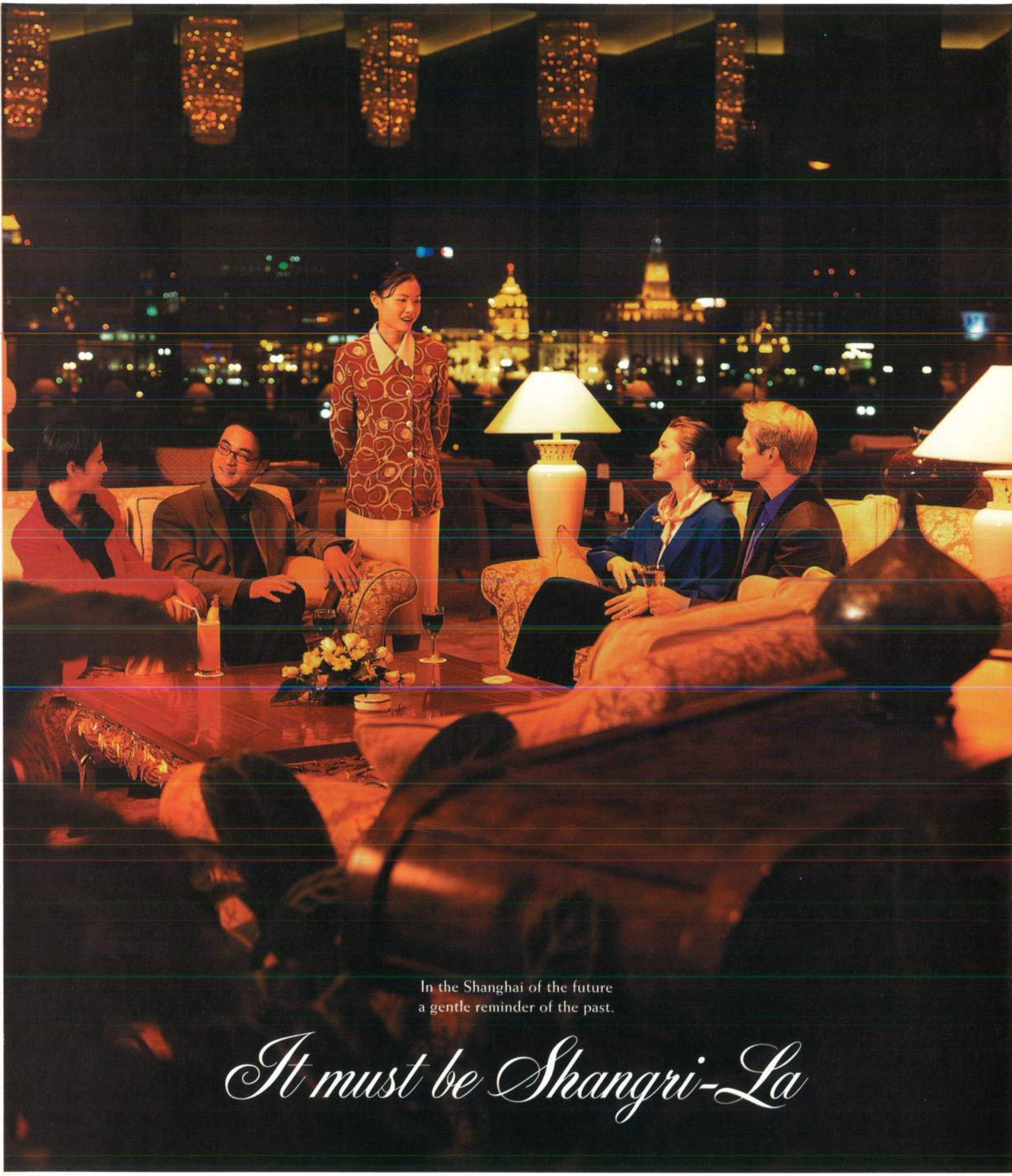
THE CHINA BUSINESS REVIEW

MAY–JUNE 1999 VOLUME 26 NUMBER 3



IT Frontiers

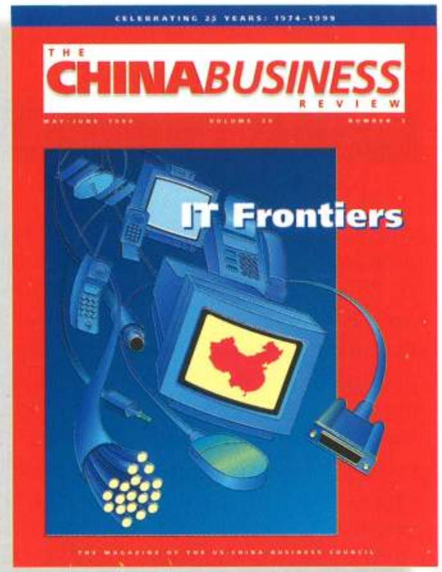
THE MAGAZINE OF THE US-CHINA BUSINESS COUNCIL


In the Shanghai of the future
a gentle reminder of the past.
It must be Shangri-La

1999 MAY JUNE

CONTENTS

美中商贸评论



Cover illustration by John Yanson

FOCUS *IT Frontiers*

FEATURES

DEPARTMENTS

A Giant Leap (Maybe) for WTO

The list of Chinese market-access and World Trade Organization (WTO) protocol commitments released by the US Trade Representative (USTR) on April 8 were certainly more impressive than many China-watchers would have predicted only weeks before. The document, entitled "Market Access and Protocol Commitments," claims to list all concessions agreed to by PRC negotiators (*see* **www.uschina.org**). But because the Chinese side subsequently tried to back away from some of the commitments detailed in the USTR report, it thus represents only a tentative outline of what might eventually be contained in the final WTO Accession Protocol for the PRC. The USTR move nonetheless has ushered in what some have billed the "home stretch" of China's WTO accession negotiations.

Protocol yet to come

Indeed, the WTO Protocol of Accession for China—which ultimately must be voted on by the full WTO membership—still has some way to go. Briefly, the WTO obligations contained in each member country's protocol are a set of agreements on goods, services, and standards that protect the principles of national treatment and non-discrimination for foreign goods and services. The Agreements on Trade in Goods cover policies on trade in agricultural products and textiles, sanitary and phytosanitary (SPS) measures, Trade-Related Investment Measures (TRIMs), antidumping policies, and customs valuation, preshipment inspection, rules of origin, import licensing, subsidies, and safeguards.

The WTO also maintains agreements on trade in services, intellectual property rights, and dispute resolution. Other parallel agreements exist as well, the most notable for the United States and China being the Information Technology Agreement, because of the importance to both countries of this market.

Many analysts were surprised at the extent of the protocol-related concessions USTR won from the Chinese in early April. According to USTR, China agreed to comply with the TRIMs agreement without the transition period for which it might be eligible as a developing country. To comply with TRIMs, a number of the PRC policies most troublesome to foreign investors must be phased out. One such policy requires foreign-invested firms that manufacture in the PRC to include a certain level of local content in their products.

The two sides also made progress in the area of SPS restrictions. WTO members all must agree to base their evaluations of the safety of foreign goods on internationally accepted scientific standards. The bilateral agreements the United States and China signed in mid-April, which open significantly PRC agricultural markets, particularly for US wheat, indicate that China is willing to accept such standards for food product imports.

In a surprising move, however, USTR stated that the Chinese would accept the methodology the United States employs in its antidumping determinations—namely, classifying China as a non-market economy. This methodology uses third-country price data to assess whether Chinese goods are being dumped on the US market. The methodology tends to distort US dumping calculations in US plaintiffs' favor.

USTR also asserted that China conceded ground in the area of safeguards. But final rules on safeguards, along with the laundry list of other protocol-related issues, will involve the input of more than just the United States. Even if the United States manages to obtain a satisfactory bilateral agreement, the European Union has yet to sign off on its own bilateral agreement.

A long list of broad concessions

According to USTR, the Chinese negotiators have agreed to provide access to PRC markets for a wide range of goods, and even some services, crucial to US businesses in China. The Chinese agreed to reduce tariffs substantially upon WTO accession and agreed that these tariff reductions would be binding—that they would not be raised after joining the trade body. In key sectors such as agriculture, telecommunications, and insurance, US companies will gain access to Chinese markets within a fairly short period. Though some sectors, particularly financial services, saw less progress, US negotiators returned to Beijing in late April to continue talks.

Of note in the USTR list of PRC commitments were:

- The short phase-in periods (of 3-5 years) agreed to for many tariff reductions and market liberalization measures.
- The assurance that foreign investors in services in China would be eligible for grandfather protection of existing benefits.
- The opening of China's distribution and trading sectors to foreign participation. Currently, foreign companies that manufacture in China may not distribute goods made outside of China and must import most goods through Chinese trading companies.
- The increase in the percentage of foreign investment permitted to firms in the telecommunications sector.

China's accession had been stalled for at least a year over the PRC government's unwillingness to make just these kinds of concessions—concessions that US firms, in particular, considered essential elements of any WTO accession package.

The big wins

The announcement of a breakthrough on agricultural market access was perhaps the most concrete result of this negotiating round. The signing of bilateral agreements on wheat, citrus, and meat will open China's markets regardless of the outcome of the WTO talks. China agreed to accept US Department of Agriculture certification for US meat exports, in effect opening its virtually closed market to US beef, pork, and poultry. Similarly, the current ban on US exports of citrus fruits will be lifted. According to USTR, the US citrus industry estimates the market in China for these products could reach $1.2 billion.

The PRC lifted the ban against imports of US wheat from the Pacific Northwest. US wheat imports were blocked almost three years ago because

continued on page 62

Letter from the Editor

Breaking News

This issue's focus on information technology developments in China was planned months ago, so we we can't claim the credit for what has become extremely good timing. The recent visit to the United States of Premier Zhu Rongji, and the resulting progress in China's World Trade Organization accession negotiations, have thrown the entire sector into the spotlight. Where the trend seemed to be toward greater protectionism of China's IT sector, now, if the US Trade Representative is to be believed, China may yet fling its doors open to foreign IT firms. The authors of the three focus pieces thus all graciously agreed to revise their articles to reflect China's new WTO market-access commitments in the telecommunications sector, and parallel developments such as the PRC's new willingness to encourage foreign-invested projects using the Code Division Multiple Access (CDMA) cellular standard.

Nonetheless, it seems as if the conventional wisdom changes almost daily about which way the IT winds in China are blowing. By the time this issue of *The CBR* reaches your mailboxes, some of the information in the focus articles may already have become ancient history, notwithstanding the best efforts of our authors. But as John Wang points out in the lead article, China is known for the "evolutionary" pace of its economic reform process, and the IT sector is likely to be no exception. For analysis of where things stand, and are likely to stand for some time (regardless of the outcome of WTO), the articles on China's telecommunications sector, IT regulatory environment, and cable television industry will be invaluable. And be sure to check for updates in subsequent issues of *The CBR*.

Catherine Gelb

Short Takes

Hong Kong Plans for Retirement

Currently only one-third of Hong Kong's 3 million-strong work force is enrolled in a retirement plan, but the government's new Mandatory Provident Fund aims to extend retirement planning to all Hong Kong employees. Starting in 2000, individuals and companies must contribute 5 percent of their net monthly earnings to this fund, up to HK$20,000 ($2,582). Contributions above that amount are voluntary.

Plugging In Abroad (Zap!)

Before packing their electrical appliances, executives planning to relocate to another country would do well to find out what voltage is used at their destination—and prepare themselves for sticker shock when purchasing replacements abroad. According to ECA Windham, a New York firm specializing in international relocation, color TVs, washing machines, and steam irons are all cheaper in the United States than in Hong Kong, France, Germany, Japan, and Britain.

Polyester Makes a Comeback

According to a *Textiles Intelligence* report, China's output of polyester staple fiber expanded more than 90 percent between 1990 and 1997. Asian output of man-made fibers is expected to continue increasing to make up the shortfall in the supply of natural fibers.

Rent Ceilings?

Tokyo has surpassed London as the world's most expensive office market, according to CB Richard Ellis Global Research and Consulting. Even with the fourth-largest rent decrease (22 percent)—Hong Kong still ranks as fourth most expensive. In the wake of Asian currency devaluations, eight of the top 10 cities with the steepest rent decreases are in Asia. Joining Hong Kong on this list are Shanghai and Beijing, ranked second and third with decreases of about 31 and 23 percent, respectively. Despite these declines, no Chinese cities are among the top 10 cities with the most affordable office rents.

THE **CHINA*BUSINESS*** REVIEW

美中商贸评论

The magazine of the US-China Business Council

EDITOR
Catherine Gelb

ASSISTANT EDITORS
Virginia A. Hulme
Darlene M. Liao

BUSINESS MANAGER
Gregory S. Heslin

PUBLICATIONS ASSISTANT
Lissa Michalak

DESIGN/PRODUCTION MANAGER
Jon Howard/JHDesign

RESEARCH ASSISTANT
Julie Walton

1818 N St., NW Suite 200
Washington, DC 20036-2470
Tel: 202/429-0340
Fax: 202/833-9027,
775-2476
www.uschina.org/cbr

PRINTED IN THE USA

The China Business Review welcomes articles from outside contributors. Manuscripts submitted for consideration should be sent to the editor at the address above. The US-China Business Council retains all rights to articles and artwork published in *The China Business Review*. Articles or artwork published in *The China Business Review* may be reprinted or reproduced only with the written permission of the US-China Business Council. Articles in *The CBR* do not reflect US-China Business Council policy, unless indicated.

The China Business Review, ISSN No. 0163-7169, is published bimonthly by the US-China Business Council, 1818 N Street NW, Suite 200, Washington DC 20036-2470, USA (Tel: 202/429-0340), a nonprofit organization incorporated under the laws of the District of Columbia. Periodicals postage paid at Washington, DC, and additional mailing offices. Postmaster, please send address changes to *The China Business Review*, 1818 N Street NW, Suite 200, Washington DC 20036-2470, USA.

ISSN No. 0163-7169; USPS No. 320-050

Annual Subscription rates: $99 US/Canada; $150 international. Single copy issues: $20, airmail $25; issues over 1 yr: $10, airmail $12.50. DC residents add 5.75% sales tax.

Subscriptions to *The China Business Review* are not deductible as charitable contributions for Federal income tax purposes.

All commercial inquiries and renewal/purchase orders should be sent to the above USA address.

ASIA:
Godfrey Wu
1305, 13 Fl, CC Wu Building
302-308 Hennessy Rd.
Wanchai, Hong Kong
Tel: 852/2591-1077 Fax: 852/2572-5158
E-mail: mhi@hk.gin.net

NORTH AMERICA:
Gregory S. Heslin
1818 N St., NW Suite 200
Washington, DC 20036-2470
Tel: 202/429-0340 Fax: 202/833-9027
E-mail: gheslin@uschina.org

Robert A. Kapp

Beyond WTO

The time has come for the United States and China to scale the WTO mountain and move on

The time has come for the United States and China to scale the World Trade Organization mountain and move on. Business needs to contemplate its opportunities—and its very real challenges—in a post-accession world.

The yet-unrealized commitments by China to market liberalization and a truly extraordinary array of structural changes in the Chinese economic and trade regime represent a far, far greater commitment to a market- and competition-oriented Chinese future than US observers had dreamed possible only a few weeks before.

These commitments are "yet-unrealized" because the United States and China must first close the full bilateral agreement on terms of China's WTO accession; because China must then work out similar bilateral understandings with a couple of dozen other WTO-member trade partners; and because China must then fully accede to WTO membership.

While President Clinton and Premier Zhu were not quite able to complete the arduous US-China dialogue on WTO in time for the Premier's very striking visit to the United States in April, the momentum to complete the negotiation was very much intact as the Premier departed the United States.

Assuming that the US and China really do close on their bilateral WTO agreement, and that we could be looking at China's accession to the WTO in calendar 1999, we need to focus our energies on two questions: Permanent Normal Trade Relations (NTR) treatment for Chinese goods entering the United States, and life in a post-accession world trade system.

PERMANENT NTR: APPROVE IT ON THE MERITS

The reasons to support the elimination of annual renewal of ordinary US tariffs on Chinese goods are straightforward:

- **We don't win the benefits if we don't play the game.** The opportunities garnered by our negotiators for American companies, workers, farmers, exporters, and investors—as well as American consumers—cannot be fully brought home to American communities until the United States takes the legal steps to treat China as a WTO member.

Permanent standard WTO tariff treatment—NTR—both given and received is at the top of the roster of WTO member obligations and benefits. It would be self-defeating, to say the least, if the United States, after signing the PRC on to an extensive list of fundamental commitments to world standards of economic and trade behavior, were to reject the fruits of its labors while America's own competitors moved to enjoy them.

- **Chinese accession to the WTO is a key step toward the global rule of law.** No one understands the powerful value of universally accepted and binding commitments to orderly behavior better than do Americans, who pride themselves on this nation's adherence to the rule of law and yearn to see the rule of law grow and thrive around the globe.

The predecessor of today's WTO, the General Agreement on Tariffs and Trade (GATT), was created at the end of World War II to substitute a "Trade Code of Conduct" for the predatory international economy of the 1930s, which had led many nations to catastrophic impoverishment, social and political collapse, and ultimately world war. The original GATT "rules of the road," now broader and more enforceable under the WTO, bring a degree of economic predictability and security to the world economy that has benefited the United States on many, many occasions. China's participation in the WTO system, on the basis of the long list of commitments the United States has managed to secure, is a contribution to US international economic security.

■ **The US retains its arsenal of laws with which to defend the American economy in time of need, over and above the effective WTO arrangements for the bringing and adjudicating of trade disagreements.** This requires no elaboration, but it is critically important to US domestic economic security.

China in the WTO: The Case Against, So Far

Faced with the unusual revelation by the US side of China's negotiating concessions—the so-called "Market Access and Protocol Commitments" (see the Council's website: **www.uschina.org** for the full text) that will, we hope, be retained when the two sides finally seal a bilateral WTO package—the old claim that the US-China WTO agreement would be a cheap "political deal" is in ruins. Arguments against proceeding to closure have instead made the following points:

■ **China doesn't abide by the rules or by its solemn contractual commitments anyway, so why let them in?** The evidence, however, suggests otherwise. A remarkably timely book, *China Joins The World*, edited by Elizabeth Economy and Michel Oksenberg for The Council on Foreign Relations, portrays a China that acts self-interestedly but responsibly in a wide range of international regimes that it has entered over the past 20 years, from the United Nations to multilateral financial institutions. The editors note that, while US relations with China in most fields will continue to move forward and back from time to time,

> *American bilateral efforts are most effective when reinforced through multilateral efforts and supported by the bilateral efforts of others.... Integration proceeds best when there is an international consensus on the norms to which the outside world expects China to adhere. (30-31)*

Scholar Margaret Pearson, in the same volume, notes,

> *Thus far, China's integration into the world trade and investment systems has occurred without significant disruption to the regime [i.e., the global trade regime]. China has not forced a change of rules on those systems; rather, the dominant trend has been for its reformers to adjust their rules to fit those of the [global trade] regime. (184)*

Finally, it is worth noting that the US business community that has, over more than two decades, actually negotiated and implemented commercial contracts with China, sometimes clashing bitterly with Chinese counterparts, overwhelmingly supports the finalization of China's accession to the WTO along the lines outlined in the USTR's "Market Access and Protocol Commitments" paper. The consensus is clear: China committed to the world's trading rules and restraints is better by far than China adrift outside the system.

■ **Preserving the annual threat of US trade punishment against China, outside of WTO norms, is too good a tool for compelling China to change various objectionable non-trade behaviors; the US must not relinquish it.** Again, political scientists Oksenberg and Economy speak succinctly to this:

> *The threat of well-targeted and limited sanction, especially in the trade realm, is more effective... than efforts to link two broad and diverse areas of Chinese behavior....Establishing linkages between widely separate spheres of Chinese behavior is much more difficult....Only top leaders have the authority to make the trade-offs such linkages require. Only they can issue binding and connected orders to such diverse bureaucratic domains as the public security apparatus and the manufacturing sector. And China's top leaders are unlikely to yield often to such pressures; their colleagues and subordinates would perceive them as weak.... (36)*

The "limited and credible" sanctions in the area of trade and economics, of course, are what the WTO represents. Just ask the parties who have lost to the United States in numerous WTO disputes in recent years.

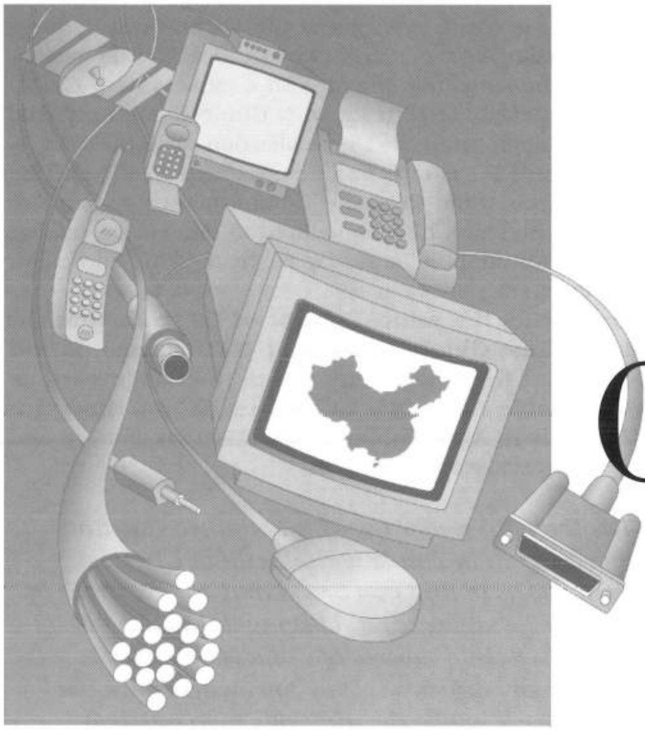
Looking Ahead

The full implications for American companies of the pending WTO-driven market openings and measures to normalize China's trade and investment regime have not yet fully sunk in. But, looking a bit ahead, we can guess at a few obvious prospects.

Business with China is still not going to be "just like home." Opportunities will expand markedly with WTO, but companies are going to have to work to turn those opportunities into successes.

Competition will increase. One of the most striking things about Premier Zhu's demeanor during his recent US tour was his blunt confidence that China was now just about ready to take on foreign competitors without the wedding cake of protectionism that has dominated the Chinese trade and investment regime so far. If he's right—and I suspect he is, in most fields—the opening of China's markets for US goods and services will engender tremendous competitive efforts within China.

In short, get set for an exciting ride, in a world both familiar to business veterans and yet—in important ways—new, once we all start down the other side of the WTO accession mountain. 完



Signs of Opening in Telecom

Recent talk of opening China's telecom market has again ignited world interest and anticipation

John Wang

For years, China's telecommunications services market has been off-limits to foreign telecom companies. Recently, however, Premier Zhu Rongji confirmed rumors that China is indeed prepared to open up its lucrative market for telecom services to international participation.

The proposed plan would, for the first time, allow foreign companies to own directly up to a 30 percent stake in PRC telecom providers. Although details have yet to be worked out, this plan is almost certainly contingent upon China's successful entry into the World Trade Organization (WTO). Moreover, Beijing is reportedly prepared to sweeten the deal by agreeing to raise the permitted level of foreign ownership gradually to 49 percent. While no details or timetable have been given for these important changes, the news has already sparked intense interest among the world's top telecommunications companies, each of which is hoping to gain entry into what is potentially the largest telecom market of the next century.

THE NUMBERS ADD UP...

China's telecommunications market has come a long way in a short time. At the end of 1988, the Ministry of Posts and Telecommunications reported that China had 4.7 million fixed-line telephone subscribers, and a paltry 10,000 mobile subscribers. A decade later, the Ministry of Information Industry (MII) registered 87 million fixed-line subscribers and 24 million cellular subscribers. Over the last 10 years, China's telephone switching capacity jumped from fewer than 9 million lines to 130 million lines. In the past 10 years, total investment in telecom infrastructure has posted an amazing compound annual growth rate of 62 percent (*see* Figure).

According to MII, which oversees China's massive telecom market, growth will continue at this impressive pace. By 2000, MII plans to have over 112 million main lines in service, over 166 million lines of switching capacity, and over 35 million cellular subscribers. By 2010, MII estimates that China will have 290 million main lines in service, 300 million lines of switching capacity, and 200 million subscribers (*see* Table). Considering MII's track record of underestimating market growth, these numbers are indeed impressive.

The numbers have sparked the keen interest of nearly all of the world's major telecom equipment makers and service providers, many of whom have made a top priority of gaining a strategic foothold in this "market of the next century." Only a small percentage

John Wang is a strategy manager in the Communications and High Technology Practice of Andersen Consulting in Hong Kong.

of China's huge population has telephone service—the fixed-line penetration rate is only 7 percent, while cellular penetration is only 2 percent. When compared with the 50-plus percent fixed-line penetration and more than 30 percent wireless penetration in most advanced economies, these figures spell out the potential for massive growth in China.

...BUT HAVE REMAINED TANTALIZINGLY BEYOND REACH UNTIL NOW

The allure of this giant market belies a system filled with pitfalls. Foreign companies have learned—often the hard way—to temper enthusiasm with realistic expectations, market insight, and common-sense business practices. Foreign telecom-equipment vendors face intense competition from each other, as well as from an ever-stronger field of domestic players, all of whom are willing to sacrifice near-term margins for long-term market-share growth. And earlier this year, some foreign companies were explicitly prohibited from providing telecom services in China, despite having already committed millions in the country.

Most of the targeted investments are in Chinese-Chinese-Foreign (CCF) arrangements with China's only other licensed carrier, China United Telecommunications Corp. (Unicom). CCFs are a complex arrangement of company structures by which foreign firms were able to take advantage of legal ambiguities—before the government froze all new ventures adopting this practice (*see* p.16).

Meanwhile, China Telecom continues to dominate the market for basic, long-distance, and mobile services and looks to maintain its leadership position over Unicom, which has barely gained a 4 percent market share in mobile services and a less than 1 percent share overall since starting service in 1994. Thus, a recent move by MII to break up China Telecom's fixed, mobile, paging, and satellite operations into separate companies is understandably seen by many analysts as trading in one monopoly for four.

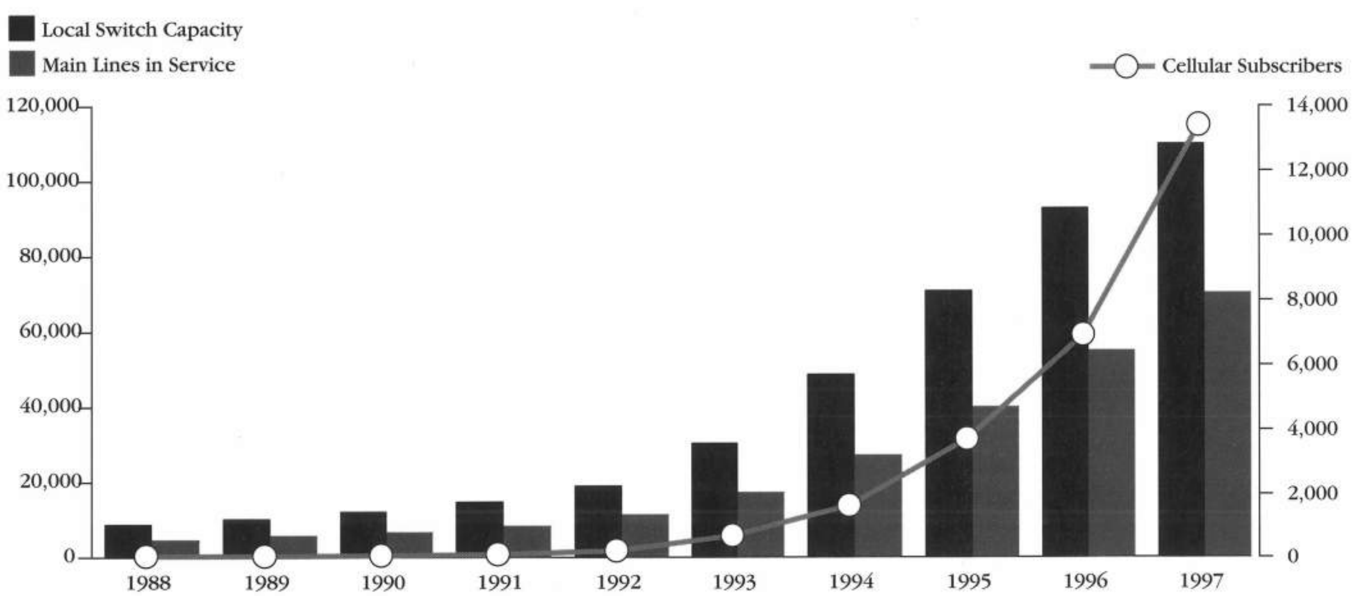
In fact, the move to split up China Telecom's monopoly more likely reflects the government's desire to separate the mobile and paging sectors, which can be opened to international competition more quickly than the traditionally guarded fixed-line and satellite communications sectors. Thus, when MII breaks up China Telecom into four separate companies—China Telecom, for fixed-line services; Guoxin, for paging services; China Telecom Mobile; and China Telecom Satellite—it probably will be aiming to liberalize two of the four sectors and keep the other two sectors protected.

For the optimistic, there is a glimmer of hope in the April deal between AT&T and Shanghai Posts and Telecommunications (P&T) Administration to jointly develop and manage an Internet protocol-based broadband network in Pudong, in Shanghai. For the pessimist, however, history and experience demand an answer to the question: "Will this deal be different from others?" Though touted as a breakthrough agreement, the AT&T deal still awaits official approval. In fact, over the years many companies, including Hongkong Telecom's parent company Cable & Wireless, and even AT&T itself, have signed these kinds of "breakthrough" agreements, only to be disappointed later.

Foreign companies have learned—often the hard way—to temper enthusiasm with realistic expectations, market insight, and common-sense business practices.

Notwithstanding the recent excitement over possible liberalization, foreign companies would do well to remember that China's journey toward liberalization has in recent history taken

FIGURE
CHINA'S UNPARALLELED DECADE OF TELECOMS GROWTH (THOUSANDS), 1988–1997



SOURCE: China Telecom

Before exposing China Telecom to intense competitive forces from the likes of AT&T and Cable & Wireless, the government wanted to make the company internationally competitive.

an evolutionary pace, rather than the revolutionary one many observers had hoped for. At the highest levels, the Chinese government, and not only MII Minister Wu Jichuan, has been unwilling to loosen control over a sector of the economy that contributed so much to government coffers and to economic growth. For years, economic theory, which clearly supports the idea that open markets yield more long-term benefits than monopolistic ones, bowed to short-term political realities in China.

Before exposing China Telecom to intense competitive forces from the likes of AT&T and Cable & Wireless, the government wanted to make the company internationally competitive. Beijing also wanted to support local producers of high-tech telecom equipment via China Telecom's huge purchasing power—part of a desire to maintain control over an economy that faces serious external challenges from the Asian financial crisis.

Nevertheless, the "economics of volume"—the strength of China's market potential—requires foreign companies to include China in their strategic world view. If you want to be a major player in the telecommunications market of the next century, conventional wisdom demands, you had better be a major player in China.

Moreover, the "economics of interdependence"—the new dynamics of an emerging network economy that ties together telecommunications, media, and computing across international borders—requires fundamental changes in market structure, which neither the Chinese government nor MII can control. To be successful, foreign companies must first understand the changing context of the Chinese telecommunications market. Each company must then decide how China fits into its global strategy and what course of action will help it reach its strategic vision for China.

Volume and more volume

China is arguably the largest market in the world for telecommunications equipment. It adds the equivalent of one US regional Bell operating company per year to its public network, and its mobile market has come from nowhere five years ago to become the third largest in the world today, surpassed only by the United States and Japan. Despite a clear effort by the Chinese government to reduce its reliance on foreign equipment, major telecom equipment vendors around the world will continue to expand sales in China as they fight for a shrinking share of an ever-larger pie.

Companies such as Alcatel, LM Ericsson, Lucent Technologies, Motorola Inc., Nokia Group, and Siemens AG were among the first to enter the China telecom market. After over a decade of investment and effort, their patience and tenacity have started to pay off. For example, China has already become the largest market for the products and services of Swedish equipment vendor Ericsson, accounting for 12 percent of its worldwide sales. The picture is much the same for US mobile-equipment provider Motorola, whose combined sales to China and Hong Kong account for about 12 percent of the company's total.

The development in China of GSM (Global System for Mobile Communications), a European digital standard for mobile communications, is one good case study of the opportunities anticipated by most equipment vendors. In 1993, before government approval of GSM as a viable digital technology for China, Guangdong P&T Administration, China's largest and most audacious, asked five vendors to put in "trial networks" in the province. Some months later, the so-called "trial" network had grown to over 100,000 subscribers.

China Telecom began to roll out GSM *en masse* soon after Unicom announced its plans to pursue a nationwide rollout of GSM. Ericsson, having won the confidence of the Guangdong P&T Administration, became the preferred vendor in Guangdong. As Guangdong developed into a 2 million-subscriber GSM market in the ensuing 5-6 years, Ericsson rode the wave to success in China.

Many vendors are now hoping that Code Division Multiple Access (CDMA), the digital standard prevalent in North America, will provide another wave of opportunities in the China market.

Table
China's Telecom Plan for 2010

- China's telecom market will rank among the most advanced in the world in terms of scale, technology, and quality of service.
- Overall communication capacity will be twice the level achieved by 2000, or 370 million main lines.
- Service revenue will top $132.5 billion.
- Advanced equipment of 20-40 Gbps SDH or even higher speed technology will be deployed on the trunk optical lines.
- A broadband multimedia communication network based on the ATM protocol will cover all cities above the prefecture level and all prosperous counties and villages.
- An access network will provide both urban and rural users broadband access functions.
- Supporting networks will meet world-class standards in intelligence and automation, efficiency, quality, safety, and reliability.
- The total number of fixed-line subscribers will top 290 million, pushing main-line penetration to 28 percent of China's entire population.
- Mobile subscribers will reach 200 million with cellular penetration at 15 percent of China's total population.

SOURCES: Ministry of Information Industry, China Telecom, Pyramid Research

CDMA has already been approved in China. However, to date, it has only been developed in some limited capacity by China Great Wall, a 50-50 joint venture between the People's Liberation Army (PLA) and China Telecom.

The government's 1998 order that the PLA withdraw from all commercial activities has called into question the continued viability of China Great Wall CDMA. At the same time, Beijing is reportedly considering plans to allow Unicom to get involved in building CDMA networks, a move that could spark the growth of CDMA networks in China. Such a development would certainly be welcomed by the likes of Motorola, Lucent, and Nortel, whose major markets in North America have used CDMA for years.

A key to success for many equipment vendors in China was localization—the setting up of local joint ventures and the transfer of the technology, financial resources, and management expertise needed to support them. Because of razor-thin margins, heavy import tariffs, and China Telecom's propensity to purchase local products where possible, relying solely on imports to compete is nearly out of the question. Local production in China is thus playing an increasingly important part in the global strategies of nearly all telecom equipment vendors.

All of the major players have local joint ventures producing in huge volumes for the China market. Motorola is the largest US telecom investor in China, having committed some $1.2 billion. Alcatel's Shanghai Bell switch equipment facility, one of China's first and largest telecom joint ventures, attributes its success to being considered a Chinese company.

Inevitable interdependence

Though China is keeping a tight grip on traditional telephone services, cutting-edge technologies and services may provide alternate entry routes for foreign firms. As they have done elsewhere in the world, emerging services, which include network-centric broadband, interactive, and multimedia services, will alter the competitive landscape of the telecom market in China. These emerging services are inherently anti-monopolistic because they require "supply convergence" and enable "demand divergence." The merger of AT&T and Tele-Communications, Inc. (TCI) in the United States provides a good example of "supply convergence," in which companies in traditionally different industries come together to create a seamless union between television, telephone, and Internet services.

As companies from different sectors compete more with each other, these kinds of technology-enabled mergers provide consumers with a range of new choices and thereby create "demand divergence." For example, emerging Internet telephone services put Internet service providers (ISPs) squarely in competition with telecom firms, while services like video-on-demand, such as the project launched by Hongkong Telecom's Interactive Multimedia Services, force traditional telecom providers to compete directly with cable companies. In China, cable television providers already have plans to get into the telephone and Internet business, while China Telecom is moving aggressively into the television and Internet market (*see* p.20). Without any formal liberalization, industry convergence has already created market competition.

Equipment vendors also stand to benefit from this convergence. Recently, Lucent Technologies announced it will partner with China Telecom and Shanghai P&T Administration in a $29.8 million venture to develop software for merging networks. The establishment of this joint venture, called Guoxin-Lucent Network Technology Co., is significant in two ways. First, it shows the willingness of China Telecom to partner with a foreign company. Second, it shows an important shift in focus to software rather than network equipment, which has been the traditional focus of China Telecom.

Chinese surfers take to the Net

One of the most hotly contested areas will be the Internet, where growth seems to be taking off (*see* p.12). As of mid-1998, the number of Internet users in China was roughly 2 million, with estimates ranging from 1.2-2.4 million. The wide range of estimates is mainly due to the ambiguity of the number of users accessing each dial-up account. Surveys are also showing an increase of time spent online per account. In October 1997, most users spent 1-5 hours a month online; by June 1998 the majority of users were spending over 10 hours online. The significant rise in both the number of Internet users and the amount of time they spend online can be attributed to investments in telecommunication networks that provide faster access, as well as a substantial rise in Chinese-language content.

The Internet has spawned a new generation of Chinese entrepreneurs and will open the door to new opportunities for Western companies. Microsoft Corp. Chairman Bill Gates was in China on March 8 to launch the Venus program—a Windows CE-based system designed to help Chinese viewers surf the Internet on their TVs or video compact-disc players. Internet content providers (ICPs) and ISPs are also growing rapidly in China. Strict content regulations and the prohibition against foreign companies providing Internet service in China continue to block the entry of many Western ISPs and ICPs. Nevertheless, if popular predictions that the prevailing language on the Net will be Chinese are correct, then interest from Western companies such as Yahoo—which has already developed a Chinese site—is sure to grow.

According to *Business China*, studies have also pointed out that most Internet users in China are members of an elite: they are young, well-educated males (93 percent), concentrated in the richest parts of the country (Beijing, Shanghai, and Guangdong), who earn higher-than-average incomes. As Internet users are likely to spend more than the rest of Chinese society, this natural segmentation has serious impli-

China Promotes the Internet

Though recent crackdowns on the Internet indicate to some that China's leaders are wary of this new medium, in fact, the government is encouraging widespread Internet use both to boost economic growth and to spread its own message. Thus, foreign investors might interpret these recent moves—which include launching government websites and projects to improve related infra-

structure—as preparation for a far wider Internet penetration in China, but with the government trying to set the terms of use.

A tremendous surge in the number of Internet users is likely driving the government's recent activities. According to a survey conducted by China National Information Center (*www.cnnic.gov.cn*), the arm of the Chinese Academy of Sciences charged with overseeing the Internet's development in China, 2.1 million Chinese made use of the Internet in December 1998, up from 1.2 million just six months earlier. But according to research and consulting firms Big Brains Ltd. and Matrix East Inc., that figure could be as high as 3.4 million. Big Brains forecasts that the number of Internet users could reach 5.5 million by mid-1999 and 10 million by mid-2000.

Moreover, though stagnant consumer demand has forced retail prices down for six consecutive quarters in most sectors, demand for telecommunications and information technology is expanding rapidly. According to the Ministry of Information Industry (MII), last year the number of mobile phones jumped an astonishing 70 percent to nearly 25 million, while the total number of fixed-line subscribers exceeded 80 million.

E-commerce: An Economic Engine

At the highest levels, the government is already aware that telecommunications and information technology (IT) converge on the Internet, and that e-commerce is a promising source of economic growth. At last November's Asia Pacific Economic Cooperation meeting, President Jiang Zemin described e-commerce as "the future of business," calling on technologically advanced countries to provide developing nations with technology and other assistance needed to build e-commerce infrastructure.

Last summer, the Ministry of Foreign Trade and Economic Cooperation launched its China Market website (*www.chinamarket.com.cn*), the country's first official export-oriented, business-to-business e-commerce site. More recently, the government has announced a number of initiatives aimed at providing nationwide standards and infrastructure to support e-commerce. In November 1998, Beijing Vice Mayor Liu Qichu and representatives from MII, the Bank of China, and tax and customs authorities launched a project to draft laws and regulations, develop an Internet portal, and develop secure-payment and credit-card verification systems.

In fact, credit-card verification systems may soon be up and running. According to internal ministry reports and industry accounts from Beijing, the Golden Card project, launched in 1994 to boost card usage in China, is on schedule to meet its target of creating a nationwide, interbank credit-card clearinghouse by 2000. Some businesses, however, are not waiting for a nationwide system. Last November, a Shanghai-based, online CD store became the first online merchant in China to accept credit cards, albeit only those issued by the Agricultural Bank of Shanghai. If the move is successful, other businesses and banks are sure to follow.

Other companies have found different ways around the problem. Dell Computer Corp. accepts payment via wire transfer for Internet orders delivered from its base in Xiamen, Fujian Province. Australia's Television Shopping Network, with a turnover of cations for the way merchants of the future would want to market and sell to these upwardly mobile, upper-middle-class consumers. More specifically, the development of e-commerce, another area of emerging competition, will play an increasingly pervasive role in the consumer economy of China.

The Rise of E-Commerce

After sitting silently at the end of words for eons, the letter "e" is finally taking its revenge on the world. Not only has it broken its silence, but its mere appearance in the front of any word exponentially increases that word's excitement and meaning—e-commerce, e-banking, e-government. This is true even in Chinese, as even the typically staid bureaucracy of the Chinese government has jumped onto the e-commerce bandwagon. For example, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) recently released bidding information on export quotas for electronic and machinery products over its web sites (*www.moftec.gov.cn* and *www.chinamarket.com.cn*). This was the second time that MOFTEC had employed electronic bidding for export quotas, following the earlier success of the quota bidding for textile products. Watch out eBay? Probably not. But MOFTEC and other ministries expect to expand this type of electronic interaction with the market.

In line with these moves, MII Minister Wu announced earlier this year that the government views the construction of

$300,000 a month, uses China Post's Express Mail Service, which handles cash-on-delivery business and takes a 2 percent commission on top of its delivery fee. Though credit cards would boost both companies' turnover, the majority of e-commerce users will be companies and institutions, not individuals. Because credit risk is lower for corporate card-holders, credit-card verification systems will not be as crucial to e-commerce in China as long as development focuses on this institutional part of the market. Corporate credit cards have become so popular that China has become MasterCard International Inc.'s second-largest market—even without a nationwide card-verification system in place.

Policy in the Making

While some government officials obviously support the development of e-commerce and Internet use, a struggle is reportedly taking place between Premier Zhu Rongji and conservative MII Minister Wu Jichuan. Wu clearly wants to retain control of the national telephone network (and by extension, Internet connections)—either directly, through his ministry, or indirectly, through China Telecom, the country's public telephone network operator. Zhu, however, apparently prefers to open up the network to businesses, fostering competition to drive down prices.

It is not yet clear whether Zhu will be successful in countering MII's monopolistic tendencies. A court case conducted in early 1999 tested MII's assertion that voice and fax services can only flow over the public network, and not over the Internet. The case arose after two brothers in Fuzhou, the capital of Fujian Province, began running an Internet phone service offering international calls at half China Telecom's rates. The brothers claimed they offered a computer service, not a telecommunications service, and so were outside MII's jurisdiction. They lost the original hearing, but won their appeal at the Fuzhou Intermediate People's Court. The court reportedly consulted with Internet experts and based its decision on the fact that Internet telephony is technologically different from conventional telephony. Some analysts have speculated that higher authorities urged the court to rule in favor of the brothers. In similar cases, it is unlikely a court would reach a decision solely on a legal basis.

In response to the Fuzhou decision, MII issued a statement maintaining that it alone had responsibility for all matters pertaining to telecommunications in China. Though this will probably be true for the foreseeable future, MII may have difficulties enforcing its writ, especially if it fails to receive backing from the top leadership.

Several other ministries and players with their own communication networks are already taking steps to bypass China Telecom, by developing their own Internet and telecom connections to the rest of the world. Heavy backing is also emerging for Unicom (which, while weak, is China Telecom's only officially sanctioned competitor) as evidenced by the pressure on China Telecom to lower its charges for both Internet and phone services. Though building the telecom network was Beijing's priority until the mid-1990s, the stress now is on using the network to help boost the economy and maintain the leadership's legitimacy—based in large part on its ability to deliver rising standards of living.

This alone is a compelling reason for the government to encourage widespread use of the Internet. But Beijing believes that information technology in general—and enhanced national communications in particular—will increase its ability to monitor and control China's economic and political situation. So while increased networking may provide a platform for a national political discourse, government officials in Beijing believe that the new technology will allow them to monitor the economy and polity more effectively.

If the government can cope with the social issues raised by the Internet—and recent actions suggest that it is confident it can—then the expansion of the Internet in China is far less surprising than it first appears. Throw in the lure of e-commerce, and Beijing will almost certainly let this growth proceed at a pace that will continue to astonish all observers, even those who may be expecting it.

—Simon Cartledge and Peter Lovelock

Simon Cartledge and Peter Lovelock are founding directors of Big Brains Ltd., a Hong Kong-based research organization specializing in Asia's information technology and telecommunication sectors.

several major information application systems for macroeconomic operations management as the first step to national "informatization"—a direct translation from Chinese that refers generally to the shift from an industrial economy toward an information-based economy. According to Wu, MII will speed up the formulation of corresponding regulations and strongly promote e-commerce in order to improve corporate ability to exchange information worldwide.

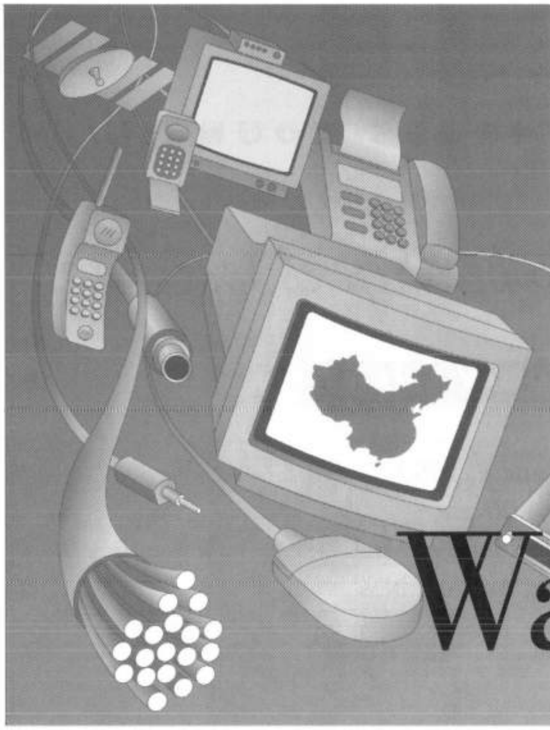
In fact, China has already initiated a number of data communications net work construction projects since 1994. Known as the "Golden Projects," these are essentially network-construction projects aimed at providing a common platform for information exchange in data, voice, and video formats. The three major projects are Golden Bridge, Golden Customs, and Golden Card. When integrated, the projects will constitute a basic nationwide e-commerce infrastructure.

A MADDENING PACE

For China, these network-centric developments will have a profound impact on the structure of the market because traditional service lines are still clearly demarcated and organizationally enshrined in state-owned monopolies. While grappling with these practical issues, the Chinese government is also attempting to balance control versus market efficiency. Beijing is likely to find it increasingly difficult to resolve problems without loosening control, however, and the current leadership still seems unprepared to accept such a trade-off in full. Though the listing of China Telecom (HK) Ltd., the establishment of MII, and the breakup of China Telecom are all steps in the right direction, more restructuring is necessary.

A positive sign of changing times is the impact of demand-side efficacy on pricing decisions. Pricing for telecom services is still centrally coordinated, with the price bureau setting "guidelines" for local telecom operators. But the increasing power of consumers was recently reflected in MII's decision to lower rates and fees in response to overwhelming consumer complaints about paying exorbitant prices for bad service. Telephone line installation charges were reduced from as high as ¥3,600 ($435) to ¥500-¥1,000 ($60-$121). Mobile network access charges came down from over ¥2,000 ($242) to ¥500-¥1,500 ($60-$182). ISPs also welcomed the price reductions, as the cost of leasing of an international line dropped ¥111,600 ($13,479) to ¥320,000 ($38,649) per month. Prices are expected to continue to fall, spurred by consumer activism and China Telecom's effort to attract a broader base of subscribers.

If there is one constant in the Chinese telecommunications market, it is the fact that demand will be strong. In the final analysis, companies looking to invest in China should always bear in mind three simple observations: demand does not always equal sales; sales do not always translate into profits; and short-term profit seldom brings long-term success. Companies must have a vision for China, fully understand market opportunities—as well as constraints and eccentricities—and then adopt a course of action to reach reasonable and well-defined goals. 完



The Regulatory Waiting Game

The evolving PRC telecom regulatory environment leaves key questions about foreign participation unanswered

Jeanette K. Chan and Charles F. Goldsmith

The past year has seen many changes to China's telecommunications regulatory regime. The relevant government machinery regulating the industry has been restructured, and the traditional monopoly telecom provider, China Telecom, is to be split into several companies. China United Telecommunications Corp. (Unicom), China Telecom's sole authorized competitor in the provision of basic and wireless telephone services, has gone through another change of guard—the fourth since its inception five years ago. Though Unicom will continue to expand its business, the company's strategy of relying on foreign investment has come under heavy attack within the government.

Hopes for a third network based on Code Division Multiple Access (CDMA) technology, which was to be jointly operated by the People's Liberation Army (PLA) and China Telecom, are on a roller coaster of uncertainty. The PRC government has enunciated a strategy of encouraging telecommunications operators to procure Global System for Mobile Communications (GSM) wireless equipment. However, recent reports indicate a change of heart towards CDMA technology.

Of most importance to existing and potential foreign investors is the fact that the highest levels of government have questioned the so-called Chinese-Chinese-Foreign (CCF) model of foreign investment. The CCF model is a creative, if legally ambiguous, scheme used by Unicom in recent years to avoid the legal prohibition against foreign investment in Chinese telecommunications businesses.

Recent Developments

Government bodies that oversaw China's telecom industry were a main target of last year's restructuring. The restructuring combined several government agencies into MII, including the Ministry of Posts and Telecommunications (MPT), Ministry of Electronics Industry (MEI), State Radio Regulatory Commission, and certain functions of the former Ministry of Radio, Film, and Television (MRFT). One purpose of this move was to further separate the regulatory authority from the traditional monopoly telecom provider, China Telecom. Because Wu Jichuan, the former head of MPT and its operating arm, China Telecom, became the minister of MII, and because the majority of high-level MII officials came from MPT, industry participants became concerned that China Telecom was being favored over Unicom and other telecommunications opera-

Jeanette K. Chan is a partner and Charles F. Goldsmith an associate at the law firm of Paul, Weiss, Rifkind, Wharton & Garrison.

tors. To date, MII's actions have failed to alleviate many of these concerns.

MII recently announced its decision to divide China Telecom into separate fixed line (including local and data communications) long distance, wireless, paging, and satellite businesses. Presumably, the local branches of China Telecom will be split correspondingly, but the specific details of how this split will be accomplished have not yet been announced. On the other hand, Unicom's future seems secure at this point, despite the strong attack on its previous strategy of relying on foreign investment for its network rollout.

Meanwhile, the hoped-for third network based on CDMA technology appears to have regained some momentum. Prior to Zhu Rongji's visit to the United States, it was doubtful whether China would adopt the CDMA technology. However, shortly before Zhu's departure, signs seemed to indicate that MII had approved the adoption of CDMA technology, and Unicom had been approved to roll out a CDMA network.

Nevertheless, questions remain regarding the PLA's involvement in China Telecom's CDMA project, known as Great Wall. China announced a new policy prohibiting the PLA from conducting business activities, but it is not clear whether this type of telecommunications business will be an explicit exception to restrictions on PLA business activities. Notwithstanding the prohibition of PLA business endeavors, the PLA may be permitted to lease out its radio frequencies to licensed telecommunications operators. Given the uncertainties about the role of the PLA, and the ongoing questions about the CCF model of foreign investment, the jury is still out on whether CDMA technology will be the key avenue for foreign participation in the near future.

In the short term, meanwhile, it seems unlikely that MII will permit various data network operators, Internet service providers, or broadband cable operators to compete with China Telecom or Unicom in the provision of basic telephone services. MII's Wu has spoken several times in the past year against the duplication of resources. To the extent that China Telecom's monopoly cannot be maintained, he appears to prefer a controlled duopoly in the provision of basic telephony.

Finally, the State Council issued a directive asking local operators of GSM networks to purchase locally produced telephone equipment rather than imports. It is unclear whether the "buy local" directive means that only equipment made by Chinese companies should be bought, or if products made by Chinese-foreign joint ventures also count as local. Moreover, subsequent statements by MII seem to make certain exceptions to the binding nature of any such directive, and there are no public documents that clarify the policy.

The buy-local directive coincided with the announcement that two leading local manufacturers, Huawei Technologies and Datang Telecom Technology, plan to introduce their own mobile telephone systems. As long as China's application to join the World Trade Organization (WTO) remains pending, there is nothing to prevent PRC authorities from enacting specific protectionist measures of this sort as binding regulation in China.

Longstanding bans

The recent government restructuring thus far has done little to indicate that the PRC government will lift its longstanding legal ban on foreign participation in telecommunications operations. Beijing lifted some restrictions on certain telecommunications businesses, including wireless, paging, computer information services, and value-added services, in 1993. The relaxation allowed domestic entities not controlled by China Telecom to operate those businesses, provided they had received relevant permits from or had registered with MPT. That limited liberalization explicitly excluded foreign companies and foreign-invested enterprises (FIEs) in China.

To create competition for China Telecom in basic and wireless telephony and to utilize the excess internal telecommunications resources of various government ministries, the State Council authorized the establishment of Unicom in 1994. Though the State Council designated the Ministry of Electric Power (MEP, now the State Power Corp.), the Ministry of Railways (MOR), and MEI as the major shareholders of Unicom, Unicom never integrated the networks of either the power or railways ministries into its system. As a result, Unicom became almost exclusively MEI-controlled.

This new carrier needed substantial capital in order to roll out networks that could compete effectively with

The jury is still out on whether CDMA technology will be the key avenue for foreign participation in the near future.

China Telecom. Along with other Chinese operators of liberalized telecommunications businesses, Unicom sought ways to obtain funds from foreign investors despite the ban on foreign equity investment in telecom business operations. Unicom utilized the CCF model to raise such funds, primarily for projects using GSM wireless technology.

A roundabout investment model

The CCF model starts with the establishment of a cooperative joint venture in China by a foreign investor and a PRC entity. The foreign investor contributes the bulk of the capital of the joint venture, the business scope of which is to construct and provide services for telecommunications networks. The joint venture then enters into a cooperation contract with a domestic telecommunications network operator that may be related to the Chinese partner in the joint venture. The operator commissions the joint venture to construct the network and provide ongoing network services, and in exchange pays the joint venture service fees and/or network usage fees, which are specified percentages of operating revenues. The cooperation contract typically is set for a fixed term ranging from 15 to 30 years, and provides for the joint venture to retain title to the network assets constructed by the joint venture for a minimum period of time. The contract also gives the operator rights to use the network.

The usual legal justification for the CCF model is that the arrangement is based merely on a contractual relationship and is not, in form at least, an equity investment by a foreign investor in a telecom operator. A November 1994 MPT notice permits posts and telecommunications enterprises (meaning China Telecom and its local counterparts) to use overseas investment in

The lack of a specific regulatory framework for the CCF model has, to a certain extent, worked to the advantage of foreign investors.

the *construction* of telecommunications networks, and to allow the foreign party to recover its costs and a certain return. Though the notice does not specifically authorize the CCF structure, it provides some additional legal support for it by way of analogy. Defenders of the legality of CCF projects also point out that local foreign-investment approval authorities have permitted the establishment of the joint ventures.

Despite arguments that the letter of the law has been observed, the legal status of the CCF model has always been ambiguous. These projects are invariably vulnerable to the risk that the authorities would construe the prohibition on foreign investment as precluding an FIE from obtaining equity-like returns from telecommunications businesses in the form of contractual use and service fees. This risk has been highlighted in the past year, as central-level authorities have explicitly questioned the legality of the CCF model.

In addition to the broad general concerns about the model's legality, other legal ambiguities regarding the CCF model could pose problems for foreign participants. For instance, a joint venture that owns the network assets and permits the operator to use such assets for the cooperation term might be deemed to be leasing equipment. If leasing is a foreign-invested joint venture's primary scope of business, then central-level approval of the joint venture's establishment is required. The Ministry of Foreign Trade and Economic Cooperation (MOFTEC) has indicated orally that if leasing is not the primary business scope of the joint venture, only local-level approval is required.

But determining the appropriate level of approval authority for a proposed foreign investment is not always easy. Investment projects in the PRC under \$30 million can be approved locally, while larger projects must be approved at the national level. It is generally more difficult to obtain approval for CCF joint ventures at the national level than the local level. Because the initial investment in a CCF joint venture is typically less than \$30 million, local approval is sufficient for that initial investment.

But problems may arise when it comes time to increase the total amount of investment in the network. At that stage, the foreign investor must decide whether to expand the total amount of investment in the joint venture, which could require national approval—at considerable expense and with no guarantee that the approval would be granted. Alternatively, the investment may be increased through one of the many methods commonly used to avoid national-level approval. One such method is to break up the network project into several discrete projects and to establish a separate cooperative joint venture for each project. This approach is quite common and may be justifiable where the subprojects have different geographical scopes and function independently. The risk of employing this strategy is that a government authority might view the division of a network into several projects as a ruse designed to circumvent regulatory requirements.

Far from ideal for both foreigners...

Foreign investors have several practical complaints about the CCF model, many of which relate to legal issues. Probably the most common of these is that the joint venture is by law only a consultant of, and not an equity owner in, the network operator. This lack of ownership status may restrict a foreign investor's ability to veto the operator's actions when a disagreement arises or when the operator chooses a course that could prove detrimental to the network. The foreign investor rightly wants to make sure that the operator is using the investor's money wisely, to ensure that the foreign party will be able to recover its investment and earn a reasonable return.

The investor also wants to avoid dilution of the cash-flow stream that is supposed to flow back to the joint venture from the operator. The contract between the joint venture and the operator thus usually places contractual restrictions on the operator's freedom of action, particularly with regard to its finances and important business decisions. More specifically, restrictions could pertain to network expansion and equipment procurement, or take the form of tariff and fee changes. The contract can also provide for a joint committee or committees of all parties to supervise the operator and to decide major issues. In light of the legal prohibition against foreign participation in network operations, however, the enforceability of such contract provisions is questionable at best.

Another common complaint concerning the CCF model is the uncertainty over whether the joint venture can own network assets. While it is common in most CCF transactions for the joint venture to retain title to the equipment it will procure and install on behalf of the network operator, it is unclear whether MII or a PRC court would interpret the restriction on foreign participation in telecommunications operations so broadly as to restrict retention of title to operational assets, even when the operations are performed by other parties.

At the same time, the lack of a specific regulatory framework for the CCF model has, to a certain extent, worked to the advantage of foreign investors: they face fewer restrictions and limitations than would likely be the case with a full set of regulations. In particular, foreign investors have had a freer hand to negotiate favorable percentage returns from projects in which they invest. By the same token, certain officials in the PRC government apparently believe that the unregulated nature of the CCF model gives the foreign investor too much leeway.

...and Chinese policymakers

During the internal debate among Chinese policymakers about the future of Unicom, the CCF model of foreign investment has been explicitly and harshly criticized in the past year at the highest levels of the Chinese government. Though no statements have been made public, the State Planning Commission (now the State Development Planning Commission [SDPC]) in March 1998 reportedly proposed to the State Council restrictions on the use of the CCF model by Unicom in the near term, and recommended that the CCF method be prohibited after next year. The proposed restrictions would limit the term of the contract between the joint venture and the operator to no more than 15 years, require transfer of title to 90 percent of the network assets within five years of the contract signing, require that all Chinese joint-venture partners be affiliates of Unicom, and limit the foreign party's percentage profit share after the first five years of the cooperation contract. Existing arrangements would be implemented once all of the capital has been paid in. Should capital not yet be paid in full, existing arrangements would have to be revised according to the proposed restrictions.

Several of the specific concerns evidently raised by Chinese policymakers mirror those of foreign investors. For instance, policymakers apparently are concerned that foreign investors control both the investment amounts and direction of CCF projects through the operational controls, such as joint committees, set forth in the cooperation contract. The Chinese are also concerned that ownership of network assets would mean that in the event of a dispute, the Chinese operator might not be able to use the network assets freely. Some policymakers believe that the revenue percentages that go to the foreign party are too high, and may lead to a huge outflow of revenue from the country and prevent Unicom from accumulating needed capital from its minor returns.

Moreover, the foreign investor's percentage share of returns is currently often much higher than what China promises to foreign investors in its WTO proposal. Industry analysts thus believe that China's bargaining position in the WTO negotiations has consequently been undermined. The latest bilateral discussions between the United States and China, which focused in part on market access in the telecommunications sector, attempted to address this discrepancy. However, China's latest offer is still much more restrictive than what foreign investors have been receiving under the CCF model.

Other drawbacks of the CCF model from the Chinese perspective include the difficulty Unicom has encountered in its attempts to centralize project funds and plan network construction. The arbitrary terms and conditions of the cooperation contracts has led to great discrepancies in documentation of the various projects, exacerbating difficulties reaching tariff and fee settlement between the projects.

Lastly, there are no provisions under the current laws and regulations for accounting systems to track funds raised through a CCF arrangement, which cannot be categorized as either equity or debt, although there are elements of both in CCF transactions. But this is not a serious legal concern. To the extent that no applicable legal regulations exist, the cooperation contract relationship would simply be governed by the PRC Economic Contract Law (or, once it takes effect, the Uniform Contract Law).

In August 1998, the State Council met to discuss CCF and apparently resolved that the model should be cleaned up, regulated, and investigated. That meeting introduced a proposal, reportedly backed by Zhu Rongji, to establish a working group led by MII and composed of officials from SDPC, the Ministry of Finance, and the State Economic and Trade Commission to study existing CCF contracts of Unicom and make recommendations. The proposal also supposedly stated that alternatives to foreign funding should be sought for Unicom. This review of existing CCF contracts apparently is still under way. While no official statements have been issued, MII has, in press conferences, criticized the CCF model, particularly the sharing of installation fees with foreign investors.

Rumors have circulated that high-level policymakers in the State Council, recognizing that the restriction may not be prudent, are reconsidering the plan to restrict severely the use of the CCF structure. The current uncertainty casts a cloud over both the use of the CCF model for projects with Unicom and projects with other authorized operators of liberalized telecommunications businesses in China, such as paging operators.

The legal prohibition against foreign direct investment in telecommunications remains more or less intact. Any possible change of policy to allow such investment in PRC telecom operators remains hostage to ongoing debates within the Chinese bureaucracy and the talks on China's accession to the WTO. The one bright spot would appear to be in the area of public listings. The flotation of China Telecom Hong Kong in 1998 appears to have been a relative success. Unicom and the new China Telecom paging company may also list domestically on the Shanghai or Shenzhen stock exchanges in the near future. The rumored listing may include B shares, which can be held by foreign investors.

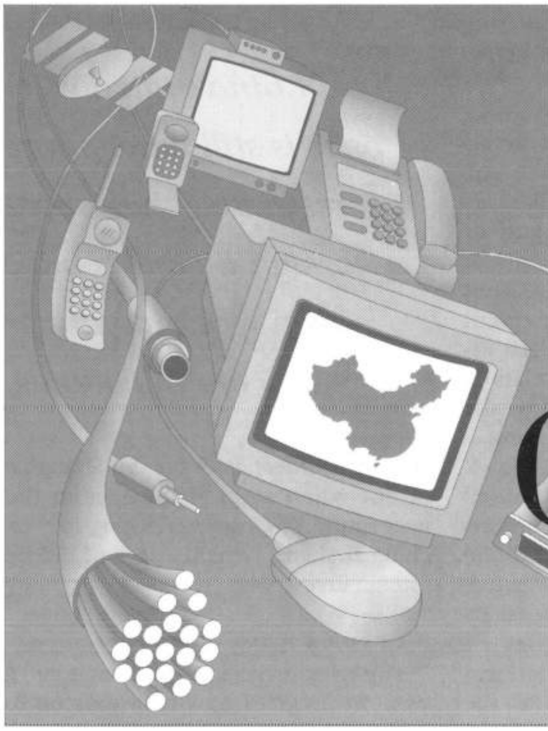
China's latest WTO offer is still much more restrictive than what foreign investors have been receiving under the CCF model.

Patience is key

The telecom regime in China is still a work in progress, making it difficult to determine the direction of future developments. The continuing uncertainty results from both the relative opacity of the Chinese legal and administrative systems and the apparent differences of opinion among various policymakers in the Chinese government. As a result, current and potential foreign investors are confused about what to do and how to plan.

In the context of serious reform, Beijing appears to be sincerely looking for ways to promote telecommunications infrastructure development and utilize foreign capital while protecting its sovereignty. The reform effort may result in a clearer set of rules governing the industry, the role and rights of foreign investors, and some liberalization in the area of foreign direct investment.

A policy that prohibits or restricts use of the CCF model but permits a certain degree of foreign direct investment in telecom companies in China might, in the end, be the best foreign companies can hope for. Under such a policy, foreign investors would relinquish their majority control over operations but would benefit from standing on firmer legal ground. Such a system would be similar to those of other countries—including the United States—that have traditionally limited foreign ownership of telecommunications companies in the name of national sovereignty. But foreign investors will have to wait patiently while PRC authorities complete WTO negotiations with the United States. 完



Cable Connections

Foreign firms must adapt their business strategies to the major restructuring taking place in the PRC cable television industry

Warren H. Rothman and Jonathan P. Barker

The development of broadband technologies has called into question in China, as elsewhere, the traditional boundaries that separate voice, video, and data transmission services. While Chinese service providers once monopolized their respective domains, broadband technologies now enable telephone companies and broadcasters each to offer voice, data, and video services. Thus, China Telecom and China's broadcasting establishment, headed by the PRC State Administration of Radio, Film, and Television (SARFT), have become fierce rivals. At the same time, government agencies are battling over who will regulate China's information industry.

All this ferment creates new opportunities for foreigners in equipment sales, technology transfer, investment in equipment manufacture, and, possibly, regularized investment in the service area. SARFT estimates that between 1998 and 2002, China's cable television (CATV) equipment market alone will total $61.7 billion, with hardware accounting for two-thirds and software one-third.

Among the focal points of this market are digital compression, intra-provincial and nationwide CATV interconnects, and value-added service offerings, including video-on-demand (VOD), the Internet, distance learning and medicine, e-commerce, and cable telephony. But the country's legal and structural complexities more than ever require any foreign company seeking success in China's CATV market to conduct extensive and ongoing due diligence.

China's CATV networks

China began forming public CATV networks in the 1980s, and is now home to the world's largest network. Large-scale development of CATV networks began in 1992, after the government became concerned that foreign-based satellite television posed an ideological threat.

As with other officially planned goals in the Chinese telecom industry—such as raising telephone density—the Chinese have far exceeded the targeted number of cable subscribers. In 1995, the Ministry of Electronics Industry (MEI) estimated that China would have 60 million cable subscribers by 2000. According to SARFT, the number of cable subscribers is now at least 70 million and is growing at a rate of 10 million per year. Cable is, and will remain, the dominant urban television broadcasting medium.

Warren H. Rothman and Jonathan P. Barker are the principals of Rothman, Barker & Associates Inc. (Rothman Barker), a China management-consulting and implementation firm based in San Francisco.

SUBSCRIBER LEVELS FOR CERTAIN CABLE STATIONS (IN THOUSANDS)

STATION	SUBSCRIBERS
Shanghai CATV	2,350
Beijing CATV	1,800
Hangzhou CATV	1,000
Wuhan CATV	1,000
Tianjin CATV	850
Qingdao CATV	750
Guangzhou CATV	700
Shenzhen CATV	500
Dalian CATV	300
Xiamen CATV	280
Hefei CATV	200
Luoyang CATV	200

SOURCE: Rothman, Barker & Associates Inc.
NOTE: Figures as of January 1999

Later this year, China expects to begin operations of a direct-to-home (DTH) satellite television network for its 45 million rural households, which currently have minimal access to terrestrial and cable-based services. However, Beijing is unlikely to permit satellite television on a widespread basis in China's cities and towns anytime soon because of the government's continuing concerns about foreign content.

The Chinese CATV network remains highly fragmented, with roughly 1,200 stations nationwide (*see* Table). Each station is currently managed and financed autonomously by the local government, the local SARFT branch, and the local Communist Party committee. The Party's Propaganda Department heavily influences China's cable television industry and ensures that basic CATV rates are subsidized. Monthly subscription fees range from \$1.00 to \$2.50. Nonetheless, market principles are making inroads. Advertising is now the major revenue source for CATV stations, and many stations have begun to offer premium programming and other value-added services such as VOD, Internet access, and, quietly, cable telephony. But even technically advanced stations often lack effective business and marketing plans.

The technologies in use in China's CATV networks vary by region. Most major metropolitan areas have upgraded or are upgrading from 300, 450,

Advertising is now the major revenue source for CATV stations, and many stations have begun to offer premium programming.

and 550 megahertz to the international 750 MHz standard. China is also experimenting with 1 gigahertz systems. Microwave is used when cable is not cost effective. Two-way networks using hybrid fiber coax (HFC) cable, synchronous digital hierarchy (SDH) transmission, and asynchronous transfer mode (ATM) switches are being established throughout China—for example in Changsha in Hunan Province; Guangzhou and Shenzhen in Guangdong Province; Dalian in Liaoning Province; and Qingdao in Shandong Province, (*see* glossary, p.24).

To accommodate increased capacity, and to improve quality, the PRC is moving rapidly toward digital compression of signals and expansion of networks based on digital technologies.

Many provinces have created or are creating province-wide CATV link-ups, often on a trial basis on internal networks. Shandong Province offers cable telephony on a trial basis. Qingdao CATV station, which claims more than 750,000 subscribers (an 85 percent penetration rate), offers 23 channels, Internet access, telephony, and securities trading, among other services. Hubei Province's new General Information CATV network links the transport backbones of 11 cities and consists of 1,700 kilometers of fiber optic cable, 365 km of microwave transmission, and 31 network stations. The network can transmit more than 100 television programs and 80 audio channels, as well as data, video, and voice.

According to SARFT, China aims to broadcast 100 channels from CATV stations by 2005 and 200 channels by 2010. To accommodate this increased capacity, and to improve quality, the PRC is moving rapidly toward digital compression of signals and expansion of networks based on digital technologies. In 1996, the Chinese Academy of Sciences approved the development of digital audio broadcasting (DAB) as a major research project. China's first DAB test network was established that year connecting the cities of Foshan, Guangzhou, and Zhongshan in Guangdong Province using Eureka 147 technology. This year, Beijing and Tianjin will test DAB applications for data transmission and traffic routing.

Chinese officials have decided to base the country's nascent digital satellite-broadcasting network on the European Digital Video Broadcasting Satellite (DVB-S) standard. For cable and terrestrial broadcasting standards, China is comparing DVB-S with US digital television (DTV) technologies.

High-definition television (HDTV) is also a top Chinese industrial priority. China Central Television conducted an HDTV experiment last year from its Beijing equipment center. Konka Group Co., Ltd. and other Chinese television manufacturers have established overseas HDTV research and development centers in the United States and other countries.

Government Reforms and CATV

The future of China's CATV industry will hinge in part on the implementation of the governmental restructuring that began in March 1998 (*see The CBR*, May-June 1998, p.36). Among the major reforms was the creation of the Ministry of Information Industry (MII). Intended to be an entity broadly similar to the US Federal Communications Commission, MII absorbed the Ministry of Posts and Telecommunications (MPT), MEI, and several other agencies, and assumed regulatory powers over all public broadcasting networks, including CATV networks. The former Ministry of Radio, Film, and Television (MRFT), which previously regulated the television industry, was downgraded to a sub-ministerial body under the State Council and became SARFT. This new body is responsible for the operation of China's CATV networks.

But the relationship and balance of power between MII and SARFT are far from clear. On the one hand, the broadcasting industry is no longer represented by a ministry-level entity, and crucial rule-making power has been placed, at least nominally, in the hands of MII. On the other hand, MII, unlike its predecessors (MPT and MEI), does not run the telephone companies it regulates: SARFT and its provincial and local affiliates retain control over MRFT's broadcasting facilities. Moreover, SARFT was not placed under MII, probably because SARFT is a special preserve of the Propaganda Department of the Communist Party, which has a particular interest in program content.

The inherent rivalry between MII and SARFT surfaced soon after March 1998. Although a 1997 State Council decree permitted MRFT to build a nationwide CATV link-up, State Council regulations that took effect in 1998 indicated that MRFT should use MPT's infrastructure to build the national network. In May 1998, SARFT announced its intention to proceed with construction of its national CATV network. The day after that announcement, MII publicly and forcefully stated its opposition. The result of this rivalry is that MII has been working on its own plan for a single, unified platform for all information industry service providers, while SARFT has proceeded with construction of its national network.

SARFT may be able to claim a victory. Chen Xiaoning, director of SARFT's Information Network Center, announced on April 6, 1999, that SARFT and the various regional CATV stations will jointly form a national cable television company—the China Cable TV Network (Group) Co. Although SARFT has not announced when this new company will actually begin operations, recent reports indicate that SARFT has made "rapid progress" in creating a national network with more than a dozen provinces on a single network and another 20 provincial trunk networks already built or under construction. China's national network will introduce digital broadcasts, feature dozens of channels, and allow for cheaper and faster Internet access than is possible over telephone lines.

Before the April announcement, MII tried continuously to block an international Internet gateway for broadcasters, as well as connections with the public-switched telephone networks. Certain CATV stations circumvented the ban on Internet gateways by using Jitong Communications Co. Ltd.'s international gateway. (Jitong was formed by MEI and other ministries to build and operate the various "Golden Projects"—government-sponsored campaigns to create nationwide financial and information networks.) It is unclear whether the Internet access referred to by Chen will be through a new SARFT-controlled international gateway or through one of China's four existing gateways.

New battle lines are already being drawn between MII and SARFT. Although it has yet to release any rules relating to the CATV networks, in March 1999 MII announced that through September of this year, China Telecom, China United Telecommunications Corp. (Unicom), and Jitong will be the only entities in China allowed to offer Internet protocol telephone services, an area into which some CATV stations have been delving.

Additional variables in the regulatory and enterprise picture include the impending break-up of China Telecom along functional lines (fixed-line, wireless, satellite, and paging) and speculation that Beijing will order the reorganization of CATV networks into a national conglomerate, the local affiliates of which may be allowed to go public. How these changes may affect competition in broadband services, and indeed the extent to which these changes are carried out, remains to be seen. At this point, it seems that the plan to dismantle China Telecom should favor CATV stations, because until now China Telecom was quite hostile to any increase in their scopes of business. Presumably, a deconstructed China Telecom would be a less-effective obstacle or competitor.

Much depends upon the organization, ownership, and management structure of the "baby" China Telecoms and the degree to which MII can transcend its monopolist, MPT orientation. If it comes to pass, a national CATV conglomerate should strengthen the organization of the CATV system and provide major infusions of capital.

At the Provincial Level

While central-government authorities wrangle over the shape of China's information industry, their provincial and local counterparts are otherwise occupied. In part, this is because local-level restructuring, originally planned for July 1998, has been delayed at least a year, according to high-level MII and SARFT officials.

"Informatization" and "Infoports" are all the rage in the provinces and cities, where the players are building ever-more sophisticated networks and organizational structures. China's regional and local informatization models have taken many forms, but in general, provincial and local governments have pushed to link up telephone, data, and television networks to avoid redundant network construction.

Some infoports are based on joint-stock companies in which telephone, broadcasting, and data companies obtain equity shares in exchange for contributions of network assets and continue to operate over a common platform. In other cases, an interconnect company is formed to link the various networks. The telephone company is often the strongest player in an infoport, although in some areas, such as Qingdao, the CATV station dominates. In still other cases, the telephone and CATV station entities cooperate through jointly owned companies, particularly in new business areas such as interactive television.

In provinces and cities, cable players are building ever-more sophisticated networks and organizational structures.

Local and provincial entities are not always in perfect harmony with each other, however. In 1997, a riot broke out

IT multinationals are revising their China business models from supplying the Chinese market via traditional trading channels to technology-transfer and joint-venture agreements.

in Zhuzhou, Hunan Province, between partisans of the local posts and telecommunications administration and the local radio, film, and television administration because the latter had begun to offer cable telephony at cut-rate prices.

Plans to restructure information-related entities at the provincial and local levels may affect these trends. In recent personal interviews, some central-level officials indicated that future structures at the local level will not be clones of the central-level ministries, but rather will reflect local realities. That is, local infoports and balances of power will remain for the foreseeable future. Under this scenario, the new provincial entities would incorporate existing local structures. Their main impact would be to reduce the overall levels of personnel, rather than to introduce major structural changes to the infoports. On the other hand, it is possible that MII will push a more uniform model at the provincial level.

Foreigners should link up cautiously

Foreign companies involved in China's CATV sector must adapt rapidly but cautiously to these changes. For example, with the separation of government from enterprise management has come the need to re-evaluate the importance of traditional relationships (*guanxi*) with government officials, among other issues. Old friends in government bodies (assuming they still have jobs) may have valuable business contacts and may serve as important guides or advocates in any government approval process.

However, as business decisions are increasingly in the hands of the enterprises, foreign companies should weigh carefully the pros and cons of involving government officials in business deals—and at what point in the decisionmaking and approval process. Another factor to consider is the emergence of consultants, intermediaries, systems integrators, agents, providers of value-added services, and trade channels of every description, often staffed by downsized government personnel. The foreign company must understand the relationship of such entities to a given project and governmental agency as well as their backgrounds, capabilities, and connections.

Localization is another major concern to information technology multinationals. In November 1998, MII issued new "buy local" rules for the telecom sector. These rules are designed to push multinationals toward technology transfer and direct investment (*see* p.16).

The buy-local rules have not yet been enforced in the CATV sector, however. For example, the Hubei General Information CATV network uses entirely imported equipment. With the outcome of China's WTO negotiations far from assured, foreign firms should not rule out the possibility that localization and technology-transfer requirements could be extended to broadcasting equipment and services. Many IT firms, including Lucent Technologies, Northern Telecom Inc., and Microsoft Corp., have already enhanced their competitive positions in the PRC by establishing local R&D entities and increasing the pace of technology transfer and investment.

But to some extent the renewed localization effort represents a negotiating position with foreign investors, trade partners, and the World Trade Organization (WTO). Premier Zhu Rongji made dramatic WTO concessions during his April visit to the United States (*see* p.4). His agreement to drop these very localization rules and permit foreign entities to invest directly in the PRC telecom service sector will represent a watershed in this critical sector

Cable Terminology

Asynchronous transfer mode (ATM) A data transfer mode in which the information is organized into cells. It is asynchronous in the sense that the recurrence of cells containing information from an individual user is not necessarily periodic.

Data over cable systems interface specifications (DOCSIS) This standard interface for cable modems specifies modulation schemes and the protocol for exchanging incoming and outgoing signals over cable. Ratified by the International Telecommunication Union in March 1998, DOCSIS supports data rates of up to 30 megabits per second.

Digital video broadcasting satellite standard (DVB-S) A standard of satellite transmission of digital broadcasting signals. This is a single-carrier system that can handle a full range of bandwidths. It is currently being used for video broadcasting in six continents.

Infoports In China, hubs established to manage information technology (IT) and infrastructure within a given geographical area.

Informatization A translation of the Chinese term for the adoption of technologies, such as computers, communication lines, and modems, that enable a society or an economy to produce, circulate, and utilize information efficiently.

Synchronous digital hierarchy (SDH) A digital transmission structure that operates by organizing information streams into "payloads" and inserting them into time-synchronized networks. SDH-based networks offer greater control over discrete streams of information and enhanced operation, administration, and management capabilities.

Video-on-demand Provision of programming or information as demanded by a user, as opposed to a pre-determined schedule.

High fiber coax (HFC) A combination of fiber and coaxial cable that allows for more reliable service and greater bandwidth, enabling high-speed cable access (typically 750 megahertz).

SOURCES: Digital Video Broadcasting Project (www.dvb.org); National Cable Television Association; Rothman, Barker & Associates Inc.; The US-China Business Council; Whatis?com if carried out, and if Zhu can sell the reforms back home.

Regardless of whether the localization rules are ultimately dropped as part of an eventual WTO agreement, China's bargaining power and appetite for technology transfer can only grow as a natural consequence of the great increase in wealth and sophistication of its market. If the PRC does not specifically mandate localization, it will obtain it through more indirect means—tax and investment incentives, and market access obstacles. Zhu's visit highlighted and advanced significantly the foreign position in China's telecom sector, though the results may only become visible in the long run. China has conceded that its attempt to enter the WTO is clearly dependent upon the extent to which the country can prove its willingness to ease market restrictions.

As a result, other IT multinationals are revising their China business models from supplying the Chinese market via traditional trading channels to technology-transfer and joint-venture agreements. Cisco Systems, for example, has stepped up its involvement in China. Cisco, which has been supplying China with networking products since 1994, signed its first PRC technology-transfer agreement in January. Cisco, Dalian CATV, and Daxian Group (a Chinese consumer electronics company) will develop, manufacture, and distribute cable modems based on Cisco's NetWorks Internet protocol technology and built to data over cable systems interface specifications (DOCSIS), a leading US industry standard. General Instrument of the United States, meanwhile, recently joint-ventured with Huaguang Satellite Cable TV Co., Ltd. to produce satellite integrated receiver decoders. The joint venture, with a total annual production capacity of 100,000 units, aims to provide access to four CCTV channels.

Small Steps in Services

Compared to the equipment market, the cable services sector is more difficult for foreign firms to crack, reflecting China's tight rein over services in general and content in particular. PRC law still strictly prohibits foreign ownership or operation of television stations. However, the prohibition does not appear to extend to investment, or at least revenue-sharing, in transmission backbones that serve broadband networks, including television stations.

One of the companies at the cutting edge of revenue-sharing projects in China is AmTec, Inc., a New York-based telecommunications firm that has been building GSM networks with Unicom through the Chinese-Chinese-Foreign joint-venture model since 1995. AmTec recently acquired a 49 percent stake in Hunan International TV Communications Company (HITC), a Chinese joint venture with the Broadcasting Bureau of Hunan. AmTec and HITC have a revenue-sharing agreement concerning the transmission backbone of a digital broadcasting network. HITC supplies technical and management assistance in exchange for a share of revenues based on the number of subscribers, the level of advertising revenues, and the number of channels. HITC has no ownership interest in the network.

The possible explanations for AmTec's ability to proceed with the project include bureaucratic laxity, *guanxi*, the fact that Hunan is geographically distant from Beijing, the possibility that this project is a test case, and considerations relating to WTO negotiations. Other companies are following aggressive business models in the CATV area. In exchange for a share in network revenues, MIH, a South African company, reportedly will provide at a substantial discount $100 million worth of equipment and setup assistance for China's DTH satellite system.

With respect to foreign broadcasters, only two have gained a foothold to date in the local market for Chinese audiences: Phoenix TV, a Hong Kong-mainland joint venture; and China Entertainment Television (CETV), a Hong Kong-owned channel. Phoenix and CETV have gained "landing rights" to broadcast via satellite to Guangdong CATV stations. The companies obtained these landing rights—which are based on informal approvals—through tremendous lobbying of provincial officials. Phoenix TV is owned by StarTV (45 percent), a Newscorp subsidiary; Asia Today Ltd. (45 percent), a mainland diversified trade and investment company; and China Wise International (10 percent), a mainland television-sales and -advertising agency. Phoenix's signals are beamed to CATV headends via satellites AsiaSat I and Palapa C2. Programming is controlled by the Chinese partners, and thus does not feature politically sensitive issues. CETV offers even more conservative programming, with no sex, no violence, and no news, via Apstar I. CETV started broadcasting in 1995, but the slow pace of acquiring landing rights has put great financial strain on the network.

Phoenix and CETV are experiments in an extremely sensitive broadcasting area that are the result, in large part, of crucial personal relationships between key PRC government officials and the companies' owners, and the extremely limited business scopes that these owners agreed to accept. Phoenix and CETV are restricted to outlets in regions of China that are particularly advanced. It will be some time before PRC authorities assess the effects of these experiments, much less take any definitive action to open China's airwaves generally to foreign broadcasters and programmers. Nonetheless, the authorities may become more flexible in the future in attracting some foreign participation in the broadcasting sector—if only to satisfy the vastly increasing (and unfilled) leisure time of the Chinese populace.

Broadband's Future

Zhu Rongji's dramatic proposals to open wholesale and secondary telecommunications markets to foreign investment and drop localization requirements have changed the landscape dramatically. It is possible that some liberalization will take place officially or unofficially in advance of the conclusion of WTO talks.

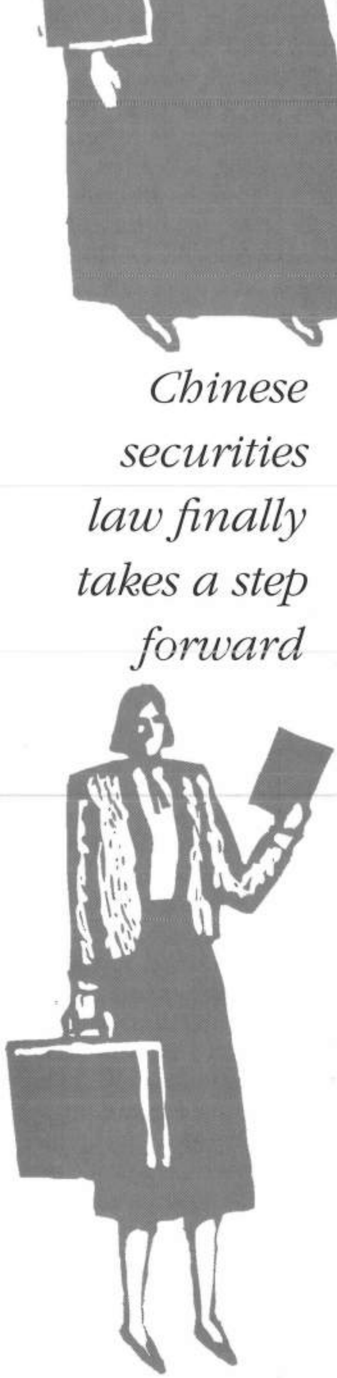
In the meantime, major opportunities exist for foreign companies able to adapt their business methods and models to the changing circumstances and to address effectively the business and technological imperatives brought on by the broadband revolution in China. In the past, for example, many equipment suppliers were able to mount an effective China strategy simply by managing import and distribution channels. This model will become increasingly difficult as CATV networks grow wealthier and more technologically advanced, and as technology transfer becomes a practical, if not legal, necessity.

Due diligence and real-time information should be the watchwords of foreign cable companies in China (*see The CBR*, January-February 1999, p.32). Each telecom and broadcasting project will have to be investigated carefully and without preconceptions about governmental sponsorship, enterprise structure or backing, and market position. 完

A Legal Framework for Securities

Anthony Zaloom and Liu Hongchuan

Chinese securities law finally takes a step forward



After six years of drafting and debate, the Standing Committee of the National People's Congress (NPC) adopted the Securities Law of the PRC, China's first comprehensive national law on securities, on December 29, 1998. Effective as of July 1, 1999, the law, which is made up of 214 articles in 12 chapters, covers securities issuing and trading, the takeover of listed companies, stock exchanges, securities firms, securities intermediaries, and regulatory authorities (*see* Table). Significantly for foreign investors, shares of Chinese companies designated for subscription and trading by foreign investors—particularly B shares, listed domestically, and H shares, listed in Hong Kong—are governed by measures separately formulated by the State Council.

The securities law aims to curb the fraudulent practices and frequent volatility that have come to characterize China's stock markets since their establishment in the early 1990s. Though the law does not contain many breakthroughs, it does bring some substantial changes, such as banning banks and state companies from trading in stocks, banning brokerage firms from mixing their own and client's money to trade shares, and giving the China Securities Regulatory Commission (CSRC) sole authority over all aspects of the securities business.

Growing pains

Between 1949 and 1979, stock markets were considered incompatible with a socialist economy. Beijing's attitude began to change only as the country's economic reforms progressed. By the mid-1980s, a handful of companies had started to issue stocks on a trial basis, mainly to their own employees. Stocks and stock markets, however, remained novel concepts to ordinary Chinese.

But stock exchanges were established in Shanghai and Shenzhen in the early 1990s, and by the end of 1998, 851 companies had listed on them. Ordinary Chinese suddenly found a new way—or, perhaps more accurately, new hope—of making money quickly. But the new markets have been a disappointment for most investors. As many observers have pointed out, Chinese securities markets are driven primarily by rumor and speculation, not the overall economic situation or the financial health of the listing companies themselves (*see The CBR*, July-August 1997, p.55). As a result, the markets have been extremely volatile and often racked by fraud and scandal.

The blame for this inattention to firms' financial fundamentals and the resulting volatility rests not just with unsophisti-

Anthony Zaloom and Liu Hongchuan are lawyers in the Beijing office of Skadden, Arps, Slate, Meagher & Flom.

cated individual investors. The most basic government policies and their implementation are also responsible. Until very recently, China's government has looked upon the securities market primarily as a means by which to tap Chinese individual savings for the benefit of favored state-owned enterprises (SOEs). Access to the market has therefore been strictly controlled, and approvals for new listings have been granted as much for policy and political considerations as because of market fundamentals. Majority-share control of listed state enterprises stays with the state, which has created two ownership categories of shares that do not trade on the open market—"state-owned" and "legal person."

Foreign participation in the securities market is permitted, but only through another special category of ownership shares reserved exclusively for foreign investors, known as B shares. The final category, A shares, is reserved for Chinese investors. With the markets thus divided into several ownership categories permitting no cross trading, and most stock-issuing enterprises not always run on a profit-maximizing basis, it is not surprising that China's stock markets suffer from price volatility and inattention to fundamentals.

Too many regulators

The State Council formed the Securities Commission (SCSC) and its executive arm, the CSRC, in October 1992. They were charged with overall supervision and regulation of China's securities markets, similar in function to the US Securities and Exchange Commission. But they shared their regulatory powers initially with the People's Bank of China and several powerful government agencies, including the State Commission for Restructuring the Economy. The large number of regulators made for high transaction costs for companies seeking a listing.

Paradoxically, these multiple regulators also made for a lack of sufficient focus on and weak supervision over unlawful activities. And although these regulatory agencies all had certain legislative powers, their legislative approach was piecemeal. They tended to issue "urgent" notices in response to rampant abusive practices. By the end of 1998, more than 250 sets of rules and regulations applied to securities transactions, some already no longer enforced or in conflict with each other.

Multiple regulators made for a lack of sufficient focus on and weak supervision over unlawful activities.

From the outset Beijing realized that a more unified approach was necessary. The NPC thus set up a committee

Modern vs. Traditional Approaches

From the beginning of the drafting process in the early 1990s, there have been two basic and often conflicting approaches to the Securities Law, which differ from each other on many major issues.

At one end of the spectrum is the so-called "modern school," the adherents of which believe that stock markets everywhere are governed by universal rules, and that what works in other countries should work in China. According to this group, if the ultimate goal of China's reform is to establish a market economy, the securities law should reflect the latest developments of world markets and should draw broadly from the experience of other countries, especially Western countries. It should not be dragged down by the reality of China's undeveloped market. Not surprisingly, most representatives of the modern school are well educated and have substantial international experience.

In contrast, while acknowledging that China can learn much from other countries, the adherents of the "transitional" school place greater emphasis on China's transitional process. They agree that the ultimate goal of China's reform is to establish a market economy, but believe that the process will be a long one, and that certain controls will have to remain in place during this period. Thus, any new securities law must have "Chinese characteristics," so as to suit this transitional period. This school includes government officials and some scholars.

The two schools differ on many issues, and for a long time it seemed as if neither could score a decisive victory. The Asian financial crisis has had both a demonstration effect and a real economic effect on China—seeming to confirm the transitional school's conclusion that China should be cautious in opening up its securities market to the outside world.

As a result, the transitional school has gained ground. For instance, the transitional school maintain that the Securities Law should regulate only stocks and bonds, while the modern school had wanted to broaden the concept of "securities" to include new financial products such as derivatives. Article 2 of the Securities Law opts for the narrower approach, Article 35 further says the Securities Law does not regulate futures, and Article 75 prohibits the trading of securities futures. Article 10, for the most part, keeps the current quota and approval system for IPOs, as the transitional school advocates.

At the same time, a number of provisions in the new law are clearly drawn both from the lessons learned in other countries as well as from China's own experience. Article 6, for instance, separates the securities and banking businesses. And the law contains some "modern" aspects. Though the emphasis on disclosure is not new, it is perhaps one of the most important elements the law contains.

Nevertheless, the predominance of "transitional" school views in the new law is basically a legitimization of the status quo. Other than the limitation on broker activity, which should spur a fundamental transformation of the industry, there are few surprises in the law.

—A. Zaloom and H.C. Liu

The securities firms are being forced to change the most, in ways that will have a deep and lasting impact on the development of the market.

to draft a securities law in 1992, headed by the renowned economist Li Yining (nicknamed "Stock Li" for his enthusiastic promotion of stock markets in the early 1980s). Since then, the NPC Standing Committee has reviewed successive drafts of the law at five different conventions, a reflection of the intense controversies the lawmakers encountered in the drafting process (*see* p.27). Li has admitted publicly that the new law is a transitional one with "Chinese characteristics"—a reference to the many current restrictions that the law retains. For example, it maintains the quota and approval system for initial public offerings (IPOs), the A- and B-share dichotomy, and the appointment of stock-exchange leadership by CSRC, which has emerged as China's sole securities regulator.

Winner of the Turf War

CSRC had gradually been accumulating power in the years leading up to the law's passage, and the new Securities Law further strengthens its position. Chapter 10 of the law formally grants CSRC many of the powers it is already exercising, but for which it previously lacked a clear legal basis. As a result, CSRC now enjoys legislative, administrative, supervisory, regulatory, investigative, and disciplinary powers in the securities sector, subject to only a few restrictions.

This leaves analysts wondering whether CSRC has become too powerful, particularly regarding its authority to approve IPOs. In China, a company seeking a listing must first be selected by provincial or ministerial offices that must fill yearly, central government-set quotas. It then must submit for approval required documentation to CSRC, which has significant discretionary power in reviewing that documentation. The approval process lacks a detailed, objective standard and is far from transparent.

CSRC decisions have reflected political and policy inputs, and likely will continue to do so. For example, CSRC now requires every company seeking a listing first to take over a bankrupt SOE, as an aid to restructuring the economy. CSRC also has a heavy hand in setting IPO prices. To guarantee the success of IPOs, their pricing is artificially set at a price-earnings (P/E) ratio between 15 and 20, which is far below P/E ratios (currently averaging over 40) in the secondary market. This has made investment in the primary market a risk-free event and has driven IPO underwriters to compete fiercely.

Some of the changes in the new Securities Law respond to these concerns and appear to try to introduce a more market-driven process. First, CSRC approval for IPOs is replaced by the requirement of a "confirmation" by CSRC (Article 11). It is still too early to say whether this change in terminology alone will make any real difference in practice, but it is a step in the right direction. Second, CSRC is required to establish a review committee consisting of both its own professionals and outside specialists in order to improve the qualities of listing companies (Article 14). Finally, there is at least a gesture toward loosening CSRC's control over IPO pricing—issuers and underwriters can now negotiate IPO prices on their own, albeit subject to CSRC approval (Article 28).

Cleanup Time for Securities Houses

In an effort to counter the speculation and volatility in the Chinese stock market, the Securities Law imposes more discipline on and clearly defines the liabilities of all market participants—including listing companies, their directors and officers, underwriters, brokers, dealers, and law and accounting firms. But it is the securities firms that are being forced to change the most, in ways that will have a deep and lasting impact on the development of the market.

Article 6 provides for the separation of securities business from banking, trust, and insurance business. At present, many commercial banks and international trust and investment corporations (ITICs) have securities operations. It remains to be seen how these operations will be spun off to operate independently.

Securities companies will be divided into comprehensive and brokerage securities companies. Those in the first category may offer a full range of

Table
China's New Securities Law

Chapter	Title	Articles
1	General provisions	1-9
2	Issuing of securities	10-29
3	Trading of securities	30-77
3.1	General regulations	30-42
3.2	Listing of securities	43-57
3.3	Continuing disclosure	58-66
3.4	Prohibited trading acts	67-77
4	Takeover of listed companies	78-94
5	Stock exchanges	95-116
6	Securities companies	117-145
7	Securities registration and clearing institutions	146-156
8	Securities trading service	157-161
9	Securities association	162-165
10	Securities regulatory authority	166-174
11	Legal liability	175-210
12	Supplementary provisions	211-214

SOURCE: The US-China Business Council services, from brokerage and trading on their own accounts, to underwriting new issues. Those in the second category can only act as brokers for their clients. To qualify as a comprehensive securities company, a company must have a minimum capitalization of ¥500 million ($60 million). Among the more than 100 securities companies presently active, only a few will be able to satisfy this requirement. Substantial consolidation within the industry is anticipated.

Securities companies will no longer be allowed to take possession of their clients' transaction settlement funds. Rather, they must deposit these funds in a designated bank. Until now it has been a common practice for securities companies to use such funds without paying interest to their clients, and the income generated by these interest-free loans often constitutes a significant portion of securities companies' profits.

The law expressly prohibits bank loans from flowing into the stock market in violation of applicable regulations (Article 133) and also prohibits SOEs from speculating in the market (Article 76), although the term "speculation" is not defined. Covert bank loans and SOE funds have been the driving forces behind market speculation to date, contributing to the market's volatility.

Finally, the law bans margin trading and over-the-counter trading of listed securities (Articles 32 and 36). All of these restrictions, some of which are statements of existing rules, are aimed at curbing market volatility and manipulation. Together, the rules will make the lives of many securities companies difficult indeed. Some are finding themselves driven out of heretofore-profitable business by the new minimum capital requirements. All will be deprived of the free use of client transaction settlement funds. And the newly emphasized prohibition on over-the-counter and margin trading applies to all of them as well.

All securities firms will be deprived of the free use of client transaction settlement funds.

A NEW HORIZON FOR CHINESE M&A

In contrast to the tighter regulation of securities firms, the Securities Law tries to relax restrictions on the acquisition of publicly traded companies. Thus far, the legal framework governing merger-and-acquisition activities in the open market has been set out in the Provisional Administrative Regulation on Issuance and Trade of Stocks (the Regulation), promulgated in 1993, when China's stock market had just started to develop. Because the government worried that a surge of M&A in the open market would cause speculation and fraud that the newly established CSRC would be ill-equipped to handle, the Regulation tightly controlled tender offers for publicly traded companies. But for whatever reason—some analysts blame the Regulation, which they deem overly strict—there have been no successful acquisitions through tender offer since the Regulation came into effect.

In a recent policy statement, CSRC signaled a change in attitude: it would rather see a failed SOE acquired by another company than see it go bankrupt and throw employees out of work. This new attitude is reflected in the Securities Law's new rules for the acquisition of public companies. The most important changes to the acquisition process are:

- Elimination of the prohibition on a natural person owning more than 0.5 percent of the issued stock of a listed company.
- An increase in the amount of stock investors who hold more than 5 percent of a company's issued stock may buy after the waiting period.
- The ability to request an exemption from the requirement that investors wishing to purchase 30 percent of a listed company must offer to buy all outstanding stock of the company.
- Elimination of the restrictions on the pricing of a tender offer. (However, pricing, together with documentation for the tender offer, must still be submitted to the CSRC for prior approval.)
- The ability of an acquirer to use its own stock to pay for the company it is acquiring. (The Regulation required payment in cash.)
- Formal recognition and approval of acquisition by negotiation—a method of public company acquisition, alternative to tender, that is already practiced. This method had evolved primarily because of the Regulation's restrictive tender-offer rules.

It remains to be seen how much M&A activity will result from these new rules. Detailed implementing regulations are probably necessary before investors become comfortable relying on them. Also, the fact that the majority of issued shares of most listed companies do not trade in the open market will continue to limit the role of tender offers.

Inadequate remedies for violation

In response to complaints about weak enforcement of Chinese laws, it has become customary for new laws to contain a separate chapter entitled "legal liability," which sets forth detailed penalties for different kinds of violations. Thus, Chapter 11 of the Securities Law contains 36 sections on the details of administrative punishment for violations of the Securities Law, including the forfeiture of unlawful income, fines, and business license revocation. Seventeen of those sections impose criminal liability, which is unusual for a commercial law. The intent of the legislators is clearly to curb widespread fraud, manipulation, and other wrongdoing in securities markets by imposing harsh penalties.

In contrast, the Securities Law fails to provide any detail about civil remedies available to victimized investors. The most important of these, of course, is the right of shareholders to sue the company and its directors, officers, and underwriters for investment losses suffered as a result of inadequate or inaccurate disclosure.

Although such remedies might be inferred from some provisions, such as Articles 62 and 207, such inferences provide an insufficient basis for Chinese courts to act, especially given their relative lack of sophistication about securities matters. Article 62 (10) requires listed companies to report promptly to CSRC and the stock exchange and make a public announcement if a court nullifies a shareholder or board resolution in a material litigation involving the company. Thus, it can be inferred that investors can apply to a court for such a nullification. Article 207 provides that if any violator of the Securities Law cannot pay both administrative and civil penalties, civil penalties have priority. Remedies available under other laws are also too general or vague to be of much use.

This neglect of remedies for the individual investor is not accidental. The PRC legislators' mindset is still strongly influenced by the planned economy. Legislators therefore rely on administrative measures to prevent and correct wrongdoing. What they failed to realize is that, despite the tremendous powers granted to the regulator by the law, the regulator has its own limitations. Enforcement resources are limited, and violations cannot always be easily identified and addressed. Investors themselves are often in a better position to know when their legitimate interests have been harmed and what would be an adequate remedy.

THE LIGHT AT THE END OF THE TUNNEL

There are few breakthroughs in the Securities Law. Many of the issues have been debated for years, and many provisions have predecessors in current regulations and decrees. Futhermore, fundamental structural problems remain: the separation of A and B shares, the illiquidity on the open market of state-owned and legal-person shares, and the requirement that CSRC approve IPOs.

On the other hand, the impact this new law will have on the market over the long term should not be underestimated. The new restrictions on securities firms will force drastic consolidation in the industry, while the relaxation of restrictions on tender offers should eventually lead to a new environment conducive to changes in corporate control. And the passage of this comprehensive law, to be followed by more detailed implementing regulations, is also the beginning of the end to the confused patchwork of regulations that have been issued to date. Thus, despite its shortcomings, the new Securities Law is a step forward in the development of China's capital markets. 完

China's Economic and Financial Indicators, 1994-98

	1994	1995	1996	1997	1998 (preliminary)
Gross Domestic Product (GDP)	4,675.9	5,847.8	6,788.5	7,477.2	7,955.3
Real GDP growth (%)	12.6%	10.5%	9.6%	8.8%	7.8%
Retail price index (%)	21.7%	14.8%	6.1%	0.8%	-2.6%
Consumer price index (%)	24.1%	17.1%	8.3%	2.8%	-0.8%
Urban per capita income (RMB)	3,496.2	4,283.0	4,838.9	5,160.3	7,113.9
Rural per capita income (RMB)	1,221.0	1,577.7	1,926.0	2,090.1	2,160.0
Urban unemployment rate* (%)	2.8%	2.9%	3.0%	3.1%	3.1%
M2 supply	4,692.4	5,823.0	7,609.5	9,099.5	10,449.9
M2 supply growth (%)	34.5%	29.9%	30.7%	17.1%	15.3%
Exchange rate (RMB/$)	8.6	8.4	8.3	8.0	8.3
Foreign-exchange reserves ($ billion)	51.6	73.6	105.0	139.9	145.0
Government revenue (total)	5,218.1	6,242.2	7,408.0	8,651.1	—
Tax revenue	5,126.9	6,038.0	6,909.8	8,234.0	855.1
Domestic debt (Treasury bond issues)	102.9	151.1	184.8	241.2	280.0
Foreign debt ($ billion)	9.3	10.6	11.6	13.1	—
Government deficit	57.5	58.2	53.0	57.0	96.0

SOURCE: *Almanac of China's Finance and Banking* 1996; PRC State Statistical Bureau, *China Statistical Yearbook*, 1997, 1998; *China Monthly Statistics*; Dow Jones News Service; Foreign Broadcast Information Service; *Financial Times*; CNN; *China Economic News*

NOTE: Figures in billions of RMB unless otherwise indicated

*According to official SSB figures, which do not include under-employment or the migrant population

— Not available

China's Output and Investment, 1994-98

Gross value of industrial output	1994	1995	1996	1997	1998 (preliminary)
Total industrial output	7,017.6	9,189.4	9,959.5	11,373.3	3,354.1*
% growth	24.2%	20.3%	16.6%	13.1%	8.9%
State-owned enterprises	2,620.1	3,122.0	2,836.1	2,902.8	1,136.5*
% growth	6.5%	8.2%	5.1%	3.8%	4.9%
Collectively owned enterprises	2,647.2	3,362.3	3,923.2	4,334.7	499.0*
% growth	24.9%	15.2%	20.9%	10.2%	8.7%
Individually owned enterprises	708.2	1,182.1	1,542.0	2,037.6	—
% growth	56.0%	51.5%	20.0%	15.3%	—
Other enterprises**	1,042.1	1,523.1	1,658.2	2,098.2	383.5*
% growth	74.3%	37.2%	23.8%	30.2%	12.7%
Fixed-asset investment					
Total investment	1,704.3	2,001.9	2,297.4	2,494.1	2,845.7
% growth	30.4%	17.5%	14.8%	8.9%	14.1%
State-owned enterprises	961.5	1,089.8	1,205.6	1,309.2	1,566.2
% growth	21.3%	13.4%	10.6%	9.0%	19.6%
Collectively owned enterprises	275.9	328.9	366.1	385.1	371.7
% growth	19.1%	19.2%	11.3%	5.5%	-3.5%
Individually owned enterprises	197.1	256.0	321.1	342.9	363.8
% growth	33.5%	29.9%	25.4%	6.8%	6.1%
Other enterprises**	269.8	327.2	404.6	456.9	544.0
% growth	99.4%	21.3%	23.7%	13.0%	19.1%

SOURCE: PRC State Statistical Bureau (SSB), *China Statistical Yearbook*, 1997, 1998; Foreign Broadcast Information Service; *China Economic News*

NOTE: Figures are in billions of RMB unless otherwise indicated

*Value-added industrial output; gross-value figures unavailable

**Includes joint-venture and foreign-funded enterprises; 1998 figure includes *only* foreign-invested enterprises

— Not available

US Direct Investment in China

	1994	1995	1996	1997	1998	Percent Change	Total 1994-98
Amount Contracted	6,010	7,471	6,920	4,940	6,210	26%	46,339
Utilized	2,491	3,083	3,440	3,240	3,910	21%	21,246
US Share of PRC Contracted Investment	7.3%	8.2%	9.4%	9.5%	11.9%	—	8.1%

SOURCE: Ministry of Foreign Trade and Economic Cooperation

Foreign Investment in China by Source

Source	Projects 1997	Projects 1998	Contracted 1997	Contracted 1998	FDI 1997	FDI 1998
Asia	76.6%	73.4%	63.8%	54.2%	75.6%	68.7%
Europe	5.0	5.0	8.3	12.3	9.2	10.0
North America	12.3	13.3	11.5	15.0	7.9	9.4
Offshore	2.2	3.7	11.1	15.3	4.6	8.4
Other	3.9	4.6	5.4	3.3	2.7	3.5

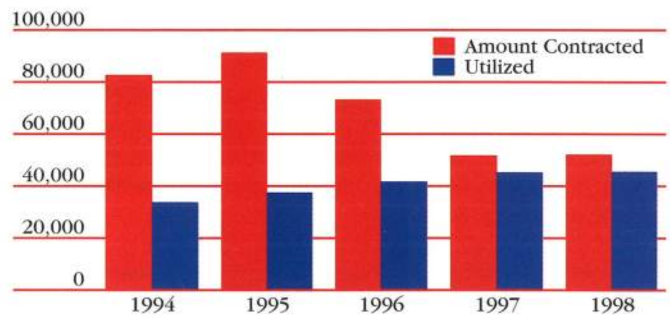
SOURCE: Ministry of Foreign Trade and Economic Cooperation
NOTE: Totals may not add to 100% due to rounding

China's Trade with the World, 1994-98 ($ billion)

	1994	1995	1996	1997	1998
Exports	121.0	148.8	151.1	182.7	183.8
% change	32.0%	23.0%	1.5%	20.9%	0.5%
Imports	115.6	132.1	138.8	142.4	140.2
% change	11.2%	14.3%	5.1%	2.6%	-1.5%
Total	236.6	280.9	289.9	325.1	324.0
% change	20.9%	18.7%	3.2%	12.1%	-0.4%
Balance	5.4	16.7	12.3	40.3	43.6

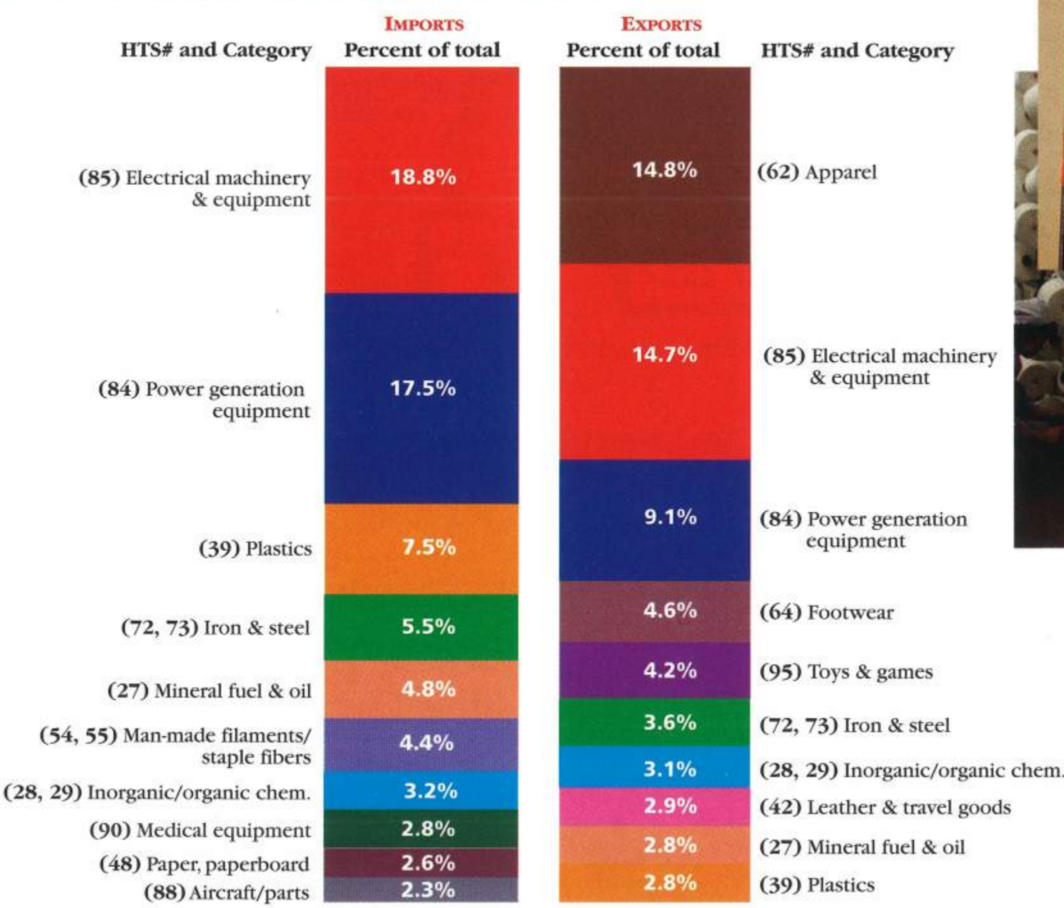
SOURCE: PRC General Administration of Customs, *China's Customs Statistics*
NOTES: PRC exports reported on an FOB basis; imports on a CIF basis
— Not available

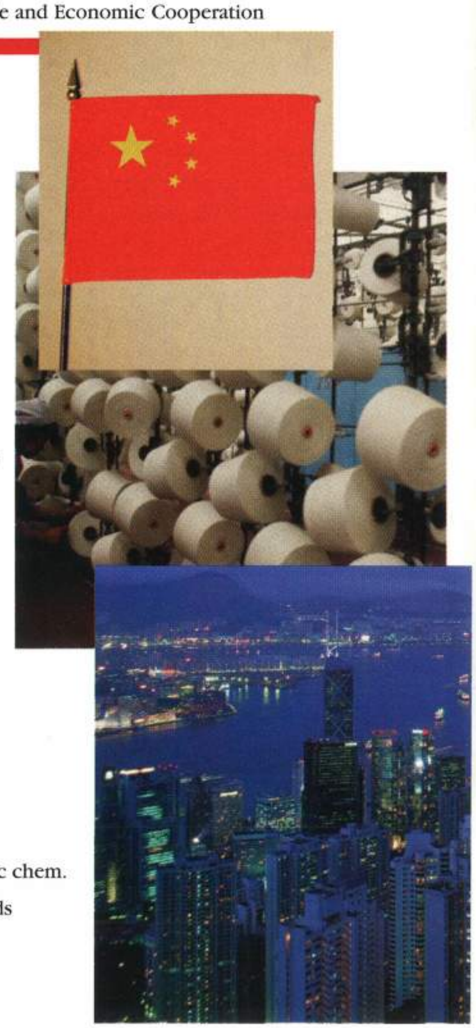
FDI in China, 1994-98 ($ million)



SOURCE: Ministry of Foreign Trade and Economic Cooperation

China's Top Imports and Exports, 1998 ($ million)





SOURCE: PRC General Administration of Customs, *China's Customs Statistics*

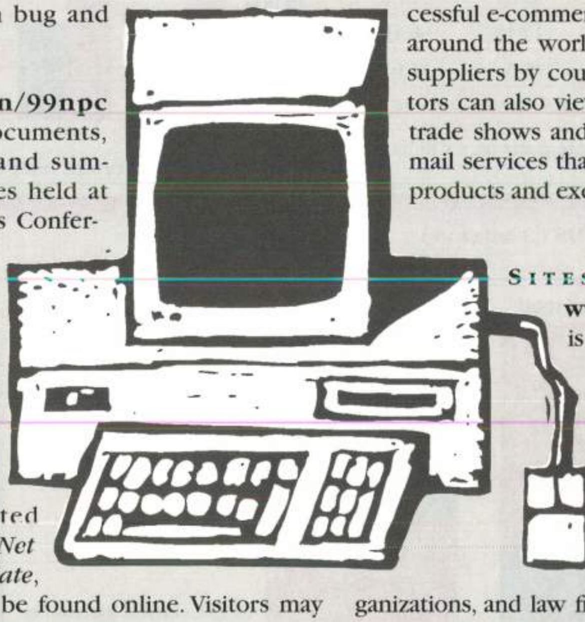
Y2K, China's Internet, and MOFTEC

www.itpolicy.gsa.gov/mks/yr2000/y2khome This site is the US Federal Government Gateway for Year 2000 Information Directories. It contains a multitude of links to sites about Y2K tools and services, contingency planning and testing certification, and other US and foreign government sites.

www.usia.gov/topical/global/y2k The US Information Agency's Y2K site covers various Y2K issues. One of the more interesting sections is on Y2K handbooks from the likes of the US Small Business Administration, the Federal Emergency Management System, and the World Bank. Also featured are links to other Y2K sites.

travel.state.gov/y2kca.html The US State Department posts announcements about the Y2K problem on this site, which contains links to US and other government Y2K sites that give general information about the millennium bug and how it is being addressed.

www.chinadaily.com.cn/99npc This site features news, documents, speeches, commentary, and summaries of press conferences held at the Ninth National People's Conference in March.



www.csis.org The Center for Strategic International Studies, a Washington-based public policy research institution, covers many areas of the globe, including the Asia-Pacific region. The full text of several Asia-related newsletters—including *PacNet Newsletter*, *Hong Kong Update*, and *Capital Markets*—may be found online. Visitors may also order other CSIS publications online.

www.gpo.gov./bxa The US Department of Commerce's Bureau of Export Administration (BXA) has created a searchable site devoted to Export Administration Regulations (EAR). Many parts of EAR, as well as relevant articles from the Federal Register, may be downloaded in PDF, ASCII, or WP6.1 formats. For $88, site visitors with a US address can order a full print version of EAR, which comes with a year's worth of updates and Export Administration Bulletins.

www.virtualchina.com/matrix/index.html The China Matrix site provides full-text news articles on the Internet in China. The site, updated daily, also features archives back to 1996 and links to other China Internet sites, including those posting network regulations in both Chinese and English. Visitors may also register for a free weekly e-mail newsletter.

www.chinamarket.com.cn On the Ministry of Foreign Trade and Economic Cooperation's (MOFTEC) Chinamarket site, visitors can view notices calling for bids or post their own calls for bids. The site also contains information on trade exhibitions and fairs; investment opportunities; product, company, and investment information by region and sector; and products made in China arranged by sector. Another MOFTEC site (**www.moftec.gov.cn**) carries translations of Chinese laws related to business. A third MOFTEC site (**www.techfair.com.cn**) arranges technology-related products, companies, and research institutes by sector and carries a brief description of and contact information for each company and institute. Aimed primarily at helping Chinese companies find foreign business partners, all three free sites are also available in Chinese.

www.asiansources.com Asian Sources Online, based in the Philippines, bills itself as the largest and most successful e-commerce site in the world. Companies from around the world can search for Asian products and suppliers by country, product, or company name. Visitors can also view news items and information about trade shows and travel, as well as sign up for free e-mail services that will alert them to the availability of products and excess stocks throughout Asia.

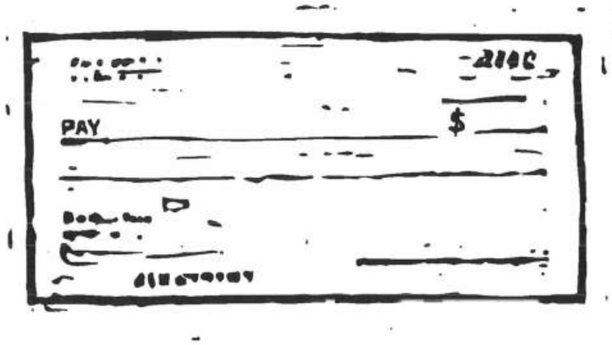
Sites in Chinese

www.sohu.com Sohu, formerly Sohoo, is perhaps the world's most popular Chinese-language portal. Visitors can find international and domestic news, business and economic intelligence, scientific and technological knowledge, literary and recreational information, and much more, all at no cost. The site also offers links to Chinese and foreign companies, organizations, and law firms in China, which are conveniently classified according to sector and city.

www.snweb.com/gb/people_daily/gbrm The website of *The People's Daily*, China's main government newspaper, provides daily news and information on China's economic, political, social, and cultural developments. The Monday edition offers special reports on the economy, finance, and banking (*jingji zhoukan* and *caishui jinrong*). The Wednesday edition presents articles on the development of China's legal system and law enforcement (*lifa yu zhifa*). There is no keyword search function, but visitors to this free site can search current or past information by publication date.

—*Virginia A. Hulme and Mi Puyang*

Virginia A. Hulme is assistant editor of The CBR. *Mi Puyang is a former research assistant at The US-China Business Council.*



The Lessons of GITIC

GITIC's bankruptcy has ushered in a new era of foreign lending in China

Mitchell Silk and Michael Openshaw

Bankers in Hong Kong found themselves in the unaccustomed position of queuing up at Lo Wu at the Shenzhen border one Sunday afternoon in January, behind Hong Kong weekenders on family visits and countryside visitors with live game and three generations of family in tow. The bankers were on their way to the headquarters of Guangdong International and Trust Investment Corp. (GITIC) in Guangzhou, the Guangdong provincial capital, to attend a creditors' meeting. By the end of the meeting, it wasn't just their Sunday lunch plans that had been ruined; GITIC's temporary liquidation committee had announced at the meeting that GITIC would be filing for bankruptcy, making it the first PRC financial institution to file for bankruptcy since 1949.

Long held up as a success story, GITIC was the second-largest of China's roughly 240 international trust and investment corporations (ITICs). The GITIC bankruptcy has prompted creditors, and foreign investors in China in general, to re-evaluate their lending and credit-assessment strategies. But GITIC's forced bankruptcy also signals China's intention to proceed with reforms. In the long run, the PRC financial system, as well as foreign investors, may be better off.

What happened?

The closure of GITIC occurred three months before the January meeting, with the issue by the People's Bank of China (PBOC) on October 6, 1998, of a notice (the October Notice) announcing PBOC's closure of GITIC and revocation of the ITIC's financial licenses. The October Notice stated that the reason for this action was GITIC's inability to pay its maturing debts.

Following the procedures outlined in the October Notice, PBOC established a temporary liquidation committee to carry out GITIC's liquidation and assigned the Bank of China (BOC) custody during the liquidation process of all outstanding debts owed to and by GITIC. The October Notice also stated that all external (foreign currency-denominated) debts registered by GITIC with the State Administration of Foreign Exchange (SAFE) and all the principal and interest on deposits held by PRC individuals would be paid in priority to all other debts. The October Notice did not indicate that these debts would be paid in full, however.

On the same date in October, BOC issued a notice requesting that GITIC's creditors register outstanding debts owed to or by GITIC with BOC by January 6, 1999; many foreign creditors did so. Nonetheless, attempts to seek BOC clarification on questions relating to debt filing and registration were often unsuccessful. Representatives of

Mitchell Silk is a partner and Michael Openshaw is an associate with Allen & Overy in Hong Kong. Allen & Overy represents a number of banks and financial institutions pursuing claims relating to GITIC and is counsel to the creditors' steering committee in the restructuring of Guangdong Enterprises (Holdings) Ltd.

law firms regularly ventured to Guangzhou to file claims on behalf of their clients, while Hong Kong bankers sat in their offices, wondering what would happen after the January 6 deadline.

The liquidation committee held a meeting for foreign creditors on January 10, at which it announced that GITIC and GITIC's three principal PRC subsidiaries, Guangdong International Leasing Co., Guangxin Enterprises Development Co., and GITIC Shenzhen, would file for bankruptcy with the Guangdong Higher People's Court. This landmark decision dispelled the widely held presumption that the central government would at least repay the principal amount of the debts registered with SAFE to foreign creditors, as it had previously done in the closures of China Agricultural Development Trust and Investment Corp. in 1997, and Hainan Development Bank and the China Venturetech Investment Corp. in 1998.

The committee announced that domestic individual depositors would be immediately repaid an aggregate amount of ¥779 million ($94.1 million) in principal owed, through funds provided by the provincial government. On the other hand, foreign creditors would only have recourse to the courts under bankruptcy proceedings. GITIC reportedly had roughly $2.2 billion in foreign debts and another $1.9 billion in contingent liabilities (i.e. guarantees).

Becoming ever more used to queuing up at Lo Wu, Hong Kong's banking community trudged back to Guangzhou on January 16 to hear the Guangdong Higher People's Court formally declare GITIC and its three subsidiaries bankrupt. The court ordered the immediate formation of an official liquidation committee to replace the temporary committee. Creditors were given an additional three months to register their claims.

WHY GITIC FELL: THE WILD WEST

GITIC's demise traces back to its original mandate. Established in 1980, authorities intended for GITIC to facilitate the economic policies of the Guangdong government by carrying out activities such as domestic and international financial services, investment banking, property development, equity investment, and general trading. GITIC was one of the original ten "windows" that enjoyed special privileges within the PRC to secure foreign currency borrowing. Originally designed to bolster the Open Door policy and achieve China's modernization goals, these financial vehicles facilitated provincial and municipal finance and development through relatively flexible means.

But several of the ITICs, including GITIC, quickly began to engage in financial practices that could hardly be described as "safe and sound" according to internationally accepted financial-institution regulatory standards. Under the control and even encouragement of provincial leaders largely outside the oversight of the central government, these ITICs became increasingly involved in leveraged and speculative investments, with a particularly heavy exposure to the property market and off-balance-sheet obligations. Simply put, the ITICs became the all-in-one, fix-it institutions into which residual risks in provincial projects were parked—for a fee.

As GITIC's speculative activities multiplied and those activities gave rise to real as opposed to contingent liabilities, it was only a matter of time before GITIC lost its financial footing and became a target for closure. The deteriorating economic environment, combined with GITIC's worsening financial condition and the central government's growing resolve to assert its control over an arm of the financial sector that had run amok, prompted the closure.

Clearly GITIC managed, by engaging in activities not included in its mandate, to fall between the regulatory cracks. The authorities have since made some moves to shore up gaps in current legislation. The recently promulgated Securities Law (*see* p.26) and the pending Trust Law both include provisions that severely curtail the scope of an ITIC's permitted business activities.

Numerous market analysts have observed that other ITICs face similar problems to GITIC's and that, given the central government's resolve to establish greater control over the financial risks of some PRC financial institutions, more closures may be imminent. At least five other ITICs have missed loan payments or defaulted since last October. Despite GITIC's bankruptcy proceedings and the poor financial condition of many other ITICs, the situation may not be cause for alarm about the

> *The ITICs became the all-in-one, fix-it institutions into which residual risks in provincial projects were parked—for a fee.*

overall health of the financial system. According to Hong Kong press reports, the ITICs altogether have just under $30 billion in assets, or roughly 2.5 percent of all financial assets in the PRC.

Just as GITIC and the other ITICs took on more and more speculative investments and obligations, foreign banks in Hong Kong became increasingly anxious to lend to these "quasi-sovereign" entities. The Hong Kong government estimates that roughly 80 local and foreign banks in Hong Kong have some degree of exposure to GITIC.

GITIC's Hong Kong branch conducted much of the borrowing. GITIC and its local lawyers apparently represented that GITIC did not need to go through the relevant SAFE approval and registration requirements for many transactions because such regulations did not apply where debt is assumed by an offshore branch of a domestic entity.

The Administration of Borrowing of International Commercial Loans by Domestic Organizations Procedures (the Borrowing Procedures) and the Statistical Monitoring of Foreign Debts Implementing Rules, both effective January 1, 1998, are designed to control and monitor the PRC's overall balance of payments—specifically the amount of foreign indebtedness that a domestic PRC entity can assume—as well as regulate flows of foreign currency in and out of China. Article 31 of the Borrowing Procedures clearly states that a branch's head office must get prior approval from SAFE to obtain loans of $50 million or higher. Article 32 stipulates that funds may only be used for developing business abroad and may not be transferred for use within the PRC without SAFE approval. As a branch, no matter where located, is not a legal entity in its own right under PRC law, it is difficult to un-

It appears that many loans were extended without thorough financial due diligence of the borrower.

derstand how the regulations could not apply.

In addition to the shaky legal foundations behind lending decisions, it appears that many loans were extended without thorough financial due diligence of the borrower. In part, this may have been due to the mistaken belief that that GITIC debt had some form of unspoken "guarantee," in the form of comfort from the provincial and municipal governments.

THE AFTERMATH

Numerous issues are contributing to foreign creditors' concerns about obtaining repayment during the bankruptcy proceedings. In particular, one of the notable omissions from the January 6 proceedings was that the People's Court did not refer to the October Notice, which stated that foreign debts registered by GITIC with SAFE would be repaid in priority. Although the October Notice was not expressly revoked, the People's Court reiterated that all unsecured creditors would be treated on an equal basis. What is clear is that the administration of GITIC's assets will be by far the largest and most public case to be settled under the Bankruptcy Law to date.

Under the Bankruptcy Law, secured creditors enjoy protections similar to those offered to secured creditors in many foreign jurisdictions' bankruptcy laws. As long as the secured creditors comply with all the procedural requirements—such as registration—these creditors should have priority over secured assets. The proceeds obtained from the disposal of bankruptcy assets will be distributed in the following order: costs and disbursements incurred in relation to the bankruptcy; employees' salaries and insurance; outstanding taxes; and claims of unsecured creditors. Thus, foreign debts that have been duly registered with SAFE will not be paid before domestic debts. Based on preliminary estimates provided by the temporary liquidation committee, GITIC's assets were roughly 59 percent of its total outstanding liabilities.

Creditors are now in a state of limbo and can do little but wait for the cogs of the court-administered bankruptcy proceedings to grind away. According to the Bankruptcy Law, the first creditor's committee meeting should take place within three months of the commencement of bankruptcy proceedings (*see* below). Given its highly public nature and the precedent it will set for other ITICs, GITIC's liquidation may be affected by extra-judicial forces. In fact, this case is too sensitive to be handled solely by the Bankruptcy Law, which, though in existence in one form or other since 1986, has yet to be thoroughly tried and tested. Many large creditors will no doubt seek clarifications from PBOC on various issues such as priority of payments, the effect of SAFE registration, enforcement of registration requirements, and the court's ability and/or willingness to set aside relevant transactions that have severely limited the size of the asset pool for creditors.

PONDERING THE TANGIBLES AND INTANGIBLES

The GITIC bankruptcy has several implications for business in the PRC.

BANKRUPTCY PROCEEDS AS SCHEDULED

About 250 creditors of the bankrupt Guangdong International Trust and Investment Corp. (GITIC) met with company officials, provincial authorities, and representatives of liquidation adviser KPMG Peat Marwick in Guangzhou on April 22 to hear yet another dose of bad news. Only one-third of GITIC's assets could be recovered for paying creditors, and it could be several years before the process is completed.

According to a report prepared by the liquidation committee of the Higher People's Court of Guangdong Province, which is overseeing the bankruptcy proceedings, GITIC's total registered debt is roughly ¥38.8 billion ($4.7 billion), of which ¥15.8 billion ($1.9 billion) is guaranteed by the provincial government. Of its ¥21.3 billion ($2.6 billion) in assets, only ¥6.5 billion ($785 million) can be recovered. GITIC has managed to collect only ¥2.0 billion ($241.6 million) of the ¥11.3 billion ($1.4 billion) it is owed.

The provincial court has already ruled that 59 banks cannot be recognized as creditors of GITIC because they did not properly document their claims. As investigators are still examining 322 claims, the final list of creditors with valid claims may not be ready for another six months.

Even then, creditors may not know how much they will be able to recover. Despite a pledge from the chief judge to deal with the case according to the law and international practices, the Higher Court's liquidation committee has departed from China's bankruptcy law and decided to repay small creditors first. (Apparently, GITIC had been collecting deposits from the general public.) PRC tax authorities are next in line for repayment, followed by foreign and domestic creditors. It may be several years before all assets can be liquidated and creditors repaid.

A steering committee of nine creditors—seven banks and two brokerage firms—was also formed on April 22. A date for the next creditors' meeting has yet to be set.

GITIC's three subsidiaries, Guangxin Enterprises Development Co., Guangdong International Leasing Co., and GITIC Shenzhen, also held late-April meetings for their creditors, most of which are Chinese firms. Unless more assets are recovered than expected, creditors of Guangxin Enterprises and Guangdong Leasing will probably only recover 10 percent of their investments. GITIC Shenzhen creditors may receive 13 percent.

—Virginia A. Hulme

Virginia A. Hulme is assistant editor of The CBR.

From a micro perspective, the GITIC bankruptcy has reinforced the fundamental rules of lending to PRC entities. GITIC reaffirms the absolute need to get back to the basics—namely, the stringent and consistent application of fundamental, safe-and-sound lending and credit criteria for China on par with other countries. Chinese borrowers are becoming increasingly sophisticated and should therefore be expected to comply with contemporary financial disclosure requirements that are just as rigorous as those in other countries of similar economic strength and importance. Bankers lending to China have in the past been prepared to waive certain requirements that they would not waive in other countries—lulled, in part, by the promise of the PRC's huge market potential. The GITIC bankruptcy has served as a rude reminder of the importance of due diligence.

The GITIC case once again highlights how many of the imponderable or unquantifiable intangibles bundled into country risk must somehow be graded and weighed against the desire and need to book assets. Two such intangibles feature heavily in this case. First, there is the political dimension. GITIC issues are being tried and tested against the backdrop of a domestic power struggle waging between the regulatory authorities at the center in Beijing and the Guangdong provincial government.

The authorities' handling of the GITIC affair is a good example of this. To a certain extent, foreign lenders have inadvertently gotten caught in the middle of this particular form of ad hoc policymaking. Beijing seems to believe that the Guangdong government has run wild for far too long, and that GITIC was an extreme example of many other similarly over-leveraged entities. By forcing GITIC, one of the largest and most prominent ITICs in China, into bankruptcy, Beijing is sending a clear message that it is cracking down on an overheated and under-regulated sector of the economy.

Second, there is the legal dimension. There has always been a propensity in China for law to be applied in a flexible way. This is reflected both in the way in which laws are drafted and in the general legislative process. Many laws go through an initial testing period before full promulgation, providing an opportunity for authorities to tailor existing law around a particular set of circumstances. For example, there was a nine- and ten-year gap, respectively, between the trial implementation and promulgation stages of the Civil Procedure Law and the Environmental Protection Law. In addition, the authorities will often attach a great deal of importance and publicity to one particular case in order to set an example and "educate" the general public. Again, there has been a long string of test cases in many areas of law (such as criminal law and environmental protection). There is every indication that GITIC will prove to be such a test case for bankruptcy.

GITIC issues are being tried and tested against the backdrop of a domestic power struggle waging between the regulatory authorities at the center in Beijing and the Guangdong provincial government.

Thus, success in future cases of foreign lending to PRC institutions will be largely dictated by the ability to quantify the tangibles arising as a result of customary due diligence and to put a price on the risk represented by the perceived intangibles. To the extent that market pricing will not permit such risk margins, agility and versatility at navigating and judging the system will be the key commodities for survival. 完

BUTLER® An American Builder in China

Chinese firms have found that Butler Manufacturing Co.'s building systems make a reasonably priced, high-quality alternative to traditional constructions

Virginia A. Hulme

China has experienced an unprecedented construction boom throughout the 1990s, with shopping plazas, hotels, and luxury apartments springing up in the nation's main cities. Despite a recent slowdown in such construction, demand remains strong. There is also a need for manufacturing and retail buildings of all sizes. As Shanghai and other large Chinese cities undergo reconstruction and modernization, factories are relocating from city centers to new suburban industrial parks, offering opportunities for companies specializing in non-residential buildings. Headquartered in Kansas City, Missouri, with $962 million in worldwide sales in 1998, Butler Manufacturing Co. is a leader in the field of marketing, design, fabrication, and supply of building systems. Like many other multinationals in the early 1990s, it saw opportunity beckoning in China.

Butler's Chinese subsidiary, Butler (Shanghai), is one of more than 100 companies involved in steel fabrication in the Shanghai area, and is the only fabricator of light steel structures that the government lists among the prestigious "500 Fortune Industries of Shanghai." The manufacturing plant is located in Songjiang Industrial Zone. Butler also has sales and engineering offices in Tianjin, Guangzhou, and downtown Shanghai.

According to Mike Alossi, president of Butler Manufacturing Co.'s Asia-Pacific Operations, Butler began exporting its building systems to multinationals setting up shop in China in the early 1990s. These multinationals were already familiar with Butler's reputation and solid brand name. Before long, Chinese firms, impressed with the multinationals' Butler buildings, began placing orders. Now, roughly 80 percent of Butler's customers are Chinese companies, providing a strong customer base.

Because shipping of Butler's extremely heavy products is a cost issue, Butler began searching for possible manufacturing locations in China in late 1994. By 1995, the company was looking at both sites and potential joint-venture partners.

WHAT IS A BUILDING SYSTEM?

Butler takes a "complete systems" approach to its buildings, focusing on the quality and predictability of all components of a structure. A Butler customer can custom-design a building at a reasonable cost by combining a variety of standard components. These building systems can be erected much more quickly than the reinforced-concrete construction predominantly used for non-residential buildings in China. They also offer more predictable quality control—Butler is ISO 9001 certified in both the United States and China.

Virginia A. Hulme is assistant editor of The CBR.

Because China is still developing its heavy-manufacturing capacity, many of the buildings there are larger than most of those now constructed in the United States. Butler's Widespan structural system, the only building system Butler currently sells in China, accommodates this need for larger structures. Widespan buildings are also used for industrial factories, large retail facilities, distribution facilities, and warehouses.

A Widespan structure can range—in increments of an eighth of an inch—from 10 to 40 feet in height, or higher if the building is to have towers. Most buildings span a width of 30 to 450 feet (in six-inch increments), though one Butler building in China is almost 1,000 feet long. The buyer can choose from a variety of wall and roof types, as well as building accessories like doors and windows, to add to this basic structure. Though Widespan is the firm's most basic building system, it is also one of its most versatile. Not only can it be used with a variety of framing, roof, and wall systems, it can also be easily extended or expanded.

Most Butler buildings in China are two stories or less, and none are more than six stories. Initially, demand for Butler products was strongest in manufacturing, but is now fairly evenly spread between manufacturing and retail. Butler's customers include 3M; Carlsberg A/S; Carrefour, a French department store chain; Caterpillar Inc.; the Cris Group, a retail seller of furniture, groceries, and home improvement items; DMS, a local retailer; Ford Motor Co.; the Hai'er Group, which produces major appliances like washing machines and refrigerators; Motorola Inc.; and Shanghai Bell. Butler also provides commodity-storage structures for large farm operations in China.

Setting up shop

As Butler had never done business on the ground in the PRC, the company initially thought it would be wise to find an experienced local partner to help it break into the Chinese market. Although Butler talked to many potential partners, the company failed to find a good match. In the world of building systems, companies must be flexible and fast, as speed of construction and predictable quality are vital. To keep control over its operations and maintain its carefully built reputation, Butler decided to forsake the local knowledge and advice a partner could bring in exchange for the flexibility of a wholly foreign-owned enterprise. Though the company faced a learning curve with regard to doing business in China, advice from officials in the Songjiang Industrial Zone helped Butler overcome normal startup difficulties, such as figuring out permits and licensing requirements.

In choosing a location, Butler focused on special investment zones, particularly those around Shanghai. Butler favored Shanghai for its infrastructure and central location, which makes it an ideal base from which to serve China's regional markets. After selecting the Songjiang Industrial Zone, Butler began constructing its manufacturing plant in late 1995. The plant started production in 1997, and 1998 was its first full year of operation.

While Butler's manufacturing plant began operations in 1997 with about 90 percent imported US and Japanese materials, from the beginning Butler planned to switch to local sources wherever possible. Early on, Butler identified suppliers in China, Korea, and Japan and showed them exactly what was needed, especially in terms of quality. Though Butler still imports light-gauge material for paneling from the United States, Japan, and Korea, most of the main steel columns used for roof beams and framing are sourced from PRC suppliers. In only two years, the company was able to reduce foreign sourcing for its inputs to 20 percent—80 percent of inputs are now Chinese. Butler is aiming for nearly 100 percent Chinese input, though some materials will have to come from other Asian suppliers, namely Korea and Japan, until they become available in China.

The interior of Butler (Shanghai) Inc. *photo courtesy of Butler Manufacturing Co.*

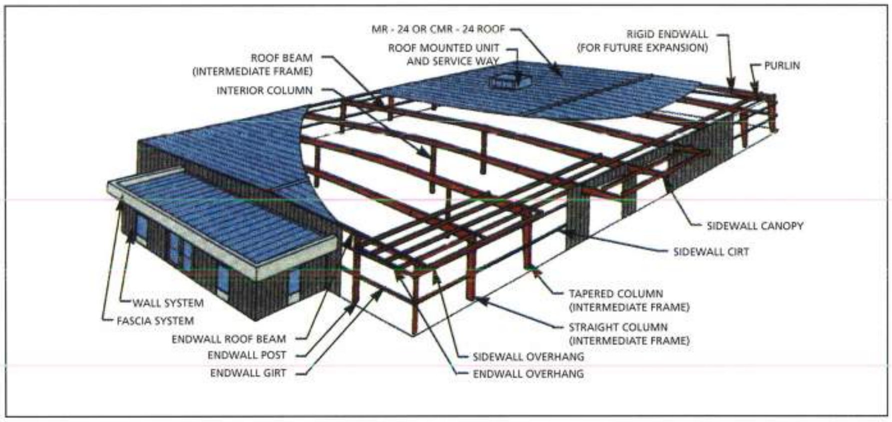
Adapting to the PRC

In China, all construction design handled by foreign firms must be approved by a Chinese design institute. Even then, foreigners are only allowed to do preliminary design work. Schematic design and working drawings are outside the purview of foreign firms.

Butler thus works closely with the customer, the local Butler Builder—Butler's designated contractors in China—and a local design institute. These design institutes, which influence much of the construction market, house engi-

In only two years, the company was able to reduce foreign sourcing for its inputs to 20 percent

neering and detailing groups and also act as a training ground for Chinese engineers. The inherent risk in this type of cooperative strategy is that the Chinese design institutes will learn quickly from a collaborative agreement, and will in a short time become capable and inexpensive competitors that use their new-found expertise with great success. But for a company like Butler, which produces an entire building-systems package, including framing and roof and wall panels, this risk may be less than for other design and construction firms.



Basic Widespan™ Structural System Components *photo courtesy of Butler Manufacturing Co.*

Butler also works with the structural engineering departments of respected universities. The firm has a technology-transfer program with two universities in Shanghai to familiarize students with the building-systems concept, manufacturing techniques, and engineering processes. As graduates of these programs are the people who are likely to approve buildings in future, exposure to Butler products and processes will only work in the company's favor.

Experienced local staff are key

With any plant comes the need for highly qualified staff, and Butler (Shanghai) was no exception. A crucial part of Butler's overall China strategy was the hiring of local management. Though it sent 12 expatriates to China to set up operations, of the company's 220 current employees, only five are expatriates.

Butler started recruiting and training Chinese management and engineers in 1996. The company brought these managers to the United States for in-house training and familiarization with the company. For instance, the PRC manufacturing manager spent three months in the United States, living at a variety of plant locations, while the Chinese operations and finance managers spent 6-8 weeks at headquarters. In addition, Butler regularly sends experts from its US operations to China. Recently, one US-based manager spent nearly 20 months in China providing onsite training in finance and operations and systems processes.

While steel construction and building systems have been relatively rare in China until recently, Butler had no trouble finding highly qualified staff with significant steel technology knowledge and skills applicable to Butler's products—usually in fields such as welding and bridge and ship fabrication. The firm found employees mainly through networking, search firms, and asking suppliers. Some employees were trained abroad; some had extensive experience in state-owned enterprises; and some had foreign experience. The Chinese managers—and the confidence and trust between them and their US supervisors—are the keys to Butler's success in China.

Butler (Shanghai) is also training a network of Butler Builders in the PRC. Butler Builders are independent, professionally trained local contracting firms that officially represent Butler and help sell, design, and construct Butler Buildings. The roughly 30 Butler Builders in China, both private and state firms, stretch from the far north to the far south of the country. Though the Butler Builders are currently concentrated along China's east coast, Butler is looking to expand its network into the interior.

Butler educates these project designers and prospective building owners about the advantages of building-systems technology and Western construction practices. Though there are many Chinese steel fabrication firms building high rises with steel frames, they use different design and fabrication techniques. For instance, Chinese firms start with I-beams rolled in steel mills, in which they drill holes and to which they then add metal plates. In contrast, Butler takes a flat plate and makes three-plate welded beams—a more efficient design.

While the Butler Builder network reflects a project delivery strategy that has worked successfully for Butler in the United States and elsewhere, the firm has had to adjust to China's market by becoming more active in the selling process. In the United States,

The Cris Group and Cris Real Estate Company Ltd. customized Butler's Widespan structure for its retail furniture store in Tianjin. The building was shipped by truck from Butler (Shanghai). *photo courtesy of Butler Manufacturing Co.*

Butler Builders do most of the selling, as they thoroughly understand the technology, value, and advantages of the product. But because Chinese Butler Builders are not yet as familiar with the technology and product, staff from Butler's sales and engineering offices often take the lead in generating direct sales by contacting design institutes, multinationals, and other customers. Once a sale is made, a Butler Builder is brought in to complete the job.

Butler's China approach is similar to the one it uses in other countries—targeting specific markets through advertising and other marketing programs, and promoting building systems technology to design institutes and contractors. But in China, the company has found, it needs to provide more education about building systems than in other markets.

THE SKY'S THE LIMIT

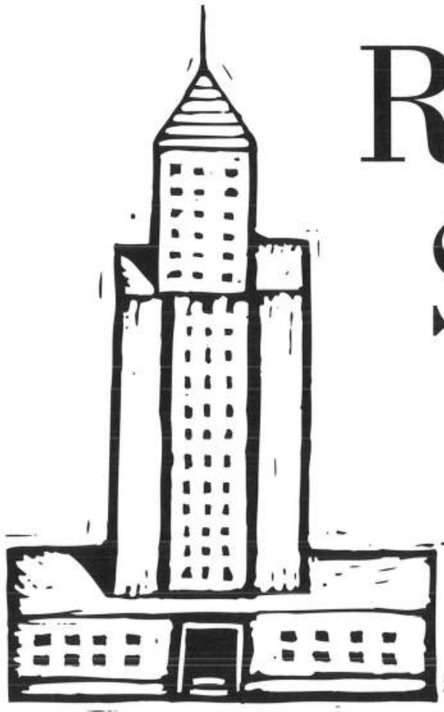
Butler (Shanghai) currently sells about 90 percent of its products in the PRC, and exports the remaining 10 percent to Korea, Vietnam, and the Philippines, where it has sales offices. In the future, Butler hopes to export more to other Asian countries. As the majority of sales and the manufacturing base are in the PRC, however, Butler is not planning to set up production facilities in other Asian countries. Though Butler has a licensing agreement with a Japanese company, which services the Japanese market, Butler (Shanghai) will remain the firm's manufacturing base for East and Southeast Asia for the foreseeable future.

Butler has both foreign and local competitors, and the market is competitive. Butler entered China fractionally ahead of its foreign competitors, and is trying to maintain and expand its market share. Roughly five of its competitors are from the United States. In the Shanghai area, there are over 100 companies involved in steel fabrication, from small to giant state-owned enterprises. Most of the Chinese companies originally specialized in shipbuilding and infrastructure, and some of them are shifting into construction.

Nevertheless, Butler (Shanghai) became profitable in the second half of 1998, a little earlier than expected, and expects to be profitable in 1999. So far, the firm has been unaffected by the Asian crisis, probably because its operations are within the PRC, where the currency has remained stable.

Steel construction has been unusual in China's sea of concrete construction—comprising only about 5 percent of the construction market, compared with 60 percent in the United States. Asia-Pacific Operations Director Alossi hopes that as China industrializes, there will be rapid growth in the use of steel construction in China. According to a US and Foreign Commercial Service and Department of State report, in 1996 and 1997 pre-engineered building systems were either among leading exports to China or there was unfulfilled demand for such products—a promising sign for Butler, and for the growth prospects of the industry as a whole. 完

Shanghai Yan Feng Automotive Trim Company Limited used the services of China No. 3 Construction Bureau, a Butler Builder, to construct its auto-components manufacturing facility. *photo courtesy of Butler Manufacturing Co.*



Retail Space to Let

Shanghai's retail real estate market comes down to earth

Andrew Ness

In part as a result of the sea change in Asia's economic fortunes, the entire Shanghai retail sector—including the retail property market—is experiencing a period of less buoyant growth. This decline, which began in 1996, has mirrored the declining rate of growth of both Shanghai's GDP and utilized foreign direct investment. Over the 1996-99 period, these rates of growth declined by 1.45 percent and 22.6 percent, respectively.

While total 1998 retail sales in Shanghai increased 11 percent over 1997 to ¥147.1 billion ($17.7 billion), the city's retail price index fell by 3.9 percent, making 1998 the second consecutive year in which consumer prices registered negative growth in Shanghai. Nineteen ninety-seven also marked the first year since 1992 in which the city's annual retail sales turnover grew by less than 15 percent—a clear indication of slowing consumer spending.

Though new retail properties continue to emerge, few buyers have come forward to purchase any of those properties offered for sale in recent years. Potential investors have been deterred from purchasing these properties as a result of the crackdown on domestic bank lending to the real estate sector, as well as the complex licensing issues involved in leasing retail units on a strata-title (individual ownership) basis. Under this arrangement, the would-be lessor must possess a retail business license permitting the operation of the type of business the tenant proposes to undertake. Alternatively, the incoming tenant must already possess a retailing license for its proposed business. Would-be purchasers have also been reluctant to acquire these properties, primarily because of high purchasing costs, which tie up large amounts of the working capital typically required to run retail operations.

New projects and their pecking order

Though Shanghai has grown in recent years into one of the more vibrant economies in China, particularly with respect to consumer goods, consumer confidence weakened considerably in 1998. As in other parts of China, this was a result of the accelerated pace of state-owned-enterprise restructuring and rising unemployment. This downturn had no impact on either the scale or pace of retail property completions in 1998, however, because multi-use commercial complexes take at least 3-4 years to develop. As a result, 29 complexes containing some sort of retail facility were completed in Shanghai in 1998.

Of these properties, 10 are in Pudong New Area, while the 18 properties located in the Puxi District provide 66.7 percent of Shanghai's total new retail floor area of 434,922 sq m. Among the more notable of the Puxi facilities are Hong Kong Plaza, Jin Yuan Building, Central Plaza, Xujiahui Metro Entertainment City, Gang Tai Plaza, Regent

Andrew Ness is departmental director, Global Research and Consulting, Greater China, CB Richard Ellis—a global real estate services company with a focus on brokerage, property management, facilities management, as well as mortgage banking, investment management and property appraisal.

Place, Bai Xin Mansion, and Golden Magnolia Place. The most prominent new facility in Pudong is the Jinmao Building retail platform. Xujiahui Metro Entertainment City and the Jinmao Building retail podium are among the larger foreign-invested retail properties to have opened in Shanghai to date.

These completions raised the number of large-scale shopping centers in Shanghai to 67. These shopping centers, each of which covers more than 10,000 sq m of retail floor space, include both standalone facilities and retail spaces embedded in larger, multi-use complexes. Shanghai's 24 large-scale, foreign-invested retail operations offer a total of over 725,000 sq m of retail space. Nine are standalone shopping centers, and the remaining 15 are retail components of multipurpose complexes. Meanwhile, most of the city's 150 medium-scale shopping complexes (each with at least 5,000 sq m in floor space) provide Shanghai retailers with commercial platforms attached to office or mixed-use developments. Of these medium-scale retailing properties, some 34 properties—with a total of over 794,000 sq m in retail space—are now foreign-operated, either as leased retail arcades or as individually owned shopping centers.

Despite the relatively active market in retail property acquisitions in nearby cities such as Hangzhou in Zhejiang Province, Shanghai presently offers relatively little retail property for sale. The few properties currently on offer are organized into a clear hierarchy according to desirability. Nanjing East Road, where the first modern retail storefronts in Shanghai developed during the late nineteenth century, is at the apex. The upper floors of newly completed retailing complexes along this narrow boulevard, which has already undergone partial conversion into a pedestrian mall, are still able to demand $6,000 per sq m. Retail property situated along Beijing East Road in the Huangpu District and Xinzha Road in the Jing'an District constitute the second rung in this hierarchy of desirability, with floors in new commercial complexes asking $4,520-$5,000 per sq m, respectively. Retail properties in more decentralized locations in the core inner city, such as Julu Road and Dapu Road, presently go for $3,000 per sq m.

The few major retail sales transactions that have taken place in recent years have typically involved bloc acquisitions of entire properties. For example, Japanese fashion retailer Itokin acquired the China Silk Building in 1997 for a total purchase price of ¥550 million ($64.4 million). This cannot be accurately described as a pure retail acquisition, however, since the building, with a gross floor area of 15,000 sq m, also provides office facilities. Itokin moved its China headquarters into the building shortly after making the acquisition.

The Lowdown on Leasing

Though Shanghai's retail property market is currently in flux, rental levels in major new shopping facilities also vary roughly in proportion to their proximity to the city's main shopping areas. At the very top of the retailing hierarchy are Shanghai's two traditional shopping streets: Huai Hai Middle Road—particularly the largely redeveloped section from Song Shan Road to Huangpi South Road—and the section of Nanjing West Road from Jiangning Road to Mao Ming South Road. These two sections command the highest fixed rental prices of any locations in Shanghai at $5-$5.50 per sq m per day. By contrast, ground-floor shops on Sichuan North Road, a major center of no-frills middle-class shopping, rent for less than half the levels of the two golden-mile shopping boulevards. Pudong Zhangyang Road and Zhabei Tianmu Road, while attractive to retailers, still retain the status of emerging retailing destinations, as reflected in the even lower ($1-$1.80 per sq m per day) fixed rental rates commanded by their prime ground-floor shop fronts.

One clear sign of consolidation in the Shanghai retail-leasing market and of the heightened competition among landlords for reputable tenants is that shopping-center owners have been finding it increasingly difficult to impose guaranteed minimum rents on tenants who have managed to secure "participating" leases. In a participating lease, the rent is payable on the basis of a fixed percentage of a given shop's retail sales turnover. In a "guaranteed minimum" arrangement, during a given month the landlord may opt to take this percentage of turnover, or a certain fixed rental rate per sq m, whichever is higher. In Shanghai, however, landlords are now increasingly being forced to forego these guaranteed minimums altogether, or lower them to very nominal levels, in order to secure the caliber of tenants they have targeted.

Despite the relatively active market in retail property acquisitions in nearby cities such as Hangzhou in Zhejiang Province, Shanghai presently offers relatively little retail property for sale.

Nonetheless, the difference between the fixed rental rate for a given location (in those instances where participating leases are not offered) and guaranteed-minimum rental levels is also a direct function of the desirability of the retailing space in question. The same hierarchy of retailing locations holds true with respect to the conditions offered in participating leases. Thus, for example, the greatest difference in rental rates is between fixed and guaranteed-minimum rentals for prime space in the Nanjing West Road and Huai Hai Middle Road. In these golden-mile shopping stretches, the differential between fixed rentals and guaranteed-minimum rentals is 30 percent and 45 percent, respectively. The width of these gaps shows the relative strength and high level of straight fixed rentals in these shopping districts.

Department Stores Slump

In 1998 only one new domestically backed department store opened in Shanghai. The Huijin Department Store opened in August in Xujiahui with 40,000 sq m in retail facilities. It has been rumored that some major foreign department-store operators previously intent on expanding in Shanghai have backed out of their leasing pre-commitments. For example, Chia Tai Friendship Department Store withdrew a formal expression of interest in leasing substantial floor area in the Hong Kong

Many department stores that managed to escape bankruptcy were forced to undertake major restructuring and re-positioning of their retail operations.

Plaza. In fact, the department store—a joint venture between Thai conglomerate C.P. Pokphand and the Shanghai municipal government—subsequently dissolved.

This halt in expansion by department store operators, who represent the largest retail space occupants in the city, combined with a rise in the number of new retail properties on the market to raise vacancies in large-scale retail facilities significantly. Vacancies swelled from 28 percent in 1997 to 38.3 percent by year-end 1998. This vacancy figure could well have been higher, were it not for the fairly substantial take-up of retail premises by the retail departments of local commercial banks, brokerage departments of local security companies, and fast-food operators. These businesses have continued to expand despite the overall downturn in the Shanghai retailing environment. Vacancies are sure to rise further, however, because a substantial number of large-scale commercial complexes currently under construction are expected to be completed in the next two to three years.

Rough times in retail

In 1998, the bulk of retail leasing transactions consisted of rentals of center-city storefront and shopping-center space, with most transactions occurring for shops in the 100-300 sq m range. The merchandising of high-end imported consumer fashions and luxury goods appears only to be viable in certain very high-end locations and in small quantities. Overseas retailers in Shanghai who have made the mistake of attempting to sell high-end, branded international fashion and accessories in a large retailing format, such as the JJ Dickson emporium on Changle Road, have lost money since day one in Shanghai. In fact, the Dickson emporium earned the nickname "retailing museum"—referring to the fact that shoppers browse there but almost never make purchases.

As consumption patterns in Shanghai have become more sophisticated and as it has become easier for Shanghainese to travel abroad, imported luxury goods have lost much of their earlier mystique. Rather, the strongest

Staid Beijing Retailers Get a Shot in the Arm

The traditional Beijing shopping districts of Wangfujing, Xidan, and the Qianmen-Dazhalan area continue to be the city's main retailing hubs and entertainment centers. The districts have presented the same relatively undisturbed face to consumers since 1949. This relative calm was disrupted, however, not by the 1992 opening of the retail sector to foreign participants, but by the 1995 completion of the first large-scale shopping centers in these areas. In 1997-98, the market underwent yet another metamorphosis with the opening of a number of stores equipped with the latest in shopping-center management technologies and presentation formats.

The opening of these more technologically advanced shopping centers dealt a blow to the city's staid, tradition-bound state-owned shopping sector, forcing these stores to adapt quickly to stay in business. These changes in one stroke robbed "golden-mile" locations such as Wangfujing of their formerly unchallenged superiority as shopping destinations. They also forced the antiquated Qianmen area to withdraw entirely from the ranks of the city's first-tier retail merchandising and shopping areas.

The bright glare cast by this heightened competition served only to accentuate the defects of the older department stores, from the aged fixtures, fittings, operational equipment, and building systems, to the lack of effective marketing and promotional programs and a tendency to use monotonously similar merchandise mixes and presentations. In their rather clumsy attempts to capture a larger share of the mass consumer market, the only strategies of which these older department stores have generally availed themselves have been discounting wars and direct price competition.

This price-cutting trend has had the direct effect of driving many of these department store operators to the wall, with as a many as eight major operators forced into bankruptcy in the 30-month period between year-end 1995 and mid-1998. These stores—the Wanhui Shuang An Commercial Centre, Tian Yuan Commercial Building, Kama Commercial Building, Asia TV Tower, Xin An Plaza, and Dong Ding Commercial Plaza—shared a number of weaknesses. Nearly all of these recently failed retailing complexes were located far from the prime shopping districts. They also all lacked a distinct theme, market niche or specialty, and made similar mistakes in targeting their market, following a merchandising strategy and mix at odds with the shopping requirements and income levels of the bulk of the households near their shops.

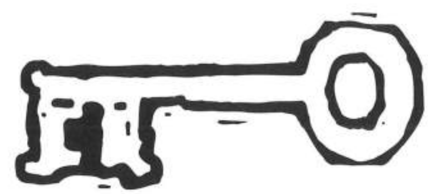
Pulling themselves up by their bootstraps

Under the pressure of shrinking profit margins caused by the explosion of new shopping facilities, a number of department stores and shopping centers have completely restructured to survive in the market's leaner and more competitive conditions. Some of what were originally the city's largest state-owned department stores have already re-organized themselves as joint-stock companies in which the Chinese government now merely holds a shareholding interest. For example, the Wangfujing No.1 Beijing Department Store and the Chengxiang Trade Centre, which were formerly the city's two largest state-owned department stores, have seen their financial results improve markedly since reorganizing as joint-stock companies and listing on the Shanghai Stock Exchange. Another state-owned survivor emerged from demand for storefront space is from retailers targeting the local yuppie market through the merchandising of middle-market casual youthwear: US-run Lawman stores selling blue jeans; Hong Kong-owned Bossini stores selling casual men's and women's fashions; and both Chlaber of Taiwan and the PRC firm GMD merchandising casual women's youthwear. These trends are likely to continue in the near future.

The department store remains the dominant type of retail outlet, accounting for 47.5 percent of the city's total retail sales volume in 1997. The sluggish performance of the department store sector since 1997 thus has had a significant impact on Shanghai's retail property market. In the first half of 1998, the total sales volume of department stores in Shanghai increased by only 5 percent, while department store operators saw the progressive erosion of their net profit margins. According to local press reports, the average net, after-tax profit of department stores in Shanghai has fallen from 3.5 percent of sales turnover in 1991 to 1.3 percent by year-end 1997. With profit margins so narrow, small and medium-sized department stores can easily run into operational difficulties.

Indeed, 1997 witnessed the bankruptcy and closing of the state-owned Qian Cun Department Store in Yangpu; the Shui Hing Department Store on Huai Hai Road; the Dong Feng Wan Bang, at the foot of the Oriental Pearl TV Tower in the Lujiazui sub-district of Pudong; the Universal Department Store at the intersection of Yu Yuan Road and Jing'ansi; and the Friendship Gift Store at the intersection of Nanjing West Road and Shimen Road. Each of these five department stores failed for slightly different reasons.

The Qian Cun failed mainly because of its remote location and general mismanagement. The Shui Hing foundered because of weak management and the



owner's lack of financial stamina to operate under the industry's present thin margins. The Dong Fang Wan Bang also suffered from its inappropriate location and management problems. The Universal lacked a clear theme or distinguishing characteristic. Similarly, the Friendship Gift Store failed to target its market and had an unsuccessful merchandising strategy.

Many department stores that managed to escape bankruptcy were forced to undertake major restructuring and repositioning of their retail operations. For example, the Bao Da Xiang Department Store, located on Nanjing East Road, shifted its merchandising focus from

the 1997 merger and consolidation of the assets of the Xidan Commercial Plaza Group with the Friendship Store Enterprise Group, another major joint-stock company in the sector.

At the same time, other state-owned retailers have adopted the strategy of completely re-formulating their merchandising mix, sometimes entirely on their own initiative and sometimes in joint venture with an overseas partner. For example, the developer of the Hai Shen Building, on Huayuan Road in the Haidian District, was initially launched as a middle- to up-market department store, but was nearly forced to shut down because of mismanagement and mistakes in merchandising policy. The venture reversed its fortunes by entering into a joint venture with Malaysian department store operator Parkson, renaming itself the Haisheng Parkson Commercial Building and successfully repositioning its merchandising strategy to focus mainly on the provision of daily use articles and consumer necessities. Similarly, the Instec Commercial Building—situated along North Third Ring Road and initially operated as an undistinguished, middle-market department store—was also repositioned and renamed the Da Zhong Audio-Visual Equipment Commercial Centre.

Finally, the Kama Commercial Building, which closed its doors in 1997, reopened after a reconfiguration in 1998 as the Nova Computer Plaza. As one of the first dedicated computer-products shopping malls in Beijing, the Nova Computer Plaza has met with a positive reception from Beijing's buying public, as its shops provide one of the widest range of computer-related equipment, software, and peripherals of any single shopping destination in Beijing.

Wangfujing gets a facelift

In the context of such restructuring, it is no surprise that Wangfujing, Beijing's premier shopping street, is slated for a major renovation. The re-engineering and re-positioning of the image of this traditional shopping avenue had begun as early as 1992. Improvements include a massive effort to lay new fiber-optic cable lines for telecommunications, new water mains, power lines, steam pipes, and wastewater evacuation pipes, replacing the completely outdated utilities supply infrastructure beneath the street's surface. Substantial portions of the avenue have been transformed into construction sites. The construction work, however, has caused the volume of pedestrian traffic to drop off sharply and has seriously disrupted the commercial atmosphere, which is now considerably less vibrant than that of neighboring Xidan.

The project to upgrade Wangfujing, though disruptive in the short term, is clearly favorable from the point of view of retailers, who will benefit from the refurbishing of the avenue's position as a modern shopping boulevard. With the completion of the upgrading efforts this year, Beijing officials are confident that Wangfujing Street will come to take on a status similar to Nanjing East Road and Nanjing West Road in Shanghai, and will stand out in Beijing as a shopping boulevard with a distinct international aura. But traffic along the renovated road will be limited to pedestrians and public buses, marking an important step toward Wangfujing's ultimate conversion into a pedestrian shopping mall—a move which is still under debate by the city's town planners, and for which no firm date has yet been fixed.

—Andrew Ness

A number of retail formats new to Shanghai have taken up some, if not all, of the slack in the property market.

fashion and accessories to wholesaling—evidently a successful move, since the lower-priced bulk goods have attracted customers. Similarly, the Mainland Department Store, situated near Dongfeng Road in Lujiazui, changed its format from that of a typical department store to one focused on home electronic appliances, and home decoration and construction materials. Other department stores went through management restructuring. Yaohan Nextage in Pudong saw its ownership transferred from bankrupt Yaohan of Japan to local backer Shanghai No.1 Department Store. Shanghai No. 1 completely and successfully shifted the store's merchandising orientation from luxury imported goods to affordable local goods.

Up-and-coming retailers

Though retailers are facing tough times across the board, a number of retail formats new to Shanghai have taken up some, if not all, of the slack in the property market. Hypermarkets, for example, first entered the Shanghai retail market in late 1995. Well-established international operators such as Carrefour, Metro AG, and Lotus boldly initiated pilot operations with individual stores of over 10,000 sq m in floor area. The instant success of these first outlets prompted the companies to open second stores. In a testament to the compatibility of this retailing format with the cost-saving mentality of Shanghai's shoppers, by June 1998 Carrefour, Metro, Lotus, E-Mart, IMM, and A&A together had opened seven hypermarkets occupying a total of 166,000 sq m.

Over the past five years, chain-store retail operations have also proven highly successful in Shanghai, and chain-store supermarket operations have taken the city's retail sector by storm. As of year-end 1997 a total of 919 supermarkets were operating in Shanghai, taking up 330,000 sq m of floor area and accounting for ¥10 billion ($1.2 billion) in annual retail sales turnover. Over the past three years, one new supermarket has opened every three days in Shanghai. The state-owned Hualian and Lianhua supermarket chains accelerated their rates of expansion by buying out a number of smaller supermarket operators. Each now operates approximately 400 stores in the greater Shanghai metropolitan area (*see The CBR*, September-October 1998, p.30).

Convenience stores are a second type of chain-store retailing format that has developed with amazing speed in Shanghai. In contrast to supermarkets, which are generally situated just outside residential subdivisions or development complexes, convenience stores tend to be located within residential developments and licensed to operate 24 hours a day. The typical convenience store is only about 100 sq m in size. Dairy Farm, one of Shanghai's leading convenience store operators, has opened over 100 Kedi stores to date. Hong Kong-backed Basics has opened more than 60 outlets across the city. Wholly domestically owned Baijia, as well as Sino-Japanese joint venture Hualian Lawson, have each opened more than 40 convenience stores in Shanghai to date. Supermarket operator Hualian, which only entered the convenience-store business in November 1997, jumped from eight convenience stores in Shanghai by year-end 1997 to 70 by year-end 1998.

Infrastructure's implications

The recent completion of a number of major infrastructure projects in Shanghai is having a double-edged effect on the development of the city's retailing sector. The completion of Metro Line No. 2, extending from Zhongshan Park in the Changning District to Central Park in Lujiazui, will certainly stimulate the performance of shopping centers situated along its east-west route as well as those clustered around both of its terminal stations. On the other hand, the continued extension of existing metro lines and the planned construction of additional lines is shifting retailers' focus to the new satellite residential communities forming in fringe urban areas. Since Shanghainese tend to shop within a short traveling distance of home, the ultimate impact of these improvements will be a decline in retail spending in the city-center shopping areas and an increase in spending in suburban supermarkets and convenience stores.

For example, the recent southern extension of Metro Line No.1 from its original terminus at Jinjiang Amusement Park to Xinzhuang in the Minhang District has made Minhang a viable suburban commuter residential location for the first time. The elevated light railroad, which is scheduled to begin construction in 1998 and be completed by 2000, will connect Caohejing in the Xuhui District to the Changning, Putuo, Zhabei, Hongkou, and Baoshan districts, substantially enhancing these areas as suburban bedroom communities.

Remember the regulations

The Shanghai government issued the Several Regulations Concerning the Operation of Chain Store Enterprises in Shanghai in December 1997, which defined some of the most common kinds of chain-store retailing formats—including supermarkets, convenience stores, and specialty shops—and permitted the development of large-scale retailing chains in the city. The regulations reflected the government's recognition of the need for a more complete set of rules to govern retail operations.

These regulations recognized the legality of franchised chain stores, operating under a licensing agreement and paying licensing fees in exchange for the use of identity kits and operating technology. The regulations also allowed for non-franchise chain store agreements, in which individual retailers retain their separate identities, agreeing only to participate in a unified procurement and sales plan under the lead retailer's direction. This regulatory advance was followed in the first half of 1998 by the Shanghai Municipal Pricing Law, and the Tentative Regulations Concerning Prohibiting Low Price Product Dumping Activities. These regulations prohibited unfair price competition and provided some retail-sector pricing guidelines.

But development of the retailing sector in major urban centers is still hampered by regulatory restrictions on overseas investment in the retail and tertiary sectors. For example, China bans wholly foreign-owned retailing enterprises and overseas investment in cinema operation and film distribution.

Removing such prohibitions would have a huge impact on the Shanghai retail sector, both by boosting the profitability of entertainment-led retailing complexes and accelerating the leasing absorption of retail space.

Further, if owners or developers of large-scale commercial complexes could seek not just department-store tenants to anchor their retail complexes, but also cinemas, bookstores, music and video chain stores, and cyber-cafés and computer arcades, retail sector leasing prospects for the next several years would be less daunting.

Meeting Shanghai's Property Needs

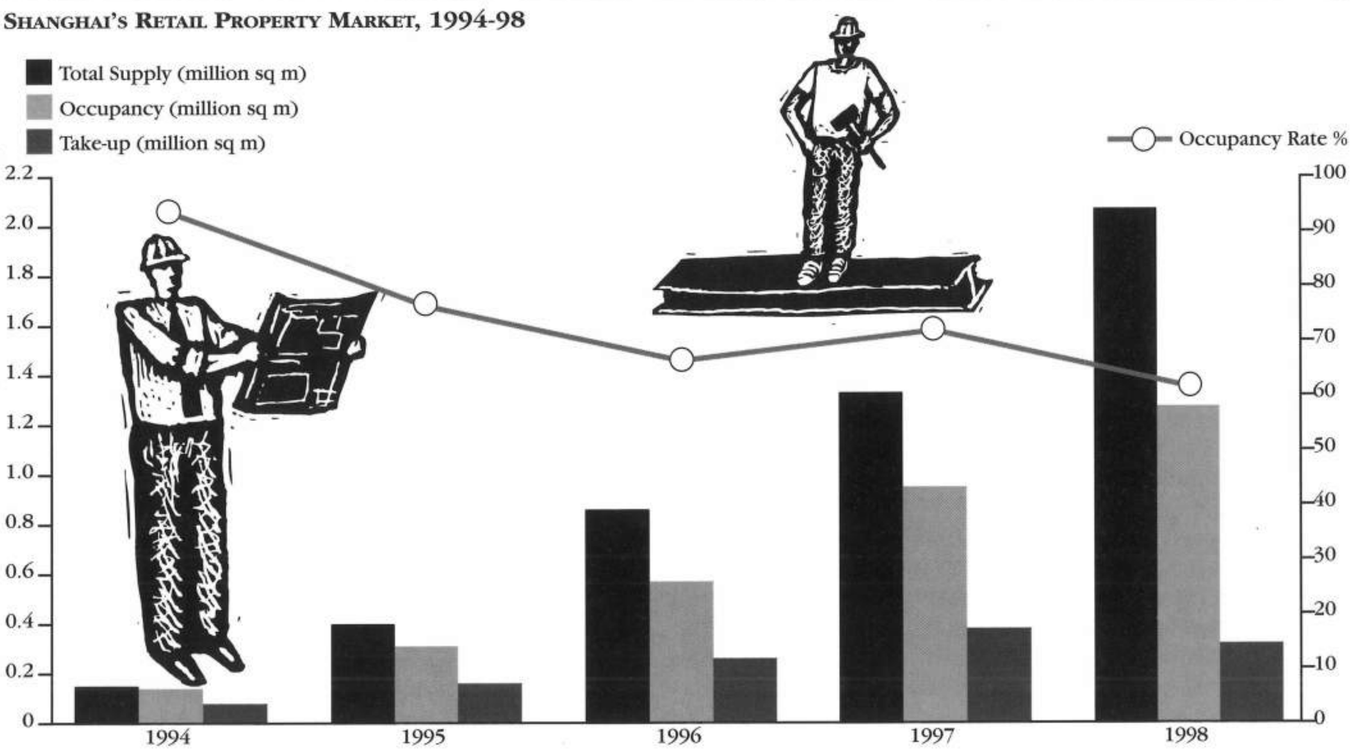
Shanghai's retail real estate sector is likely to continue to respond to the ongoing restructuring of the city's economy. Between 1999-2001 Shanghai will be very much caught up in its efforts to reform state-run enterprises which, in turn, will lead to swelling ranks of redundant workers. At the same time, evolution of the city's tertiary sector, specifically financial services and related industries, is bound to lead to a more service-based economy. A more polarized society is likely to result, and the structure of consumer demand in the city will become increasingly stratified. The perceptible gap between middle- to higher-end and low-end consumption is expected to widen further.

Department stores, already fading as the major form of urban retailing, are expected to come under even greater pressure. Retail selling will increasingly assume the format of chain-store operations targeting specific market segments. Smaller numbers of major chain-store retailing groups will centrally control these chains. These chain-store operators are increasingly employing retail technologies, such as computerized cash-register systems and point-of-sales information systems, which leave traditional state-owned department stores, with their inefficient distribution systems and lack of responsiveness to consumer requirements, even further in the dust (*see* p.46).

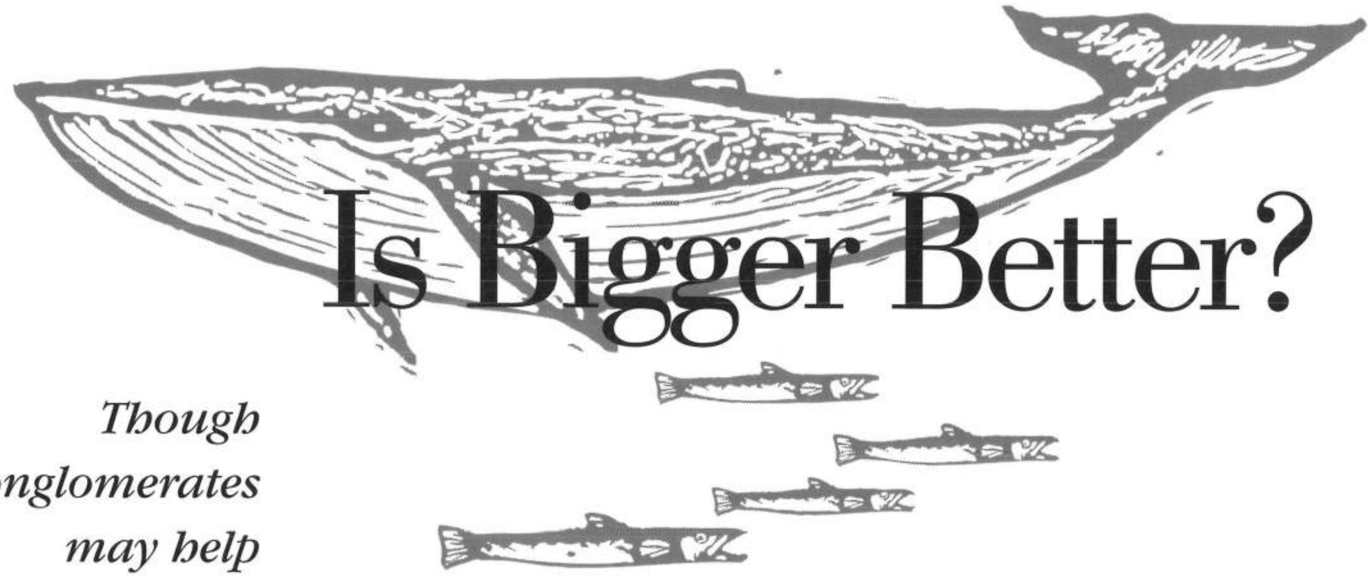
Underlying these structural changes in the market will be improvements in urban transportation infrastructure. The physical location of retailing facilities in Shanghai will thus become increasingly spread out. A multi-nuclear city structure will supplant the city's former mono-nodal urban structure, which has been supported by the older central-city retailing hubs. While the city's major shopping centers will retain their roles as centers of leisure, entertainment, and non-essential shopping, the newly ascendant hypermarket and supermarket chains will increasingly target satellite residential communities in suburban fringe areas. Such stores will focus on building market share through streamlined distribution techniques and economies of scale. These new, highly competitive chain-store operations are the single most important area for future growth in demand for retail facilities. As a result, vacancy levels will remain generally high and retail rentals correspondingly depressed in the shopping centers clustered around the traditional, central-city shopping areas. 完

If owners or developers of large-scale commercial complexes could seek out cinemas, cyber-cafés and computer arcades as anchors, retail sector leasing prospects would be less daunting.

Shanghai's Retail Property Market, 1994-98



SOURCE: CB Richard Ellis Global Research Consulting



Is Bigger Better?

Though conglomerates may help rationalize China's structurally fragmented economy, bureaucracy severely hinders their formation

Shawn Shieh

A centerpiece of China's state-owned-enterprise (SOE) reform strategy has come to be known colloquially as "managing the large and letting go of the small" (*zhua da fang xiao*). This slogan refers to the government's decision to concentrate state support on China's larger and more successful SOEs while taking measures to loosen state control and ownership over smaller ones.

In more concrete terms, this strategy involves turning China's more productive large and medium-sized SOEs into independent corporate entities and supporting the formation of large enterprise groups, or conglomerates, able to compete with foreign multinationals. Small SOEs, particularly those running in the red, will be leased out, merged with more productive enterprises, sold, or forced into bankruptcy. While this approach may help streamline China's fragmented economy, most companies must overcome a mountain of political and bureaucratic obstacles before they can form conglomerates.

A SECOND LOOK AT AN OLD IDEA

The idea of restructuring China's economy around large enterprise groups is not new. As far back as the 1960s, Liu Shaoqi, then the leader of the Communist Party, suggested forming national corporations, or trusts, which would bring enterprises within the same sector under a single roof to benefit from economies of scale. China's economy then, as it is now, was highly dispersed, with many small enterprises under regional or local control producing the same goods. Liu believed that the formation of trusts would help rationalize this fragmented economic structure. His plan, however, met resistance from regional and local officials unwilling to lose control over these trusts. Chairman Mao Zedong eventually shot down the idea, deciding instead to promote large-scale decentralization of industry.

In the early days of the reform era, supporters once again began to argue that enterprise groups would help rationalize the economy. But the lack of a coherent industrial policy, as well as the same bureaucratic obstacles that had frustrated Liu during the 1960s, slowed the formation of enterprise groups until the early 1990s.

Two major policy decisions in 1993 marked the turning point in China's policies toward conglomerates. First was the Central Committee's Decision on Certain Questions in Establishing a Socialist Market Economy Structure, which made the "modern enterprise system" the crux of enterprise reform

Shawn Shieh is an assistant professor of Political Science at Marist College in Poughkeepsie, New York.

and called for the formation of large enterprise groups that would transcend regional and sectoral divisions. Second was the Company Law, approved in 1993 and formally implemented in July 1994.

The Company Law, along with other laws and regulations that have been passed since 1993, is effectively the legal foundation for the modern enterprise system, and thus a key part of the conglomerate strategy. The modern enterprise system seeks to weaken bureaucratic ownership by making companies legal corporate entities with their own clearly defined property rights. By clarifying the property rights of enterprises and turning them into legal corporate entities responsible for their own profits and losses, the Company Law blunts political interference from bureaucratic superiors, making it easier for enterprises to base mergers on economic considerations. Parent companies would be able to exercise greater control over their subsidiaries within the group.

Following these initial moves, the central government selected 100 enterprises and 56 enterprise groups in 1994 as experiments in establishing a modern enterprise system. These entities were given greater autonomy in drafting economic plans, financing their operations, and engaging in foreign trade.

Two years after the adoption of the *zhua da fang xiao* policy in the Ninth Five-Year Plan (Ninth FYP, 1996-2000), in spring 1997 the State Council expanded the number of enterprise groups from 56 to 120. By the time Jiang Zemin made his pronouncements at the Fifteenth Party Congress in September 1997, he was only reaffirming a policy that had already been decided on at the highest levels—and implemented on an experimental basis over the previous two years (*see The CBR*, July-August 1998, p.8).

China's concerted effort at fashioning an industrial policy during the 1990s appears to have been motivated by several considerations. These include the government's belief that China can replicate the successes of Japan and Korea in using industrial policy to form large conglomerates, and the need for PRC firms to compete effectively with huge foreign multinational firms operating in China. The Ninth FYP, as a result, calls for developing economies of scale in the following pillar industries: automotives, construction, electronics, machinery, petrochemicals, and steel.

The PRC government also regards conglomerates as a vehicle for absorbing China's growing numbers of loss-making enterprises and unemployed workers. Mergers and acquisitions are, in this regard, seen as much-preferred alternatives to bankruptcy. Enterprise groups such as the Qingdao Haixin Group, Shandong Province's biggest state-owned electronics conglomerate, have received media attention because their growth is driven in large part by the acquisition of enterprises in the red. According to a 1997 Xinhua News Agency report, over the period 1994-97, mergers with profitable large groups saved some 2,000 loss-making enterprises.

Forward Momentum in Pillar Industries

The central government's renewed attention to developing large conglomerates touched off a spate of policy announcements at the central and provincial levels that supported Beijing's plans. In April 1995, the Ministry of Chemical Industry (MCI, recently downgraded to a bureau under the State Economic and Trade Commission [SETC]) announced it would support the development of five large enterprise groups, each of which would aim for more than ¥10 billion ($1.2 billion) in annual sales during the Ninth FYP. MCI also offered to provide 50 other enterprise groups in the chemical industry with assistance in the areas of policy, capital investment, science and technology, financing, and foreign trade.

Similarly, the central government announced plans in 1995 to pool more than ¥100 billion ($12 billion) to support eight key auto conglomerates, in line with the automotive industrial policy formulated a year earlier. These eight auto manufacturers are Shanghai-Volkswagen Automotive Co. Ltd., First Automobile Works (Group) Corp., Wuhan's Shenlong Automotive Co. Ltd., Beijing Jeep Corp., Tianjin Automotive Industry Group Corp., Guangzhou Peugeot Automobile Corp. Ltd., Chang An Automobile Co. Ltd., and Guizhou Aviation Industry Corp.

China's provinces and municipalities have also jumped on the conglomerate bandwagon, spawning initiatives at the ministerial, provincial, and local levels. In recent years, even the Ministry of

The modern enterprise system seeks to weaken bureaucratic ownership by making companies legal corporate entities with their own clearly defined property rights.

Agriculture and local governments have promoted enterprise groups at the township level. In the spring of 1995, the municipal government of Shanghai took an early lead by adopting measures to encourage the growth of conglomerates. Not surprisingly, areas that have been more aggressive in promoting this strategy tend to be coastal provinces and cities—in particular Shanghai Municipality and Hebei, Jiangsu, Liaoning, and Shandong provinces—where large-scale state-owned industry is more developed and where international competition has been more keenly felt.

These policy announcements, combined with mounting competition from international firms, have led to a noticeable trend toward larger, more ambitious mergers nationwide. In 1995, a number of large enterprise groups in the auto industry were either established or enlarged in response to both the government's industrial policy and the growing demand in international markets for passenger sedans (*see The CBR*, November-December 1997, p.8). China's largest existing auto group, the

In the engineering machinery industry, consolidation has gone beyond the establishment of conglomerates to the formation of strategic alliances.

Changchun-based First Automobile Works, annexed Changchun's light motor vehicle plant. Other new groups included Hubei's Dongfeng Motor Corp., Beijing Automotive Industry Group Corp., Shanghai Automotive Industry Group Corp. (which includes Shanghai-Volkswagen), and Nanjing's Yuejin Automobile Group Corp. Yuejin, built around the Nanjing Automotive General Co., includes more than 200 enterprises in Jiangsu and seeks to produce more 500,000 vehicles worth ¥60 billion ($7.2 billion) by the end of the century.

A number of important mergers have also taken place in the chemical and petrochemical industries in the last few years. In 1996, the Shanghai municipal government merged the assets of the Shanghai Chemical Industrial (Group) Corp. with those of the Shanghai Pharmaceutical Administration and its subordinate enterprises to form the Huayi (Group) Corp., which is projected to achieve sales revenue of ¥100 billion ($12.1 billion) by 2000. Huayi includes among its members a number of large enterprise groups, including Shanghai Pharmaceutical (Group) Corp., Shanghai Tianyuan (Group) Corp., Shanghai Tire and Rubber (Group) Corp., and Shanghai Pacific Chemical Industrial (Group) Co. Ltd.

In 1997 and 1998, mergers in this sector were even more impressive. Qilu Petrochemical Corp. purchased two chemical plants in Shandong; Shandong's Haihua Group absorbed 17 enterprises to expand its oceanic chemical product line; and China National Petrochemical Corp. (Sinopec) purchased a controlling share of Beijing Yanshan Petrochemical (Yanhua) Group. Yanshan Petrochemical itself had previously merged with the nation's largest producer of high-grade lubricants, Tianjin Hangu Petrochemical. Shanghai Petrochemical Co. Ltd. acquired the Shanghai Jinyang and the Zhejiang acrylic fiber plants in 1996 and 1997, respectively. The most ambitious case to date, though, has been the 1997 merger of four of the nation's largest chemical and petrochemical companies in the Nanjing area—Yizheng Chemical Fiber Group, Yangzi Petrochemical, Jinling Petrochemical Corp., and Nanjing Chemical—to form China's largest chemical enterprise group, Donglian Group.

In the engineering machinery industry, consolidation has gone beyond the establishment of conglomerates to the formation of strategic alliances among conglomerates. Four of the nation's largest enterprise groups in this sector—Shanghai Dongfeng Machinery Group, Xuzhou Construction Machinery Group (*see* below), Anhui Forklift Group, and Qinghai Engineering Group—formed such an alliance in May 1997. The alliance's purpose is to concentrate investment on the development of a united, registered-brand product to compete with overseas firms. SETC and the former Ministry of Machine-Building Industry (now a state bureau under SETC) are providing additional support for product and technology development.

A Conglomerate Case Study: Xuzhou Construction

The history of Xuzhou Construction Machinery Group, Inc. (XCMG) provides some idea of the obstacles that many of China's conglomerates face. XCMG is an enterprise group in Xuzhou, Jiangsu Province. Founded in 1989, XCMG has become one of the 10 largest groups in Jiangsu with over 20,000 employees, ¥3.4 billion ($412 million) in total assets, and ¥730 million ($88 million) in sales (as of 1996). In 1995, it ranked 132 in sales revenue among the nation's enterprises and first in the construction machinery sector.

XCMG listed on the Shanghai Stock Exchange in 1996, and is preparing to list on the Hong Kong exchange this year. Currently involved in 18 equity joint ventures with foreign multinationals such as Caterpillar Inc. and Rockwell International Corp. of the United States and Liebherr-Holdings GmbH of Germany, XCMG was one of the 100 companies selected to experiment with the modern enterprise system in 1995 and one of the 120 enterprise groups singled out for central-government support in 1997.

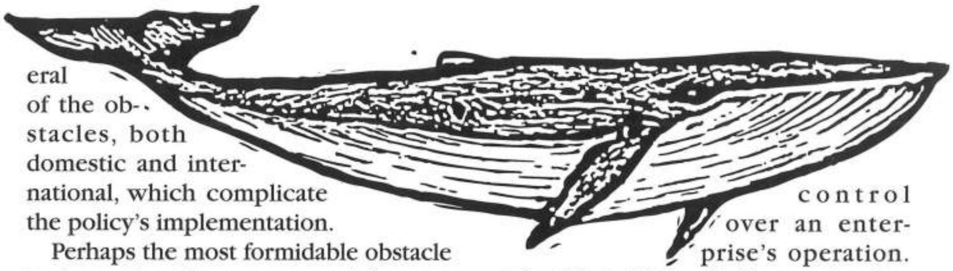
XCMG's history can be described as a three-stage progression toward greater legal autonomy and vertical integration between the parent company and its subsidiaries. During the first stage (1989-93), the three enterprises that represented the core of XCMG were incorporated as a single legal entity, but the assets of the eight subsidiaries that supplied the core remained outside XCMG's control.

During the second stage (1993-95), the Jiangsu provincial government gave XCMG the authority to manage its own assets. This decision had two important consequences. First, it gave XCMG controlling rights over the assets of its subsidiaries. Second, because the subsidiaries had previously been under the control of city government agencies, the decision increased XCMG's autonomy from the government.

During the third stage (1995-present), XCMG restructured its management in accordance with the government's efforts to introduce a modern enterprise system based on the Company Law. A key aim of the law is to achieve a clearer separation between owners and management by introducing a governance structure consisting of a board of directors, a board of supervisors, and shareholder meetings. XCMG established a board of directors and a board of supervisors, but as a solely state-owned company was not required to hold shareholder meetings.

This straightforward chronology of XCMG's evolution is deceptive, however, because it makes XCMG's formation sound smoother than it actually was. In reality, there were significant obstacles to XCMG's establishment, to which the group had to devote sub-

The emergence of such conglomerates over the past few years indicates that China's attempt at formulating and implementing an industrial policy is having an impact on China's industrial structure, even if that impact has been more visible in the northeastern and eastern parts of the country than in the interior. Nevertheless, until last year, a coordinated central-government effort to provide support for overseas marketing and investment by these conglomerates had been lacking. Last summer, the Ministry of Foreign Trade and Economic Cooperation announced it would support outstanding enterprises—especially those among the 120 enterprise groups selected by the central government for priority support—in launching projects in Africa and Latin America to produce machinery, electronics, and clothing.



Bureaucracy rears its head

While the formation and consolidation of China's industrial conglomerates has been promising, their long-term success, and that of China's industrial policy in general, is by no means assured. Success will depend on the government's ability to resolve several of the obstacles, both domestic and international, which complicate the policy's implementation.

Perhaps the most formidable obstacle is domestic—the government bureaucracy that manages and oversees the country's SOEs. Many SOEs are controlled by provincial, city, and even county governments, as a result of past policies that transferred control of these operations to the provinces and allowed provincial and local governments to invest in and establish their own enterprises. As a result, state enterprises within the same industry are not always under the control of a single ministry. Moreover, ministerial, provincial, and local authorities have developed a strong sense of ownership over enterprises they supervise and are often reluctant to allow mergers with other enterprises, particularly those under the jurisdiction of another region or ministry. Recent government restructuring has not changed this basic ownership structure, though it has streamlined and weakened the bureaucracy's control over an enterprise's operation.

The Ninth FYP calls for accelerating the formation of enterprise groups that are inter-regional and inter-sectoral in nature. This will ensure, however, that China's bureaucratic structure will remain a major obstacle to PRC industrial policy in the years to come. For enterprises seeking to form conglomerates with firms from other regions, support from local governments that administer those firms will be crucial. As the president of the successful Qingdao Haixin Group noted, an important factor in the group's success was "vigorous support from the Qingdao city government [as well as from] the government departments of places where other involved enterprises were based.... For example, Guiyang city government and Qingzhou city government actively supported Haixin's mergers and purchases" of enterprises in those two cities.

To get around just such problems of local-government resistance, the many new, large enterprise groups tend to be made up of companies concentrated in the same geographical region. Yet even geographic proximity is no guarantee. Plans to merge Shanghai Petrochemical and Shanghai's Huayi Group in 1997, for instance, fell through because of bureaucratic rivalries: Shanghai Petrochemical was under MCI in Beijing, while Huayi was under the jurisdiction of the Shanghai municipal government, which has cultivated Huayi as one of its flagship conglomerates.

The formation of the Donglian Group is instructive because it illustrates the high-level support that is often essential to overcoming these bureaucratic road blocks. The four enterprises making up Donglian were under three different bureaucratic jurisdictions: Sinopec, the China Textile Council, and the Jiangsu provincial government. A merger agreement reportedly required the intervention of a leader above the ministerial level, in this case Wu Bangguo, who as vice premier outranks both the ministries and the provincial government.

A second, related barrier is the slow pace of establishing the modern enter-

Machinery Group, Inc.

stantial political resources to overcome. According to interviews with managerial staff, enterprise directors, and the chairman of the board, the three enterprises that now form the core of XCMG initially resisted the idea of a merger in part because they feared loss of control and influence. Another factor was that these enterprises were performing well. Apparently, they either disagreed with city leaders' concern about growing competition, or thought they could compete and grow more quickly on their own.

Bureaucratic interests also complicated the merger: though all three enterprises were under the jurisdiction of the Xuzhou city government (a decided advantage), two of the enterprises received guidance from the Ministry of Machine-Building Industry (now a state bureau under SETC) and the third from the Ministry of Construction. High-level officials, particularly the mayor of Xuzhou and provincial leaders, thus had to convince the three enterprises and their bureaucratic superiors of the value of merging into a single corporate entity.

They eventually succeeded. XCMG now falls into the category of a wholly state-owned conglomerate, and ultimately control over XCMG lies in the hands of the Xuzhou city government. This final agreement only came after Xuzhou city leaders, provincial officials, and officials from the Ministry of Machine-Building Industry and the Ministry of Construction participated in negotiations in Beijing.

—Shawn Shieh

Research for this article was made possible by the financial support of the American Political Science Association, and the generous assistance of the Xuzhou Construction Machinery Group.

prise system in China's state sector. Many Chinese policymakers and scholars view the modern enterprise system as an important prerequisite to the growth of successful conglomerates. The problem is that a large majority of the enterprises that have incorporated in the last few years have done so as wholly state-owned companies, rather than limited-liability or shareholding-liability companies. Unlike limited-liability or shareholding-liability companies, wholly state-owned companies do not have to hold shareholder's meetings, and most powers vested in shareholders are exercised by the board of directors.

Indeed, a number of recently established enterprise groups have resulted from mergers undertaken by the government, in which administrative departments and corporations have been combined as a part of the ongoing effort to streamline China's vast bureaucracy. As one 1997 World Bank study points out, these wholly state-owned companies and enterprise groups do not differ significantly from traditional SOEs because their investors are still state organs, with no other shareholders to assume limited liability over the enterprise's assets. The governance structure of many of these "modern corporations" still allows the enterprises' administrative superiors to exert substantial influence over major management decisions. According to a 1998 *New York Times* article, the president of North China Pharmaceutical Group, a conglomerate that began experimenting with the modern enterprise system in 1994, admitted as much when he stated, "We say that the board of directors makes the main decisions, but it's really the Hebei Party Committee."

A third barrier arises from the dual role that conglomerates are being asked to take on now that China's state-owned economy has gone further into debt. Though Chinese authorities see the conglomerates as the vanguard of China's state-owned sector, authorities also see them as capable of rescuing loss-making enterprises and absorbing workers. There have been a number of reports that government authorities have pressured successful conglomerates to acquire loss-making enterprises—raising concerns that conglomerates are, in some cases, being formed on the basis of political considerations rather than economic ones. Moreover, the demise of many small and medium-sized local enterprises raises unemployment considerations that will certainly slow the pace of mergers and acquisitions over the coming years, especially if China's economic growth fails to rebound significantly.

Concerns on the International Front

The success of China's conglomerates hinges on the resolution not only of domestic problems, but also international ones. These mergers are taking place in an increasingly competitive international trade environment, partly because of the effects of the Asian currency devaluations and partly because of the small steps China has taken to reduce import tariffs in certain sectors as part of its World Trade Organization (WTO) accession bid. PRC industrial policy is, in this sense, a response to increasing competition from foreign and foreign-invested firms in China.

There have also been concerns that PRC industrial policy is misguided, as large conglomerates in South Korea have been exposed as contributors to that country's economic crisis. The intimate ties between the Chinese government and its conglomerates only adds weight to these concerns. Although Chinese policymakers are confident that they will be able to learn from South Korea's mistakes, there have been no significant changes in China's industrial policy regarding conglomerates since the Asian crisis hit.

A Streamlined Corporate Sector

The policies put in place by Jiang Zemin and his supporters during the mid-1990s represent a bold and historic attempt at formulating industrial policy. Certainly, China is ready, if not overdue, for such a policy. The success of Deng Xiaoping's reforms, the cumulative effect of shareholding, the Company Law, the introduction of the modern enterprise system, and a range of other reforms, combined with China's integration into the international economy, have created a more hospitable environment for the formation of conglomerates.

Yet as many Chinese policymakers, economists, and entrepreneurs recognize, conglomerates have a long way to go before they become political and economic successes. Bureaucratic obstacles will slow the transformation of SOEs into independent corporate entities, and necessitate the intervention of high-level, central-government officials and politicians to broker mergers and acquisitions. Even after conglomerates are formed, the unanswered question remains of whether they will be able to compete with foreign firms in a more liberal, post-WTO environment while fending off government pressure to absorb China's growing army of deficit enterprises and unemployed. 完

Council Welcomes Premier Zhu Rongji in New York

The Council and the Economic Club of New York hosted a reception and dinner for PRC Premier Zhu Rongji in New York on April 13. Nearly 1500 guests listened to Zhu's informal, humorous, but also quite detailed remarks about the importance of the US-PRC political and economic relationship.

Among the highlights of the speech was Zhu's thorough explanation of the importance of PRC World Trade Organization (WTO) accession both to China and the United States. Zhu stated that only through competition could China's state enterprises reform successfully, and that the Shanghai insurance sector in particular was one example of how allowing foreign competition into China benefited Chinese consumers and companies. He said that one of his colleagues in government had called him a "traitor" when he awarded the license to sell insurance in Shanghai to American International Group, Inc. but later told him he'd been right to do so. And again, when forging the landmark deal with Eastman Kodak Co. to restructure China's photographic film industry, he was called a traitor by a government colleague, who later also recanted his accusation. Thus, regarding the WTO concessions he granted in negotiations with US trade officials, he said he was confident he would not be called a traitor a third time.

Zhu also won over the audience with his well-known sense of humor, joking about topics ranging from the alleged illegal donations by PRC citizens to US political campaigns in 1996, to lighter topics such as which of the six US cities on his tour was his favorite.

Members Gather in Beijing for Annual CHOPS Meeting

The Council held China Operations 1999 on March 3-4 in Beijing. The meeting opened with a progress report on the US-China Legal Cooperation Fund by the Fund's Board of Trustees Chairman Herbert J. Hansell, and a forecast of bilateral relations by Council President Robert A. Kapp. Nicholas Lardy, senior fellow at the Brookings Institution, kicked off the March 4 morning session by outlining China's efforts to build a modern financial system. PRC political issues were addressed in speeches by Rebecca MacKinnon and Jaime FlorCruz, Beijing bureau chiefs for CNN and *TIME*, respectively. Kathie Krumm, chief economist with the World Bank Resident Mission in China, wrapped up the morning by summing up investment in the PRC. During lunch, over 100 CHOPS attendees heard from Minister of the State Economic and Trade Commission Sheng Huaren.

Developments in equity financing and mergers and acquisitions were covered during one afternoon session, which featured Gao Xiqing, CEO of Bank of China International Holdings Ltd. in Hong Kong; Doug Markel, managing partner at the Beijing office of the law firm Freshfields; and Davin MacKenzie, chief of mission at the International Finance Corp. Resident Mission in China. George Plant (sector coordinator of the World Bank Resident Mission in China's Urban, Water, and Environment Department); Husayn Anwar (managing director of ERM China); and Mitchell Silk (partner at Allen & Overy in Hong Kong) gave updates on China's environmental infrastructure in another session. The workshop on managing public relations and media fires featured Hunter Xia, manager of Marketing and Corporate Communications for Northwest Airlines; Jessica Chan, manager of Greater China Public Relations for Eastman Kodak Co.; and David M. Jacobson, managing director of Sinofile Information Services, all of whom provided case studies. The fourth workshop addressed Year 2000 problems in China. I-Lin Chow, IBM China's year 2000 manager, Hua Pinlan, director of the Beijing Informatization Office, and Jia Li, an engineer with the Beijing Y2K Computer Problem Office, explained China's efforts to prepare for the century changeover.

PRC Official Outlines China's Environmental Efforts

A group of Council member-company representatives gathered in Washington on April 19 to hear from Qu Geping, chairman of the National People's Congress Committee on Environmental Protection and Resources Conservation (CEPRC). Qu discussed China's legislative and government environmental protection initiatives.

THE US-CHINA BUSINESS COUNCIL'S

26th Annual Membership Meeting

A MEMBERS-ONLY EVENT

Wednesday, June 9, 1999
8:30 a.m. - 4:00 p.m.
Willard Inter-Continental Hotel
1401 Pennsylvania Avenue, NW
Washington, DC

Julie Walton

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

Firms whose sales and other business arrangements with China do not normally appear in press reports may have them published in *The CBR* by sending the information to the attention of the editor.

SALES AND INVESTMENT *January 16 - March 15, 1999*

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

Accounting and Insurance

OTHER

The World Bank
Approved loan to help develop China's accounting system, including the promulgation of internationally accepted accounting standards and professional certification. $32.9 million. 2/99.

Agricultural Commodities and Technology

CHINA'S INVESTMENTS ABROAD

Government of Ghana/MOFTEC
MOFTEC will provide investment for private-sector agricultural products in Ghana. $6 million. 2/99.

Ministry of Agriculture
Will donate tractors, ploughs, water wheels, pumps, trailers, and harvest combines to Cambodia. $2.8 million. 1/99.

NA (Australia)/Wanerwu Ostrich Farm (Fujian)
Will set up an ostrich-breeding farm in western Australia. $2.7 million. 1/99.

INVESTMENTS IN CHINA

ABN-AMRO Holdings (UK)/Liaohe Forage Group (Liaoning)
Established joint venture to manufacture animal feed with an annual capacity of 500,000 tons. $27.5 million. 2/99.

Affco (New Zealand)/NA (Sichuan)
Will set up a beef-processing plant in Chengdu, Sichuan Province. (New Zealand:30%-PRC:70%). $10 million. 2/99.

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

Hovev Agricultural Co. (Israel)/Shandong Changwei Agricultural School
Set up agricultural joint venture in Shandong. $4.2 million. 1/99.

OTHER

The World Bank
Approved loan for the Anning Valley Agricultural Development project in Sichuan Province. $120 million. 1/99.

Banking and Finance

INVESTMENTS IN CHINA

Zurich Financial Services Group (Switzerland)/China Securities Co.
Will partner to manage Zurich's investments in B and H shares. $10 million. 3/99.

OTHER

Deutsche Bank AG (Germany)/China Construction Bank
Will provide financial consultation to the Exxon-Aramco Fujian oil refinery joint venture. 3/99.

Standard Chartered Bank Plc (UK)
Received license to provide *Renminbi* services at its Shenzhen branch. 2/99.

Chemicals, Petrochemicals, and Related Equipment

INVESTMENTS IN CHINA

BASF AG (Germany), Imperial Chemical Industries Plc (UK), Nippon Polyurethane Industry Co. (Japan)/ Shanghai Tianyuan Corp., SINOPEC
Will construct and operate a plant in Shanghai to manufacture nitrobenzene and aniline with an annual capacity of 160,000 tons. 3/99.

Dead Sea Bromine Co. (Israel)/Haihau Shareholding Co. (Shandong)
Will set up joint venture to manufacture and market bromine compounds. $30 million. 2/99.

Para Paints (Canada)/The Stone Group (Shanghai)
Established joint venture to distribute paint. $2 million. 2/99.

Solvay SA (Spain)/Shanghai Chlor Alkali Chemical
Formed joint venture to produce PVC compounds. (Spain:60%-PRC:40%). 2/99.

AlliedSignal Laminate Systems (US)
Opened plant in Suzhou, Jiangsu Province, to manufacture epoxy copper-clad laminates for printed circuit boards. $30 million. 1/99.

BP-Amoco Co. (UK)/Chongqing Construction and Investment Co., Sichuan Vinylon Plant
Launched joint venture to produce acetic acid from methanol and carbon dioxide with an annual capacity of 150,000 tons. (UK:51%-PRC:49%). $200 million. 1/99.

Société Nationale des Poudres et Explosifs (France)/Zhong Yuan Chemicals (Shanghai)
Formed joint venture to produce phosgene derivatives. (France:60%-PRC:40%). $6 million. 1/99.

Consumer Goods

CHINA'S INVESTMENTS ABROAD

Frimex Trading (United Arab Emirates)/Hai'er Group (Shandong)
Will manufacture and market household appliances in United Arab Emirates. 2/99.

Yuxi Hongta Tobacco Group (Yunnan)
Set up cigarette manufacturing plant in Vietnam with an annual capacity of 50,000 cartons. 1/99.

INVESTMENTS IN CHINA

Fuji Car Manufacturing Co. (Japan)/Wuxi Little Swan Co. (Jiangsu)
Established joint venture to manufacture dry-cleaning machines. (Japan:25%-PRC:75%). $4 million. 3/99.

LifeTech Enterprises, Inc. (US)/Yunnan Spirin Co.
Formed joint venture to develop and market health foods and skin-care products. 3/99.

Electronics and Computer Software

CHINA'S IMPORTS

Microsoft Corp. (US)
Will provide software to PBOC. $1.2 million. 3/99.

Mitsubishi Chemical Corp., Mitsui & Co. (Japan)
Won contract from Jilin Tonghai High-Technology Co. to design a high-purity liquid feeding system for manufacturing liquid-crystal displays for notebook computers. $3.6 million. 2/99.

Solartron (UK)
Will supply flow computers for the 900 km gas pipeline between Shaanxi Province and Beijing. 1/99.

INVESTMENTS IN CHINA

Cadence Design Systems Inc. (US), Frontline Co. (Singapore)
Will set up joint venture in Guangdong Province to manufacture and service Cadence products. 3/99.

Konica Corp. (Japan)/Chongqing No. 3 Radio Plant
Established joint venture to manufacture DVD equipment and related products. (Japan:60%-PRC:40%). $13 million. 3/99.

Mitsubishi Corp. (Japan)/Chengdu Cable Co., Ltd. (Sichuan)
Will manufacture and market high-frequency cables. (Japan:30%-PRC:70%). $7.5 million. 3/99.

Adaptec, Inc. (US)/China Electronic Resources (Beijing)
Will cooperate to distribute Adaptec's computer components in Beijing and Shanghai. 2/99.

Beacon Light Holding Corp. (US)
Purchased Casin Magnetic Manufacturing Co. of Shenzhen, Guangdong Province. $1.3 million. 2/99.

Compaq Computer Corp. (US)/Guangdong P&T Administration
Will establish an e-commerce technology center to focus on digital certification, secure electronic transaction gateways, and develop enduser e-commerce applications. 2/99.

Computer Associates International (US)/Eastern Communications Group (Zhejiang)
Formed joint venture in Zhejiang Province to develop management systems and billing software for the domestic mobile telecommunications industry. $3 million. 2/99.

D'Trends, Inc. (US)/Haike Biotechnology Ltd., Zhongshan University (Guangdong)
Set up joint venture to develop bioinformatics software tools and databases. 2/99.

Elite International Group (US)
Opened new cordless telephone manufacturing plant in Guangdong Province. 2/99.

NEC (Japan)/Huahong Group (Shanghai)
Will produce 64-megabit DRAM semiconductors in Shanghai. $1.2 billion. 2/99.

Sanyo Electric Co., Toyota Corp. (Japan)/Tianjin Lantian Power Sources Co.
Will manufacture and market nickel and cadmium batteries. (Japan:66%-PRC:44). $14.6 million. 2/99.

Yaqi Science and Technology Co. (Taiwan)/Hunan Computer Co.
Will develop, manufacture, and market high-speed modems. 2/99.

Cisco Systems Inc. (US)/Shenzhen Sangda Telecom Co. (Guangdong)
Will develop and manufacture routers in Beijing. $6 million. 1/99.

Fujitsu Ltd. (Japan)/Nanjing University Science & Technology Group (Jiangsu)
Formed joint venture to develop and market software. (Japan:87%-PRC:13%). $1.3 million. 1/99.

Microsoft Corp. (US)/Legend Holdings (Beijing)
Will pre-install Chinese Windows in Legend's palm-sized computers. 1/99.

Trilux Group Corp. (US)/Industry and Commercial Association Network (Beijing)
Set up joint venture to market Chinese handicrafts over the Internet. 1/99.

V-One Corp. (US)
Received approval to market its smart-card products in China. 1/99.

Xtal Technology, Inc. (US)
Obtained license to operate wholly foreign-owned semiconductor compound substrate manufacturing company in Beijing. 1/99.

OTHER

IBM Corp. (US)/Xi'an Botong Communication Co. (Shaanxi)
Signed distribution agreement to market IBM products in northwest China. 3/99.

Microsoft Corp. (US)/China Telecom, State Economic and Trade Commission
Will cooperate to combat software piracy and to help develop Chinese government websites. 3/99.

ESS Technology (US)/Jiangsu Bureau of Education
Will develop Internet-based curriculum for secondary schools. 2/99.

Rainbow Technologies (US)
Opened representative office in Beijing. 2/99.

FORE Systems Inc. (US)/Chinese Academy of Sciences
Will set up computer training centers in Beijing and Chengdu. 1/99.

Engineering and Construction

INVESTMENTS IN CHINA

LaFarge SA (France)
Will build and operate a wholly foreign-owned aluminate manufacturing plant in Tianjin. $25 million. 2/99.

Pacific Can Investment Holdings (Singapore)/Xuzhou Transportation Construction and Development Co. (Jiangsu)
Formed infrastructure development fund to invest in highway expansion. $129 million. 2/99.

Environmental Technology and Equipment

CHINA'S IMPORTS

Microphor Co., a subsidiary of MotivePower Industries Inc. (US)
Will build 306 on-board sewage handling systems for the Changchun Railcar Co. in Jilin Province. 2/99.

OTHER

The World Bank
Authorized loan for the Fourth Rural Water Supply and Sanitation project. $46 million. 3/99.

The World Bank
Granted loan for the Jinan Water Supply Project in Shandong Province. $95 million. 3/99.

The World Bank
Approved loan for the Yangtze Flood Emergency Rehabilitation project. $80 million. 2/99.

Food and Food Proccssing

OTHER

Fosters Brewing Group Ltd. (Australia)
Sold its 700,000 hectoliter brewery in Guangdong Province to Hong Kong Pan Asia International. 2/99.

Machinery and Machine Tools

CHINA'S IMPORTS

Ebara Corp., Marubeni Co., Toshiba Corp. (Japan)
Will supply 15 sets of water pump electrical machinery and auxiliary facilities to the China National Instruments Import & Export Corp. for use in Shanxi Province. $44.2 million. 2/99.

Honeywell Inc. (US)
Will install a cement process control system in the Shuangyang Cement Plant in Changchun, Jilin Province. $300,000. 2/99.

INVESTMENTS IN CHINA

Ashland Chemical Co. (US)/Minmetals Changzhou Synthetic Chemical General Plant (Jiangsu)
Set up joint venture to manufacture foundry binders. 2/99.

Carlisle Companies International (US)/Shanghai No. 1 Chemical Machinery Plant
Formed joint venture to manufacture stainless steel in-plant processing equipment. 2/99.

OTHER

Siemens AG (Germany)
Will automate the postal center in Guangzhou, Guangdong Province. $33 million. 1/99.

Medical Equipment and Devices

INVESTMENTS IN CHINA

Calypte Biomedical Corp. (US)/China National Center for AIDS Prevention and Control
Formed joint venture to manufacture and market HIV tests. 3/99.

Smith & Nephew (UK)/Guangdong Winnerway Holdings Corp.
Signed distribution agreement to market first-aid dressings in China. 3/99.

Vaccine International Co. (New Zealand)/Gene Biotechnology Co. Ltd. (Beijing)
Will manufacture vaccines to combat parasitic cysts. 1/99.

Metals, Minerals, and Mining

CHINA'S INVESTMENT ABROAD

Government of Papua New Guinea/Government of the PRC
Signed BOT agreement for a salt plant in Papua New Guinea. $10 million. 2/99.

CHINA'S IMPORTS

Thomas William Lench Co. (UK)
Will supply structural steel high-tensile bolts and nuts for the 700 MW power plant under construction in Fuzhou, Fujian Province. $114,000. 2/99.

INVESTMENTS IN CHINA

Global Pacific Minerals Inc., Southwestern Gold Corp. (Canada)/ Brigade 217 of the Northwest Geological Bureau of China Nuclear Industry Corp. (Inner Mongolia)
Will prospect for gold in Inner Mongolia. (Canada:80%-PRC:20%). $3 million. 2/99.

Hoganas AB (Sweden)
Set up wholly owned steel component manufacturing facility. $25 million. 2/99.

NA (Canada)/Baiyin Non-ferrous Co. (Gansu)
Will explore and mine ore deposits in Gansu Province. 2/99.

Hanwa, Mitsui-Bussan, Nisshin Steel (Japan)/Shanghai Baosteel Group, Zheyong Iron and Steel Investment (Zhejiang)
Will manufacture 0.3-3 mm stainless steel sheets in Ningbo, Zhejiang Province. $1.3 billion. 2/99.

Walker Stainless Equipment (US)/Shanghai No. 1 Chemical Machinery Plant
Formed joint venture to produce stainless steel containers. 2/99.

Pohang Iron & Steel Co. (S. Korea)/Sajiang Group (Jiangsu)
Launched stainless-steel production plant in Jiangsu Province with an annual capacity of 250,000 tons. (S. Korea:80%-PRC:20%). $140 million. 1/99.

OTHER

Glencore International (Switzerland)
Acquired a 70% stake in Nanjing No. 2 Steel Works. 1/99.

Packaging, Pulp, and Paper

INVESTMENTS IN CHINA

Leading Edge Packaging, Inc. (US)
Set up wholly owned packaging products manufacturing facility in Guangdong Province. 3/99.

Petroleum, Natural Gas, and Related Equipment

CHINA'S INVESTMENTS ABROAD

Satoil AS (Sweden)/SINOPEC
Will jointly explore the Intercampo oil field in Venezuela. 2/99.

INVESTMENTS IN CHINA

Shell International Gas Ltd., a unit of Royal Dutch/Shell Group (the Netherlands)
Will build liquefied natural gas terminal near Shenzhen. $300 million. 3/99.

Al-Manhal International Group (United Arab Emirates), Century American Corp. (US)/Shanghai Energy & Chemical Corp.
Set up joint venture to transport liquefied petroleum gas from the Persian Gulf to distribution facilities off the coast of Shanghai with a monthly capacity of 40,000 tons. (United Arab Emirates:65%, US:8%-PRC:27%). 2/99.

Louisiana Exploration Co. (US)/CNOOC
Will develop the Zhaodong oil field in Hebei Province. 2/99.

Powell Co. (UK)/Lanzhou Petrochemical Machinery and Equipment Engineering Co. (Gansu)
Will upgrade facilities and manufacture drilling equipment. 1/99.

OTHER

Governments of Japan, Mongolia, S. Korea, Russia/ Government of the PRC
Will build an oil pipeline from central Russia to the Bohai Sea. $7 billion. 2/99.

Pharmaceuticals

INVESTMENTS IN CHINA

Supreme Advanced Group (Hong Kong), Zambon Group (Italy)
Will build a plant in Hainan Province to manufacture antioxidant treatments for chronic obstructive pulmonary diseases. $12.9 million. 1/99.

OTHER

Bristol-Myers Squibb Co. (US)
Established investment company in Shanghai. $30 million. 1/99.

Ports and Shipping

INVESTMENTS IN CHINA

Friede Goldman International Inc. (US)/Dalian New Shipyard (Liaoning)
Will manufacture semi-submersible mooring winches and jack-up frame elevating systems. 3/99.

Cargo Lux (Luxembourg)/China Eastern Airlines
Established cargo shipping service between Shanghai and Luxembourg. 1/99.

Yangming Marine Transport (Taiwan)/COSCO
Formed partnership to ship directly from mainland ports to US East coast via the Mediterranean Ocean. 1/99.

Power Generation Equipment

CHINA'S EXPORTS

Government of the PRC
Received permission from the UN Sanctions Committee to export six gas turbine electrical generators and related equipment to the Mullah Abdullah Power Plant in Baghdad, Iraq. $81.7 million. 1/99.

CHINA'S IMPORTS

Alanco Environmental Resources Corp. (US)
Will install sulfur dioxide reducing equipment for Beijing Energy Power Co.'s coal-fired power plant near the Beijing international airport. $200,000. 3/99.

ABB Ltd. (Switzerland)
Sold its air-cooled turbo-generator technology to Jinan Power Equipment Plant. 1/99.

INVESTMENTS IN CHINA

Southern Co. (US)/State Power Corp.
Agreed to cooperate and exchange technology in the areas of hydropower, power distribution, recycled energy, and power-facility management. 2/99.

Unified Energy Systems (Russia)/State Power Corp.
Will cooperate on designing and building a national power grid in China. 2/99.

OTHER

Export & Import Bank of Japan
Approved loan for two 300 MW generators in Anhui Province. $389 million. 2/99.

Black & Veatch (US)
Selected to consult on the Jiaxing II power project in Zhejiang Province. 1/99.

Export & Import Bank of Japan
Authorized loan to finance power projects in Shanxi and Zhejiang provinces, and Xinjiang Uygur Autonomous Region. $235 million. 1/99.

Property Management and Development

INVESTMENTS IN CHINA

Asian Star Development Inc. (Hong Kong), GIC Global Intertainment Corp. (US)
Will open an Internet sports bar and club in Shenzhen, Guangdong Province. 1/99.

Telecommunications

CHINA'S IMPORTS

ADC Telecommunications Inc. (US)
Will develop eight cellular basic stations for the Beijing Branch of UNICOM. 3/99.

Harris Corp. (US)
Will provide China Telecom with a digital wireless local loop system. $3 million. 3/99.

Newbridge Networks (US)
Will expand and upgrade the digital data network for the Zhengzhou bureau of information industry, Henan Province. 3/99.

Alcatel SA (France)
Will supply the Ministry of Railways with a SDH-based optical backbone system for the Wuhan-Guangzhou route. 2/99.

Cellstar Corp. (US)
Will supply cellular phones and accessories to China Everbright stores throughout the PRC. 2/99.

Datacraft Asia (Singapore)
Will build a multimedia network for Hainan P&T Administration. $3 million. 2/99.

Italtel Tecnomeccanica SpA (Italy)
Will build a turnkey GSM cellular network for the Hubei P&T Administration. $36 million. 2/99.

Nortel Networks (Canada)
Will supply the Ministry of Railways with equipment to develop a national railway information management system. $20 million. 2/99.

Oy Nokia AB (Finland)
Will expand the GSM network for the Jiangxi P&T Administration. $130 million. 2/99.

Motorola Inc. (US), Siemens AG (Germany)
Will expand the GSM network in Guangdong Province for UNICOM. $362 million. 1/99.

INVESTMENTS IN CHINA

Pulsecom Inc. (US)/Shanghai P&T Equipment Co.
Will manufacture and market communications equipment in Shanghai. 3/99.

Motorola Corp. (US)/Guangzhou Jinpeng Group (Guangdong)
Will jointly develop GSM systems. $12 million. 2/99.

NetUSA (US)/Sichuan International Economy and Science Exchange Center
Will market Sichuan Province to international telecommunications companies. 2/99.

Northern Telecom (Canada)/MII
Will build a fiber optic network linking Shanghai to Nanjing, Jiangsu Province. 2/99.

Oy Nokia AB (Finland)/MII
Will cooperate to develop mobile network expansion equipment. 2/99.

General Instrument Co. (US)/Guanghua Cable & Satellite TV Co. Ltd. (Beijing)
Established joint venture to manufacture satellite communications equipment in Fujian Province. $12.5 million. 1/99.

Metawave Communications Corp. (US)/Shanghai P&T Administration
Will develop and test antenna systems for GSM networks. 1/99.

OTHER

Greg Manning Auctions, Inc. (US)
Will open representative offices in Beijing and Shanghai. 3/99.

Pulsecom Inc. (US)
Will open representative office in Beijing. 3/99.

Textiles and Apparel

INVESTMENTS IN CHINA

BBA Group Plc (UK)
Will set up non-woven airlaid material manufacturing plant in Tianjin with an annual capacity of 15,000 tons. $50 million. 3/99.

Wool Marketing Group (Australia)/China National Garment Group
Formed joint venture to process raw wool into garments. $100 million. 3/99.

E. I. du Pont de Nemours & Co. (US)/Teijin Inc. (NA)
Will operate a polyester film joint venture with an annual capacity of 340,000 tons. (US:50%-PRC:50%). 2/99.

OTHER

Isolyser Co. (US)
Opened branch office in Hangzhou, Zhejiang Province. 2/99.

Transportation

CHINA'S EXPORTS

China Southern Airlines
Will lease plane, full crew, and maintenance equipment to the Government of Nepal. 3/99.

Dalian Locomotive Works (Liaoning)
Will build 15 locomotives for the Government of Nigeria. 2/99.

INVESTMENTS IN CHINA

General Electric Co. (US)/Xiamen Aviation Industry Co. Ltd., Xiamen Taeco Airplane Engineering Co. (Fujian)
Launched aircraft engine maintenance joint venture in Xiamen, Fujian Province. (US:60%-PRC:40%). $50 million. 3/99.

Leighton Holdings Ltd. (Australia)/China State Construction Engineering Corp.
Will cooperate on inter-city rail construction. $146 million. 3/99.

Fiat SpA (Italy)/Yuejin Motor Group Corp. (Shanghai)
Formed light commercial vehicle manufacturing joint venture in Shanghai. $60 million. 2/99.

Société Nationale d'Etude et de Construction de Moteurs d'Aviation (France)/China Southwest Airlines
Formed joint venture to repair jet engines. (France:51%-PRC:49%). $20 million. 2/99.

Mitsubishi Motor Vehicle Co. (Japan)/Shanghai Inchcape Co.
Mitsubishi acquired 51% of Inchcape and the new company will be Mitsubishi's sales agent in east-central China. 1/99.

Siemens AG (Germany)/Zhuzhou Electrical Locomotive Works (Hunan)
Will form train manufacturing joint venture. (Germany:51%-PRC:49%). 1/99.

OTHER

Mechanical Dynamics, Inc. (US)
Obtained a three-year sales and service contract from China National Railway Locomotive Rolling Stock Industry Corp. to provide railcar simulation software. $600,000. 3/99.

South China Canadian Industries Inc. (Canada)
Will sell its 80% interest in the Guilin Tire Factory to its joint-venture partner, Guilin South Rubber Group Corp., Guangdong Province. $10 million. 2/99.

Miscellaneous

CHINA'S INVESTMENTS ABROAD

MOFTEC
Will provide funds and programs to Vietnam's Ministry of Planning and Investment to train government personnel. $2.4 million. 3/99.

Tianjin Development General Co./Misr Bank (Egypt)
Recently opened a 21 sq. km investment zone in Egypt along the Suez Canal. $70 million. 3/99.

OTHER

Government of the PRC
Approved loan to the Government of Ukraine for economic development. $6.25 million. 3/99.

Georgia Institute of Technology (US)/Ministry of Communications
Set up three-year cooperative education training program for highway and bridge engineering technicians and managers. 1/99.

LM Ericsson AB (Sweden), PepsiCo, Inc. (US)
Won five-year contract to sponsor first- and second-division soccer clubs. $11 million. 1/99.

ADVERTISERS IN THIS ISSUE:

WTO—*continued from page 4*

of contamination of some shipments with the tilletia controversa kuhn fungus (TCK smut). Though the wheat is treatable, the PRC nevertheless refused to accept US shipments from that part of the country. This rejection reduced US wheat exports to China to a trickle. The bilateral agreement reportedly states that China will accept and treat any infected US shipments.

Other, WTO-specific agriculture commitments that were not in the bilateral agreements include:

- **Tariffs** Tariffs on key US exports such as soybeans, meat, fruit (particularly citrus fruits, grapes, apples, and almonds) would fall from as high as 45 percent for beef and 40 percent for citrus to 12 percent immediately upon accession to the WTO. Average rates would drop to 17 percent, and all tariff reductions would be phased in by 2004.
- **Tariff rate quotas** Products China considers sensitive for food security reasons, such as most grains, would, according to the USTR document, be subject to a tariff rate quota system. The quotas would rise until eventually phased out, generally before 2010.

Works in progress

The USTR document states that the Chinese agreed to reduce and bind tariffs on industrial goods an average of 17 percent. A number of the goods of most importance to US firms would see their tariff rates fall to an average of 7.1 percent from the current average of 24.6 percent. USTR notes that many countries have refused to agree to bind tariff rates. The Chinese will phase in all reductions by 2005.

The tariff reductions apply to such sectors as information technology, autos, and those in the Asia Pacific Economic Cooperation (APEC) voluntary early sectoral liberalization initiative. The sectors include wood and paper products, chemicals, medical equipment, and environmental goods and services, among others.

China purportedly restated its commitment to implement the Information Technology Agreement upon accession, which calls for elimination of tariffs for products such as semiconductors, computers, and telecommunications equipment (*see* p.8). PRC President Jiang Zemin first announced China's willingness to sign on to the agreement in 1997.

In the auto sector, China agreed to reduce tariffs to 25 percent by 2005. Chemical harmonization will involve reduction of tariffs to roughly 6 percent.

Are you being served?

Service sectors have been another major sticking point between US and PRC negotiators, making the PRC commitments in the areas of trading and distribution particularly astounding. US companies will, according to the USTR document, be able to distribute goods not manufactured in China within three years of accession—a radical departure from current policy.

In telecommunications services, China agreed to phase out restrictions for paging, mobile, and domestic fixed-line services within six years. Foreign firms will also eventually be allowed to hold equity investments of up to 49 percent in telecommunications services firms.

Insurance and professional services are other areas that saw progress, with the Chinese agreeing to lift current restrictions on the geographic locations in which foreign insurance, law, and accounting firms may set up operations. In insurance, foreign companies will be able to assume 51 percent ownership of life-insurance joint ventures within one year of China's accession (non-life and reinsurers will have to wait another year for this benefit) and all foreign firms will be able to choose their joint-venture partners. Foreign insurers in the property and casualty market will be able to operate nationwide upon PRC accession.

In professional services including legal, taxation, accounting, management consulting, medical care, urban planning, and engineering, the USTR release said that geographic restrictions would be lifted, as would restrictions on foreign majority control of joint ventures. The PRC also agreed to confer national treatment on professionals in accounting firms. Other details of the agreements for all of these services have yet to be resolved.

Financial sector on hold

Two outstanding areas of discussion are financial services and securities. China's banking sector is currently largely closed to foreign banks. The few that have been permitted to set up branches in China have been restricted to the Pudong New Area in Shanghai, or Shenzhen. Banks can handle only limited transactions in local currency, and may not serve PRC customers. Press reports have indicated that at least in commercial banking, China agreed to lift restrictions on geographic scope and also the ban on serving PRC customers. Details on banking liberalization were not included in USTR's report.

But China has apparently so far failed to budge in offering market-opening concessions in investment banking services and the securities sector in general. This affects other sectors that engage in finance. For instance, licensed foreign insurance companies in China currently have very few instruments available in which to invest the premiums they receive from PRC insurance policies. Similarly, the auto sector requires financial liberalization if auto financing is to become a viable option in China.

Getting the Chinese negotiators to consent to significant liberalization in these areas may be the most difficult task for USTR negotiators. China's financial-sector woes are well known, and the Asian financial crisis warned China of the dangers of hasty financial liberalization. Beijing may be reluctant to agree to short phase-in periods for any liberalization measures it finally agrees to undertake.

Though it is too soon to tell whether China's renewed push for accession to the WTO will succeed this year, many key sticking points of the accession process appeared to be swept away in these latest US-PRC negotiations. The key will be for USTR to lock in the concessions contained in its April 8 report. Recent press reports indicate that Chinese negotiators may want to revisit earlier commitments made regarding market access for foreign banks and telecom firms, and the concession on US antidumping methodology. The US protection of its textile industry is also likely to be a source of ongoing tension—USTR has stated it wants to retain import quotas on PRC textiles until 2010, while China would like these quotas phased out by 2005.

But the ultimate success of the deal may hinge on politics, both in the United States, where many members of Congress have publicly stated their opposition to China's accession, and in the PRC, where bureaucrats have long resisted exposing struggling domestic industries to foreign competition.

—Catherine Gelb

Joy. There are more than 80 languages spoken in China. Photography speaks them all fluently. Take a simple word: "Joy." It often speaks loudest in silence—glances, gestures, smiles. You can expect to find it at birthdays, weddings, celebrations. But its most beautiful expressions may come suddenly—especially around home, especially around children. Joys fly. But your camera can catch them in mid-air, and turn them into treasures. A girl's laugh may last but a moment. A photo of her laughter may someday spark an echoing joy in her grandson's eyes. We have been steadily working to spread the language of photography throughout China. As we move toward, then beyond, the dawn of the next millennium, we will continue to find ways to capture and commemorate joy. And all those other words that never need translation.

Kodak

TAKE PICTURES. FURTHER.™

WWW.KODAK.COM