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THE CHINA BUSINESS REVIEW

NOVEMBER-DECEMBER 1999 VOLUME 26 NUMBER 6

Adventures in FINANCE

IN THIS ISSUE:

- The banks, venture capital, and retail credit
- Guandong Province
- An education investor's education

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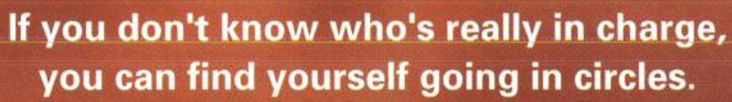

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THE CHINA BUSINESS REVIEW

美中商贸评论

The magazine of the US-China Business Council

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SPOTLIGHT ON IPR

Barbie: Dressed to Prosecute

Toy manufacturer Mattel, Inc. was richly rewarded for breaking a four-year-old counterfeiting ring that stretched from mainland China to the Netherlands. Mattel discovered a shipment of fake Barbie Gift Pack Fashion Sets in the Netherlands and traced the shipment through Hong Kong to the original manufacturers in mainland China.

In what turned out to be a successful strategy, the company filed cases in China against the manufacturers; in Hong Kong against the two implicated trading companies; and in Europe against the Dutch wholesaler. The PRC ordered the Hung Hing Plastic Factory, Ltd. to pay Mattel $257,200—perhaps the largest fine ever imposed in an infringement case. The Chinese government has proved willing to prosecute and punish counterfeiters, a promising sign for companies willing to pursue IPR cases from start to finish.

Hong Kong Fights Piracy on the High CDs

The 1998 Prevention of Copyright Piracy Ordinance, which requires Hong Kong CD factories to obtain a license from Hong Kong Customs, seems to be having an effect. Over the past year, Hong Kong Department of Customs and Excise officers have closed down 11 underground CD factories and seized 18 production lines worth roughly $12.8 million. The resulting boom in the flow of illegal CDs from outside the territory has led to more interceptions at Hong Kong's borders. To help combat CD piracy, Customs has set up a special task force, whose officers patrol the streets, and the Anti-Piracy Reward Scheme, which has paid out more than $150,000 for information leading to successful prosecutions.

Cracking Down on Fake Receipts

China's State Administration of Taxation (SAT) is continuing its aggressive tax collection program by cracking down on receipt and invoice abuse. Since the inception of the program on April 1 of this year, SAT has uprooted nine fake-invoice makers and three gangs dealing in counterfeit receipts. Sichuan Province tax officials discovered fake invoices worth $26.5 million, while Anhui Province tax authorities collected $578,000 in fines and recovered $493,000 in taxes.

Domain-Name Wars

Sweden's Ikea Furniture Co. has objected to Beijing Guowang Information Co.'s registered domain name: *www.ikea.com.cn*. The *Beijing Youth Daily* reports that Ikea is suing Guowang, though Guowang insists that its domain name, registered with the Chinese government, is legal. Guowang plans to open an Internet voice-related service on the site.

Note to readers: The Letter from the President does not appear in this issue but will resume in the January-February 2000 *CBR*.

Short TAKES

Big Noses, Small Profits

Though total profits for foreign-owned or -invested firms were up more than 6 percent in 1998 over 1997, a State Administration of Taxation (SAT) study shows that only one out of three foreign-owned or -invested firms in China posted a profit in 1998. According to foreign firms' tax returns, the number of profitable firms has decreased by more than 2,000. An official from the Foreign Tax Department attributes this downturn to poor planning, fierce competition, and inability to profit from economies of scale. Recently, tax officials have been scrutinizing foreign tax returns to discover other possible reasons for the low profitability rates.

Americans: High-Tech Movie Cowboys

An overwhelming majority of Beijing and Shanghai residents believe that Hollywood movies and Western cowboys best reflect American culture, followed by US corporations McDonalds, Microsoft, and Intel. A survey pub-

Unicom's Joint-Venture Woes Derail Listing Plans

Problems associated with dismantling Chinese-Chinese-foreign (CCF) joint ventures appear to have delayed China United Telecommunications Corp. (Unicom)'s planned initial public offering (IPO) in overseas stock markets. Originally scheduled for October, the listing may not occur until the first quarter of 2000 at the earliest. How Unicom's CCF issue is resolved could affect not only the success of the IPO, but also Unicom's ability to compete against China Telecom, and could also indicate what investment vehicles Beijing will sanction for use by foreign companies and the overall pace and direction of reform in the sector.

Impermissible legal investments

Foreign telecom companies have engaged in CCF ventures because PRC regulations prohibit direct investment in telecom services (*see The CBR*, May-June 1999, p.16). Under the CCF model, a foreign company forms a joint venture with a Chinese firm, and the joint venture in turn forms a venture with a Chinese telecommunications provider.

Unicom seems to be in a sticky situation. In order to gain government approval to list, it appears that Unicom must dissolve its CCF ventures in a way that satisfies foreign partners without bankrupting itself. The $1.4 billion invested in Unicom CCF ventures by roughly 45 foreign companies accounts for almost 70 percent of Unicom's operating capital. Up to half of the $3 billion Unicom expected to raise through its IPO thus would probably have gone to buyouts of its foreign partners. Unicom stands to lose not only its foreign partners' valuable capital but also the accompanying technology and management expertise, all of which it sorely needs to compete with the dominant China Telecom and newcomers like China International Network Telecommunications Co. Ltd., known as Netcom.

After the China Securities Regulatory Commission approved its request to pursue an overseas IPO, Unicom announced that foreign firms had to accept Unicom's compensation offers in exchange for their interests in their CCF ventures, or risk receiving no compensation. But as *CBR* goes to press, few foreign partners have settled. At least one company, Daewoo of South Korea, has initiated legal action and others have announced their opposition to the order.

The CCF outcome could also have broader implications for investment patterns and investor confidence. The order to dissolve the CCF ventures, combined with a new push for IPOs, suggests that Beijing aims to minimize direct foreign control in telecom projects. With CCF no longer a viable option, foreign companies will be forced either to take minority stakes in telecom ventures through stock listings or find a viable alternative investment vehicle, such as the leasing-contract arrangement recently pioneered by Siemens AG.

Internet investment next?

If Wu Jichuan, head of the Ministry of Information Industry (MII), has his way, foreign investors in Internet-related companies may well see their investments go the way of CCF. Wu announced in late September that Internet-related investments were covered under MII's ban on foreign investment in telecommunications. Though a number of foreign-PRC Internet ventures have gone ahead since the Wu statement, industry analysts say foreign companies should expect an announcement on this issue before the end of the year—and caution that Wu should not be underestimated.

—Ann M. Weeks
and Catherine Gelb

Ann M. Weeks is a business advisory services associate in The US-China Business Council's Washington, DC office. Catherine Gelb is editor of The CBR.

lished by Shaohai Market Research Co. discovered that respondents agreed unanimously on their three favorite American movies: "Titanic," "Saving Private Ryan," and "Gone with the Wind." The effects of American culture on China are harder to measure. Roughly half of those polled believe American culture is too complex to categorize as good or bad. But more Beijingers feel that the influx of American products and culture is harmful—negative responses were 10 percent higher than in Shanghai.

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(Signed) Catherine Gelb, Editor

The Rise of Venture Capital in China

Paul H. Folta

Context and cases for newcomers and skeptics

Venture capital has reached a new level of prominence in China since the mid-1990s, and its influence and impact on traditional participants in foreign direct investment (FDI) is only likely to grow. Venture capital groups working in China have, in recent years, enhanced the ability of traditional participants in the establishment and expansion of industrial, service, infrastructure, and new technology projects to achieve their objectives.

Experienced China project-development specialists and strategists in Western corporations might occasionally have dealt with venture capital groups working in China. More often they have dealt with the usual players, including state-owned enterprises (SOEs); Chinese entrepreneurs; overseas Chinese companies; and intermediaries associated with trading companies, vendors, government offices, investment bankers, and consultants.

In China's increasingly competitive environment for sound projects and attractive local partners, a broader awareness of venture capital's role in China could prove useful to investors. Even more valuable may be the examination of several cases that illustrate a venture capitalist's typical interactions with the major participants in various hypothetical investment projects. The cases, drawn from actual situations, illustrate the process by which the venture capitalist can exert influence both cooperatively and competitively (*see* p.11).

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Part I: Venture Capital in China and Asia

The Context

Venture capital groups have participated meaningfully in project development worldwide. Recent Chinese projects have ranged from toll roads to consumer goods to Internet start-ups and have been described in specialized sources such as *The Asian Venture Capital Journal*, business journals such as *The China Business Review*, and public and online news services.

Venture capital is often called private equity investment since the recipients of most venture capital investments are companies not listed on stock exchanges. Most investments take the form of shares or loans convertible into shares at a certain price in the

future. Investee companies might be at early stages of development, but in China and Asia they more often are companies that have already established a market and are in various stages of expansion. Usually, these investments introduce technologies or services that might be advanced by international standards, but that have already been developed and demonstrated to be effective in economically advanced countries.

In 1995, only 1-2 percent of venture capital fund investment in China went to "seed stage" projects—research and development, or product-development investments made before a product even exists or a company is even organized. In contrast, about 30 percent went into start-ups, about 65 percent into expansion projects, and the balance into buy-outs, according to Anthony Alyward, in "Trends in Venture Capital Finance in Developing Countries" (International Finance Corp. [IFC] Discussion Paper No. 36).

Venture capital investments typically range from a few million to the low tens of millions of dollars for industrial and service-oriented investments. Investments in infrastructure projects range from the low tens to the low hundreds of millions of dollars. Usually venture capitalists take passive equity stakes of 10-49 percent of effective voting control and require at least one out of five seats on the board of the investee company. In Asia, investors hold such stakes for an average of 4-5 years.

Fund managers are typically professional fund-management companies associated with international financial institutions or independently established companies with track records of managing investments in China. Funding commitments come from groups such as insurance companies, pension funds, corporations, and high-net-worth individuals, and are pooled in closed-end funds. Financial institutions also make private equity investments on a project-by-project basis, either paid for from the institution's funds or syndicated to other institutions.

Although industrial and service corporations technically also engage in private equity transactions when they invest in joint ventures, such investments are not considered "private equity investments," which solely emphasize financial returns. Instead, they are called "direct investing" or "corporate venturing" since they are made for strategic considerations and involve a significant degree of board and day-to-day management control. Foreign venture capital investment in Asia is best considered a component of foreign direct investment, given the usual size, degree of control, and duration of VC investments.

China Funds

There are different types of venture capital funds oriented to investing in China, as examples from press and industry sources indicate. Most are based in Hong Kong, but some have head offices in Beijing. Other funds invest in China from elsewhere in Asia or from the United States or Europe.

The Walden Group, managing over $850 million in Asia, focuses its $100 million China Walden Fund on early stage, high-tech private enterprises launched by local entrepreneurs.

Since its inception in 1985, ChinaVest has invested over $200 million in Greater China—China, Taiwan, and Hong Kong—primarily in expansion projects. One recent investor in a ChinaVest fund, John Hancock Mutual Life Insurance Co., has reportedly invested $60 million in Chinese infrastructure projects since 1996.

Usually venture capitalists take passive equity stakes of 10-49 percent of effective voting control and require at least one out of five seats on the board of the investee company.

Chase Capital Partners, an affiliate of Chase Manhattan Corp., had $100 million under management in Asia with about 50 percent in China. This year it raised a new Asia Opportunities Fund of $521 million, with $250 million from Chase and $100 million from the World Bank's IFC, according to press reports. The fund limits its allocation of total investments to no more than 40 percent for any country, including China (see also Ting Yu Seng and Abhay Agarwal, "A Bigger Role for Private Equity," *Business Times* [Singapore], July 27, 1999).

Some venture capital funds are joint-venture management groups. For example, a $50 million Beijing Technology Development Fund was set up in 1999 by the US arm of WI Harper Group; Beijing Enterprises Holdings Ltd. (which reportedly provided $10 million); and Qinghua University Enterprise Group. This followed the 1994 establishment of a successful $85 million China Dynamic Growth Fund partnership among Hambrecht & Quist Asia Pacific; the Bank of China (which com-

Table 1

Venture Capital Under Management in Asia and China, 1990 and 1995-1998 ($ million)

	1990	1995	1996	1997	1998
China VC Funds*	113	3,458	3,612	3,500	3,112
Asian VC Funds**	4,298	15,722	19,157	21,102	29,600
Asian Infrastructure Funds***	0	1,100	1,880	3,410	4,005
Estimated Total China VC Funds****	532	5,069	5,825	6,454	7,163

SOURCES: *Asian Venture Capital Journal* and estimates

* Exclusively China-oriented funds

** China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand

*** According to available information

**** China VC Funds, 10 percent of Asian VC Funds (except China) and 35 percent of Asian Infrastructure Funds

Most funds consider an investment of less than $2 million not worth their while, given the cost of due diligence and risk of failure to complete the investment.

mitted $10 million); and the China International Trust and Development Corp.

Another recent joint fund, valued at $100 million, is between International Data Group (IDG) and the Ministry of Information Industry (MII), the government body supervising China's telecommunications, postal, and media sectors. IDG, a Boston-based information technology publishing and research company operating several joint-venture computer magazines in China, has managed another $100 million venture capital fund since 1993 through which it invested in 55 high-tech companies in China. Nearly half of the IDG fund investments are in Internet companies, with the rest in software, hardware, and biotechnology firms.

Other funds include the First Eastern Investment Group, started by lawyer Victor Chu in 1988. First Eastern manages over $500 million under six joint-venture funds with Chinese state enterprises such as an Irish Stock Exchange-listed fund with GE Capital Services and a trading company, CMEC, which is under China's State Bureau of Machine-Building Industry. The company has invested in expansion and pre-IPO (initial public offering) bridge-financing projects in 10 provinces. First Eastern typically seeks to appoint key staff such as the deputy general manager and chief finance manager.

Asian Strategic Investments Corp. (ASIMCO), based in Beijing, was started in early 1994 by US investment banker Jack Perkowski. It manages $400 million and is known for its investments in automotive components and brewing facilities throughout China's inland provinces. It has emphasized management control, distribution, co-investments with companies such as Caterpillar Inc., and technology-licensing arrangements with groups like Nippon Piston Ring. Not one of its general and limited fund partners has invested over $25 million. ASIMCO eventually aims to convert from a fund to a corporate structure and to list itself.

The Range of Deals

China deals vary in size, shares, stage, and duration of investment. Most funds consider an investment of less than $2 million not worth their while, given the cost of due diligence and risk of failure to complete the investment. Sometimes they will invest less if due diligence is managed cooperatively with other investors.

For instance, the Beijing Technology Development Fund recently invested in two start-ups—about $3 million in an Internet-development company and $3 million in a wireless local loop equipment manufacturer. US-educated Chinese entrepreneurs started both companies.

IDG invested $2.4 million in Huicong, a Chinese market-research and information joint venture with $6 million in revenue, giving IDG 20 percent ownership, rights to appoint a vice chairman, and one board seat.

Suez Asia manages $400 million in funds, half from French financial groups, and has made 30 percent of its investments in China. Known for providing financial engineering and strategic advice, it invested in 25 percent of a private Chinese food-flavorings company (which now has $40 million in sales, and a 15 percent net profit margin).

The American International Group Asian Infrastructure Fund II (AIG-AIF II) and Sithe Energies (New York) invested $200 million in Sithe Asia Holdings, an independent power producer. AIG-AIF II contributed 40 percent, according to press reports. The proceeds will be used to fund other Sithe Asia projects and add another power project to the two it currently operates in China and three more it is building there.

In some cases, foreign-controlled funds have forced the clarification or modification of Chinese regulations in sensitive areas such as aviation and telecommunications operations. For example, in 1996, George Soros reportedly acquired 25 percent of the then-unlisted Hainan Airlines Co. Ltd. by purchasing Chinese government-held shares, despite the fact that PRC regulations prohibited foreign purchase of government shares. Subsequently, the ratio of foreign investment allowed in domestic airlines was raised to 35 percent, and might be increased to 40 percent in the future to facilitate further funding. Following its listing, Hainan Airlines sought a 25 percent-stake in Hainan's new Haikou Meilan International Airport for about $23.9 million to promote a critical expansion program.

Previously, Chinese airlines were banned from investments in airports to prevent monopolistic practices. Also, foreign ownership of airports was limited to 49 percent; foreign involvement in critical airport operations is also highly restricted. Thus, the indirect investment structure offered by Hainan Airlines and the local government's flexibility likely provided foreign investors with important operational transparency while maintaining the Chinese government's objectives of control.

Because foreign investors have experienced difficulty in resolving control and transparency issues with local partners, Wuhan, Hubei Province, has the only airport that has received direct foreign investment, according to press reports.

In telecommunications, the first of the "Chinese-Chinese-foreign" (CCF) equipment lease and operating services structures for telecommunications projects was developed by venture capital

Table 2

Venture Capital Fundraising Relative to Foreign Direct Investment in Asia and China, 1995, 1997, 1998 (Percent)

	1995	1997	1998
Estimated Total China VC Funds Raised/FDI	4.7%	2.4%	2.0%
Asian VC Funds and Infrastructure Funds Raised/FDI	8.5%	7.5%	8.5%

SOURCES: *Asian Venture Capital Journal*; UNCTAD; Asian Development Bank; country government data; press reports and estimates

group SC&M International, Ltd. (US), Brooks Telecommunications (US), the Guangzhou City Government, and other Chinese groups licensed by the central telecommunications authority in 1994. This project built the first broadband integrated services digital network (BISDN) backbone around Guangzhou. Although this project broke new ground in foreign participation in telecommunications operating services, the PRC government has recently sought to dissolve subsequent CCF ventures (*see The CBR*, May-June 1999, p.16).

Scale of Funds

The pools of venture capital funds under management and funds available for investment in China and Asia have been growing rapidly since 1990. Although these funds remain small relative to GDP and as a contribution to FDI, they are an indication of investor interest regardless of whether deals reach completion. Moreover, the portfolio of actual investments in China and Asia has grown continuously since 1990.

According to data collected by the *Asian Venture Capital Journal* (AVCJ Holdings Ltd.) for venture capital fund management companies investing in Asia's 10 largest developing economies (Asian VC funds), about 10 percent of investments go to Chinese projects (*see* Table 1). This category excludes both funds set up for Asian infrastructure, which target about 30-40 percent of their investments for China projects, and China-specific VC funds (China VC funds). In 1990, the China VC funds pool was only $113 million or about 0.03 percent of China's GDP, versus $4.3 billion for Asian VC funds. Asian VC funds had grown by 1998 to $29.6 billion. Asian infrastructure funds were at least $4.0 billion in 1998, mostly with the raising of AIG-AIF II in late 1997 and two new funds in 1998. By 1998, the China VC funds had declined from their peak of $3.6 billion in 1996 to $3.1 billion.

For all Asian venture capital funds, including Japan, Australia, New Zealand and other smaller Asian countries, the *Asian Venture Capital Journal* reports that 63 percent of the commitments came from Asian sources in 1998. Sixty-five percent of commitments to China VC funds came from Asian sources in 1998.

Combining the Asian VC and Asian infrastructure funds' China-related allocations with the China-specific VC funds yields a total China VC fund pool of roughly $7.2 billion, or 0.75 percent of China's GDP in 1998. In comparison, the Asian VC fund pool plus Asian infrastructure funds made up 1.31 percent of Asian GDP in 1998.

These figures pale in comparison to the US fund pool from 1990 to 1998, which was made up of about $275.6 billion in private equity. These funds went mostly into US mergers and acquisitions, and $59.1 billion of this went to venture capital funds, or 0.69 percent of GDP, according to the *Private Equity Analyst Newsletter* database (www.assetnews.com).

The total China VC fund pool in 1998 was roughly $7.2 billion, or 0.75 of China's GDP.

Table 3
Asian and PRC Venture Capital Investment Portfolio Growth Compared with GDP and FDI Growth, 1997 and 1998 (Percent year-on-year)

	1997	1998
Asia *		
VC Investment Portfolio	10.1%	26.7%
GDP Growth	0.0%	-9.4%
FDI Growth	2.6%	-7.0%
China (exclusively China-oriented funds)		
VC Investment Portfolio	23.7%	6.6%
GDP Growth	14.5%	2.8%
FDI Growth	4.5%	2.9%

SOURCES: *Asian Venture Capital Journal*; UNCTAD; Asian Development Bank; country government data; and press reports.
* China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand
NOTE: Percentage growth figures are based on figures in current US dollars.

Venture Capital vs. Foreign Direct Investment

Total newly raised China VC funds in 1995 made up 4.7 percent of China's FDI that year, and 2.4 percent and 2.0 percent of China's FDI in 1997 and 1998 (*see* Table 2). New Asian VC funds plus Asian infrastructure funds in 1995 made up 8.5 percent of FDI invested in Asia that year, and 7.5 percent and 8.5 percent of Asian inward FDI in 1997 and 1998, respectively. This poor fundraising for China and Asia in 1997 as the Asian crisis hit indicates that venture capital funds and their investors are more risk averse and less "vulture-like" than sometimes thought.

Given the relatively small rise in China's FDI in 1998 (2 percent) and drop in Asian FDI in 1998 (-7 percent), and the supposed dire need for foreign investment in the region, VC funds raised for Asia appear more opportunistic than those raised for China. Of course, these figures may reflect other issues among investors and local companies seeking capital—such as perception of risk, value, and willingness to share management control. It possibly also reflects the speed at which funds can be raised.

Comparing the 1997-98 growth in VC funds actually invested with the expansion of the VC fund pools fills out the picture. In Asia, VC investments increased even as GDP and FDI growth slowed. China-oriented funds mimicked this trend in 1997, but not in 1998 (*see* Table 3). Again, "vulture-like" investors would not have been expected to slow their investments in China in 1998.

It is entirely possible that additional funds were available for investments in China in 1997 while investors waited to see what would be the extent and duration of the Asian economic crisis.

Chinese entrepreneurs and venture capitalists could be a strong combination for Western industrial groups to tap.

Then in 1998, investments to China slowed as attention shifted back to the rest of Asia and as fears about China's moderated growth took hold. It may be too soon to place too much weight on this limited data. But it is clear that foreign private equity is a force that is neither easy nor wise to ignore.

Domestic PRC funds

Within China, 80 entirely domestic, technology-oriented funding groups (trust, venture capital, and credit funds) managed $480 million in 1999. The Ministry of Science and Technology added $360 million to this in the form of an innovation fund for small high-tech firms. The small size of these funds is not surprising, given the absence of a regulatory framework in China for venture capital firms and the slow pace of the development of such guidelines. (China's December 1998 securities law does not address venture capital in depth.) In addition, local funds domiciled in China would not have the same foreign investor status and tax advantages as those based offshore.

The importance of Chinese entrepreneurs

More significant than local investment funds are Chinese entrepreneurial enterprises. Entrepreneurial enterprises have been formed by individuals; groups of businesspeople and technical experts formerly under a collective enterprise structure and supported by local government bureaus; SOEs' trusted managers, bureaucrats (or sometimes relatives) empowered to spin off independent companies; or other groups such as university or government research units that obtained private-enterprise status.

These entrepreneurial enterprises all face the same obstacles: marketing and distributing products, competing and protecting their brands and technology, obtaining new technology, working with foreign partners, finding funds, obtaining suitable labor, and managing local- and sometimes central-government interests. Their success is best reflected in the growth of the private sector, which new estimates for 1997 put at 53 percent of GDP for all sectors, including services and agriculture, and 51 percent of industrial production.

These firms have invested increasingly significant sums of local and foreign currency in private transactions in China. They often act more as mergers-and-acquisition players than passive venture capitalists, usually investing through structures that give them and their partners or affiliates effective control. In other cases, however, they invest passively both for profit and to obtain access to other business opportunities.

In addition to Chinese entrepreneurs, overseas Chinese play an important role, as do Chinese investors, whose funds often "round trip" through Hong Kong. Based on various sources, an estimated 69 percent of China's FDI comes from Chinese or overseas Chinese.

Influence—value added

"In a business situation, try to understand the context of the word friend or *pengyou* to learn what level of influence or actual *guanxi* really exists and whether your friend has the interest to use his or her friendship for you or for others to your benefit," a Chinese colleague once advised. Too often, when Western corporations strategize and develop projects in China, they fail to recognize sufficiently the influence and interests of the various parties involved. This lack of understanding often has delayed and undermined the desired outcome—an acceptable, risk-adjusted profitability for a project in a given time frame. For this reason, it is useful to review the roles of the groups which, to some degree, almost always are or may threaten to be involved in the development of many China projects.

■ **Chinese entrepreneurs** The availability of and leverage offered by private equity is no longer new to leaders of Chinese entrepreneurial enterprises. These firms often perceive venture capitalists, whether fund managers, institutional investors, or private individuals, as offering financial and strategic managerial advice that will ultimately lead toward a mutually acceptable outcome.

Such an outcome might be significant growth in the venture's value, with shares sold to a strategic industrial investor at a higher price—along with more favorable terms and commitments for technical improvements, and possibly also offers of access to new markets. Alternatively, it might be an IPO on one of China's stock exchanges, on Hong Kong's new Growth Enterprise Market secondary stock market, on another main Asian stock exchange, or on the US NASDAQ. Chinese entrepreneurs see an IPO as not only a route to profits but also as a symbol of corporate success and independence.

■ **Brokers or intermediaries** Quite often, Chinese entrepreneurs work with a diverse set of local and foreign trading companies, government officials and contacts, overseas Chinese companies, and a wide variety of technology vendors, consultants, and investment advisers. These intermediaries help entrepreneurs structure protective holding companies in China or offshore, manage suppliers and technical partners, introduce potential Western industrial investment partners, borrow money, and raise private equity funding. Often, such groups not only act as deal brokers, but also promote their own strategic interests, which a skillful entrepreneur attempts to balance against the interests of other parties.

■ **Private equity specialists** Entrepreneurs and their intermediaries have more and more frequently sought out private equity specialists as venture capital has grown and as venture capital representatives have promoted their funding and relevant expertise. Perhaps more important, venture capitalists increasingly get the initial call because they often appear more closely aligned with the local Chinese entrepreneur's immediate interests, and less interested in controlling the company, than Western industrial groups. Thus, Western industrial corporations—which hold key technology, markets, management skills, and funds—might no longer be at the top of the list for partnerships.

Furthermore, it has been increasingly common for deal brokers and vendors to act as principals as well, ex-

changing equity for their payment. Once such value-adding groups—intermediaries, venture capitalists, and vendors—have met with the entrepreneurs, and plans have been outlined with the help of eager investment bankers, the confidence of many Chinese entrepreneurs grows further, even during the current period of economic retrenchment.

■ **Western industrial firms** In many recent cases, Western companies have opted to set up wholly foreign-owned enterprises in China, thus bypassing all partnering options. These decisions may have been due not only to an unwillingness to accept many SOEs' inefficient assets, but also because they have found themselves unprepared for the—as they see it—unfounded confidence of Chinese entrepreneurial groups. In some of these cases, Western companies might have missed opportunities to leverage off of the influence and interest of venture capitalists in order to partner with profitable Chinese entrepreneurs.

According to a recent survey, private Chinese companies have produced an average return on equity of 19.5 percent, whereas foreign-funded companies averaged 3.1 percent. A survey earlier this year, reported in the *Economist*, found that 60 percent of multinational corporations in China since 1993 had achieved positive cash flow. Of those in China since 1985 only 50 percent had positive cash flow. Previous studies found that only 40 percent of 70 major MNCs in China and fewer than half of the foreign-invested enterprises in Shanghai were making profits.

In many cases, Chinese entrepreneurs have been at the forefront of reforms through *fait accompli* agreements with foreign groups, particularly involving private equity deal structures as in the Hainan Airlines case. This may imply that Chinese entrepreneurs and venture capitalists could be a strong combination for Western industrial groups to tap. Perhaps this is one reason why 45-55 percent of China VC funds came from non-financial corporations between 1995 and 1998. In contrast, 39-47 percent of Asian VC funds came from non-financial corporations during this period. Recently, among venture capital funds in the United States, such corporations contributed 30 percent of those reporting on contributor types.

VC is here to stay

Considering the venture capital funds available and invested in China and the interests and needs of the various actors in China investment projects, the role of venture capital is potentially significant. Understanding the role that venture capitalists might play in the investment process, MNC strategists and managers would be wise to consider how they might more effectively cooperate or compete with this rising group of investors.

Part II: Venture Capital Cases

To illustrate the recent expansion of the influence of venture capital in China, suppose that you are a private equity specialist.

The investment fund you represent wishes to be a relatively passive investor, but generally requires at least one board seat on the ventures in which it invests. According to your fund's strategy, start-ups are to be avoided. Yet your fund accepts that many expansion projects have start-up type risks even if one of the parties is a foreign technical or industrial partner. You must conduct due diligence to identify and reduce such potential problems, but you will have to accept some risk or else there will be a high premium on a more mature deal. You must put in some "sweat," or add value, to create goodwill in order to justify locking in your rights, otherwise you will face serious competition as the deal progresses.

In many cases, a good deal can take from one to two years to complete from your first introduction, particularly if government and multiple parties' board approvals are required. You must seal the deal sooner, but without funding it until all the preconditions are met.

The key to your job is to understand your various counterparts: what problems they face, what actions they need you to help them carry out, and the results that they and you can reasonably expect. The following scenarios are drawn from a variety of possible situations, based on the author's personal and observed experience, and are not necessarily intended to represent a single hypothetical deal.

The Chinese entrepreneur

Situation: As noted, the Chinese entrepreneur often has a growing local market, but lacks capital and skills to expand, diversify, or achieve quality levels necessary to increase market share significantly and/or export to developed economies. He might have local political support, but government involvement also can be a liability. The entrepreneur will be very cautious about whether, how, and when to obtain central-government approvals, which are required for deals over $30 million.

Action: After the initial introduction, identify the local and international market potential by researching news, journal, and trade articles. Consider the evolution of that market in more developed Asian countries and in the West to identify likely future patterns in that sector in China. Understand the keys to success and barriers to entry. Talk to Western corporations, local competitors, suppliers, buyers, trade associations, government bureaus, and international bankers. Ask about the sector, successful companies, competitors, and relevant trends in the general region. For reasons of confidentiality and to evade your competition, you might not wish to reveal the entrepreneur's company name or project details.

Get to know the entrepreneur personally and understand, as soon as possible, his and his enterprise's broader interests, opportunities, and problems. Visit the head office, plant, and subsidiary organizations and talk with executives and the key staff, individually if possible. Discuss and define your and the entrepreneur's exit strategies. Note the business problems he or she faces and determine whether they can be solved with your fund's money within an acceptable time frame.

If, after analysis, it is clear that the project requires a foreign technical or

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industrial partner, quickly break the news to the entrepreneur and offer a solution that both parties can accept. For example, tell the entrepreneur that you cannot invest at all until you complete financial, technical, and legal due diligence; structures and agreements are in place to solve identified problems; and your own committee approves the proposal. Explain your investment process and how you will keep the entrepreneur informed of your progress. If a foreign technical or industrial partner is required, outline a mutually acceptable plan to identify, evaluate, and negotiate with such a partner.

Include these points in a detailed letter of intent (LOI), designing it to protect your company and outlining all of the key likely terms, requirements, intentions, protection rights, confidentiality issues, future steps, and time frame. Consider establishing onshore and/or offshore investment holding structures, and the conditions under which the Chinese entrepreneur might participate in such a structure. If he or she participates offshore, such participation should be conditioned on the Chinese authorities' approval.

Results:

- Signed LOI leading to a 40/15/45-30/10/60 cooperative joint venture (CJV) (meaning the Chinese entrepreneur would have 40-30 percent voting shares, you would have 15-10 percent and the foreign technical or industrial partner would have 45-60 percent equity-equivalent control depending on other terms and super-majority rights). The LOI includes the possible addition of an investment holding company above the CJV.
- Under the terms of the LOI, the CJV would try to raise 20-40 percent of the total investment; all other parties would guarantee or contribute their pro rata portion of this debt in a shareholders' loan. Certain required assets could be contributed or leased to the CJV as part of this debt, but at fair market value—determined by a neutral body if necessary.
- The partners agreed on and outlined the process of arranging approval to convert profits to foreign currency.
- You and the entrepreneur worked together to identify and select a "friendly" foreign technical or industrial partner. Such a partner could obtain more control in the CJV by, for example, stepping up technology transfer, increasing export targets, or sharing in the sale in China of its products manufactured overseas through approved arrangements with licensed affiliates.
- All three parties agreed to form a unified business plan to submit to the authorities for approval. Since the project was expected to be over $30 million, you showed the draft LOI to the relevant industrial department in charge at the local level for their informal approval (and your added protection) before the LOI signing.
- The partners outlined terms in the LOI related to the entrepreneur's possible participation in an offshore holding company, possible IPO of either the onshore or offshore companies, and exit options (priced at market rates).

In this case, the foreign technical or industrial partner pulled out of the deal because of a shift in strategic priorities. But, since your fund committee had become sufficiently comfortable with the deal, you decided to proceed. The local partner would maintain provisional control during the search for another foreign technical or industrial partner. Any future partner, however, would not necessarily be given control.

Southeast Asian "Overseas Chinese" company

Situation: Many overseas Chinese (*huaqiao*) companies have diversified products, international markets, and opportunities to obtain controlling shares in their various JVs in China, but the recent economic downturn has robbed them of capital. They know the local language and have developed expertise in many aspects of conducting business in China, but appear to lack the sophistication of their Western competitors.

You are not fooled, however. Even the most traditional of these companies understand modern business practices and technologies quite well. They have executives who have graduated from the best Western schools and have worked in leading international companies. Their "problem" seems to be getting the same respect that their still-wealthy Asian financiers and wiser Western industrial executives give them.

Action: Ensure that you understand the *huaqiao* group's capabilities, local-partner relationships, and government connections. Explain that to meet the time frame they desire (possibly immediately) your due diligence process requires their assistance. If you have noted deficiencies in the project, you might point out that this exercise can be constructive for them as well. You might insist on receiving a business plan with a financial model, but you would not need to sign a confidentiality agreement until they have actually agreed to provide you with hard documents. Although they will realize that the price you are willing to pay will decline as you identify problems and risks, remind them that you are asking the same questions they will have to answer should they seek additional financing or an IPO in the future.

Openly address the risks you identify, but describe them in terms of how your funds can add more value to the enterprise by helping solve these problems. Clarify both parties' exit strategies. Sign an LOI after receiving the business plan. If you need to build a business plan together, then this indicates their limitations or their lack of transparency, and you might need to insist on including a Western technical or industrial partner. Without their cooperation, you are probably wasting time if they intend to stay involved in the target company.

Results: An LOI was signed. But since much better information had been provided than in the other deal with the local entrepreneur, the parties were able to commit to more specific and wider-ranging items. The parties agreed to rewrite the business plan, but to complete it only after extensive joint

discussions with alternative vendors for the required new equipment and possibly also an additional study. You would be allowed to contact the buyers of the venture's products in China and overseas, but would not disclose your intentions. Depending on the results, this could lead to a preliminary term sheet to be borne out by further due diligence.

Local or offshore intermediary (deal broker, trader, or government officer)

Situation: Some professional brokers specialize in seeking opportunities to introduce projects to financial or strategic investors. Chinese and foreign business executives involved in trade or selling equipment are also often in a position to introduce a project to foreign investors.

In some cases, traders may try to initially build, or later inject, themselves into a deal with a company with which they have business. Their motivation may be to avoid the squeeze on profit margins in their trading business, or simply to get the "upside" or profit potential of being a principal. Chinese government officials also sometimes broker deals on behalf of their bureaus, or act for themselves in order to shift out of government work. Their *guanxi* and inside knowledge has a limited lifespan, so they need to make the most of it before their value and leverage decline.

The target company that such intermediaries represent often needs someone trustworthy who understands how to protect the company's basic interests. But the company owners will not need an intermediary who tries to position himself out of proportion to the value he can bring to the deal.

Actions: Ask the intermediary for details. Analyze the capabilities and strengths of the broker's relationship with the local enterprise owners and position in the deal; his intentions, transparency, and honesty; and the ongoing value of his role. Ask to see evidence of the broker's relationship with the principals of the company. How the broker gets paid (often in shares) depends on an agreement with the principals. Sometimes the broker already has created and holds shares in a JV with the company. In other cases, the broker's role is undefined, and he will try to establish his position in the project as you show interest.

In general, do not sign a confidentiality agreement or LOI with the broker, who might present this to the owner as a validation of his role and as justification for participating in the project. A precondition to your signing an LOI might well be the clarification of the role or exclusion of the broker. If the broker's role is clearly defined and authorized with written evidence, explain your company's strategy and process, and insist on seeing project documentation and meeting the principals of the deal. If the investment amount sought is greater than the amount your fund can invest, then set out what the process and criteria will be in seeking other investors. If your management committee agrees, then you might consider helping to organize the brokering and due diligence process if certain rights of first refusal are provided in return. This might threaten the role of the broker, but the broker role faces much uncertainty anyway, and such a cooperative step might be in everyone's interest. If you like the deal enough, you might strike an agreement with the principals to be a cornerstone investor and take an earlier position upon resolution of certain issues and possibly at a lower share price.

Results: The LOI signed with the target company owners includes an agreement for your company to lead the due diligence and fundraising effort. You will fund the due diligence effort depending on certain specified milestones. You clarified that these costs will be shared by you and future investors.

American or European industrialist

Situation: MNCs share many common problems in China. The MNCs with existing investments will likely not want to give up equity for your money. They believe that they have already removed most of the risk and will not need your expertise. "At how many basis points above LIBOR would you be willing to help finance our new equipment?" might be their tongue-in-cheek reply to your inquiry. But some are also seeking a new partner or market and, if you have access to either, then they will almost certainly deal with you.

MNCs with existing investments will likely not want to give up equity for your money. They believe that they have already removed most of the risk and will not need your expertise.

Action: If you have established a firm and mutually beneficial relationship with a local enterprise with which the MNC hopes to partner, the MNC usually has no choice but to work with you. You can make it easy for both the local enterprise and the MNC and ensure that they get closer to what they want more quickly. Both know that you will work to help consummate the deal—otherwise why would you bother in the first place? You empower the local partner with your potential capital, knowledge of finance, and understanding of the MNC's culture. You enable the MNC to see that it can get what it wants—usually control. If it does not respect your agreements with the local partner, the deal might go to the MNC's competitor.

For a weaker and privately held MNC with a listing potential in its home country, you might consider investing in the company rather than in the deal, with the money used for the deal. However, recognize that this might threaten your relationship with the Chinese entrepreneur if it is not justified and explained clearly.

Results: The MNC, which already had a few projects in Asia, including one in China, agreed to work with you and your local partner and to negotiate for increased control. Since its board might not support the JV's IPO, you (and possibly the entrepreneur) received a put option to sell out to the MNC after a defined time and at the greater of an independent valuation or a set price-earnings multiple. Since the JV's value would not be realized with-

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out cooperation, the MNC judged that the entrepreneur—particularly with your support—would be fully committed to the venture's success.

During negotiations, you tried to argue for better clarification on use of the MNC's international sales channels, a stepped-up schedule for technology improvements, and higher commissions to the venture for the MNC's use of the venture's domestic sales channels.

The MNC initiated last-minute efforts to obtain a call option on your shares, which would have capped your upside by enabling the MNC to buy you out at a given price or multiple of earnings. With the support of the entrepreneur, you were able to prevent a call option and received clarification on international sales and technology improvements. The MNC ended up with the management and key voting control it wanted, including control over the venture's name and its brand names.

Chinese State-Owned Enterprise

Situation: "Yes, we would like to see your corporate brochure. How can you help us IPO our company?" was the reply to your initial inquiry to the SOE. Since then, however, you have shown proper earnestness, respect, knowledge of China, and proof of direct access to funds. While relaxing after a nice dinner you were told, "By the way, we do have a subsidiary enterprise that is looking for a foreign industrial partner, and perhaps you could locate such a partner company with whom we could spin-off this enterprise."

Actions: Do your homework before making commitments. The SOE management must report to various government bureaus, including its "industrial ministry in charge," and it will try to hold you to your commitments, even if they are only verbal. Listen for nuances such as, "We are interested (*xingqu*) in..." rather than "We have approval (*pijun*) to..." and find out what is already written in stone and what is flexible.

Identify contingent liabilities such as environmental problems or assets—like the SOE's hospital—that you do not want. Emphasize the need to shed such unwanted assets to end up with ones you can put to effective use. Ensure that you understand—and try to protect yourself from—possible future competition from the other SOE subsidiaries that you wish to exclude from the venture.

Check that valuable existing licenses such as distribution, service, and import/export rights stay with or are given to the venture. See whether your sales or supply arrangements might be affected by inter-provincial or interministerial rivalries.

Try to learn in advance who will be representing the Chinese side of the venture's management team, and whether he or she is qualified, or got the position through political connections. If this person was brought on for political reasons, then consider assigning him or her to a government relations office under the business management's control, where government skills and contacts can be best utilized.

Results: The SOE prematurely introduced an established MNC to the subsidiary and you decided not to pursue the deal. Two years later they finally received approval to form the JV, but the market opportunity had already moved and competitors had expanded their presence.

European or American Investment Banker or Consultant

Situation: Investment bankers and consultants often prefer assignments from Western corporations to help them raise finance, structure projects, and identify local Chinese partners. However, they also seek or are sought out by Chinese companies needing similar assistance. In either case, such advisers need to get mandated for fees, usually including an up-front retainer. Western corporations serious about China are able and prepared to pay for such services, but usually do not seek venture capital funding.

In contrast, Chinese parties often do not want to make commitments to pay, even if they can. The Chinese enterprise knows that it can benefit from the investment banker's or consultant's expertise and introductions to various alternative foreign technical, industrial, and venture capital partners. The enterprise—and foreign technical partners—may know that often the most critical assistance will come from the foreign technical partner. So, without an acceptable mandate, the advisers delay, and the enterprise might seek out new competing advisers. The adviser might then start giving advice and introductions under an agreement that provides for payment upon success. However, the quality of advice and understanding is often unsatisfactory, since the enterprise does not fully trust the adviser, who is less sure of success.

Actions: Most advisers will not want to see you at the table prior to their mandate, because you have many of the same skills, but you directly represent funds. Yet, you can help advisers learn to appreciate you. In fact, they might bring you another deal later or significantly enhance this deal for you. If they already have a mandate, are reputable, you get along well, and you like the deal, but they are having a hard time raising interest, then consider being a cornerstone or lead investor.

If you sourced the deal, but it is premature—requiring a lot of work that you have no time to conduct—then consider passing the deal on to a reputable investment adviser who can enhance it and bring it back to you later. Personally handle such a turnover of your relationship to the Chinese entrepreneur or SOE, and put the necessary arrangements in writing. Explain to the Chinese entrepreneur or SOE that such advisory work will be required for an IPO anyway.

Results: You decided to pass the deal to an experienced investment adviser. He brought it back to you just as you had hoped, with a preliminary financial model, and with much of the initial validation of the business concept accomplished. The IPO should occur about three years from the funding date, plus or minus one, depending on how

quickly you and the investment adviser can help the local company determine which foreign vendors to select and how soon you can finalize a strategic marketing relationship with an MNC. The vendor might even offer financing, and you have learned that one MNC also might want to invest (maybe a mixed blessing).

Either or both the vendor and MNC have expressed willingness to participate in an extended market study if invited. Part of your investment would be used to pay the investment adviser's fees, but that was a transparent up-front agreement. You expect to pay a higher premium over net asset value (NAV) for the investment, but this is justified by the adviser's contribution, which raised the probability of the deal's completion and the expected earnings growth over the original plan.

Venture capitalist competitor

Situation: You have made progress on a new project and have signed an LOI with the Chinese enterprise and/or your foreign technical or industrial partner, but issues of material importance remain outstanding. The enterprise and the foreign technical or industrial partner believe that they can work out these issues later. You stall. The investment adviser (or broker) informs you that another private equity group has expressed interest in the deal and that the new investor does not seem to have a problem with these issues.

Actions: You decide it would be useless to issue threats based on the violation of agreed principles. Instead, you politely remind the Chinese entrepreneur or SOE and MNC that the outstanding issues you seek to resolve are legitimate, that such issues were anticipated in the LOI, and that you clarified earlier that it is only responsible of you to require further progress on or to have sufficient understanding about how these issues will be resolved. Privately remind the local partner that since the new investor does not know the local partner, the new investor likely will rely on the MNC and this will swing the balance of power by building a "foreign consortium." Explain that if they force you out they will likely strike less favorable terms later and that the MNC and new investor might already have confidential side agreements between themselves.

If there is no MNC or the local partner otherwise brought in your competition, then remind them that everyone's goal is to build trust, create value, and reduce risk. Also, remind the local partner of your LOI and understandings concurred by the local political authorities. Consider suggesting that you meet with the new investor and evaluate the option of sharing the investment and risk with them. This also will help you gauge the local partner's character and commitment to you.

Quickly discuss the situation with your management to understand your maneuvering room and devise alternative means to stay in the deal.

The investment adviser (or broker) informs you that another private equity group has expressed interest in the deal and that the new investor does not seem to have a problem with your outstanding issues.

Results: Although the MNC had introduced the competing investor group, the local entrepreneur supported your meeting with the new investors. The new investors shared your concerns, but explained their confidence in the existing plans to resolve these issues. However, they also shared your interest in getting a good price for the deal and promoting the IPO. Also, they were glad to see the depth of your relationship with the local entrepreneur. In the end, the new investors supported your deal structure, but gave the MNC more confidence in your intentions. You, the local entrepreneur, and the MNC all gave up enough shares to give the new investor one board seat. You only wanted one board seat anyway, so the results were quite acceptable. 完

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Banking on China

China nudges its banking reforms along, tossing an occasional bone to foreign financial institutions

Ji Chen and Stephen C. Thomas

Banks, which perform some of the most important financial functions in a market economy, have been key targets for reform in post-1979 China. This is understandable, as the role of a modern commercial bank is to attract funds and reallocate them to the most efficient users, thereby supporting economic growth. A commercial bank also needs to make a stable profit by offering financially rational and prudent loans that carry a lending rate high enough to cover both operating expenses and interest on deposits.

Among the government's more aggressive reforms has been the modernization of state-owned banks and the creation of new ownership structures. These reforms have yet to force China's previously non-market banks to achieve the most basic but crucial commercial-bank objectives, however. And the gradual pace of the reform process has kept foreign commercial banks, with limited access to the market, from becoming major participants.

The players and how they came to be

China has a long history of commercial banking (*see* p.17), but the current system dates from the 1948 establishment of the People's Bank of China (PBOC). After the founding of the PRC in October 1949, PBOC assumed all of the existing Chinese and foreign banks' functions. PBOC served as a central bank and government treasury, and directed and supervised all specialized subsidiary banks, non-bank financial institutions, and insurance companies. Three major, specialized banks existed under PBOC: the Agricultural Bank of China (ABC), serving the agricultural sector; the People's Construction Bank of China (CCB), specializing in infrastructure finance; and the Bank of China (BOC), which acted as China's foreign-exchange bank.

PBOC held a monopoly on banking functions until 1979. During this period, China had a roughly 40 percent savings rate, and PBOC allocated these savings to industries and agricultural projects according to a national credit plan set by the State Council's State Planning Commission. Ninety percent of investment funds went to large state-owned enterprises (SOEs), which employed about 70 percent of China's largely urban industrial work force of 100 million.

An integral part of China's economic reforms, banking reforms received the government's immediate attention after 1979. The first reforms began with the devolution of various banking functions from PBOC to the three specialized state-owned banks. Spun off as an independent but still government-owned commercial bank in 1979, ABC began providing commercial banking services, focusing on agricultural and rural industrial projects. BOC retained its autonomy to con-

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duct foreign-exchange operations. And a reconstituted CCB began financing fixed-asset investments in China.

PBOC became China's official central bank in 1984. To facilitate this transformation, China established the Industrial and Commercial Bank of China (ICBC). ICBC took over from PBOC various commercial banking functions, and became the largest of China's four state-owned banks. Other financial institutions were also launched at this time, such as insurance companies and international trust and investment corporations (ITICs).

China formed three "policy" banks in 1994 to assume the government-directed ("policy") lending functions of the four state-owned banks. These were the State Development Bank, specializing in national infrastructure finance; the China Export-Import Bank, providing trade finance; and the China Agricultural Development Bank, financing agricultural development reforms (*see The CBR*, January-February 1997, p.16). The Ministry of Finance directed these banks to provide capital or make loans to SOEs or national infrastructure projects.

China's reforms have yet to force its banks to achieve the most basic but crucial commercial-bank objectives.

China's Banking History

Both traditional and modern banks served China during the Qing Dynasty (1644-1911). Most traditional banks were called Shanxi Banks, otherwise known as *piao-zhuang* or *piao-hao*. These operated as "draft banks," financial institutions that issue unconditional promissory notes, and by 1900 conducted more than half of Chinese banking business nationwide. But in 1900 the Shanxi Banks lost one of their largest customers, the Qing government, to foreign banks offering more favorable lending terms. Only a few Shanxi Banks continued to operate after the founding of the Republic of China in 1911.

The earliest modern banks in China were branch offices of foreign banks, beginning with the Oriental Banking Corp. (*Dongfang Yinhang*), which opened in Shanghai in 1848. The Oriental Banking Corp., along with the Chartered Bank of India, Australia, and China, and the Hongkong and Shanghai Banking Corp., gave Britain a virtual monopoly among foreign banks in China until the 1890s. Citibank (first called the International Banking Corp., then the National City Bank of New York) opened a branch in China in 1902, and the American Express Co. and Chase Bank (formerly Equitable Eastern Banking Corp.) followed suit in 1918 and 1921, respectively.

Li Hongzhang, one of Qing China's highest officials, set up the first modern-style Chinese commercial bank in 1897, the state-supported, merchant-managed (*guantu shangban*) Imperial Bank of China (*Zhongguo Tongshang Yinhang*) to finance China's railway development. The burden of the indemnities imposed on China after the Sino-Japanese War of 1895, however, meant that the bank, later renamed the Commercial Bank of China, was never fully capitalized and played only a minor role in the development of the few miles of Chinese railway not controlled by foreigners.

The first Chinese government-owned modern national bank, Hu Bu (Board of Revenue of the Qing Government), was not established until 1905. The Hu Bu Bank became the Da Qing ("Great Qing") Bank in 1908 and later the Bank of China. China established the Communications Bank in 1907, which specialized in collecting income from China's railways and telegraphs, established a postal-savings system, and provided banking services for the shipping sector.

Because of the stipulations of the Sino-foreign unequal treaties of 1842, 1860, and 1895, foreign banks were able to operate unhampered by Chinese laws and taxes. Foreign banks held much of the Chinese customs deposits pledged against foreign loans used to pay off the Japanese indemnity of 1896 and the Boxer indemnity of 1901. But foreign banks back then, like today, primarily financed foreign businesses, which were mostly involved with foreign trade, particularly the sale of opium in China. These banks dominated China's foreign-exchange market from 1911 to 1949, setting exchange rates between China and the rest of the world until about 1930.

After 1911, the new Chinese government sponsored the further development of the two largest of the modern Chinese banks of the time, the Bank of Communications and the Da Qing Bank. Foreign banks in China also continued to function and expand, both in number and in profitability. But the Chinese government lacked sufficient capital to support modern industrial development or to carry out government functions. The two Chinese national banks therefore borrowed heavily from foreign banks to lend to the Chinese government and, to a much lesser extent, to Chinese enterprises.

China established a third bank, the Central Bank of China (*Zhongyang Yinhang*), in Shanghai after the Kuomintang unified China in 1928 and set up its capital in Nanjing. Although banks of the same name had been set up earlier both in Guangdong and Hubei provinces, the new Central Bank of China in Shanghai was meant to be the state bank of the Republic of China.

Also in 1928, China reorganized the Bank of Communications to focus on promoting Chinese trade and industry, and the Bank of China began handling foreign exchange. In 1935, China added the Farmers Bank of China (*Zhongguo Nongmin Yinhang*) to these three, forming what was known until 1949 as the "four banks" or *sihang*. They issued legal tender, held the government's domestic- and foreign-currency funds, and provided an internal money market.

—Ji Chen and Stephen C. Thomas

While domestic banks undergo restructuring and expansion, foreign banks are slowly gaining entry into the market.

Following the 1995 release of the Commercial Bank Law and Central Bank Law, ICBC, ABC, BOC, and CCB began to function as commercial banks, subject to new rules and regulations holding them responsible for their profits and losses. The Central Bank Law also furnished a legal underpinning for PBOC's central-bank role.

This period saw the development of other financial institutions to meet the increasingly complex and growing needs of a modernizing economy. One new type of banking institution was the share-ownership commercial bank, in which various levels of government, Chinese institutions, and in rare cases individuals, hold shares. These banks include the Bank of Communications, the Shenzhen Development Bank, the China International Trust and Investment Corp. (CITIC) Industrial Bank, China Everbright Bank, Hua Xia Bank, China Investment Bank, China Merchant's Bank, Guangdong Development Bank, Fujian Xingye Bank, The Shanghai Pudong Development Bank, Hainan Development Bank, and China Minsheng Bank.

Another new type of financial institution was the urban cooperative bank, which evolved out of China's 5,000-plus urban credit cooperatives. This ongoing restructuring process resulted in 88 new urban commercial banks and 3,240 urban credit cooperatives by the end of 1998. There are also still 41,500 rural credit cooperatives. These operations serve mainly individuals and small enterprises.

THE SMALL FOREIGN PRESENCE

While domestic banks undergo restructuring and expansion, foreign banks are slowly gaining entry into the market. At the outset of the financial reform program, PRC leaders debated whether foreign banks should be allowed to operate in China at all, and if so, in what form and under what conditions. Officials who favored opening the banking industry argued that foreign banks would introduce more competition into the Chinese banking system and thereby improve efficiency. They reasoned that such banks could also be an additional source of foreign capital and would help introduce modern banking standards and practices. Moreover, foreign banks would improve the Chinese foreign-investment environment, particularly by providing banking services to foreign-invested businesses in China.

But other Chinese officials were concerned that foreign banks might come to dominate the domestic banking sector just as they had before 1949. Such domination could then lead to excessive foreign control of the economy. China also wanted to protect its young commercial banks. These concerns are not unique to China—in many countries, foreigners are not permitted to own banks entirely, and many countries have severe limits on even partial foreign ownership. Australia and Canada, for example, permit no more than 10 percent foreign ownership of any one bank; Denmark allows no more than 30 percent; and South Africa sets the limit at 50 percent. Cautious PRC officials also argued that China still lacked a legal and regulatory framework to guide domestic—much less foreign—bank operations.

After some debate, Chinese leaders decided in 1979 that opening the banking sector to foreign players was a risk worth taking. Their strategy has been to offer foreign banks access gradually and within certain financial limitations. The Import-Export Bank of Japan became the first foreign bank to open a representative office in the PRC, setting up shop in 1979 in Beijing. Hong Kong's Nanyang Commercial Bank was the first foreign bank to open a branch in China, and it began offering full commercial banking services in Shenzhen in 1982.

In 1985, China promulgated its first set of rules and regulations for the operation of wholly foreign-owned and joint-venture financial institutions located in the five Special Economic Zones. On April 1, 1994, new regulations superseded all past rules and laid the groundwork for foreign participation in Chinese banking. The Regulations Governing Foreign Financial Institutions in the People's Republic of China declared that to establish branch operations in China, foreign banks must have a representative office at least two years old; the branch bank's parent company must have total assets of over $20 billion (foreign bank subsidiaries and financial institutions need only $10 billion); and the bank must be headquartered in a country with sound financial supervisory and administrative systems. The regulations also stipulated that PBOC would regulate all foreign bank activities.

By late 1994, the government had begun permitting foreign banks to conduct foreign-currency business for foreign and overseas Chinese individuals and enterprises both in and outside of China, and for SOEs needing foreign-currency loans. China limited foreign operations to major coastal cities. By 1997, 234 cities, most of them on the coast, had been opened to foreign banks, but foreign banks concentrated their operations in Beijing, Shanghai, Guangzhou, and Shenzhen. The number of foreign banks in China had reached 172 by the end of 1998—153 were representative offices and branches of foreign banks, 7 were joint-venture banks, 6 were wholly foreign-owned banks, and 6 were part of financial companies, either wholly foreign-owned or joint ventures, as reported in *International Finance Studies*.

Most recently, the International Finance Corp., the private lending arm of the World Bank, invested $22 million in exchange for a 5 percent equity position in the Bank of Shanghai. The only other Chinese bank with foreign investment is China Everbright Bank, in which the Asian Development Bank holds a 3.3 percent equity stake, valued at about $20 million.

Foreign banks' total assets amounted to an estimated $36 billion by February 1999, accounting for 2.58 percent of the assets of China's entire banking sector, according to *China Economics Network*. China's foreign-currency loans from foreign banks totaled $27 billion, or 23 percent of total foreign-currency loans in the country.

The current PRC banking regime offers foreign banks several advantages over their domestic counterparts. First, they enjoy the preferences given to foreign enterprises in China, such as

lower taxes and certain tax exemptions. They also have more freedom than Chinese banks in their personnel and management policies, though at least one senior executive must be a Chinese citizen. And foreign institutions are able to operate without the level of government intervention faced by domestic competitors. They also do not have the non-performing loans that burden Chinese commercial banks.

On the other hand, foreign banks face significant constraints. For example, only a few banks are allowed to conduct *renminbi* (RMB) business, and they are restricted to limited loan amounts and to certain cities. China also lacks business transparency, making it difficult to obtain accurate accounting and operational information on borrowers. Enforcement of lending rules and loan recovery is also a problem. Issues of ownership and of responsibility for losses are ambiguous, as the demise of the Guangdong ITIC revealed (*see The CBR*, May-June 1999, p.36). The legal framework and enforcement mechanisms for banking are also far from complete, and experience handling financial failures and problems, including bankruptcy procedures, is lacking. Moreover, there is a dire need for trained personnel to perform modern banking functions.

Some foreign banks remain frustrated by the basics of China's banking sector—they find it difficult to understand why the government permits the four largest state-owned banks, though inefficient, technically bankrupt, and deficient in customer service, to continue to grant loans, absorb savings from the general public, and otherwise dominate the banking industry.

The Downside of Gradual Reform

Before 1978, Chinese banks simply collected savings and allocated them according to quotas set by the central government. Even though this system was relatively easy to administer, it did not permit capital allocation based on market forces or individual investment decisions by banking officials, enterprise managers, or entrepreneurs.

This dearth of market mechanisms created problems the government has tried, with limited success, to solve. The most serious problem has been the government's interference in capital allocation, principally by directing banks to base financing decisions on social and political considerations rather than market criteria. Banks served as implementers of government policy rather than as independent business units basing lending decisions only on the creditworthiness of the borrower. The most serious consequences of this system have been large SOEs' dependence on non-recourse loans and the resulting growth on the state banks' books of non-performing loans.

The cumulative level of non-performing loans—loans classified as substandard, doubtful, and loss—is officially estimated at ¥1 trillion ($120.8 billion). This is equivalent to 12.5 percent of China's 1998 GDP or China's entire 1998 fiscal revenue. But some analysts estimate that bad loan levels may run as high as ¥2.5 trillion ($302 billion). Non-performing loans represent up to 20 percent of China's state-owned banks' assets. Based on the internationally recognized 8 percent capital-adequacy standard, all four of China's state-owned commercial banks are insolvent.

The Asian financial crisis and its aftermath have only exacerbated China's banking problems. The falling demand from Southeast Asia for Chinese products and steeper competition from both foreign and domestic private-sector products have reduced SOE income and ability to repay loans. A foreign-investment decline has reduced the amount of foreign exchange available to SOEs interested in upgrading their operations. Finally, in the wake of the overall domestic economic slowdown, Chinese consumers have been cutting down on their spending and instead are focusing more on saving for retirement, medical costs, and children's needs. Savings now total nearly ¥6 trillion ($724.6 billion), even though the central bank has lowered savings interest rates seven times over the last three years. Interest rates remain attractive, however, because of the nationwide price deflation.

Are Beijing's Best Efforts Enough?

To sustain high levels of economic growth and to support the country's integration into the world financial system, the Chinese government has taken a number of initiatives to speed up eco-

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THE RTC MODEL GOES EAST

The PRC government has considered several ways to rid China's banks of their overhang of bad loans, including writing them off at a faster rate; auctioning them off; setting up debt-equity swaps; establishing deposit insurance; and forming Resolution Trust Corp. (RTC)-type institutions to assume and resolve the bad debt.

China initiated this last, most dramatic experiment in 1999. The State Council, under the central bank's decision, set up the Xinda (Cinda) Asset Management Corp. (XAMC) to tackle up to ¥200 billion ($24.1 billion) of the China Construction Bank (CCB)'s most promising pre-1996 non-performing loans. The first of its kind in China, XAMC is authorized to try various methods to remove non-performing loans from CCB's books. XAMC is financed with ¥10 billion ($1.2 billion) from the Ministry of Finance and future earnings from bond issuance or borrowing from commercial banks and PBOC. All transactions dealing with the bad loans are to be tax exempt.

XAMC's first action was to sign an agreement on September 2 with the Beijing Cement Plant Corp. (BCPC), which has outstanding debts to CCB of ¥900 million ($108.7 million) plus accumulated interest. BCPC agreed to trade XAMC an equity position for an undisclosed amount of BCPC's debt. XAMC has thus become a major shareholder of BCPC and has assumed responsibility for paying back to CCB the agreed-upon loan amount. XAMC may implement several different mechanisms to pay off the loan (*see* Figure). For example, XAMC may float shares of BCPC in cooperation with the company, or issue bonds to CCB to redeem the loan. XAMC may later sell its equity position back to BCPC or to a third party, perhaps at a discount.

CCB's books appear somewhat healthier for having been relieved of some of its problem loans. It could also benefit financially from any coupon interest should XAMC decide to issue bonds. And BCPC improved its financial position as its equity increased and its long-term liability fell. The Chinese government hopes that BCPC will now be able to turn a profit and that its management will improve under XAMC's influence.

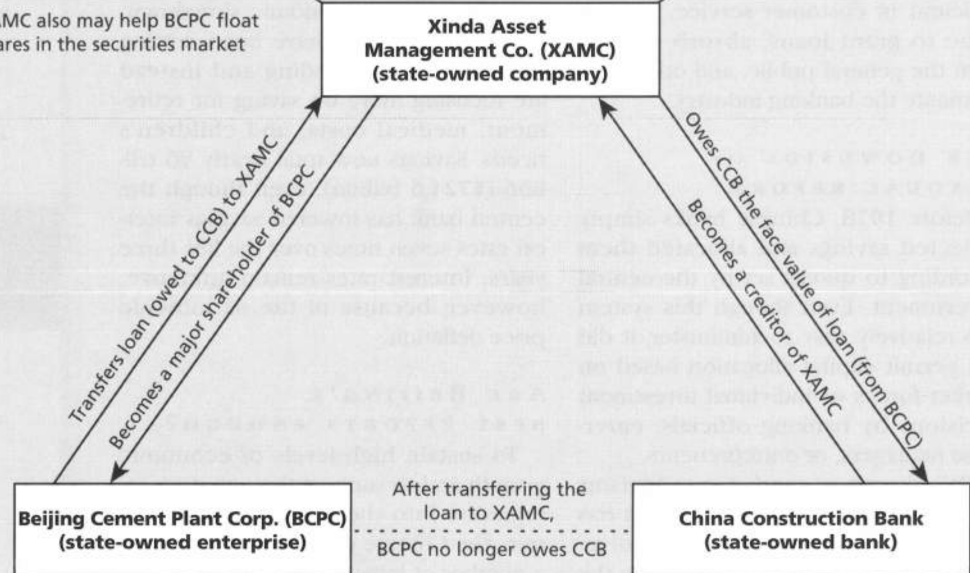
But this is China's first effort at loan resolution, and it is not clear whether all of the government's objectives are realistic, for a number of reasons:

- XAMC will handle only the most easily resolved problem loans, and recovery rates even for these loans may not exceed 30 percent.
- There may not be a market for BCPC shares, and no clear mechanism exists for selling the shares should there be willing buyers.
- BCPC and other SOEs are still trying to get rid of their loans rather than focusing on becoming more efficient or profitable, or finding other ways to repay them. Defaulting SOEs have no incentive to improve their management if they believe any losses will eventually be covered through bailouts from government financial institutions such as XAMC. But the success of the debt-equity swap depends on whether BCPC is better managed and profitable under the new shareholder scheme. If it isn't, BCPC is sure to resort to its past practice of seeking easy money from state-owned banks.
- Banks have no incentive to try to recover non-performing loans if they believe they can simply pass them on to the government.

XAMC thus faces many hurdles. Though its success has yet to be proven, XAMC serves as the model for three additional asset-management companies recently approved by the State Council. The Hua Rong Asset Management Co. will handle non-performing loans for the Industrial and Commercial Bank of China; the Great Wall Asset Management Co. (GWAMC) will work out the Agricultural Bank of China's non-performing loans; and the Dong Fang Asset Management Co. will tackle the bad debt of the Bank of China.

—*Ji Chen and Stephen C. Thomas*

DEBT BAILOUT STRATEGIES



SOURCE: Ji Chen and Stephen C. Thomas

Continued from p.19

nomic reforms, particularly in the banking and SOE sectors. The government aims to move China's banks toward world standards of commercial organization, service, and competitiveness by

- **Improving central bank independence** to permit it to carry out monetary policy without political influence from any level of government. To this end, Beijing has reorganized PBOC into nine regional branches, each with the power and autonomy to carry out monetary policy.
- **Reducing the burden of past policy loans** that are primarily to blame for the state-owned commercial banks' insolvency. The government injected ¥270 billion ($33 billion)—financed by Treasury-bond issues—into the banks in August 1998 to bring them up to the international banking standard for adequate equity of 8 percent of total assets.
- **Adopting a new loan classification system** to help bring China's loans up to international standards and to improve the management of loan portfolios. The system, which PBOC adopted in April 1998, categorizes loans either as "pass," "special-mention," "substandard," "doubtful," or "loss."
- **Relaxing control over interest rates**, allowing commercial banks to float loan interest rates within a limited range. This is to encourage lending to small and medium-sized companies, providing liquidity to firms thus far all but shut out of the market.
- **Strengthening China's supervisory and regulatory environment and implementing sound banking practices**. Banks will be responsible for profits and losses, and unsound or failed financial institutions can be taken over, closed, or declared bankrupt.
- **Establishing asset-management companies** to address the bad-loan problem (*see* p.20). These companies are similar to the US Resolution Trust Corp. (RTC), which dealt with the assets of the country's failed savings and loan institutions.
- **Further opening China's banking sector to foreign banks**, thereby exposing Chinese banks to foreign practices and competition. This seems to have accelerated recently as part of government efforts to open up the financial services industry, probably in response to World Trade Organization (WTO) accession requirements.

More breaks for foreign players

Indeed, China has lifted several restrictions on foreign banks in the last few years. Since 1997, 25 foreign banks have been permitted to conduct RMB business with foreign-funded businesses in Shenzhen and Shanghai on an experimental basis. They also gained permission in 1998 to participate in syndicated loans to Chinese businesses. A group of six Chinese and foreign banks became the first to undertake such a loan, agreeing in December 1998 to extend ¥80 million ($9.7 million) to the Shanghai Tyre and Rubber Co. Ltd.

Measures initiated in 1999 have further expanded the role of foreign banks in China. Foreign banks are now permitted to operate in any Chinese city. PBOC also relaxed geographic restrictions on foreign banks authorized to conduct local-currency business. The six banks licensed to conduct such transactions in Shenzhen are now able to handle clients in Guangdong and Hunan provinces and the Guangxi Zhuang Autonomous Region, while the 19 banks in Shanghai may extend their RMB business to Jiangsu and Zhejiang provinces, subject to certain conditions.

China has increased RMB lending levels this year, from 35 to 50 percent of total RMB deposits, for foreign banks licensed to lend in local currency. Foreign banks may also now borrow long-term RMB funds from domestic banks on China's interbank lending market. Citibank's Shanghai branch recently received a one-year interbank loan of ¥50 million ($6 million) from the Bank of Communications. And the Shanghai Pudong Development Bank provided ¥160 million ($19.3 million) in 3-5 year loans to the Shanghai branches of Bank of America Corp., Credit Lyonnais, and the Industrial Bank of Japan to support foreign-invested enterprises. This is the first time since 1949 that China has allowed Chinese-foreign interbank loans. This step may open the door to greater cooperation between Chinese and foreign banks in China.

Keeping the crisis at bay

Mounting bad loans to SOEs, the use of loans for stock and real-estate speculation, slackening domestic demand for Chinese products, and falling foreign demand and investment have sparked speculation about the chances of a banking crisis in China. It is true that China's four state-owned commercial banks remain basically insolvent and uncompetitive. Should they be judged by international banking standards, they would be declared bankrupt.

> *Banks served as implementers of government policy rather than as independent business units basing lending decisions only on the creditworthiness of the borrower.*

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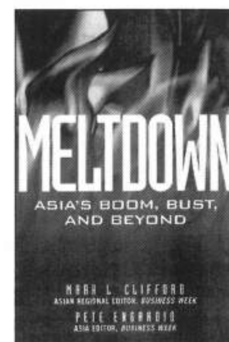

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China will likely continue to open the door further to foreign banks to meet WTO requirements and attract foreign investment.

Should they be thrown into full and open competition with foreign banks, they would fail. And should they be declared bankrupt or fail, they would frighten away the Chinese savers who are keeping the financial system afloat.

As part of the commercialization process, China's state banks were supposed to abandon the directed-credit system and begin to make loans based on traditional banking criteria. China finally phased out the traditional quota system for credit in 1997 and initiated new borrowing requirements. Commercial banks were also supposed to increase their level and scope of service in other areas such as risk management and credit analysis, and adopt accounting practices that would accurately reflect current assets and liabilities.

Though the Chinese government has tried to force its commercial banks to become more accountable for their profits and losses, it is also asking them to help promote a government demand-led, Keynesian-style pump-priming operation designed to enable China to spend its way through the Asian recession. Thus, as Nicholas Lardy has recently noted, just as Premier Zhu Rongji was promising to hold the state banks to stringent standards of accountability, the government once more ordered the banks to help fund the economic stimulus—with loans that will most likely never be repaid. The lack of domestic and foreign demand for SOE-made goods will make it harder for SOEs to pay back any loans, old or new.

One ironic consequence of China's banking reforms is that their success might in fact serve to highlight the banks' weaknesses, leading to a serious drop in their international credit ratings, with the risk of large-scale withdrawals by PRC depositors. Only convincing government guarantees will continue to inspire savers' confidence.

Foreign banks in China will no doubt continue to monitor the Chinese economy carefully, as economic performance will have spillover effects on the banking sector. The government is still using the banks as tools in its economic stimulus program. In October, PRC officials moved to spur the lagging economy by cutting bank reserve requirements, which they hoped would induce banks to make more funds available to borrowers. Foreign banks will watch for signs of recovery, for the better the economy, the higher the domestic demand for goods and services including loans—loans which would go to companies increasingly able to repay them.

China will likely continue to open the door further to foreign banks to meet WTO requirements and attract foreign investment. Most Chinese officials have come to realize that a more competitive banking environment will improve both service in the industry and bank profitability. They also value the opportunity to learn from foreign banks.

The pace of China's banking sector opening to foreign participation will remain modest, however. Until a strong legal and regulatory regime has been implemented, this may be a wise strategy. According to current regulations, large foreign banks are welcome in the Chinese market. But to succeed when eventually permitted to conduct large-scale operations, these banks must understand China's banking and business environment thoroughly. 完

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Financing Agricultural Equipment on Credit

Though major obstacles block widespread retail credit for equipment financing, the potential for profit exists

Roy McCall

Chinese have long understood, managed, and, as is true of any other country, abused credit. In *Village Families in the Vicinity of Peiping* (Peiping, 1929), China scholar Hunter Hale described one typical pre-1949 case:

A 'good money-lender,' described as a blessing to his village, has been known to charge only 25 percent; but such self-restraint is exceptional. Interest at 40 to 80 per cent is said to be common; interest at 150 to 200 per cent to be not unknown. Goods pledged are taken at two-thirds of their true value. As far as the poorer peasants are concerned, permanent indebtedness is the rule rather than the exception. They pawn their crops in summer, their farm implements in winter, and their household belongings throughout the whole twelve months.

It was practices such as these that contributed to the popular support for China's Communist revolution and meant that for the next half-century farms would have to rely on centralized planning and top-down allocation of capital. Farms may have been liberated from constant indebtedness after 1949, but the command system of credit allocation undermined these farms' investment and productivity levels.

Despite agricultural reforms in the early 1980s, China's state farms have found it difficult to keep up with the best methods and practices in the 1990s. This is partly due to the absence of private-sector financing and a reluctance to accept farm credit risk. Thus, China's state farms have remained reliant on government ministries, whose special capital allocations have been the primary means to purchase new machinery.

Roy McCall manages credit for Deere & Co.'s China operations. Born and raised in Asia, he has lived in the region for 25 years.

Poor Execution

The Chinese saying "The newborn calf does not fear a tiger" (*Chu sheng niu du, bu pa hu*) refers to an old story in which a poor strategy is so well executed that it results in success. But another Chinese saying, "Seven by eight" (*Heng qi, shu ba*), referring to systematic plans for planting rice, indicates that a good strategy poorly executed can result in less-than-optimal results.

This second saying describes the expansion of retail credit in China over the past 15 years: after setting up shop in the early 1980s, many foreign leasing companies lost hundreds of millions of dollars in investments due to poor execution. Ironically, the retail credit strategy originated with meticulous Japanese institutions that crafted municipal guarantees as contingencies. Unfortunately, the credit companies could not have foreseen the central government's 1989 annulment of municipal credit guarantees and the rejection of standby commitments. After this annulment the companies' loans were effectively unsupported and then defaulted on. Careful credit screening ultimately matters as much in China as in any other part of the world.

Hope Remains

Despite this severe setback, and the failure of the government to focus on the potential of retail credit in the 1990s, expanding retail credit in China is still a viable

strategy. Purchasing and maintaining productivity-enhancing and standardized, quality equipment can help Chinese retail credit customers improve cash flows. If project financing is managed responsibly—a big if—the cash flows can pay off credit obligations and more. A hypothetical case illustrates how retail credit can facilitate increases in cash flow.

For example, suppose a 75,000-acre state farm imports a large-horsepower tractor unavailable domestically, along with plowing and planting implements, which cost a total of $100,000. Improved productivity in the form of more efficient equipment run-time and land tillage might reasonably be estimated at 0.1 percent for the farm, which—let's suppose for illustrative purposes—is generating $40 million in annual revenues. This would result in $40,000 in additional benefits per year. The farm also purchases a superior combine harvester for wheat, corn, or rice that costs $250,000. If the harvester yields a 0.2 percent productivity improvement, then this would translate to a benefit equivalent to 0.2% x $40 million or $80,000 per year. Suppose that, to make the purchases, the state farm takes out an installment loan with 30 percent down, financed over 3 years at 10 percent, an obligation of $98,518 per year for three years, excluding operating costs and any damage insurance. This equates to an internal rate of return of 43 percent and a net present value of $80,469.04 (*see* Table).

Credit risk exists in China—as everywhere

This example demonstrates the possible benefits of retail credit expansion in China. But contrary to what many may believe, the difficulty of assuming credit risk in China lies not with the excessive magnitude of China risk, but with the inability to measure or quantify it. Managing unquantifiable risks is exceedingly difficult, if not impossible.

A case can still be made for customer creditworthiness, defined by borrower ability and willingness to satisfy credit terms. Willingness to pay in most cases is dictated by ability to pay, where borrowers have been screened up front. Ability to pay depends on cash-flow availability. The keys to evaluating cash flows are reliable and readily available financial statements.

Borrower financials in China are often translucent, if not transparent—as indicated by the local-bank requirement that small, remotely located, or private firms furnish up to 100 percent in compensating balances. Buyers are rarely able to rely on borrowing against collateral value in China: secondary markets are undeveloped; pricing of used equipment uncertain; and collateral values difficult to measure with confidence.

In the case of customer default, recovery options for lenders are impractical or expensive. While court procedures have been defined to provide restitution, there are few success stories for lawyers to whisper about behind closed doors. Indeed, court proceedings, especially for financial leases and installment sales, have not been widely tested in China. Recovery is theoretically possible but difficult and expensive in practice.

An in additional challenge is establishing a liquid secondary market for repossessed equipment. For instance, the North American Equipment Dealers Association quarterly publishes a 500-page list of wholesale and retail values of secondary equipment by model, year of production, starting serial number, and hours of use. Ability to value repossessed equipment is important for determining default-corrective procedures.

Even if legal repossession and commercial resale corrective procedures can be streamlined and processed competitively, a preferable approach obviously would be to avoid or prevent defaults. Better default prevention in China will depend on whether reliable, transparent financial statements become widely available to creditors. In the United States, such transparency is tremendously aided by credit-rating agencies. While similar agencies are desperately needed in China, their development and reliability are still in their infancy. Nevertheless, some US rating agencies are beginning to survey credit-management performance in China and circulate survey results.

Skeptics often point to the failure of the PRC's major state banks to collect on loans as evidence that responsible borrowers are hard to find in China. But from another perspective this failure can be viewed as a success, at least until China's economic reforms progress. Though some estimates put the rate of non-performing loans to China's state-owned enterprises at 30 percent, even if the actual percentage is higher, these non-performing loans represent transfer payments to stabilize employment and social order.

Strict regulations

China regulates the credit options now available in an attempt to control the expansion of credit for US dollar-denominated imports and prevent the contraction of foreign reserves.

In a simple example, suppose an American exporter extends installment credit to a Chinese buyer of equipment. In this case, the buyer's lease payments are subject to neither withholding nor business tax. The importer would still be liable for customs duty

A Farm Equipment Financing Case

	Downpayment	Year 1	Year 2	Year 3	Terminal value at a 30 percent discount
Productivity benefit	$0	$120,000	$120,000	$120,000	$400,000
Tractor financing	($30,000)	($28,148)	($28,148)	($28,148)	$0
Combine financing	($75,000)	($70,370)	($70,370)	($70,370)	$0
Operations cost		($9,852)	($9,852)	($9,852)	($32,839)
Total	($105,000)	$11,630	$11,630	$11,630	$367,161

NOTES: Internal rate of return is 43 percent; net present value is $80,469.04
SOURCE: Roy McCall

and value-added tax (VAT). The exporter would also need to register the equipment mortgage with the buyer's local administration of industry and commerce.

If the exporter wishes to retain title, it can lease the equipment. Leasing offers greater legal protections but fewer tax advantages. Even though the lessor retains title, its *operating* leases are subject to 10 percent tax withholding on all gross rental payments. In the case of *finance* leases, in contrast, withholding applies to the net interest charges over the US Export-Import Bank rate for a similar period loan. The US Ex-Im Bank rate is based on the Commercial Interest Reference Rate (CIRR), which roughly translates to 100-150 basis points above LIBOR and 100-150 basis points below the US Prime lending rate. Fortunately, business taxes—normally a minimum of 5 percent of gross rental values or 8 percent of the finance charges—do not apply to offshore operating or finance leases.

In the case where a foreign joint venture imports the equipment and leases it to local customers, the joint venture must not only pay customs duty and VAT, it must also pay a 5 percent business tax on gross operating-lease revenue and a 33 percent income tax on net income. (If the joint venture imports through a bonded zone, these rates apply to products sold into China from the zone.) For a finance lease, the withholding requirements are the minimum of 5 percent of gross lease revenue or 8 percent of the gross lease revenue less the equipment price, that is, the finance charges.

For comparable lease terms and residual values, then, tax treatment favors finance leasing over operating leasing. But gaining government approval to establish finance leasing is potentially more difficult, particularly if the People's Bank of China (PBOC)—the central bank and the main bank regulatory body—views the financial leasing as non-bank financing. Currently, PBOC is attempting to limit over-expansion of non-bank finance companies and is extremely selective about which companies it will approve for registration, particularly in the aftermath of the Guangdong International Trust and Investment Corp. (GITIC) bankruptcy (*see The CBR,* May-June 1999, p.36).

In spite of GITIC's bankruptcy and the even greater concern it has generated about the instability of China's finance companies, PBOC appears to respect sound financial subsidiaries of foreign firms such as Siemens AG (already approved for a finance company in China), Motorola Inc., and Ford Motor Co., to name just a few. The requirements for establishing a finance company nonetheless remain high. A non-bank finance company must be established as part of a holding company with $80 million (expected to increase to $100 million in future) invested in China. During each of the three years prior to application, revenue must have been at least $3 billion annually. But even if a foreign firm qualifies and is approved to establish a finance company in China, at present it can only manage the cash of its holding company and subsidiaries. It cannot yet extend retail credit directly to customers.

From installment loans to multilateral finance

The simplest option for US exporters attempting to finance Chinese customers would be to extend an offshore installment loan to creditworthy candidates. Offshore leasing, whether operating or finance, would not possess enough of a practical legal advantage to outweigh the tax benefits to installment leasing.

Some foreign firms in China have established leasing subsidiaries. Where firms have leased to unworthy customers or where firms have invested in the wrong assets or even the right assets at the wrong time, stories of costly lessons still abound. But established industrials such as IBM Corp. and pioneers such as GE Capital are still venturing selectively into leasing in China.

Third-party bank financing represents an interim approach. Ford has been successful in cooperating with China Construction Bank's 90 branches to extend retail credit to urban buyers of the Vantage minivan. Other banks potentially interested in retail credit include the Bank of China, the Agricultural Bank of China, and the Industrial and Commercial Bank of China. But these banks are generally interested in *renminbi* (RMB) financing for local buyers of local products. Only recently have the few licensed foreign banks been able to extend RMB loans in addition to foreign loans to foreign firms (*see* p.16).

Imported products denominated in US dollars must eventually be repaid in dollars. Local buyers borrowing and paying for imported equipment in US dollars must register for approval from China's State Administration of Foreign Exchange.

Where local banks are reluctant to lend in US dollars, foreign-bank lending offers no easy alternative. Foreign banks generally extend foreign-currency loans to foreign firms or joint ventures. Foreign banks generally do not lend to local entities except through local banks and with a US Ex-Im Bank guarantee, which generally requires a quasi-sovereign guarantee from China's Ministry of Finance, the State Development Bank, or the Bank of China. But these entities are reluctant to issue guarantees except for selective, highly creditworthy customers. For geographically dispersed and unfamiliar customers, US exporters cannot expect to ride the US Ex-Im Bank into the countryside. Ex-Im will still consider loans and guarantees for local entities without sovereign guarantees, but this unusual approach requires three years of financial statements audited by an international firm able to provide extensive notes—something local firms without an international profile are hard pressed to pay for or provide.

A final alternative is the World Bank's private-sector arm, the International Finance Corp. (IFC). The IFC does invest in and lend to private entities. Where these private investments and loans to one particular entity are large enough (e.g. on the order of several million dollars) to justify the due diligence, and where the duration of due diligence processes is feasible, IFC financing represents a viable longer-term option.

What holds it all back

Three obstacles are preventing credit from fueling market growth in China. First, assessing equipment collateral values is difficult because of the lack of measurable/quantifiable secondary market valuations. Second, inefficiencies and expenses abound in the repossession of defaulting credit customers' assets. Third, China lacks established credit-rating agencies, which are essential for financial transparency. Despite these barriers, PRC financial institutions have concrete incentives and opportunities to develop a socialist market retail sector with financially credible characteristics. 完

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Leader of the Pack

Two decades after opening its doors, Guangdong continues to attract foreign companies

Darlene M. Liao

Business fuels Guangdong Province, the leader of the economic boom that has brought tremendous prosperity to coastal China over the last 20 years. But the province was hit hard by the fallout from the Asian crisis and the Guangdong International Investment and Trust Corp. (GITIC) bankruptcy. Exports have faced greater competition from Southeast Asia for two years, and exports to these economies and Hong Kong and Japan are down, though exports to the United States are up.

Investment has also suffered from the Asian slump. The number of new agreements signed fell 40 percent in the first half of 1999 compared to the same period in 1998, and utilized foreign direct investment dropped 4.2 percent (*see* Table 1).

In some ways, the province's overall investment environment is no longer as enticing as before. It no longer enjoys nearly exclusive preferential status—trade and investment incentives once unique to Guangdong have now spread to other parts of the country. And the costs of land and labor in the province, though still low compared to Hong Kong and other East Asian tigers, have risen over the years, prompting some companies to relocate to other parts of China.

Despite these changes, interviews with US firms and US and PRC government officials reveal that the province, which is making the transition from a labor-intensive industrial economy to one more engaged in high technology and services, retains its allure.

Numbers say it all

Guangdong leads the country in GDP, number of foreign-funded enterprises, total foreign investment, exports, per capita income, and consumption. The province accounts for 10 percent of China's total GDP, 30 percent of its foreign investment, and 40 percent of exports. Exports account for 80 percent of Guangdong's GDP, compared to the average of 20 percent for the rest of the country. According to provincial government statistics, Guangdong's GDP totaled ¥793.7 billion ($95.8 billion) in 1998, up 10.1 percent over 1997. This year, GDP is forecast to grow 8.5 percent. Guangdong residents lead the country in income—Shenzhen and Guangzhou place first and second, respectively—so it is no surprise that Guangdong leads the country in retail sales and pays the most taxes to the central government.

The *China Daily* estimated that up to 70,000 foreign-invested enterprises (FIEs) have set up operations in the province, and many foreign companies have established their China headquarters there. FIEs employ seven million workers, make up half of the province's industrial output, contribute 40 percent of provincial construction funds, and account for 26 percent of provincial tax revenue. Most projects are in labor-intensive industries, particularly those

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producing consumer goods. Forty-one percent of foreign operations are in manufacturing, 31 percent in real estate, and the rest scattered across other sectors.

WHY GUANGDONG?

This mecca for businesses ranks first in terms of market structure, second in tax policy, and second in overall attractiveness among regions in China, according to a study conducted by Shaomin Li et al. (*see The CBR*, March-April 1999, p.20). More specifically, foreign companies remain drawn to Guangdong for its:

■ **Infrastructure** The province has well-developed energy, transportation, and telecommunications systems. It has 91,862 km of highways, the highest density in the country. Guangdong boasts 163 trading ports and has been China's telecommunications pioneer. The province has hosted the country's first wireless paging station, digital telecommunications network, 900 megahertz analog and digital cellular network, advanced 2.5 gigahertz synchronized digital hierarchy transmission, and digital cellular network based on Code Division Multiple Access technology. And Shenzhen-based Guowei Electronic Corp. was the first company to make digital mobile phones in the PRC. Mobile revenue turnover in Guangdong now accounts for 15-20 percent of China's total.

The province is committed to further improvements. Last year, it spent ¥23.3 billion ($2.8 billion) on infrastructure, and this year increased the infrastructure budget by 11.3 percent. Shenzhen, for example, recently opened a new expressway, and Guangzhou became the fourth Chinese city to build a subway. The trains run on 18.5 km of track and are projected to carry 300,000 passengers daily. Guangzhou is also building ring roads and a new airport designed by two US firms, Parsons Co. and URS Greiner Co.

■ **Government** As Guangdong was the first province to benefit from China's economic reforms—and Beijing, until recently, exerted little influence over the provincial government—local officials are well trained in the art of doing business. The general consensus among foreign companies in Guangdong is that the local government is more straightforward and sophisticated than elsewhere in China. Foreign opinion on government officials is mixed, with some companies praising their helpfulness and efforts to simplify procedures, but others complaining of hassles and unofficial fees.

Restrictions on what proportion of goods manufactured in China must be exported have loosened over the years. Previously, 51-70 percent of output had to be exported. Today, many contracts

The general consensus among foreign firms in Guangdong is that the local government is more straightforward and sophisticated than those elsewhere in China.

state 25 percent. According to the Guangzhou Commission of Foreign Trade and Economic Cooperation (COFTEC), however, the contractual figure is generally only enforced for certain products such as textiles and rubber.

Guangdong's neighbors, though also keen to attract foreign companies, have not fared as well. Guangxi Zhuang Autonomous Region and Hainan Province, for instance, experienced spurts of economic growth but could not sustain them.

■ **Location** Proximity to Hong Kong, with its complementary comparative advantages and common dialect, is another advantage. Hong Kong has served as China's gateway to the world for over a century, providing foreign companies with a powerful incentive to set up China operations in Guangdong. Hong Kong and Taiwan are Guangdong's biggest investors, accounting for three-quarters of total investment in 1998.

Thousands of Hong Kong companies have relocated their manufacturing facilities to Guangdong to take advantage of its relatively cheap and abundant labor and land. Hong Kong-invested factories provide millions of jobs and offer technological and managerial skills. According to one study, goods produced in Guangdong have a 70 percent profit margin compared to the 20 percent margin for goods made in Hong Kong. Trade and investment flows have thus skyrocketed since the late 1970s. Hong Kong accounted for 80 percent of the investment in Guangzhou and 65 percent in Shenzhen from 1993 to 1997.

Taiwan companies invest heavily in Guangdong for similar reasons. Many companies have relocated their manufacturing facilities to the mainland, particularly to Guangdong and Fujian provinces, where land and labor costs are lower than on Taiwan. Taiwan invests more in Guangdong than in any other PRC region, including Fujian, which is closer to Taiwan not just geographically but also in heritage and language. At the end of 1998, Taiwan investment in 11,000 firms in Guangdong exceeded $7 billion according to PRC figures. In line with Guangdong provincial government goals, Taiwan companies are shifting investment from labor-intensive to high-tech projects. And with direct trade between the PRC and Taiwan still prohibited, the most common indirect route is through Hong Kong and Guangdong. Trade volume climbed 4.8 percent last year, to $12.4 billion.

■ **Consumers** Much like their Hong Kong neighbors, Guangdong residents are avid consumers. Guangdong ranks first in the country in household consumption, spending nearly ¥3.2 billion ($386 million) in 1997—Jiangsu Province ranked second, at ¥2.4 billion ($289 million). Guangdong's urban consumption rate jumped 7.8 percent in the first half of 1999 over the same period in 1998. The rural consumption growth rate was even higher, at 11.6 percent.

Strong consumption growth appears to be here to stay. The provincial government has been encouraging domestic consumption to stave off the effects of falling demand for exports from Southeast Asia. The government aims to sustain consumption growth over the long term in part by increasing investment in education. Province-run colleges and universities expect new student enrollment to jump 64 percent this year.

Consumers in Guangdong tend to look for quality; whether the product is local is a secondary issue. For example, three of the top four shampoos in Guangdong are American brands. One company representative explained simply that a buy-local campaign may have worked 5-10 years ago, but today business and society are more open—Guangdong consumers cannot be coerced into purchasing local products that are inferior.

■ **Zones** The province features a full range of economic zones, from a free-

Continued on p. 34

TABLE 1
GUANGDONG'S MAIN ECONOMIC INDICATORS

INDICATOR	1998	% CHANGE OVER 1997	FIRST HALF 1999	% CHANGE OVER FIRST HALF 1998
GDP (RMB billion)	793.7	10.1	367.6	9.6
GDP per capita (RMB)	11,183.0	7.8	—	—
Industrial output (RMB billion)	997.8	12.2	456.2	15.1
State-owned enterprises	166.7	—	—	—
Collectives & shareholding firms	275.5	—	—	—
Foreign-invested enterprises	500.4	—	—	—
Other	55.2	—	—	—
Number of registered FIEs	57,665.0	-2.3	—	—
Number of investment agreements signed	4,348.0	16.0	1,401.0	-40.8
Utilized FDI ($ billion)	12.0	2.6	4.9	-4.2
Retail sales (RMB billion)	324.9	11.3	172.8	8.9

SOURCES: Guangdong Customs Office, *Guangdong Socioeonomic Monthly Statistics*, *China Monthly Statistics*, *PRC 1998 State Statistical Yearbook*

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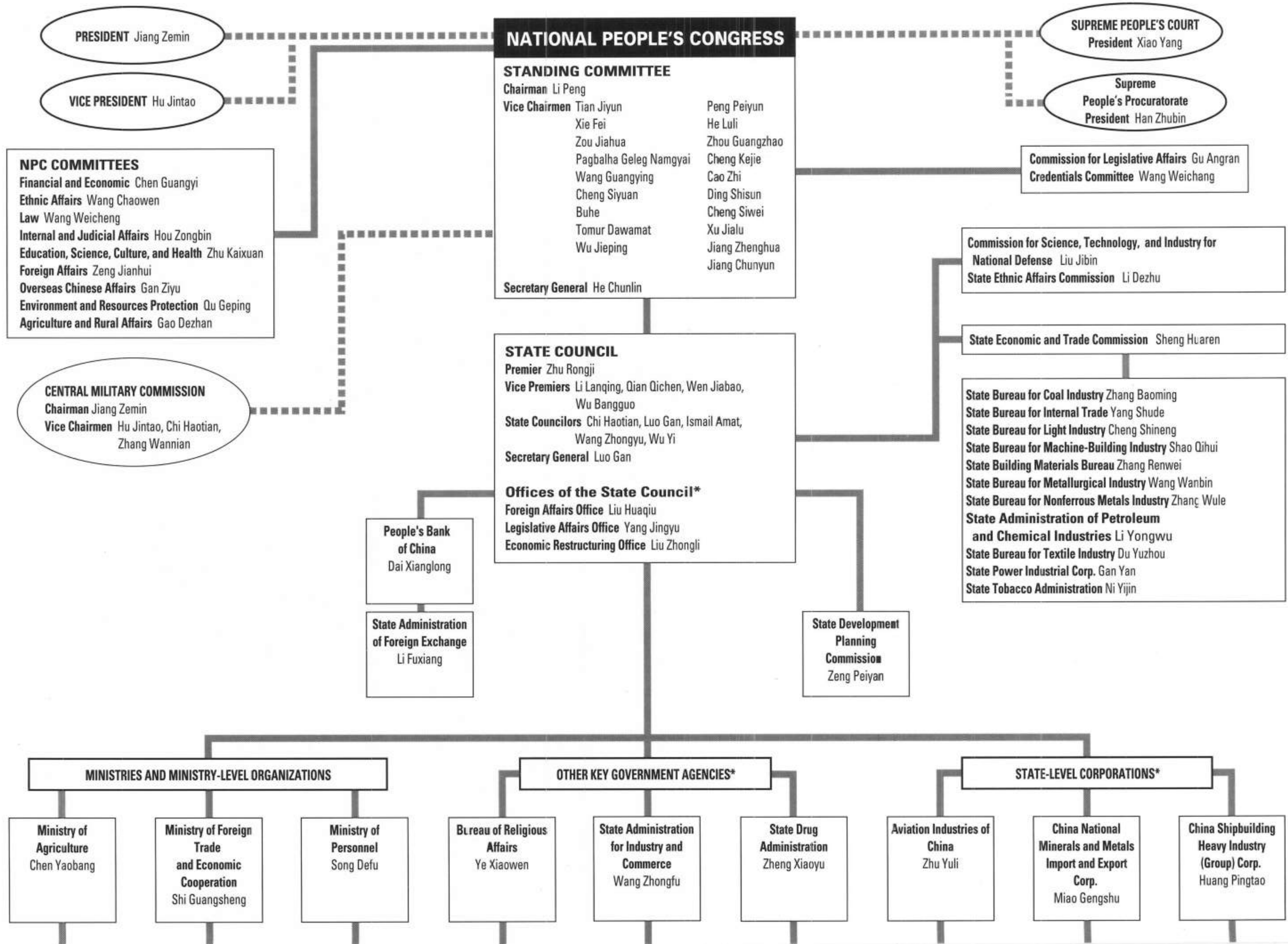
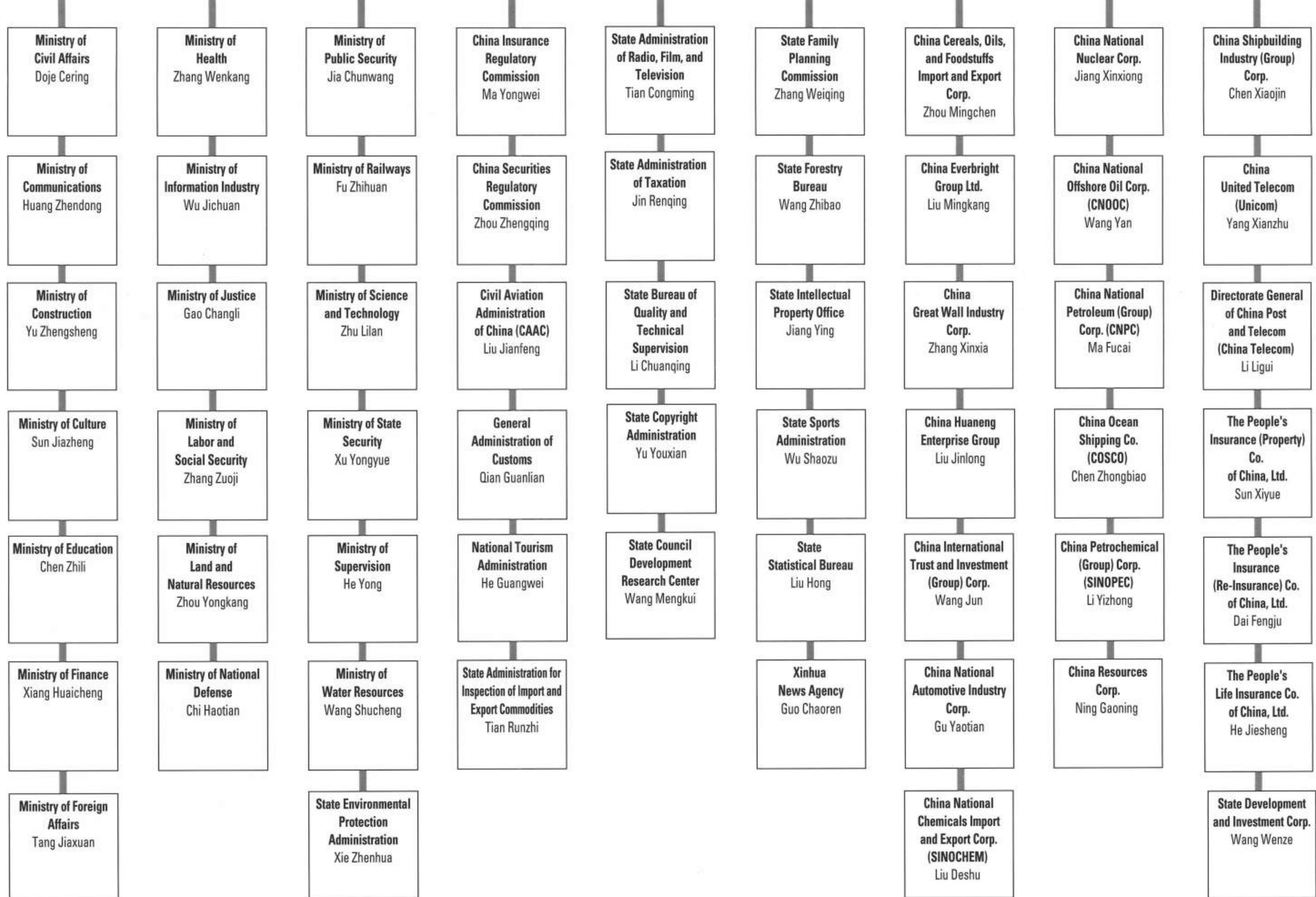
China's Government Structure





SOURCE: US-China Business Council files, FBIS, China Directory 1999-2000,
US-China Business Council: *China's Government Restructuring: Who's In, Who's Out, and What it Means for US Business* (www.uscbc.org/members/washington/other/restructure)

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*These listings are not meant to be comprehensive

Continued from p. 30

trade zone and three Special Economic Zones (SEZs) to a number of high-tech and economic and technological development zones (HTDZs and ETDZs). One company with Guangdong operations both inside and outside of special zones noted that decisionmaking and approval processes are much more transparent and less bureaucratic in the zones. A state industrial zone, the Guangzhou Free Trade Zone, otherwise known as the Guangzhou Economic & Technical Development District (GETDD), can approve projects worth up to $30 million. In general, the application process takes only a week, according to a GETDD official. Companies investing less than $10 million can obtain approval from ETDZ authorities, while the local COFTEC must approve most investments between $10 and $30 million. Investments worth more than $30 million require central-government approval.

These zones tend to offer similar tax breaks and incentives but differ in purpose. SEZs aim to attract manufacturers intending to export, though Shenzhen, the largest SEZ in China, is developing a high-tech base. ETDZs were set up to target high-tech manufacturers and tend to be ports with large berths or near bonded zones, also enabling companies to import or export easily. HTDZs seek to attract companies engaged in the research and development, production, and sale of certain technological products in areas such as electronic information, marine engineering, biotechnology, pharmaceuticals, and environmental preservation. And bonded zones have their own customs facilities, allowing companies in these areas to enjoy additional conveniences—a license is not needed to import and export goods, and foreign goods can be stored, processed, and manufactured tariff-free.

Over 300 FIEs have taken advantage of GETDD, which boasts its own port, customs, and tax authorities. Aiming to attract companies engaged in export processing and bonded warehousing, GETDD regulations exempt many companies from import and export licensing requirements. Tax holidays and breaks from tariffs for imported equipment are other pull factors for companies.

TABLE 2
GUANGDONG'S TRADE ($ BILLION)

LOCATION	1998	% CHANGE OVER 1997	FIRST HALF 1999	% CHANGE OVER FIRST HALF 1998
Guangdong				
Exports	75.7	1.6	32.2	-12.3
Imports	54.3	-2.3	28.3	9.9
Guangzhou				
Exports	7.8	2.5	3.2	-12.7
Imports	5.7	-6.6	3.2	31.4
Shenzhen				
Exports	26.4	3.0	12.3	3.9
Imports	18.9	-2.7	10.0	15.5
Zhuhai				
Exports	2.9	-3.4	1.2	-25.0
Imports	3.0	3.9	1.6	14.7
Shantou				
Exports	3.4	-18.5	.71	-68.5
Imports	3.2	-7.7	.92	-50.7
Zhanjiang				
Exports	.34	-5.6	.12	-36.0
Imports	.57	-8.6	.23	-26.7
GETTD				
Exports	.44	20.7	.23	17.7
Imports	.74	1.0	.47	53.5
Guangzhou Tianhe HTDZ				
Exports	.03	80.4	.01	1.7
Imports	.03	3.2	.01	29.5
Guangzhou Bonded Zone				
Exports	.11	24.5	.04	-46.0
Imports	.17	53.3	.09	2.7
Shenzhen Sci-Tech Industrial Zone				
Exports	.38	52.1	.24	61.5
Imports	.33	32.8	.24	96.8
Shenzhen Bonded Zone				
Exports	1.3	40.1	.68	16.4
Imports	1.3	36.0	.67	2.5
Zhanjiang ETDZ				
Exports	.05	-18.9	.02	1.6
Imports	.07	-1.8	.03	-30.0

SOURCE: *China Monthly Statistics*

THE PEARL OF THE ZONES

Of Guangdong's three SEZs, Shenzhen is the most successful—its GDP is targeted to grow 13 percent this year. This city bordering Hong Kong is a high-tech center with a talented, educated, and young labor force. Though export growth fell from 20 percent in 1997 to 3.0 percent in 1998, Shenzhen continues to lead China in exports for the sixth year in a row, accounting for 15 percent of the country's total exports (*see* Table 2).

Shenzhen boasts 1,500 manufacturers of computer components and accessories. The output of high-tech companies in Shenzhen totaled ¥65.5 billion ($7.9 billion) in 1998, up 65 percent over 1997. These companies produced 35 percent of the city's total industrial output, the highest proportion of high-tech production of any city in China.

Shenzhen is one of the few cities in China with rail, highway, sea, and airport facilities. Having overtaken Shanghai, its seaport now hosts more international lines and records more cargo than any other PRC city. In 1998, the port handled nearly 2 million 20-foot equivalent unit (TEU) containers, an increase of 70 percent over 1997. The number of berths will expand from 116 today to 270 by 2020, for a capacity of 12.5 million TEUs.

Also one of China's financial centers, Shenzhen is home to one of China's two stock exchanges. So far, six foreign banks in Shenzhen have been authorized to conduct local-currency transactions in Guangdong, and neighboring Hunan Province and Guangxi. Nineteen banks in Shanghai are the only others permitted to conduct such transactions.

Shenzhen is not picture perfect, however. The thriving city is also a major smuggling center. In 1998, Shenzhen Customs investigated 2,800 smuggling cases involving ¥950 million ($114.7 million). To aid its anti-smuggling efforts, Shenzhen Customs set up a special police force last January. And Chinese Premier Zhu Rongji visited Shenzhen earlier this year to stress the importance of the country's anti-smuggling campaign.

Guangdong's other two SEZs lag far behind Shenzhen. The mayor of Zhuhai reported that the city will record 12 percent growth this year, a 10 percent rise in foreign investment, and a 4 percent jump in exports. But Zhuhai's international airport is far from busy, traffic is noticeably light on the highways, and many buildings remain half empty. Several new investments, such as the bridge linking the city to Hong Kong, have stalled because of financing difficulties.

Shantou, too, is feeling the crunch. Its economy grew only 2 percent in the first six months of 1999, compared to the 20 percent growth registered for the same period in 1998. Foreign investment and trade have dropped just as steeply. Recognizing stiff competition from Southeast Asia, Shantou plans to focus export production on more-promising mechanical and electronic goods sectors, reducing its dependence on textiles and foodstuffs.

A MIXED RECORD

Foreign companies in Guangdong are doing relatively well. One US firm has experienced 23 percent annual growth over the last five years, and is expecting growth to climb to 30 percent annually for the next five. Over 70 percent of Taiwan-funded firms in Shenzhen are profitable. Yet companies do experience difficulties. According to a US government official, some problems stem from company missteps such as bad partner choices, unrealistic market expectations, and underestimating the competition.

But others stem from imperfections in Guangdong's business environment. A significant blow was the forced bankruptcy of GITIC, China's second-largest ITIC, last year, though most Guangdong-based FIEs were untouched by the scandal (*see The CBR*, May-June 1999, p.36). Widely touted as a successful fundraising vehicle with government backing, GITIC's demise invalidated both of these assumptions, shocking creditors and outside observers alike. The central government made clear that it would not always come to the rescue. Confusion soon surfaced as to how GITIC's estimated $2.2 billion in foreign debt and $1.9 billion in contingent liabilities would be settled. Though details are still being hashed out, creditors may have no choice but to take a "hair cut." The GITIC failure has prompted investors to re-evaluate their policies and has led to tighter credit. Companies have learned their lessons.

Guangdong, particularly its two main smuggling ports, Shantou and Zhanjiang, has also been the focus of Beijing's ongoing anti-smuggling campaign. Customs reported over 6,000 smuggling cases in the first seven months of this year. Last May, Guangdong courts sentenced the former head of Zhanjiang Customs and his anti-smuggling unit chief to death for taking bribes. The campaign has caused both exports and imports to fall dramatically. In the first half of 1999, Shantou's exports dropped by 68.5 percent, and imports shrank nearly 51 percent. Zhanjiang reported 36 percent and 26.7 percent declines, respectively.

Last May, Guangdong courts sentenced the former head of Zhanjiang Customs and his anti-smuggling unit chief to death for taking bribes.

Guangdong has not been insulated from other nationwide problems. Over the last year, the PRC central government has tightened the rules governing rules on foreign-exchange transactions (*see The CBR*, March-April 1999, p.26). Perhaps inadvertently, the rules have lengthened the foreign-exchange process. Many companies in Guangdong cited the forex rules as inconvenient, but not wholly obstructive. As one US government official put it, the rules have simply caused "minor burps."

Corruption seems to be a bigger problem. Last year, the provincial procuratorate investigated over 1,600 corruption cases, ranging from smug-

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gling, bribery, taxation, and intellectual property rights violations to currency fraud and negligence. Among the cases, former provincial Vice Governor Yu Fei was charged with corruption and abuse of power. A court recently sentenced two provincial officials to 13 years in prison for embezzlement. And a former party secretary of Enping city received a four-year prison term for enacting illegal policies that increased local debt and created problems for companies and banks.

Abuse of labor rights, though apparently not a major issue of late according to one US official, remains pervasive in Guangdong. Nonetheless, more than 11 million people from other parts of the country have flocked to Guangdong in search of work. In Dongguan, these migrant workers make up 87.4 percent of the labor force, one World Bank study reports. Though migrant workers have played a crucial part in Guangdong's economic success, many are treated poorly and work under harsh conditions.

Unlike permanent local residents, migrants are ineligible for social welfare benefits such as health care and education. Instead, these workers, on whom factories depend, must pay for a temporary work permit. It is not uncommon for factories to pay the expensive permit fee, a practice that reinforces the bind between workers and factories. Anita Chan, a professor at Australian National University, cites a survey by a Guangdong trade union revealing that 35 percent of workers do not receive higher pay when working overtime. More alarming is the fact that 32 percent of these workers are paid below minimum wage. One company that Chan investigated requires workers to put in 60-80 hours of overtime a month, well above the legal maximum of 36 hours. And some firms have been known to delay or entirely withhold workers' pay. Work-related deaths and injuries are also common. More than 80 workers have died and 12,000 have been injured in Shenzhen factories in 1998.

The Guangdong Labor Department estimates that roughly 500,000 workers in the province will lose their jobs this year, of which 90 percent will come from state enterprises. But a US government official pointed out that laid-off workers have better chances of finding new employment in Guangdong than in other areas of China, given the opportunities in the private sector.

Power wars

Guangdong has been able to reap the benefits and overcome the obstacles of economic reforms largely because Beijing has given the province a high degree of autonomy. But even as it lets provincial authorities handle the GITIC bankruptcy, Beijing periodically pulls in the reins and attempts to reassert control. These attempts come primarily in the form of personnel reshuffling. Last year, the central government uprooted independent-minded reformist Xie Fei from his job as Communist Party secretary in Guangdong, bringing him to Beijing to serve as vice chairman of the National People's Congress. The central government replaced Xie with Li Changchun, an outsider who previously served in Henan and Liaoning provinces. Beijing also appeared intent on curbing Guangdong's power with the late 1997 appointment of Wang Qishan, a close ally of Zhu Rongji, as executive vice governor of the province. Wang, however, no longer has absolute power over financial issues, and may soon find himself back in Beijing, as the PRC's top leaders continue to reshuffle officials.

Company wish list

Despite Guangdong's attractive characteristics and the government's efforts to clean up the business environment, foreign companies see room for improvement. They suffer from many of the problems foreign investors face throughout China. Though a US government official has noted a rise in counterfeit domestic products, rather than of foreign goods, manufacturers of consumer goods have indicated that counterfeiting remains their biggest problem. One US company estimates that 15-20 percent of its reported sales are actually counterfeit goods. The company's representative stressed that counterfeiting warrants the same level of attention given smuggling.

Other leading company concerns are consistency and transparency of government policies. FIEs report that it is sometimes hard to figure out which government—local, provincial, or central—is in charge of a certain process.

Foreign companies also desire further opening of the PRC market. China prohibits foreign companies from selling goods not manufactured in the country. This discourages certain companies from engaging fully in the market. For example, one major foreign manufacturer would like to be able to import certain products to test their marketability in China before setting up a manufacturing plant.

Difficulty retaining staff is another major concern. Foreign companies are increasingly looking for local Chinese to step into managerial roles, but individuals qualified for such roles are scarce. Local managers in high demand tend to jump from one company to another. According to a Watson Wyatt Worldwide report, the turnover rate among FIEs in Guangdong is 17 percent.

What's next

Economic prosperity has touched most of the province—Huizhou city, which had no industry in the late 1970s, now produces 60 percent of the country's telephones. While China's overall utilized FDI rose only 0.45 percent in 1998, Guangdong's climbed 2.6 percent. But as first half 1999 statistics indicate, Guangdong is not immune to the regional slowdown in investment. And some areas like mountainous Shaoguan remain impoverished.

Company concerns and flaws in the business environment, which tend not to be Guangdong-specific, are likely to be addressed directly or indirectly as China continues to negotiate its accession to the World Trade Organization. To prepare the economy for accession, Beijing has stated that it will gradually reduce the preferential treatment foreign investors enjoy in SEZs. But while Beijing may try to reassert control from time to time, it is unlikely to do anything that would significantly disrupt Guangdong's economy. Some foreign companies may choose to relocate inland, where labor and land are cheaper, but many will continue to find Guangdong's business-savvy governments, local entrepreneurs, and prosperous consumers more enticing.

Provincial officials remain eager to work with foreign companies, and have even established complaint centers. The local governments have proven they can handle the effects of the Asian crisis and the GITIC bankruptcy. Thus companies already in the province are sticking it out, while those exploring opportunities are taking their time when deciding whether to invest. Guangdong, with its business-friendly government and ever-improving infrastructure, will continue to be one of the most attractive commercial areas in China. 完

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The Tourism Engine

A review of the potential of travel and tourism in China and Hong Kong

Scott Wayne

China is fast becoming one of the world's top countries for travel and tourism. Already a magnet for tourists from elsewhere in Asia, China is expected to witness explosive growth in international business and tourist arrivals over the next decade. The industry's benefits to China and the Hong Kong Special Administrative Region include not just overall wealth but also job creation.

According to WTTC/WEFA research, in 1999 travel and tourism will have contributed an estimated $87 billion to China's GDP and accounted for almost 494 million jobs, or 7 percent of total employment. In Hong Kong, travel and tourism supports 224,000 jobs, or 9 percent of total employment. And the China and Hong Kong travel and tourism economies together are expected to generate more than $41 billion in capital investment this year.

Overall economic activity stimulated by travel and tourism will grow 3 percent per year from 1999 to 2010. By 2010, the sector could account for more than 1 in 11 jobs in China and 1 out of every 10 jobs in Hong Kong. Tourism could make up 9 percent of China's GDP and 11.4 percent of Hong Kong's.

In the long term, China's travel and tourism economy is forecast to grow at a real rate of 7.9 percent per year, while Hong Kong's is set to expand 1.7 percent annually through at least 2010. Demand for travel and tourism in China is expected to grow at more than twice the predicted global rate of 3.4 percent per year, despite the fact that the recent Asian crisis lowered previous forecasts (*see* Tables).

The travel and tourism industry—which includes transport, accommodation, catering, and recreation—is part of a broader travel and tourism economy, which includes businesses that supply the industry. Analyzing the flow-through effects of these second-tier businesses across the wider economy demonstrates the overall impact of travel and tourism. This important analysis is made possible by a technique called satellite accounting, first developed by the World Tourism Organization. Current public-sector analysis and related policies tend either to overlook or understate the impact of the industry, or deal with its smaller components. Most countries' national accounts, including those of China, fail to show the economic impact of travel and tourism clearly. Satellite accounting allows the government to measure both the direct economic effects of visitor consumption and the indirect economic impact of travel companies, suppliers, and support services.

A number of Asia Pacific Economic Cooperation economies, including Canada, Singapore, and Australia, are now developing detailed satellite accounts for travel and tourism within their national accounts systems. China recently adopted the standards of the World Tourism Organization for tourism satellite accounting, and WTTC and PRC officials have been discussing imple-

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menting this methodology in China and Hong Kong.

More Than the Great Wall

China is the world's fifth leading international tourist destination, ranking eighth in foreign-exchange earnings from tourism. Domestic tourism is also an emerging source of revenue.

In 1998, 63.5 million domestic and international visitors traveled in China, according to Xinhua News Agency reports. Although the bulk of visitors continue to come from Hong Kong, Macao, and Taiwan, there has been a steady increase in visitors from further afield, notably Japan, South Korea, the United States, and Russia. In 1998, according to World Tourism Organization figures, roughly 24 million foreign tourists traveled to China and almost 10 million to Hong Kong.

Despite the negative impact of the Asian crisis on regional tourism, the number of foreign tourists arriving in China rose by more than 15 percent in the first seven months of 1999 over the same period in 1998, according to the Quarterly Statistical Report of the Pacific Asia Travel Association. Most of this increase came from northeast Asia, which accounted for almost two-thirds of arrival traffic. The World Tourism Organization reports that receipts from foreign tourists totaled about $12.5 billion in 1998.

As one of the fastest-growing service sectors, tourism is listed as a key or "pillar" industry by 24 of China's 31 provinces, autonomous regions, and municipalities. The industry is also beginning to diversify from its traditional focus on city-based cultural and heritage sites. In mid-1999, for example, WTTC was informed of projects related to a ski resort in the Changbai Mountains and archaeological tourism in the Tumen River region, both in Jilin Province.

Travel and tourism exports are a growing source of foreign exchange in economies with expanding service sectors. There are two categories of exports: international visitors and travel-related merchandise exports. In 1999, travel and tourism service exports—or international visitor spending—were estimated at $14.3 billion in China and $13.6 billion in Hong Kong. These figures are expected to more than double by 2010.

China's capital investment in travel and tourism is roughly 11.3 percent of the worldwide 1999 total, or $733 billion. Though travel and tourism-related capital investment in Hong Kong has already exceeded the world average, China is still well below it, and long-term forecasts do not show the gap closing. Airplanes will continue to be a source of major capital investment in China. In January 1998, for example, The Boeing Co. reported the sale of five 737s to Chinese airlines. Boeing has delivered more than 250 commercial aircraft over the past 25 years to China, representing more than 60 percent of China's market for Western-built commercial jet aircraft. The temporary freeze on airplane purchases issued in 1998 appears to have been lifted. According to the *China Daily*, airline passenger traffic grew by 6.3 percent in 1998.

Despite tourism's importance to the economy, public spending on the sector is relatively low. The PRC government is allocating around 3.8 percent of public spending in 1999 to travel and tourism services—well below the world average of 6.7 percent. Hong Kong government spending represents just over 7 percent of public spending.

Despite the negative impact of the Asian crisis on regional tourism, the number of foreign tourists arriving in China rose by more than 15 percent in the first seven months of 1999 over the same period in 1998.

Table 1
Travel and Tourism in China

	1999 $ million	% of Total	Real Growth 1998-99	2010* $ million	% of Total	Real Growth 1999-2010*
Personal Travel & Tourism (T&T)	35,828.8	6.8	-1.3	71,563.9	6.8	6.4
Business Travel	7,818.9	—	21.9	19,202.2	—	9.3
Government Expenditures	3,014.0	3.7	-24.3	4,604.3	3.7	3.8
Capital Investment	33,538.4	8.5	23.6	92,589.1	8.2	9.8
Visitor Exports	14,344.6	6.4	7.3	31,646.6	7.2	8.6
Other Exports	5,766.4	2.6	7.3	17,971.1	4.1	8.6
T&T Demand	100,311.1	—	8.0	237,577.2	—	8.2
T&T Industry GDP	24,759.7	2.5	1.1	49,698.3	2.3	6.7
T&T Economy GDP	86,736.1	8.7	7.1	197,300.5	9.0	7.9
T&T Industry Employment	13,934.2	2.0	-7.7	17,630.2	2.2	2.2
T&T Economy Employment	48,813.0	6.9	-2.2	69,991.2	8.5	3.3

SOURCE: WTTC/WEFA
NOTE: Employment is in thousands; Real growth (adjusted for inflation) is annualized; T&T Industry refers to the direct effect of travel demand; T&T Economy refers to the effect of travel demand across the economy.
* WTTC/WEFA projections

The tourism sector's impact is felt throughout the economy, from construction and manufacturing to retail and financial services.

Both governments are likely to raise their spending on this sector in the next decade.

Releasing the Potential

Travel and tourism is a catalyst for social and economic development. The sector's impact is felt throughout the economy, from construction and manufacturing to retail and financial services. But Beijing is only beginning to acknowledge that private capital, in particular foreign investment, can be a boon.

In another new development, international tourism consists not just of foreign arrivals in China—mainlanders themselves are beginning to travel abroad. According to a 1998 report published by the *Travel and Tourism Analyst*, outbound trips more than doubled between 1991 and 1997. Although Hong Kong was the main destination, countries such as Thailand, Japan, Singapore, the United States, and South Korea each received over 200,000 visitors from China in 1997, a figure that is likely to increase.

Tourism is one of the largest creators of direct and indirect employment worldwide. More than 20 million jobs in China—and 116,000 in Hong Kong—could be added across the economy over the next 12 years.

The full benefits of these developments, however, will only come with greater funding for key agencies, such as the China National Tourism Administration (CNTA). China would do well to factor travel and tourism into policy decisions across the spectrum of economic and public-sector decisionmaking. In particular, infrastructure and planning policies should be designed to generate employment and export earnings. Consideration should be given to tourism in policy mechanisms that enhance employment opportunities in both rural areas and areas where manufacturing is declining.

To improve the quality of travel services and promote growth in China's tourism sector, CNTA's Laws and Regulation Department in 1998 released a set of regulations allowing joint-venture travel agencies. The regulations stipulate that "overseas applicants should be engaged in international travel services, or wholly owned enterprises running international travel services. They should have an annual tourism turnover value of at least $50 million" (*see* p.41).

Taking Wing

Since the mid-1980s, decentralization has stimulated an increase in international routes to and from airports throughout China, improving access to Chinese points of interest. Today, airports in 27 cities offer international service. The majority of international business travelers, as well as a significant number of leisure travelers, arrive by air—particularly from Korea, Japan, and the United States. Nevertheless, the biggest single challenge in developing travel and tourism is to increase air transport opportunities.

A vital component of a strong travel and tourism industry is good infrastructure—improvement of which remains critical to the future of China's travel and tourism industry. In most cases public infrastructure that supports travel and tourism expansion—such as roads and airports—will also serve other urban and regional development purposes. Expanding airports and modernizing air-traffic control systems are priorities. Current land-based air-traffic control systems should be switched to satellite navigation as soon as possible to contain operating costs, improve safety, and reduce congestion.

China's recent investments in airport construction are substantial. The Ninth Five-Year Plan (1996-2000) allocated $12 billion for the construction, reno-

Table 2
Travel and Tourism in Hong Kong

	1999 $ million	% of Total	Real Growth 1998-99	2010* $ million	% of Total	Real Growth 1999-2010*
Personal Travel & Tourism (T&T)	8,420.1	8.6	-6.1	17,761.5	8.8	3.3
Business Travel	1,724.1	—	20.2	4,244.0	—	6.5
Government Expenditures	1,161.6	7.3	5.0	2,734.4	7.7	4.8
Capital Investment	7,686.4	12.9	-0.6	21,847.4	12.8	6.3
Visitor Exports	13,575.6	6.0	0.4	35,549.1	10.8	4.8
Other Exports	8,177.4	3.6	0.4	13,545.8	4.1	4.8
T&T Demand	40,745.2	—	-0.6	95,682.2	—	4.8
T&T Industry GDP	5,096.2	3.1	-1.2	10,031.8	3.0	3.0
T&T Economy GDP	18,131.6	11.1	-5.5	31,740.9	9.6	1.7
T&T Industry Employment	63.2	2.8	4.9	98.1	3.6	4.0
T&T Economy Employment	224.8	9.9	0.3	310.4	11.4	2.7

SOURCE: WTTC/WEFA
NOTE: Employment is in thousands; Real growth (adjusted for inflation) is annualized; T&T Industry refers to the direct effect of travel demand; T&T Economy refers to the effect of travel demand across the economy.
* WTTC/WEFA projections

vation, and expansion of 41 airports. Eight new airports opened in 1997, and 13 more opened in 1998. Recent rules permitting foreign investment in airport development and management may boost expansion.

TAXES AND TRAINING

International visitor spending is an export but is not yet treated like other exports. An increasing number of "user fees" are being applied to travel and tourism—for air tickets, security, airport construction, and highways, among other things. It is important that China employ the principle of "user pays, user benefits," with funds earmarked for related travel and tourism infrastructure and transparently dispersed, and with collection time limited to the specified project completion.

Further, China must develop strategies that enhance the employment capacity of this sector and increase the quality of service to international levels. The travel and tourism sector should have access to government-funded training and education programs on an equal basis with other industries. Beijing could emphasize public education and career programs for job prospects in travel and tourism. The private sector can also play an active role in maintaining high international management and service standards, through access to both international skills and experience, to ensure competitiveness. The private sector itself can implement training and career structures capable of developing skills.

NOWHERE TO GO BUT UP

Thanks to its wealth of natural assets, China is a leader in the global tourism market. It is therefore important that promotion budgets are upgraded to ensure continuing competitiveness. Moreover, travel and tourism should enjoy the same incentive regimes as other industry and export sectors. Whether the government can involve the private sector in decisionmaking and provide incentives for increased investment—as well as integrate infrastructure, fiscal, education, and training policies and programs into the tourism-based economy—will determine the difference between a stagnant tourism industry and a vibrant one. 完

LIMITED OPPORTUNITIES FOR FOREIGN INVESTMENT IN TOURISM

While foreign companies have been able to invest in PRC hotels and to sell tourism-related equipment such as planes and buses to the PRC for nearly two decades, other areas of the tourism industry are more restricted. China's tourism industry is governed by the PRC Regulations on the Management for Travel Agencies (the Regulations), issued in 1996, and the Interim Procedures for Overseas-Invested Travel Agencies (Interim Procedures), issued last December. The Regulations legalized joint Sino-foreign cooperation in the tour-operator business, while the Interim Procedures, promulgated by the National Tourism Administration and the Ministry of Foreign Trade and Economic Cooperation, allow foreign investors to take minority positions in joint-venture travel agencies. The Interim Procedures also restrict the business scope of joint-venture agencies and require firms to meet certain conditions before forming such a venture.

A joint-venture travel agency must have registered capital of at least ¥5 million ($603,864), be structured as a limited-liability company, and have suitable facilities, equipment, and staff. The agency's legal representative must be appointed by the Chinese side. In addition, foreign companies can only set up one joint venture in China, and the joint venture cannot establish subsidiaries. The joint-venture travel agency may handle only international visitors to China and Chinese domestic tourism—it may not handle Chinese citizens' trips abroad or to Hong Kong, Macao, or Taiwan.

Chinese partners must perform international travel services, have annual turnover from tourism of at least ¥50 million ($6 million), be a member of the China Tourism Association, and have served an annual average of at least 30,000 tourists for the past three years. Foreign firms must have an annual tourism turnover of $50 million; be connected to computerized reservation networks; and be a member of their own country's tourism industry association.

RIGHT THIS WAY

In May 1998 Diethelm Travel Yunnan Co. Ltd. became the first official Sino-foreign joint-venture travel company. The State Tourism Administration granted approval to China International Travel Service (CITS)'s Beijing office, Yunnan Tourism Group, and Switzerland-based Diethelm Co. to set up a travel company in Kunming, Yunnan Province. The partners established the new venture with $1 million in registered capital. Diethelm holds a 49 percent stake, Yunnan Tourism Group holds 26 percent, and CITS 25 percent. As part of the arrangement, Diethelm relies on its existing network to attract tourists from the United States, Europe, Japan, and Southeast Asia to Yunnan. The Chinese partners, meanwhile, are responsible for logistical arrangements including local transportation and accommodations.

Though the US Department of Commerce reports that five more foreign travel agencies from Germany, Japan, Hong Kong, and the United States have applied to set up joint ventures, they have yet to be approved. Earlier this year, the US-based Student Travel Association, the world's largest student travel agency, reportedly opened a branch in Guangzhou and a franchise store with International Travel Holiday, Guangdong Province's largest travel agency.

Foreign participation in the PRC travel agency market will likely expand once China joins the World Trade Organization, but China's current offer still restricts the number and location of travel joint ventures, which would make it difficult for foreign firms to enter the China market profitably. US travel and tourism firms argue that they must be permitted to engage in a broad range of services throughout the country to be able to serve their customers properly. Should they be allowed into the market on commercially viable terms, however, China's underdeveloped tourist market promises tremendous opportunities.

—Staff of The US-China Business Council

Commentary

A Practical Education

Learning how to set up a company in China—the hard way

Seth Kaplan

Many businesses base decisions concerning the Chinese market on knowledge and expectations that are not necessarily accurate, with unfortunate consequences. If I knew two years ago what I know now about doing business in China, I might never have embarked on my China venture. At the very least, I would have started with the strategy that I eventually molded in response to experience gained from my many early mistakes.

This is a cautionary tale about the challenges facing companies in China—especially small, entrepreneurial firms—that offers insights into how one can turn China's unique playing field to one's own advantage. The story is relevant for any small-to-mid-sized company operating or considering operating in an industry characterized by strong government involvement and the need for special approvals or interpretation of existing laws or regulations.

What Led Me to China

The education business in both the United States and China is much more dynamic and fast-growing than is apparent to outsiders. There is a growing movement in the United States and elsewhere for the private sector to play a larger role in managing schools. Private companies are doing everything from running primary schools and universities to offering advanced computer training and standardized-testing preparation. Dozens of education companies have listed on US stock markets. In recent years, for-profit education companies such as the Apollo Group (which owns the University of Phoenix), Sylvan Learning Systems, and DeVry have attracted much attention for their successful education models and high-flying stock prices. Michael Milken founded and built Knowledge Universe into a company with more than $1 billion in revenue.

In China, education is an exciting new industry in the early stages of development. There are already hundreds of small, private education companies running all sorts of schools. Elite primary and secondary schools are the most common, with investments sometimes topping $10 million a school. Business training and education in particular is a field with great potential, as the country is sorely in need of skilled middle managers.

First Attempt: A Comedy of Errors

With work experience at several large multinationals and an MBA from The Wharton School of the University of Pennsylvania, I believed myself well-qualified to start my own company. Fluent in both Japanese and Mandarin Chinese and having worked for over six years in Asia, I also figured I knew how to do business in the PRC, and decided to start a chain of for-profit universities in China with the aim of eventually developing a much larger education com-

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pany. My confidence in the usefulness of my education, professional experience, and cultural knowledge was my first big mistake.

Following the letter of the law

Most businesspeople know that China's government bureaucracy plays an enormous role in the country's economy. But few newcomers actually understand the implications of this bureaucratic involvement for planning and executing a company's strategy in China. The combination of a huge bureaucracy and an incomplete legal system make a company's strategy and chances of success dependent on factors very different from those in the United States.

Chinese law on foreign involvement in education is nonetheless quite explicit. There are specific procedures to follow, documents to provide, requirements for a local partner, and limitations on the type of joint venture that may be established. Our company's first step was similar to that of any US-based start-up: we listened to people who had excellent local experience and hired the best local lawyer we could find. This, we reasoned, would not only keep costs down, but would provide us with a more Chinese perspective of how things work in China. Our lawyer, who was a PRC citizen, had spent two years at an American law school and gave advice that made sense to us.

We started by approaching the provincial education commission—the body that grants joint-venture approvals—and asking its officials how to follow the regulations to gain approval. In retrospect, this meeting was a big mistake. As we were to learn, the last thing we should have done in the highly regulated and *guanxi*-intensive PRC education industry was to enter through the front door with a lawyer and start asking questions. We found out later that the bureaucrats thought we were planning to sue them!

For nine months, we relied on our savvy Chinese lawyer's seemingly logical advice about negotiating with the Chinese partner and dealing with government officials. It didn't work. The lawyer was too Westernized and too confrontational. He did everything a Westerner would—talked plainly and showed his hand too early. The end result was that after months of negotiation, we were not only without our approval, but also without a local partner. To top it all off, we had earned a bad reputation among the approval authorities.

Mistakes in the partner search

We assumed from the beginning that the ideal local partner would be another school, probably a well-known institution whose reputation would enhance ours and whose contacts or students would help our business expand rapidly. The very best schools—the city's only state-run university and its top college—turned us down. They wanted more money and more control over the joint venture than we were comfortable offering. We found seven potential partners in our target city and met them one by one, eventually narrowing our choices to two institutions. The two schools were both introduced to us by friends who promised to help.

A man whose family owned one of the largest private companies in the city suggested the first school. His relative worked in the local economic commission, which controlled the school. We considered this school because I thought my friend could help us secure approval and because the school was not directly beneath the education commission—we feared too much bureaucratic involvement. In addition, the school was by far the most enthusiastic of the ones we had met, yet showed no interest in running the joint-venture school itself.

Negotiations progressed exceedingly slowly, with this would-be partner constantly assuring us that they would take care of us, that they were very powerful, and that we needed them. Finally, we realized that they were stalling because they lacked the necessary *guanxi* and did not know how to get approval. Their real motivation to work with us seemed to stem from the fact that a partnership might provide them with a source of funding to renovate one of their buildings.

The second school we considered was referred to us by a friend who was completing her master's degree at Fudan University, one of China's finest schools. Personable and always helpful, she introduced me to her former employer at the city's top technical high school. This school seemed like a good fit because it was the only one of its type in the city to have an approved joint venture and had close connections with government officials. Furthermore, as the best and largest technical high school in the city, it would provide a steady supply of students. Moreover, my friend assured me that the principal—her ex-boss—was an extremely ethical man who would take good care of us.

After months of negotiation, we were not only without our approval, but also without a local partner. To top it all off, we had earned a bad reputation among the approval authorities.

I spent almost a year trying to figure out this enigmatic man who was always saying one thing but appearing to mean something else. He was more typical of a businessman than a school principal. Though my friend continually reassured me about his character, his description of the requirements for government approval changed as he sensed the chance to get a better deal from us. He kept insisting that only a school with a strong principal could get government approval, which we eventually realized was a negotiating tactic aimed at maximizing his control in any eventual partnership.

Finding the right consultant

During this fruitless period, I became convinced that a good consultant familiar with the industry and its players would be a more effective advocate for us than a lawyer who knew the law but not the practical aspects of setting up a joint venture in our industry in China. We decided to switch, yet had no idea where to find a suitable consultant.

We first engaged an ex-teacher who was quite a talker and a doer, but not knowledgeable about school approvals and a bit too eager to swallow our money before getting anything done. Then there was the frank lawyer-con-

"Friends" in the loose sense of the term are everywhere. Some mean well but do not know what they are doing, while others are just looking after their own interests.

sultant, who concluded that we had made such a mess that he did not have sufficient contacts to undo it. Finally, we were introduced to the extremely capable—but ultimately untrustworthy—man who would come to our rescue, but later succumb to greed.

This last consultant taught me a lot about doing business in China. He showed me that a talented consultant can perform amazing feats, such as obtaining approval for a school quickly. Over three months, this consultant negotiated with all the parties involved until he confidently announced that he was approaching the end of his work and that we could expect our approval shortly. It was only at that stage that we learned just how close the technical high school was to the government officials. Following the principal's advice, the government insisted that we rent a certain building from him at an extortionate price. We never contacted the principal again.

A LEARNING EXPERIENCE

I learned a number of lessons from all of this. I came to understand that Chinese government officials may place as high a priority on preserving their own positions in the bureaucracy as on implementing the letter of the law. As in other highly bureaucratic societies and environments, including many large Western government agencies and companies, this usually means inertia rather than pure corruption, because it is always safer to do nothing than to take responsibility for action. In such cases, however, personal relationships can make a difference.

PRC government agencies may implement laws and rules flexibly depending on the situation, and—more important—the people involved. If you have good relations with the right people, laws and rules can be interpreted extremely liberally in your favor, or even changed on your behalf. Alternatively, it only takes one government official to delay or penalize your project. In the education business, one unhappy parent with good contacts can sue you, create bad publicity in the media, or cause unforeseen problems with the government.

But finding people with the right connections can be difficult. Those who say they are useful or well connected usually are not, while those who are modest often turn out to be extremely capable. "Friends" in the loose sense of the term are everywhere. Some mean well but do not know what they are doing, while others are just looking after their own interests. Once found, however, truly capable, trustworthy employees deserve special support and flexible human-resource policies. Finding the right people to manage operations and develop government relations should be a high strategic priority for any company in China, far more so than in many other countries.

Thus, I learned from my mistakes and from watching others—possibly the only way to truly understand how to do business in China. Throughout this lengthy and frustrating process, persistence, and the ability to admit and learn from mistakes, were crucial.

SECOND ATTEMPT: OLDER AND WISER

We started over, switched cities, and changed everything we did. We worked with our Chinese consultant, rather than a lawyer—this was one lesson we had learned early. We had previously tried to save money by staying at budget hotels and working for a swift conclusion to negotiations. This time, we acted as big as we could, staying in fancy hotels and making clear we were ready to stay for weeks, if necessary, to make a deal. We had also become more savvy about negotiating: at the beginning, we never spoke Chinese and allowed the potential partner to think we knew little about China and depended on them for everything. We promised the leaders of the local partner a trip to Singapore after the negotiations and approval—and kept this promise. We became very patient and comfortable with the Chinese negotiating pace, and set no deadlines, so that there was no pressure for speed. The consultant represented us so well that the new potential Chinese partner voluntarily sped up the negotiating pace.

In our search for a new partner, we focused on finding a high-ranking government body. We decided that our worries about government involvement were outweighed by the benefits of a government partner who could work the system to our mutual benefit. However, to ensure minimal interference and maximum management control, this government body had to be outside the education commission's system. As the body we eventually chose was not a school, there was no conflict in objectives and no desire on their part to manage the operation.

Choosing an entity higher than the education commission in the government hierarchy as we did meant we would have an easy time getting approval and dealing with all other government issues in the future. Finding such a partner was also a marketing coup—their status meant that Chinese students and parents were more likely to hold our institution in high esteem. Most important, the head of our Chinese partner was trustworthy, had solid relations with key government officials, and would be looking for work after he retired in two years. We assured him that there would be room for him on the staff of the new school, giving him an added incentive to make sure the project was successful.

NEW NEGOTIATING TECHNIQUES

Joint-venture schools require a dual-approval process. The first approval is the harder one and can take more than a year, if it comes at all. A careful reading of the relevant regulation, the Joint Venture Cooperative Schools Temporary Regulations, shows that a letter of intent can substitute for a contract when applying for the first approval. So we applied with a letter of intent before signing a contract and eliminated the most contentious part of the process. We purposely made sure that the feasibility study did not lock us into any potentially difficult commitments and carefully crafted the school bylaws, which were required submissions as part of the approval application. Throughout, we conveyed modest long-term ambitions for the joint venture to avoid arousing jealousy among

government officials who might have blocked our application.

We also worded our approval documents to indicate that the JV was only a first round of investment and that, if everything went well, we would invest more later. This reduced the required up-front capital to a manageable level. We structured our broad goals to match exactly those of the Chinese partner, but made sure we had control of both the board of directors and daily operations. (In China, control on paper does not always guarantee control of a venture's staff, funds, daily operations, and connections, so this by itself would not be enough to protect us in the long term.)

The first approval came about four-and-a-half months from the time we first approached the Chinese party. The Chinese partner did much of the work, and we could not have been happier with the result. They were not only powerful enough to push everything through quickly, they were eager and motivated to do so.

Once we had the key initial approval, we finalized the contract. Always receptive and friendly, we tried to write whatever the Chinese requested into the contract—as long as it did not affect our basic principles of control. Then we transferred the necessary funds and began renovating our space. The final approval came in a mere two months. The wording of this final document was especially important as it established our status and rights as a school. The document gave us among the best terms for such documents in the whole country. We are the first foreign school to have the right to open schools throughout a province without further approvals—other joint-venture schools only have approvals valid for one city—and do not need to register new companies (usually an expensive proposition).

We are also among the first foreign technical schools to offer students a four-year bachelor's degree, recognized at the province level, which enables all of our students to enter local job-placement markets (*rencai shichang*). Such markets are usually limited to students with state-backed college (2- or 3-year) or university (4-year) degrees. Those without such degrees are relegated to second-rate job markets.

Don't let your guard down

After our approvals came through, our very capable consultant turned greedy. He decided that a long-term relationship and more work from us or others to whom we might introduce him were worth less than the chance to make some quick money. He tried to convince our Chinese partner to help him hijack our school and its funds. But by this time, we were armed with experience and prepared for anything. We sent our previously chosen general manager to run the school at the appropriate moment, equipped with the right titles and authority—making it clear that she represented us and had our full support. We also emphasized to our Chinese partner her importance in running our school. Her actions over the next two months to counter the machinations of the increasingly desperate consultant proved again that the most valuable assets in China are capable and loyal employees.

My company now has one successful university running in China and is setting up a second one. Classes began in late September after an opening ceremony, which was attended by several top provincial officials, including a vice governor. In the first year, all students must study English intensively: 35 hours a week for 11 months. Then they must choose one of four majors leading to a bachelor's degree in a business or computer-related field.

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This term the school has 100 students, and has already surpassed its enrollment projections by 25 percent. Revenue is 37.5 percent higher than expected. Next year, we hope to have 200 students in this school and to open two more schools with 100 students enrolled in each. Within two years, we aim to have a presence in every city in eastern China, eventually establishing 20-30 schools. Our ultimate goal is to become the leading supplier and trainer—we also offer part-time and corporate training—for multinationals across the region. Our greatest chances for success lie in the excellent people working for us and in the fact that we now know how to manage both our operations, and relations with the government, well. 完

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American Architects in Hong Kong

US firms are in demand for commercial projects in Hong Kong, though their presence is small

Alex Lui

The return of Hong Kong's sovereignty to China in 1997 marked the end of the British colonial era. It was widely believed that following the lowering of the Union Jack, Great Britain's longstanding influence in Hong Kong would recede, making room for a greater presence of another Western power, the United States. Some observers assumed that hundreds of American companies that had been looking for opportunities in Asia would use Hong Kong as their operations base for the larger China market. Though this has been the case for US firms in the financial sector, it has not been so for US architectural services firms.

In fact, the economic downturn in East Asia has dealt a harsh blow to architectural consulting companies in Hong Kong. During the last 12 months most American architectural practices have downsized their Hong Kong offices, either sending staff to home offices or laying them off. Some offices have all but closed down, leaving behind only a small representative staff. Currently, there are only an estimated 20 US architectural firms in Hong Kong.

To see how American architectural firms are weathering the current economic downturn and to probe their future in Hong Kong, the Department of Architecture of the Chinese University of Hong Kong and the Hong Kong staff of the US Department of Commerce conducted a series of interviews with local and American architects, as well as local developers, in May 1999. The small sample represented the major players in the field, including three developers, three US architectural firms, a local architect who has worked with American architects, and an American architect who has worked extensively in Hong Kong.

The pre-crisis boom

One local developer pointed out that during the few years preceding 1997, the number of large American architectural firms working on Hong Kong projects actually increased. These included internationally renowned firms like Arquitectonica; Callison Architecture Inc.; Cesar Pelli and Associates Inc.; Hellmuth, Obata + Kasselbaum, Inc.; Kohn Pederson Fox Associates PC; Leo A. Daly International; RTKL International Ltd.; and Skidmore, Owings & Merrill International Ltd. (SOM). Joining forces with local associates, they worked on a variety of mostly commercial projects, including office buildings, private clubs, hotel and office interiors, shopping malls, and—to a lesser extent—special-use facilities such as convention centers, stadiums, and other institutional buildings. Increasingly, US firms have been involved in projects on the mainland, including the Jin Mao Building, the Shanghai Plaza, the Shanghai World Financial Centre, South Pacific Plaza, Union Square, Shanghai Space City, and the Grand Gateway, all in Shanghai, as well as Bank of

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China buildings in both Shanghai and Beijing.

Although the interviewees unanimously projected a positive long-term future, they had a far less optimistic business outlook for the next six months to a year. American firms, along with their local counterparts, have had to make painful adjustments to their business plans to ride out the economic storm. Apart from reducing staff, firms have had to cut salaries, rely more on part-time staff, and consolidate departments.

Historical Precedent

The presence of foreign architects in Hong Kong dates back to the colonial and pre-World War II years, as evidenced by firms such as Palmer & Turner (recently renamed P&T Architects and Engineers Ltd.) and Leigh & Orange Ltd. Though they were originally British firms, they are now considered local. (Leigh & Orange was founded in 1874 in Hong Kong, while P&T has over 130 years of experience in Asia.) Firms with strong British and Commonwealth influence also proved to be very successful during the postwar years, securing commissions for major government projects, large foreign companies operating mainly in Hong Kong (*hongs*), banks, and institutions. This tradition persisted to the end of and beyond the colonial era with the arrival of a new generation of prominent British architects, notably Sir Norman Foster and Terry Farrell.

Large American architectural firms like SOM arrived in the late 1970s and early 1980s to work on large commercial projects. Unlike their British counterparts, they were first brought in by local developers, who recognized American expertise in designing commercial buildings. However, some of these firms have been in Hong Kong only intermittently. One developer, who has several US architects working on his current projects, noted that American architects' interest in the Hong Kong market fluctuates with the US economy. When the US economy is down, more American architectural firms tend to come to Hong Kong, but when the US economy is thriving, they tend to concentrate on their home market. Under current economic conditions, it is not surprising to see major US firms withdrawing from Hong Kong.

High operating costs have made it difficult for most of these firms to maintain offices in Hong Kong. Many firms thus justify the expense of a local office by using it as a regional center to serve not only Hong Kong, but also mainland China and Southeast Asia. These offices handle a variety of activities ranging from business development, liaison work, and coordination to project design and production.

When asked about the reasons for choosing Hong Kong over other Asian locations as its base, an American firm in Hong Kong for many years pointed to reliable and convenient communication systems (both electronic and physical); ready access to international banking and legal services; a high-quality, experienced, and sophisticated local work force; and the ease of reaching any part of China. This particular firm decided to withdraw from Hong Kong—a decision it now regrets and has since reversed. The company has pledged to keep its Hong Kong office open over the long term despite the current condition of the Asian and US economies, which would seem to be pushing it back home in the short term.

This view of the importance of a strong local presence is also shared by many Hong Kong developers, who treasure long-term working relationships with their architects. In particular, they appreciate prompt, responsive, direct, and dependable services. Architectural firms that show a strong commitment to the market by staying in business and continuing to serve their clients during lean years have in the past reaped the rewards in the form of steady projects and repeat business once the economy recovers. Another developer of high-class offices in Hong Kong said that the single most important factor his company uses in choosing an American over another architectural firm is a strong local presence. He believes that a full-service local office plays a key role in the effective delivery of professional services. A local office acting merely as a courier for the main office in the United States would not be acceptable.

The Draw of American Expertise

When local developers are asked why they hire US architects, most respond that the single most important factor is American expertise. Such expertise is partly the result of the globalization of commercial architectural design. But American firms' appeal also stems from the international nature of Hong Kong, especially its position as a major financial center. One developer has observed that prospective tenants often demand commercial offices that match top American standards. US architects, who have gained abundant experience from their work on similar projects at home and in other parts of the world, are more likely to achieve such standards.

When local developers are asked why they hire US architects, most respond that the single most important factor is American expertise.

Moreover, many international corporations no longer make their leasing decisions in their Hong Kong offices but in their US headquarters. It is therefore natural that American firms are considered favorably for overseas projects. Another developer cites the Hong Kong shopping public's sophistication and desire for stimulating shopping environments and state-of-the-art shopping-mall design. Again, the American architects' experience building such malls at home has been crucial to their success in securing these kinds of design projects.

It seems that regardless of project size, American expertise has been the key to US architects' success in winning these jobs. One American architect admitted having an edge over local interior design firms since he could show his prospective clients the interiors of hundreds of lawyers' offices worldwide, all done by his company's branch offices. The cumulative experience from such a large portfolio of projects allows him to offer his clients expert advice that no local interior designer can match.

The Hong Kong Market

Many interviewees told similar success stories. But considering the expertise of US firms and the popularity of American design, their local market

Considering the expertise of US firms and the popularity of American design, their local market share has been surprisingly small.

share has been surprisingly small. The interviews indicate a consensus among developers and local and American architects that the total market share, measured in dollars, of all foreign architectural firms is less than 10 percent of the total architectural consulting workload. Apparently, although American architectural firms have been more successful in breaking into the higher-end commercial markets, they have generally been less successful in accessing other sectors, such as housing, which provide the bulk of local architectural work.

For example, more than half of the local development volume consists of residential buildings, and most of them are high-rise, high-density developments due to the territory's high land prices. Some American architects interviewed admit that they are uncomfortable handling residential projects in Hong Kong, since they remain unfamiliar with local market trends and complicated code requirements. In addition to codes based on natural lighting and ventilation, there are multiple regulations and provisions—building and zoning codes, land-lease conditions, building height limits for aviation, and environmental standards—all of which may impose different maximum allowable development of a given lot.

One developer who has used a number of American architects on commercial projects thinks that designing residential buildings for the local market is not an area of strength for American architects. A primary reason is that these architects' services are usually more expensive than their local counterparts. In residential building design, higher fees may not necessarily bring added value to the end product, since American architects are generally less responsive than local ones to ever-changing market trends. Some of these changes are due to new regulations, but the majority result from specific consumer demands concerning, for instance, ceiling height, kitchen and bathroom design, utilization of tight interior spaces, furniture size and layout, the size of various rooms, and demand for amenities such as parking and recreation facilities.

Yet another American architect, who has recently left the Hong Kong office of a prominent US firm, attributed the reluctance of his former company to enter the local market to the head office's marketing strategies. The firm's preoccupation with maintaining an upscale international image led to its decision not to pursue any less-than-prestigious projects in Hong Kong. As a result, after more than a decade in Hong Kong, the number of local projects handled by this firm has remained relatively small.

Cooperation with local firms

When it comes to collaboration between the American firms and their local architectural associates, local developers hold a range of opinions. One developer said he would prefer to see both parties working as a team throughout the development process, from the inception stage through design and construction to project completion. This developer believed that only this approach could ensure the realization of high-quality design in the completed building.

Another developer tends to involve American architectural firms only during the early stages of schematic design to help generate new and creative design concepts. After this stage, the project is usually taken over by local architects who are responsible for design development, the preparation of production drawings, submissions, and the administration of building contracts. His company has divided duties between the American and local architects to ensure a smooth design and development process—an important factor in keeping costs and scheduling under control.

Local barriers

In general, large American firms have been slow to localize. Yet there have been numerous examples of foreign firms localizing and then emerging as strong local players—particularly among smaller US firms, which are nearly all staffed locally. Among those interviewed, at least one major American architectural firm has expressed interest in hiring local professionals to handle issues like code requirements and market trends. The firm based this decision on its strong confidence in Hong Kong's long-term economy and the company's staying power in the local market.

The Hong Kong economy now seems to have bottomed out, and the developers interviewed cite the recent stabilization of property prices as a sign of economic recovery. One developer pointed to the persistence of a long-term, continuous growth pattern despite short-term instability. As a measure of his confidence, his company recently began a multimillion-dollar, high-class office-redevelopment project in Hong Kong's Central District, despite the current oversupply of office space.

But the market is still rather quiet at the moment, and the future is uncertain. Some local architects think the worst is over, but that it may take another year or two for the market to recover fully. While the time of great windfall profits for developers is gone, the stabilization following the current consolidation will lead property prices to appreciate moderately in line with economic growth. In short, a healthier property market is likely. Because endusers dominate the market, buyers will look for buildings of good quality design, and architects and developers will have to produce high-quality buildings to withstand stronger competition and satisfy demand.

After some restructuring, the remaining American architectural firms in Hong Kong seem prepared to take on new challenges. The fact that their market share has been limited implies that they have much room to grow. New opportunities are already on the horizon—The Walt Disney Co. is currently considering a facility in Hong Kong, and major tourist and commercial developments are planned for the old Kai Tak Airport site. When China eventually joins the World Trade Organization, the amount of business between China and the United States and other Western countries will grow, bringing further opportunities for American architectural firms, especially those that have weathered the current storm. 完

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Commerce Made Easier?

New regulations firm up the rules for foreign investment in commercial enterprises in the PRC

Andreas Lauffs and Stephen Lin

China welcomes foreign direct investment in production enterprises but tightly controls foreign investment in domestic and PRC-foreign commerce. New regulations may ease the restrictions on foreign players trying to access China's retail and wholesale markets.

The Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and the State Economic and Trade Commission (SETC) promulgated the Measures Concerning Pilot Projects for Commercial Enterprises with Foreign Investment (the Measures), which took effect on June 25, 1999. The Measures make significant changes in rules on foreign majority ownership of commercial enterprises and also expand the permitted geographic scope for retailing. Despite these few steps forward, however, the Measures do not represent a complete liberalization of trade in the PRC.

EARLY STEPS

Foreign-invested enterprises (FIEs) may sell products they manufacture but not products manufactured by any other party, including parent companies and subsidiaries (*see The CBR*, January-February 1998, p.43). Thus, companies' foreign-made products must be distributed through authorized foreign-trade corporations.

The 1992 State Council Provisional Regulations on Foreign Investment in the Retail Business in China permitted the establishment of Sino-foreign retail joint ventures (JVs) on a trial basis in a limited number of cities. Regardless of the total amount of investment, such retail JVs had to be approved by the central government. The State Council regulations specifically prohibited them from engaging in commercial wholesaling or import-export agencies.

The central government has approved approximately 20 retail JVs. In violation of the State Council regulations, however, local authorities have approved at least 277 retail joint ventures. To deal with these entities, the State Council initiated a screening and rectification process in 1997 that has yet to be completed. The Measures do not deal with this problem (many retailers are too small to qualify under the new regulations) but they will likely affect the State Council's decision on the future of locally approved retail JVs.

NEW REGULATIONS...

The Measures apply to "commercial enterprises" (CoJVs)—without defining this term—and cover retail JVs, wholesale JVs, retail JVs with wholesaling as a sideline business, convenience stores, specialty stores (*zhuanye dian*), and single-brand stores (*zhuanmai dian*). The Measures appear to apply only to enterprises that sell goods, not to those that sell services. Restaurant chains and service industries such as photo shops and laundromats are not covered. Small hotel shops also are not governed by the Measures, as such shops are usually approved as part of the hotel project approval.

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The Measures also contain special rules for CoJVs that have more than one store. CoJVs may operate as chain stores, provided that the stores are organized as branches of the JV, with each branch directly invested in and operated by the JV partners. The Measures prohibit the establishment of "voluntary chain stores," a form in which each store has different owners, and franchise operations. Other operational forms of CoJVs, such as contract management or leasing, also appear to be prohibited. These commercial enterprises may be established in the form of Sino-foreign equity JVs or cooperative JVs, but not as wholly foreign-owned enterprises.

...REVAMP RETAILING

The Measures also institute changes regarding retailing JVs. CoJVs may now be established in all provincial capitals, the capitals of autonomous regions, municipalities directly under the central government, municipalities with independent development plans, and Special Economic Zones (SEZs)—representing a significant departure from previous regulations, which permitted foreign investors to set up joint ventures only in six coastal cities and the SEZs. Thus, CoJVs may now be set up in strategically important cities such as Chengdu, Sichuan Province; Nanjing, Jiangsu Province; Shenyang, Liaoning Province; and Wuhan, Hubei Province.

Although the Measures do not institute a quota, SETC and MOFTEC officials have indicated that typically only one or two retail JVs will be approved in each pilot area. Certain major cities may be allowed to have three or four ventures. It is not clear whether the numerical restriction also will apply to branch stores. This policy will likely lead to intense lobbying by foreign investors for the right to establish CoJVs or branches in certain cities, and it pressures investors to act quickly before the unofficial quota is used up.

Capitalization and qualification requirements for retailing are less strict than those for wholesaling. To take part in a retail CoJV, a foreign investor must have an annual turnover of $2 billion in the three years before application, $200 million worth of assets in the year before application, and an extensive international sales network. These requirements support an unwritten Chinese policy to attract only major players. However, the threshold is significantly lower than that for foreign-trade JVs, which are governed by the 1996 Provisional Measures Concerning the Establishment of Pilot Sino-Foreign Equity Joint Venture Foreign Trade Companies. In a foreign-trade JV, the foreign party must have a total business volume of $5 billion, an average trade volume with China of $30 million, and either a representative office in China for three years or $30 million invested in China.

The Chinese investor must be experienced in the distribution of goods but need not be a commercial enterprise. It must have recorded average annual sales of ¥300 million ($36.3 million) for the three-year period prior to application, and report assets of ¥50 million ($6 million) one year before applying. The required levels for firms located in the poorer areas of central and western China are lower, however, at ¥200 million ($24.2 million) and ¥30 million ($3.6 million), respectively.

Most retail CoJVs must have at least ¥50 million ($6 million) in registered capital, but those located in underdeveloped regions require only ¥30 million ($3.6 million). The threshold is low for supermarkets or wholesale markets and may indicate that CoJVs may lease land and buildings but are not expected to invest heavily in real estate. In comparison, foreign-trade JVs must have a registered capital of at least ¥100 million ($12 million).

In the past, the Chinese partner had to "hold a controlling interest or occupy a dominant position." The Measures permit the foreign party to hold up to 65 percent of the registered capital in convenience chain stores, specialty stores, and single-brand chain stores, regardless of the number of chain stores. The foreign party may also hold majority interest in supermarket-type retail JVs that have no more than three branch stores.

In supermarket-type retail JVs with more than three branch stores, the Chinese party normally would contribute at least 51 percent of the registered capital—the same requirement as for foreign-trade JVs. The foreign party may hold a controlling interest if MOFTEC and SETC determine that the joint venture's business record is relatively good; the foreign party has already purchased large amounts of goods from China; and the retail JV is able to use the foreign party's international marketing network to expand PRC exports. This last condition is especially worrisome for foreign investors. MOFTEC officials have indicated that the foreign party must promise to export an increasing amount of Chinese products, raising the prospect that an export quota could be imposed on the CoJV. The Measures effectively link market access in China with the promotion of Chinese products abroad, echoing a past policy that made access to the Chinese consumer electronics market dependent upon the transfer of advanced technology.

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Internal MOFTEC regulations of November 1996 reportedly provided that CoJVs may establish several branch stores only in Beijing (or Shanghai), but not in other locations. The Measures are silent on this issue. Different opinions apparently exist among the various government bodies in Beijing. The majority opinion appears to be that CoJVs with chain operations may establish branches in any pilot area, subject to approval. However, should what appears to be the minority opinion win, foreign investors would be forced to establish separate joint ventures, probably with different local parties, in different parts of the country.

In any event, the establishment of each CoJV and of each branch is subject to central-government approval. Local authorities do not have the right to approve CoJVs or their branches. In this sense, the Measures are no more liberal than the 1992 State Council regulations.

The Measures permit the establishment, for the first time, of wholesale joint-venture enterprises in China

A STEP FORWARD...

In contrast, the Measures do extend beyond the State Council regulations with regard to trading rights of retail JVs. Retail CoJVs now may engage in "commercial retailing" (*shangye lingshou*), not just in "retailing general merchandise" (*baihuo lingshou*) as under the State Council regulations. Retail CoJVs may also engage in sales on both an agency and a commission basis.

As under the previous regime, retail CoJVs have import and export rights, but are not permitted to act as import-export agencies. And retail JVs still may not import more than 30 percent of their turnover in any given year. They may, however, "engage in the business of organizing the export of domestic products." While the exact meaning of this provision is unclear, this right appears to mirror the general obligation of all CoJVs "to promote the export of China-made products" (Article 3) and the specific obligation of retail JVs with foreign majority ownership "to further expand the export of Chinese products" (Article 6, Section 4).

These provisions overlap somewhat with the business scope of foreign-trade JVs under the 1996 regulations. A foreign-trade JV may import and export goods or technology either for itself or as an agent. The ability of CoJVs to export is significant in two respects. First, in foreign-trade JVs, the Chinese party must have a majority. In a CoJV, the foreign party may hold majority interest. Second, the ability and willingness to export may help a foreign partner gain approval to hold majority ownership in a CoJV.

The Measures could provide a platform for the marketing and sale of FIE products manufactured abroad. For example, a producer of widgets could establish a CoJV with branches in many pilot areas. These stores could then sell the widgets produced by the foreign parent, by FIEs, and by unrelated companies. However, the drafters of the Measures apparently did not consider such a possibility, and MOFTEC officials have opined that approval for such activities could be granted only on a case-by-case basis.

In the meantime, FIEs still face restrictions selling products manufactured by the foreign parent company or by another FIE in which the foreign parent has invested. This restriction interferes with the ability of a company to offer a whole range of products to its customers if it produces only a few of them itself. The restriction also prevents a foreign investor with multiple FIEs in China from merging its sales forces or other functions under one umbrella.

Holding companies may provide solutions to some of these problems. Under supplementary MOFTEC regulations issued on August 24, 1999, holding companies may now sell products manufactured by FIEs in China. However, holding companies are still not permitted to sell imported or third-party products manufactured in China, although they may export third-party products.

Trading companies established in bonded or free-trade zones in practice are used as vehicles to sell foreign-made or even PRC-made products in China. However, legally the business scope of such companies excludes domestic trade: sales into China of foreign-made products must be handled through an authorized import-export company, and sales in China of PRC-made products are legally possible only after the products have been exported into a bonded zone.

...OPENS THE DOOR FOR WHOLESALERS

The Measures permit the establishment, for the first time, of wholesale joint-venture enterprises in China. According to SETC Vice Chairman Chen Bangzhu, one wholesale CoJV will be approved in each of the municipalities of Beijing, Shanghai, Tianjin, and Chongqing. The Measures also permit retail JVs to engage in wholesaling as a sideline business.

Participation in such activities is subject to the fulfillment of stringent requirements, however. To qualify as a foreign partner in a wholesale JV, a company must record average annual sales of $2.5 billion in the three years prior to application and hold assets of $300 million the year before applying. The minimum registered capital for wholesale ventures is ¥80 million ($9.7 million) and ¥60 million ($7.2 million) in poorer regions. Moreover, the Chinese party must hold at least 51 percent of the registered capital, regardless of the size of operations.

A STEP BACK?

Earlier internal MOFTEC regulations limited chain licenses to Beijing and Shanghai, but the Measures do not include such restrictions. SETC's vice chairman has reportedly said that CoJVs with chain-store operations will be approved only in certain economic and trade centers, the most important of which are Beijing, Shanghai, Tianjin, and Guangzhou.

Moreover, the Measures impose a new restriction limiting royalties to the foreign party under a trademark- or trade-name-license contract and/or a technology-transfer contract to 0.3 percent of the joint venture's sales (net of value-added tax) during the year concerned, for a maximum term of 10 years. No such restriction existed under the 1992 State Council regulations.

Foreign investors often provide various kinds of services to their retail JVs. Some of them, such as software-license contracts, may be considered technology imports (even if they use different terminology) and thus be subject to the 0.3 percent rule. Other services, such as those related to the construction of stores, appear to be permitted under the Measures, but may be subject to restrictions set forth in other laws and regulations.

A WTO TOOL?

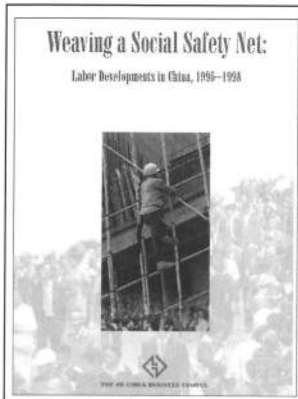
The Measures represent a cautious initial attempt by the PRC government to open domestic trade to foreign investment, almost as a test run of World Trade Organization (WTO) concessions. The substantial expansion of the number of cities in which commercial enterprises will be allowed to operate, the permission for foreign majority ownership in certain retail JVs, the introduction of wholesale JVs, and the relaxation of the rules on chain stores are all positive moves.

But the high capitalization requirements, the linking of market access with export commitments, virtual quota restrictions, and the perpetuation of the requirement for central-government approval all dampen hopes that China will really open its commercial sector to foreign firms. The PRC

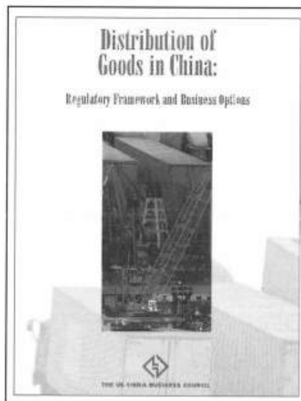
government celebrated the 1996 rules permitting the establishment of foreign-trade JVs as proof that foreign trade is open to foreign investment, but fewer than 10 foreign-trade JVs have been approved to date, and the few that operate do not play an important role in the market. Thus it remains to be seen whether the Measures are a serious attempt to liberalize the domestic trade sector, or whether they are merely a political tool intended to help China gain access to the WTO.

During WTO negotiations with the United States last April, China offered to permit full trade and distribution rights for both imported and PRC-manufactured goods within a certain period of time upon accession. Though the two sides have disputed the length of the phase-in of this provision, if China accedes to the WTO, the Measures will become history within a matter of years. Time will tell! 完

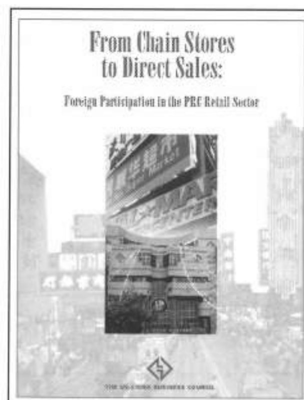
Other publications by The US-China Business Council



Weaving a Social Safety Net:
Labor Developments in China, 1996-1998
February 1999
(USCBC members $25, non-members $75)
How China's social insurance reforms affect foreign firms.



Distribution of Goods in China:
Regulatory Framework and Business Options
June 1998
(USCBC members $25, non-members $75)
How foreign firms navigate the PRC's distribution system.



From Chain Stores to Direct Sales
November 1997
(USCBC members $25, non-members $75)
Foreign participation in the PRC retail sector.

Tianjin Economic Zone Introduces Itself to Members

Li Yong, chairman of the Tianjin Economic and Technological Development Area (TEDA) addressed Council members at a September 13 luncheon. He emphasized how TEDA can help companies obtain government approvals, that it can assist in intellectual property dispute resolution, and that it offers foreign investors a money-saving supply network. Member companies expressed interest in TEDA's Internet infrastructure, the zone's benefits for service providers, and its role in the success of other foreign companies in China.

Council Holds Y2K Breakfast in Shanghai

Member-company representatives discussed their year 2000 preparations over breakfast on September 10 in Shanghai. I-Lin Chow, Y2K manager for IBM China Co., Ltd. and a member of the Shanghai Y2K Group, focused on contingency planning in her speech to representatives.

Council Hosts NPC Delegation in Washington

The first-ever Sino-American inter-parliamentary exchange took place in Washington, DC, in late October. In connection with the event, the Council held a luncheon and discussion among delegates of the PRC National People's Congress (NPC), its advisers, and member-company representatives. The Honorable Zeng Jianhui, chairman of the NPC Foreign Affairs Committee, spoke briefly on his hopes for the success of the exchange. Elizabeth Schwartz, director of Congressional Affairs for The Boeing Co., and Richard Holwill, director of International Affairs for Amway Corp., welcomed the delegation on behalf of the Council and its members and wished it success in improving communication between the US and PRC legislatures.

Minister of Finance Talks Reform

Minister Xiang Huaicheng spoke to member-company representatives on September 28 in Washington, touching on a number of issues of concern to foreign investors. He addressed China's overall economic development, including tax issues and the slowing pace of economic growth.

THE US-CHINA BUSINESS COUNCIL

CHINABUSINESS2000

Trends & Market Opportunities

Friday, January 28: Boston
Monday, January 31: San Francisco
Tuesday, February 1: Silicon Valley

A Members and Prospective* Members Roundtable Discussion

Featuring . . .

Sheila Melvin, The US-China Business Council, Director, Shanghai Office
Patrick Powers, The US-China Business Council, Director, China Operations, Beijing Office

. . . And examining . . .

China's current investment climate and Chinese thinking on attracting investment
Prospects for business in China's Tenth Five-Year Plan (2001-2005)
Appropriate trade and investment strategies in the current period and the longer term

*US Companies with commercial interests in China/Hong Kong SAR

Trade Compass, Shanghai Government, and Foreign Investment

www2.tradecompass.com Trade Compass is a Washington-based e-commerce company offering a wide range of publications and services, including notification of trade contacts and leads, sales and marketing tools, market research and analysis, and logistics. While a surprising amount of material is available at no cost, other services are available for a monthly fee. The Free Plan allows access to several briefs and newsletters on issues affecting international trade, sailing and air cargo schedules, and access to—and a basic listing in—the National Export Offer Service, which helps exporters find international buyers. The Silver Plan, at $24.95 per month, includes everything in the Free Plan, as well access to STAT-USA Plus—which contains market research information, trade opportunities, and economic statistics from over 50 US government agencies, US laws and regulations, and an export readiness assessment. The Gold Plan costs $49.95 a month and includes everything in the Silver Plan plus access to Basic World Trade Analyzer—a database of import and export transactions worldwide—and a National Export Offer Service premium listing.

www.mogpa.com Minnesota Organization for Global Professional Assignments is a nonprofit organization that links US college students and recent graduates with companies in Japan and China. Participating students are assigned full-time, entry-level positions for 6-12 months. The site posts information for students and companies interested in the program.

www.cninfo.com.cn/main_eng.html Great Trend Internet Services, created by Shenzhen Securities Information Co. Ltd., offers information on the Shenzhen Stock Exchange, daily market statistics, real-time quotes, and profiles of both A- and B-share listed companies. To access most of this information, visitors must pay up front ¥100 ($12) per month, for a minimum of three months.

www.shanghai.gov.cn At the official site of the Shanghai government, visitors can find information about foreign business, trade, industry, and commerce in Shanghai. The site also features material on the city's government, laws, and economy, as well as its legal, housing, and education systems.

www.apecsec.org.sg The official Asia Pacific Economic Cooperation website contains information about the organization, its member economies, and its activities. The site's business center provides a wide range of information and services, including an APEC Tariff Database, an investment guide, and labor market information. Visitors will also find a virtual library, publications, databases, and links. Most of the site's services are free.

http://newton.uor.edu/Departments&Programs/AsianStudiesDept/macau.html The Macau WWW Virtual Library features information about Macao's upcoming handover, government, business, economy, newsmedia, politics, society, history, and culture. Hosted by the Asian Studies Department of the University of Redlands in California, the site is part of the East Asian WWW Virtual Library.

www.asiasource.org The Asia Society's latest site is a good resource for news and information on arts, culture, business, economics, policy, government, society, and history for all of Asia. The most unusual feature of this site is its database of experts, searchable by country, language, and area of expertise.

www.worldbank.org/prospects/gdf99/vol1.htm; www.iif.com/publicpdf/cf_0499.pdf The World Bank and the Institute for International Finance have released *Global Development Finance 1999* and *Capital Flows to Emerging Market Economies*, respectively. The World Bank report contains a section on East Asia and the Pacific. Both reports are in Adobe's portable document format (.pdf) for viewing and downloading. Visitors can also find more Asia-specific information at **http://wbln0018.worldbank.org/eap/eap.nsf**, where they can access *1999 Annual Report on East Asia and Pacific* and *East Asia: Recovery Begins*, a quarterly regional update.

Chinese sites

www.chinainfobank.com PRC-based China Infobank, an online business information services company, features a database with seven years' worth of business articles, real-time news, and a worldwide financial information service. The site has excellent search engines, allowing the visitor quick access to information. The databases contain both English- and Chinese-language publications, but the Chinese databases are much more extensive. Interested viewers must contact the company to receive details on an annual subscription.

www.beijing.gov.cn/chinese The Chinese version of the Beijing Municipal Government site contains a wealth of information for residents and visitors. Weather and air quality forecasts, local news, and general information about the city can be found on the site. Links to various institutions in the city and district governments are also featured. Best of all, citizens of Beijing can now e-mail their mayor directly, but they must be sure to leave their telephone number or e-mail address if they want a reply.

www.cpn.org.cn At Capital Price Net, visitors can find prices for a wide range of items, from public transportation and water-use charges to highway tolls and entrance fees for Beijing parks. The site also shows local consumer and retail price indices by year from 1985 to the present, and for each month of the current year.

—Virginia Hulme

Jessica Huang

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 *July 15 - September 15, 1999*

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

Accounting and Insurance

INVESTMENTS IN CHINA

Colonial Mutual Group (Australia)/China Life Insurance Co. (Shanghai)
Will form China Life CMG, a joint-venture life insurance company in Shanghai. $2.5 million. 8/99.

Advertising and Public Relations

OTHER

SDL International (UK)
Established new office in Beijing offering translation, desktop-publishing, engineering, and project-management services. 9/99.

Agricultural Commodities and Technology

CHINA'S INVESTMENTS ABROAD

PT Cipendawa Enterprise (Indonesia)/NA
Will form strategic alliance with Chinese fishing company to benefit from its facilities and experience. (Indonesia:72%-PRC:28%). 9/99.

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.

Banking and Finance

OTHER

European Investment Bank
Will provide Chengdu Generale des Eaux Marubeni, a joint venture between France's Generale des Eaux and Japan's Marubeni Corp., with financing for engineering, procurement, construction, and operation services in connection with its build-operate-transfer water-supply project in Sichuan Province. $26.5 million. 9/99.

Bank of America, Imperial Bank (US)/China Construction Bank (Beijing)
China Construction Bank received loans from US banks to help monitor air-pollution projects in Tianjin Municipality, Shaanxi and Hubei provinces, and Guangxi Zhuang Autonomous Region. $5.11 million. 8/99.

Bank of Tokyo-Mitsubishi Ltd. (Japan), Morgan Stanley Dean Witter (US)/SINOPEC, China International Capital Corp. (CICC), a joint venture between Morgan Stanley Dean Witter and China Construction Bank
Morgan Stanley and CICC will act as global coordinators for SINOPEC's IPO. $5 billion. 8/99.

Citibank, a unit of Citigroup (US)
Signed agreement with Bank of Communications to receive loans in order to lend in RMB. $6.04 million. 8/99.

Dresdner Bank AG (Germany)
Established branch in Pudong New Area, Shanghai. 8/99.

Exterior Trade Bank (France)
Established branch in Pudong New Area, Shanghai. 8/99.

International Bank (Spain)
Established branch in Pudong New Area, Shanghai. 8/99.

Moody's Investors Service Inc. (US)/Dagong Global Credit Rating Co. Ltd. (Beijing)
Signed cooperative agreement to develop a rating system for China's domestic market. 8/99.

National Bank (Ukraine)/Bank of China (Beijing)
Bank of China will help National Bank pay an overdue debt payment to another bank. $30 million. 8/99.

Citibank, a unit of Citigroup (US)
Connected bank-card network to Shanghai's automated teller network through the Shanghai Golden Card Network. $3.6 million. 7/99.

Citibank, a unit of Citigroup (US)
Set up representative office in Sichuan Province. 7/99.

John Hancock Mutual Life Insurance Co. (US)
Invested through ChinaVest, a partnership investment fund, to provide entrepreneurs with capital. $15 million. 7/99.

World Bank
Funded China Pension Reform Project in Heilongjiang and Shandong provinces to develop and improve pension management. $5 million. 7/99.

Chemicals, Petrochemicals, and Related Equipment

CHINA'S EXPORTS

Zhenhai Refining & Chemical Co. (Zhejiang)
Exported 34,000 tons of jet fuel to Los Angeles, California. $42 million. 7/99.

CHINA'S IMPORTS

Industrial Rubber Innovations, Inc. (US)
Signed agreement with Shenzhen Yujiang Trade Ltd. in Guangdong Province to hand over exclusive distribution rights of all high-performance rubber products. $4.3 million. 8/99.

INVESTMENTS IN CHINA

Solucorp Industries Ltd. (US), Smart International (Hong Kong)/Bohai Chemical Group Co. (Hebei)
Signed multi-part agreement to initiate first heavy-metals cleanup in China. $1 million. 9/99.

BASF AG (Germany)/SINOPEC
Set up joint venture to establish integrated chemical production site in Nanjing, Jiangsu Province. (Germany:50%-PRC:50%). $2.9 billion. 8/99.

Toray Industries Inc. (Japan)/China Yizheng Chemical Fiber Group Ltd. (Jiangsu)
Will jointly produce polyester film. (Japan:50%-PRC:50%). $25.2 million. 8/99.

Albemarle TCI Ltd., unit of Albemarle Corp. (US)/Beijing Yanhua Petrochemical Co. Ltd.
Formed joint venture to make agricultural chemical intermediaries. 7/99.

Dead Sea Bromine, subsidiary of Israel Chemicals/Shandong Haihue Group
Will form joint venture to produce flame retardant and other bromine compounds in Weisang, Shandong Province. 7/99.

Rhein Chemie Ltd., Bayer AG (Germany)/Red Star Chemical Group Corp., a subsidiary of Qingdao Kailian Group Ltd. (Shandong)
Formed joint venture to operate rubber-processing plant. $22 million. 7/99.

Rhein Chemie Rheinau GmbH, subsidiary of Bayer AG (Germany)
Opened a predispersions plant in Shandong Province. 7/99.

OTHER

Linde AG (Germany), Linde Impianti Italia SpA (Italy)
Won contract with Lilin Chemical Industrial Group for the engineering and supply of equipment, materials, technical services, and licenses for an ammonia plant in Jilin Province. $144 million. 8/99.

Consumer Goods

INVESTMENTS IN CHINA

Seita (France)/Nanyang Brothers, Shanghai Industrial Holding Ltd.
Formed joint venture to increase cigarette sales in China through Nanyang Brothers' distribution networks in Beijing, Shanghai, and Guangdong Province. 9/99.

Ovonic Battery Co. Inc., Energy Conversion Devices Inc. (US)/Rare Earth High-Tech Co. Ltd., a unit of Baotou Steel Co. (Inner Mongolia)
Signed agreement for nickel-metal-hydride battery projects in Inner Mongolia. $100 million. 8/99.

US COSTCO/China Normart Enterprise Corp. (Beijing)
Established a joint retail-store chain in Beijing. 8/99.

Asahi Breweries (Japan), NA/Tsingtao Brewery Co. Ltd. (Shandong)
Will launch joint venture to build brewery in Shenzhen, Guangdong Province, with a production capacity of 100,000 tons. (Japan:29%-PRC:51%-NA:20%). $84 million. 7/99.

P&G (Guangzhou), subsidiary of The Procter and Gamble Co.
Will acquire the 6 percent of shares held by the Chinese partners, Guangzhou Soap Factory and the Import & Export Trade Corp., to assume full ownership. 7/99.

OTHER

BAA International, unit of BAA Plc (UK)
Won bid for five-year contract to operate two fragrance and cosmetic duty-free shops in Shanghai's Pudong International Airport. 8/99.

Electronics and Computer Software

CHINA'S IMPORTS

Infowave Software, Inc. (Canada), Tectona Electronics, Inc. (Canada/Taiwan)
Signed distributor agreement with Tectona Electronics for exclusive rights to sell Infowave's Powerprint software in the PRC. $2 million. 9/99.

Symbol Technologies, Inc. (US)
Won contract to supply its two-dimensional bar-code symbology to secure all bank drafts throughout China in partnership with Tianjin Guard Group (Hebei Province). $100 million. 9/99.

Zi Corp. (Canada)
Signed licensing agreement with Sichuan New Tech Digital Equipment Co. to provide input technology for set-top boxes in China that will allow access to the Internet using Chinese characters on remote controls. 8/99.

Zi Corp. (Canada)
Granted license for Multi-language Smart Text Input Software for set-top boxes to the MII's Research Institute of TV and Electro-coustics. 7/99.

INVESTMENTS IN CHINA

Jabil Circuit, Inc. (US)
Completed its acquisition of GET Manufacturing Inc., a China-based electronics manufacturing service provider. $243 million. 9/99.

C&D Technologies, Inc. (US)
Completed acquisition of the 67 percent foreign share of Dynasty Division, a Shanghai-based industrial-battery joint venture, previously owned by Johnson Controls, Inc. of the United States. 8/99.

Texas Instruments (US)/Legend Group (Beijing)
Jointly developed a digital subscriber line modem for client applications. 8/99.

MyWeb Inc.com (US)/Qingdao Hai'er Computer Co. Ltd. (Shandong), Beijing Telegraph Administration, a subsidiary of China Telecommunications Co.
Will jointly develop and promote television set-top boxes. $100 million. 7/99.

Sony Corp. (Japan)/Shanghai Radio and Television Holding Co., Shanghai Vacuum Electronics Co.
Launched joint venture to manufacture televisions and computer monitors for export to the US and Japanese markets. $410 million. 7/99.

OTHER

Legend CA, joint venture of Computer Associates International, Inc. (US)/The Legend Group (Beijing)
Announced development of Wen Deng, an integrated software solution for developing e-business applications. 9/99.

Avnet Electronics Marketing, a unit of Avnet Inc., Global Techsmart (US)/ChinaNet (Beijing)
Signed contract under which GTMart will develop an Avnet EM Chinese-language website accessible to users via GTMart's site on ChinaNet's homepage. 8/99.

Legend Holdings (Beijing)
Won loan from World Bank to promote technology reform in China's tax administration system via purchase of systems-integration software and hardware. $30 million. 8/99.

IBM China Co. Ltd., a unit of IBM Corp. (US)/Xi'an Shida Telecommunications Co. Ltd. (Shaanxi)
Signed agreement to cooperate on developing business intelligence and e-business solutions suitable for the Chinese market. 7/99.

Netscape Communications, a subsidiary of America Online Inc.
Announced the availability of enhanced Chinese Netcenter Internet portals with localized content and services integrated with Netscape Chinese Language Browser. 7/99.

Engineering and Construction

OTHER

Gammon Construction Ltd. (Hong Kong), unit of Kvaerner ASA (UK-Norway)
Won contract to construct the Hua Wei Electrical Appliance project, a high-tech research and development industrial unit in Guangdong Province. $26 million. 9/99.

Government of Singapore/Government of the PRC
Approved blueprint for the Suzhou Industrial Park, a cooperative project involving 379 FIEs in economics and technology. $6.3 billion. 9/99.

Environmental Technology and Equipment

CHINA'S IMPORTS

Environmental Elements Corp. (US)
Will provide EEC fabric-filter technology to Wujiang Dust Collector Factory in Jiangsu Province. 9/99.

Houston Investment Group (US)
Will provide financing and advanced equipment to build an environmental-protection center in Guilin, Guangxi Zhuang Autonomous Region. $150 million. 7/99.

OTHER

World Bank
Granted loan to PRC Government to help develop an environmental protection project on the Lijiang River in Guilin, Guangxi Zhuang Autonomous Region. $40.23 million. 8/99.

World Bank
Will fund the Fourth Water Supply and Sanitation Project, which will work to encure a safe and convenient water supply to 3.1 million people in Anhui, Fujian, Guizhou, and Hainan provinces. $46 million. 8/99.

Medical Equipment and Devices

CHINA'S IMPORTS

Direct Radiography Corp., wholly foreign-owned subsidiary of Hologic, Inc (US)
Signed three-year sales agreement with E-Com Technology Ltd. of Zhuhai, Guangdong Province, to sell DirectRay detectors on the Chinese market. 9/99.

OTHER

Eastman Kodak Co. (US)
Closed medical X-ray film factory in Wuxi, Jiangsu Province. 7/99.

Metals, Minerals, and Mining

INVESTMENTS IN CHINA

Naneco Mineral Ltd. (Canada)/Hulunbeir Nonferrous Metals Co. (Inner Mongolia)
Formed joint venture that won Jiawula District mining rights for 20 years. (Canada:75%-PRC:25%). 8/99.

Miscellaneous

OTHER

Government of Papua New Guinea/Government of the PRC
Beijing agreed to provide Papua New Guinea financial and technical aid to rebuild the country's economy. $10 million. 9/99.

Accor (France)/Beijing Tourism Group
Signed agreement to develop Accor's presence in China's tourism market and BTG's presence in Europe. 8/99.

World Bank
Granted loan to improve public health systems. 8/99.

World Bank
Granted loan to improve higher education. 8/99.

World Bank
Granted loan to the Government of the PRC for the Tarim Basin II Project, which will construct irrigation, canal, and power-generating infrastructure in Xinjiang Uygur Autonomous Region. $150 million. 8/99.

Qingdao Marine Technology Trade Center (Shandong)
China's first marine technology market will focus on trading marine development technologies, exchanging information, and providing technical services. 7/99.

Packaging, Pulp, and Paper

CHINA'S INVESTMENTS ABROAD

Government of Malaysia/Government of the PRC
Formed joint venture to build a pulp mill in Kalabakan, Sabah (Malaysian Borneo). $550 million. 8/99.

INVESTMENTS IN CHINA

Singapore Power Ltd., Asia Pulp & Paper (Indonesia)
Singapore Power Ltd. to acquire 51 percent of three power plants in Dagang and Suzhou, Jiangsu Province, and Ningbo, Zhejiang Province, owned and operated by Asia Pulp & Paper. $197 million. 8/99.

Dransfield China Paper Co. (Hong Kong)
Increased ownership share of Jiang Ying Dransfield Paper Co. Ltd. from 46% to 74.6% by acquiring a joint-venture partner, Jiangsu Huaxi Group Co. 7/99.

Fengkia Dongsung Chemical Co Ltd. (Sweden:70%-South Korea:30%)/Guangdong Hualian Corp.
Formed a joint venture to manufacture rosin derivatives for paper manufacturing. $15.5 million. 7/99.

Petroleum, Natural Gas, and Related Equipment

CHINA'S INVESTMENTS ABROAD

China National Petroleum Corp. (Beijing)
Completed the Muglad Oilfield Project in Sudan that included constructing a refinery and pipeline from southern Sudan to Port Sudan on the Red Sea. $2 billion. 7/99.

OTHER

Greka Energy Corp. (US)/China United Coal Bed Methane Corp. (Beijing)
Will jointly exploit methane resources in Jiangxi Province. (US:49%-PRC:51%). 8/99.

SABA Petroleum Inc. (US)/China United Coal Bed Methane Corp. Ltd. (Beijing)
Signed contract to explore and develop coal-bed methane resources in Jiangxi Province. $4.6 million. 8/99.

Molopo Australia NL, Lowell Petroleum NL, Hedong Energy Inc. (Canada)
Molopo, through the acquisition of Lowell, will acquire Lowell's 70% interest in the Liulin Contract, a coal-bed methane exploration and development joint venture in Shanxi Province with North China Bureau of Petroleum Geology. 7/99.

Pharmaceuticals

CHINA'S EXPORTS

American Biogenetic Sciences (ABS)/Chinese Academy of Medical Sciences (Beijing), Institute of Medicinal Plant Development (Beijing)
ABS will market and sell traditional Chinese medicines worldwide. $6.6 billion. 7/99.

CHINA'S IMPORTS

Chindex International, Inc. (US)
Chindex signed agreement to distribute Guidant Corp. of the United States's vascular-intervention products in China. 7/99.

INVESTMENTS IN CHINA

New World Development Ltd., New World Group (Hong Kong)/Government of Yunnan Province
Signed agreement to take part in 3-5 joint ventures to develop natural Chinese medicines. $20 million. 9/99.

Pharmacia & Upjohn Inc. (US)
Agreed to sell nutrition business in China to Fresnius Kabi AG, a subsidiary of Germany's Fresnius AG. 8/99.

Ports and Shipping

CHINA'S EXPORTS

Dalian New Shipyard, subsidiary of China Shipbuilding Industry Corp.
Won bid to build five 300,000 dead-weight-tonnage crude carriers for the National Iranian Tanker Co. 8/99.

The Export-Import Bank of China
Signed deal with Bangladesh Inland Water Transport Corp. to finance the building of seven ships by the CMC Hitran Shipbuilding Co. Ltd., China National Machinery Import-Export Group Corp. to improve transportation conditions in Bangladesh. $12 million. 8/99.

Power Generation Equipment

CHINA'S IMPORTS

Asea Brown Boveri AG (Switzerland)
Will supply advanced high-voltage switchgear for the Three Gorges hydro-power station in Hubei Province. $112 million. 9/99.

Siemens AG (Germany)
Will provide 15 energy transformers to Left Bank Power Station of the Three Gorges project in Hubei Province. $83.6 million. 9/99.

CAE Electronics Ltd. (Canada)
Awarded contract by Ling Ao Nuclear Power Co. Ltd. in Guangdong Province to develop a full-scope nuclear power plant simulator and to upgrade an existing power plant. $12 million. 7/99.

OTHER

World Bank
Completed a plant that provides central heating in Beijing's Haidian District. $20 million. 8/99.

Property Management and Development

INVESTMENTS IN CHINA

Macquarie Bank (Australia), AMP Ltd. (Australia)
Will jointly invest in housing projects in Beijing, Shanghai, and Tianjin. $150 million. 7/99.

Oakwood Asia Pacific (Singapore)/Gold Arch Real Estate Development Co. Ltd (Guangdong), Guangzhou City Construction & Development Holdings Co. Ltd. (Guangdong)
Signed management contract for first international serviced-residence facility in Guangdong Province. 7/99.

OTHER

Nam Tai Electronics, Inc. (Canada)
Purchased 280,000 sq ft of land in Guangdong Province for future expansion of a new high-technology facility. $1.2 million. 7/99.

Telecommunications

CHINA'S IMPORTS

Cable and Wireless HKT Ltd. (Hong Kong)
Signed agreement with Guangdong P&T Administration to boost Internet traffic between Hong Kong and Guangdong Province through development of a cross-border IP-based network and dial-up Internet roaming system. 9/99.

Glenayre Technologies Inc. (US)
Will supply paging network and provide Jiangsu Guoxin Radio Paging with transmitters, switches, and network controllers in Nanjing, Jiangsu Province. $3.8 million. 9/99.

Jenston International Ltd. (Hong Kong)
Will supply large multi-screen display walls to China Telecommunications Corp. 9/99.

LG Information and Communications Ltd. (Korea)
Will provide commercial CDMA wireless local loop system to UNICOM. $1 million. 9/99.

LM Ericsson AB (Sweden)
Will supply ATM switches to Beijing Broad Telecommunications Corp. 9/99.

LM Ericsson AB (Sweden)
Signed deal with Guangdong Mobile Communications Co. Ltd. for expansion of infrastructure development and services for the province's mobile network. $80 million. 8/99.

LM Ericsson AB (Sweden)
Signed contract for expansion of UNICOM's network in Jilin Province. $15 million. 8/99.

Motorola Inc. (US)
Awarded contract to provide digital cellular infrastructure equipment to China Eastern Communications Co. Ltd. (Eastcom). $370 million. 8/99.

Oy Nokia AB (Finland)
Signed contract with Hunan UNICOM to expand GSM network in China through creation of additional network capacity in Changsha, Zhuzhou, and Xiantang in Hunan Province. 8/99.

Alcatel Alsthom (France)
Will supply Internet dial-up access equipment for Xin Hai Technology Development Ltd., the operating arm of Xin Hai Corp. 7/99.

Cisco Systems Inc. (US)
Will consolidate CAAC's national wide-area ticket reservation networks to a single IP-based solution. $2 million. 7/99.

Gilat Communications (Israel)
Signed a purchase and sales contract with Shanghai Tontru Data Communication Co. Ltd. for Gilat's TrainNet interactive distance learning solution. $2 million. 7/99.

Oy Nokia AB (Finland)
Signed an agreement with Fujian Mobile Telecommunications Bureau to supply equipment to expand Fujian Province's GSM network. $300 million. 7/99.

Oy Nokia AB (Finland)
Signed an agreement with UNICOM for the delivery of systems and equipment to enhance GSM mobile networks. $30 million. 7/99.

CHINA'S INVESTMENTS ABROAD

Kambas Co. (Colombia)/China Great Dragon Telecommunication Co. Ltd. (Beijing)
Reached deal to form Great Dragon-Kambas Casanare Telecom Co. Ltd., a joint-venture telecom operator in Colombia. (Colombia:49%-PRC:51%) $8.5 million. 8/99.

Intermost Corp. (Guangdong)
Signed an agreement to acquire the client accounts and major assets of Labtam Corp., an information technology firm in Hong Kong. $60 million. 7/99.

INVESTMENTS IN CHINA

BICC Energy Cables and General Cable Corp. (US)/Jiangsu Baosheng Group
Formed a joint venture to manufacture and sell power and telecommunications cables. (US:66.5%-PRC:33.5%) $20 million. 9/99.

Global Crossing (UK), Microsoft Corp. (US), Softbank (Japan)
Will invest in venture to build a fiber-optic network in Asia, including a vast network in China, for high-speed Internet, voice, and video communications. $1.28 billion. 9/99.

Lycos Asia Pte Ltd., a joint venture between Lycos.com (US) and NA (Singapore)
Will launch Chinese-language versions of Lycos.com and Tripod sites in China. $42 million. 9/99.

Alcatel Alsthom (France)/Shanghai Belling Corp. Ltd., a Sino-Belgian joint venture
Will cooperate in the development, manufacture, and sales of telecommunications equipment specially designed for the Chinese market. 7/99.

Beijing Nokia Mobile Telecommunications Ltd., Beijing Nokia Hang Xing Telecommunications System Co., Ltd., joint ventures of Nokia AB (Finland)
Signed agreement with Beijing Telecommunications Administration (BTA) for further expansion of the BTA network in China. $77 million. 7/99.

Texas Instruments Inc. (US)/Great Wall Technology Co. (Beijing)
Formed joint venture to design and develop application solutions for the information-technology, telecommunications, and electronics market. 7/99.

Siemens AG (Germany)
Will expand GSM network for China Guangdong Mobile Telecommunications Co. and UNICOM. $194 million. 7/99.

OTHER

Texas Instruments Inc. (US)
Established agreement with The Legend Group for construction of a digital signal processor (DSP) laboratory in Beijing. 8/99.

Hebei United Telecommunications Engineering Co. Ltd., a joint venture between Itochu Co. (Japan)/Hebei UNICOM
Signed formal agreement to terminate cooperative projects based on the Chinese-Chinese-foreign investment structure. 8/99.

Siemens AG (Germany)/Chengdu Telecommunications Cable Co. (Sichuan)
Siemens will pay $1 million to Chengdu Telecommunications and will settle the joint venture's outstanding debts to dissolve the joint venture. 7/99.

Transportation

INVESTMENTS IN CHINA

Fiat SpA (Italy)/Yuejin Motor (Jiangsu)
Began producing hatchback cars and pickup trucks as part of an agreement to develop and design a new series of vehicles. (Italy:50%-PRC:50%). 8/99.

General Motors Corp. (US)/Jinbei Automotive (Liaoning)
Established joint venture in Shenyang, Liaoning Province, to produce Chevrolet cross-country vehicles and S-10 pickup trucks. $230 million. 8/99.

China Motor Corp. (Taiwan)
Will establish new factory for its joint venture in Fujian Province. 7/99.

OTHER

Hertz Corp. (US)
Signed letter of intent with China National Auto Anhua International Trade Co. (Shandong) to form a licensed car-rental business in China. 8/99.

World Bank
Granted loan for the construction of a Fujian highway system. $330 million. 8/99.

Europcar, joint venture of Accor (France), Volkswagen AG (Germany)
Signed license and know-how contract with Shitong Car Rental to develop car-rental market. 7/99.

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