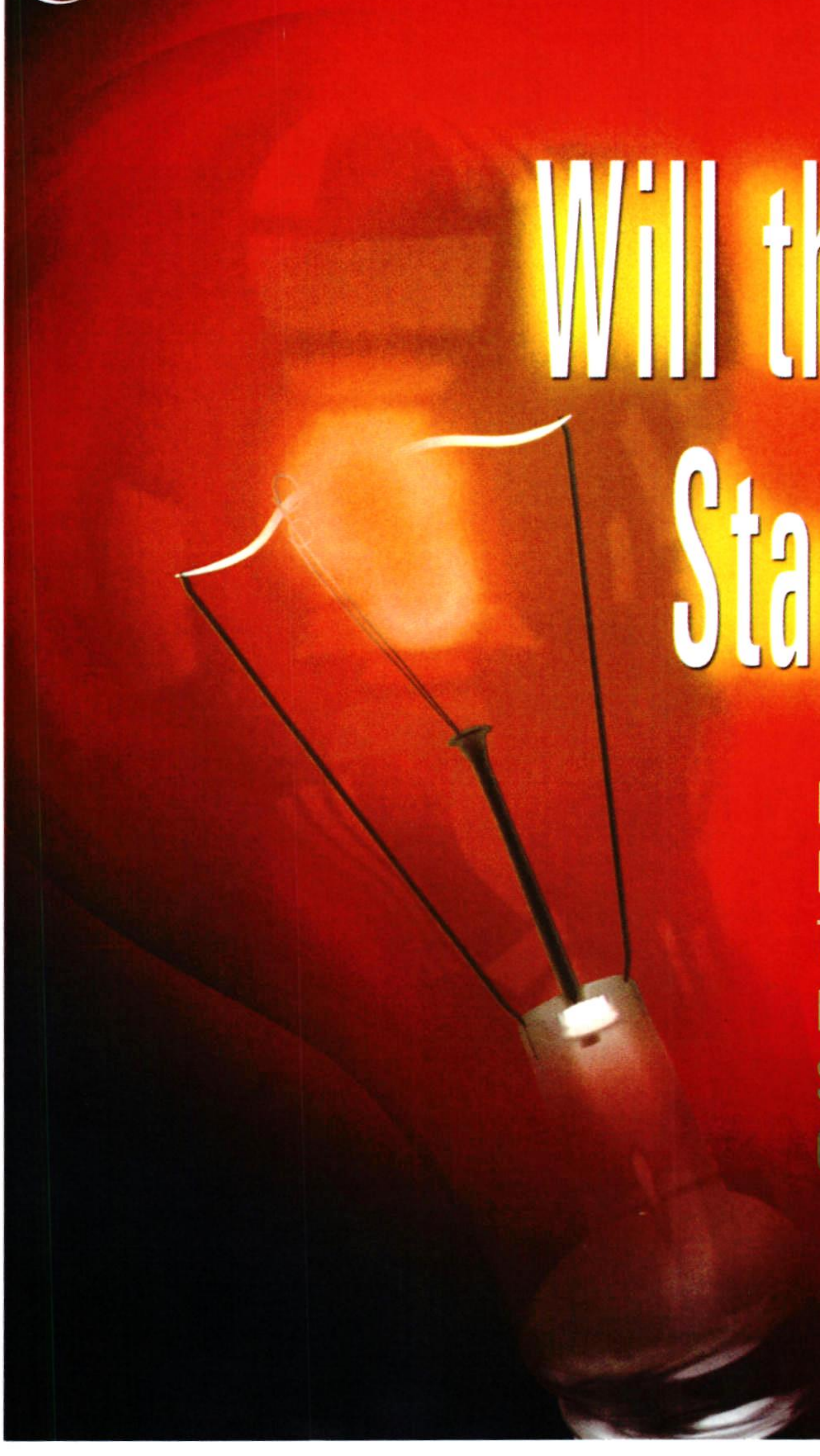
SEPTEMBER–OCTOBER 2005 VOLUME 32 NUMBER 5

THE CHINA BUSINESS REVIEW

THE MAGAZINE OF
THE US-CHINA BUSINESS COUNCIL



Will the Lights Stay On?

Power Reform
Electricity Shortages
The Soybean Trade
Media Relations
Sources of China's Growth
Chinese Textiles

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Economic Views

Implications of China's New Currency Regime

After more than a year of international and heated debate, the People's Bank of China (PBOC) announced on July 21 that it would calculate the value of the renminbi (RMB) against a basket of currencies, effective immediately. It also set the value of the RMB to the US dollar at ¥8.11/$1, up 2.1 percent from the previous rate of ¥8.28/$1. China's move to a new currency regime may be a step toward a true market-based exchange rate, but the immediate benefit to China—and to foreign companies—may be an easing of US political pressure. Indeed, the move appears to signal the PRC government's awareness of the political and economic pressures for a currency adjustment. Although some observers have criticized the small revaluation, US government officials and leading international analysts immediately praised the change and its timing.

About the change

Although China's previous currency regime was commonly referred to as a peg to the US dollar, China actually maintained a version of a managed float against the dollar: Since 1994, the RMB was allowed to fluctuate within a narrow band. Under the new regime, the band remains—the RMB may fluctuate 0.3 percent above or below the previous day's closing exchange rate—but the value will be determined by referring to a basket of currencies, not just the dollar.

The economic rationale for the move is strong. China's rising global trade surplus in 2005 put pressure on its currency. Sterilization measures to prevent inflation were taking their toll. And, as several economists pointed out, the government had put administrative tools in place that would allow it to introduce more exchange rate flexibility.

The RMB basket

In early August, PBOC Governor Zhou Xiaochuan named four factors that China takes into consideration to determine the currencies and their weights in the basket for the RMB's exchange rate: the currency's share of trade in goods and services; the currency structure of China's foreign debt; sources of foreign direct investment for China; and current transfer items under the current account. Zhou noted that the bulk of currencies in the basket are those of China's biggest trade partners: the United States, the Eurozone, Japan, and South Korea. The currencies of other significant trade partners, including Singapore, the United Kingdom, Malaysia, Russia, Australia, Canada, and Thailand, are also taken into account.

As *CBR* goes to press, PBOC has kept the exchange rate with the US dollar relatively steady since July 21, with the interbank rate appreciating less than 0.1 percent from 8.1128 to 8.1027 to the dollar at its strongest point in early August. Nondeliverable forwards in early August showed that the RMB would strengthen to 7.7551 to the dollar if traded freely, indicating a gain of 4.3 percent over a year. But leading analysts believe China will be more cautious.

Continued on page 33

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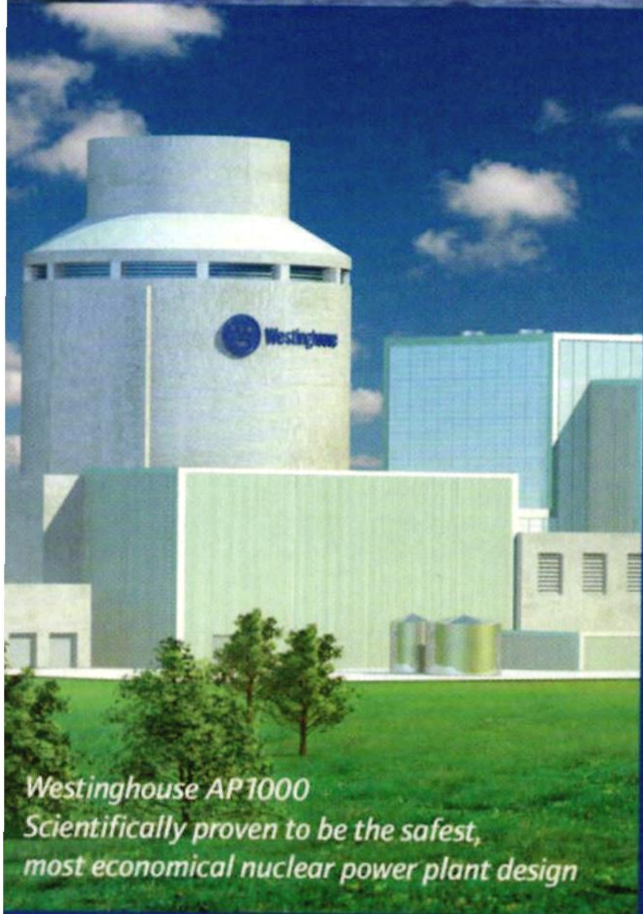

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BULLETIN

EVENT WRAP-UP

Washington

July

Issues Luncheon Featured Assistant US Trade Representative for China Affairs Charles Freeman, who briefed member companies on the US-China Joint Commission on Commerce and Trade (JCCT) discussions.

Luncheon for PRC State Councilor Tang Jiaxuan USCBC and the National Committee on US-China Relations co-hosted a luncheon in honor of PRC State Councilor Tang Jiaxuan. Senior PRC officials, including Vice Minister of Foreign Affairs Yang Jiechi and PRC Ambassador to the United States Zhou Wenzhong, were members of the delegation that accompanied Tang. US government officials present at the luncheon included James Keith, the acting deputy assistant secretary of State for East Asian and Pacific Affairs; Tim Adams, the undersecretary of the Treasury for International Affairs; and Martha Newton, the acting deputy undersecretary of Labor for International Labor Affairs. Former US ambassadors to China J. Stapleton Roy and James Sasser also attended. As part of the luncheon, Tang delivered a speech to the 140 guests, during which he reviewed Chinese reform efforts and discussed US-China relations.

Beijing

July

JCCT Breakfast Briefing USCBC and the American Chamber of Commerce in China co-hosted a breakfast meeting featuring US Secretary of Commerce Carlos Gutierrez who briefed the US business community in Beijing on the results of the JCCT meeting.

Correction The Governor's Forum event that was listed in the last issue of the *CBR* was cancelled.

UPCOMING EVENTS

Dinner Honoring PRC President Hu Jintao

September 7, 2005—Washington

Seminars on Investment Trends and China Trade Politics

September 7, 2005—Seattle
September 9, 2005—Minneapolis

Washington Issues Luncheons

September 15, 2005
October 20, 2005
November 17, 2005

China Operations (CHOPS) Conference

October 21, 2005—Shanghai

Forecast 2006

January 24–25, 2006—Washington

USCBC-SPONSORED EVENT

China International Economic Forum: Shenyang Summit

September 14–16, 2005

PRC State Councilor Tang Jiaxuan addresses luncheon guests

PRC Vice Foreign Minister Yang Jiechi and former US Ambassador to China J. Stapleton Roy

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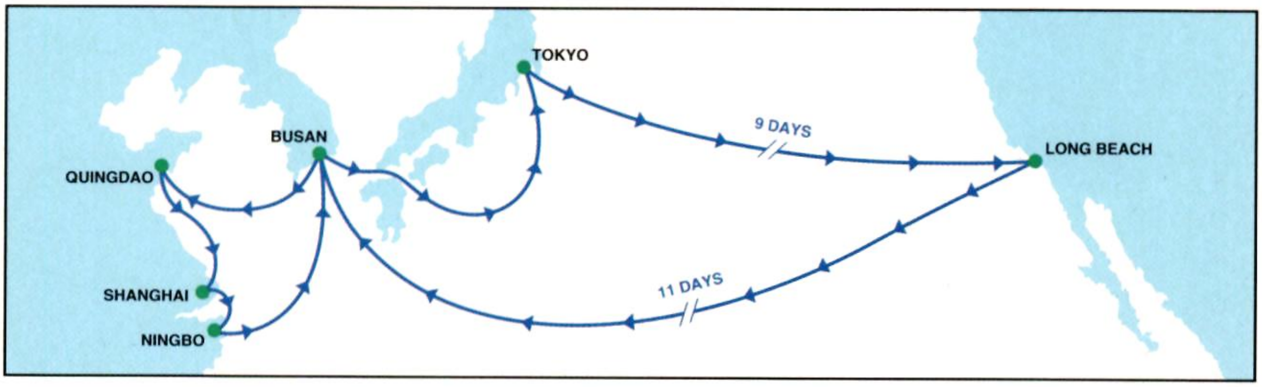

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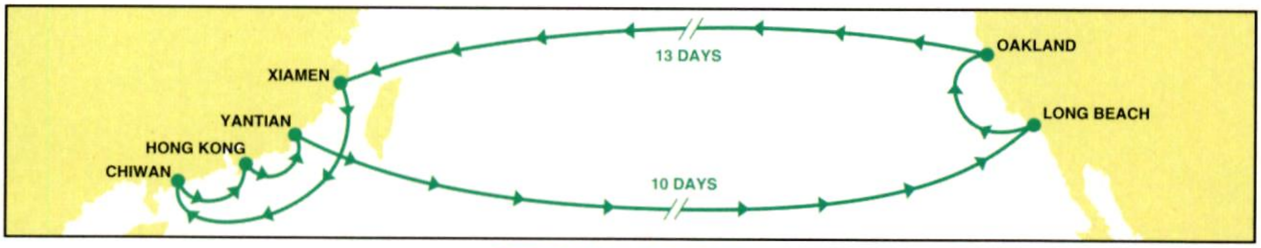

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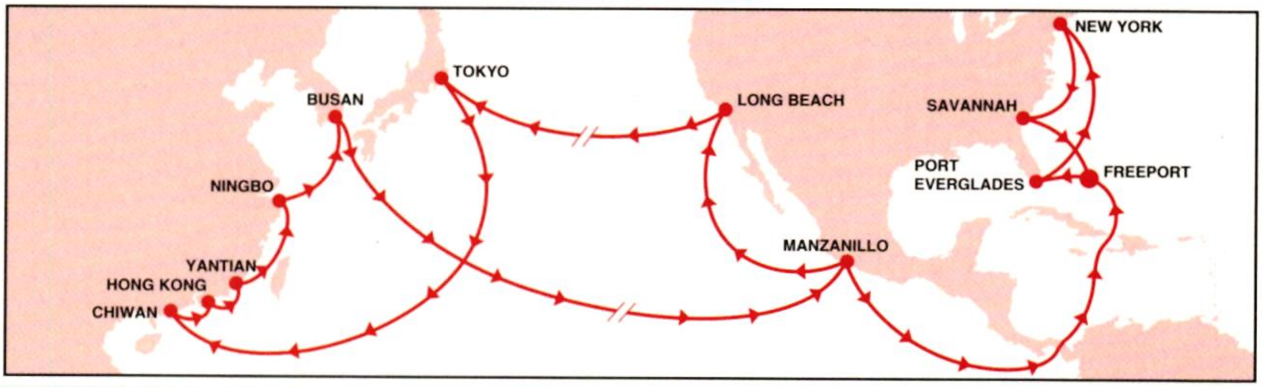

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POWER POLITICS

China must push through reforms in its energy sector—especially price reform

Julie Walton

Unimaginable though it may be, factories in some of the world's most vibrant manufacturing hubs are turning off the lights once a week. In coastal cities from Beijing to Shenzhen, and even as far inland as Chongqing, companies received notices as early as April of this year warning them of rolling blackouts for the summer months and often demanding to know which day of the week the factory would prefer to be without power. In the Yangzi River Delta, companies that made investment decisions based on promises of preferential access to the West-East Natural Gas Pipeline are quietly being told to lower their expectations because demand is so strong.

China's current electricity shortages and skyrocketing demand for fuel—whether oil, natural gas, or coal—point to a larger problem within the system: China's management of its energy resources, both domestic and imported. The fragmented regulatory structure that governs the sector inhibits strategic decisionmaking and genuine reform. In particular, the lack of transparency in pricing and regulation throughout the energy supply chain encourages waste and prevents the development of new or efficient technologies. The PRC government has undertaken several rounds of reform, but even its latest effort is unlikely to make much progress as long as the leadership remains unable to resolve the conflict between the need for market forces to play a greater role in resource allocation and the government's desire to protect state-owned enterprises (SOEs) and other vulnerable employers from the consequences of these forces—primarily rising energy prices.

Pricing problems

The National Development and Reform Commission (NDRC) sets enduser prices for natural gas, electricity, and gasoline; rarely do these prices reflect the actual market prices of these commodities. According to the World Bank, energy prices in China are one-quarter of those in the United States as a result of controls on pricing throughout the system. For example, in early 2005, NDRC issued a notice setting a ceiling for this year of 8 percent above the 2004 price of coal supplied to power plants. But coal producers, looking for a price that more accurately reflected

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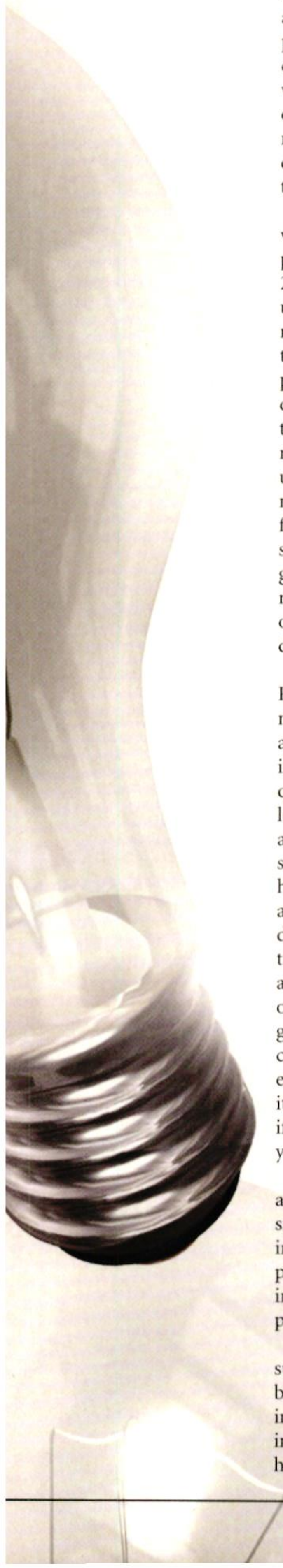

market conditions, were hoping for at least a 20 percent increase over the 2004 price. In 2004, the average PRC market price for coal was ¥206.43 ($24.93) per ton, 27 percent higher than the average price of coal supplied to state-owned power plants, which was ¥162.05 ($19.57) per ton. This type of distortion occurs throughout the supply chain: The government caps the price power generation companies charge the grid companies, which in turn have limitations on how much they can charge endusers.

NDRC also sets the price for refined petroleum, with only occasional adjustments to reflect global price fluctuations. For instance, at the end of May 2005, the price for various refined petroleum products in China was roughly $120 per ton below international prices, according to NDRC. This amounts to a subsidization of sectors that rely on refined petroleum, such as the auto sector, and impedes the development of new products and changes in customer behavior. For example, although NDRC raised the retail price of gasoline in March, it was unwilling to adjust the price of diesel fuel lest such a move adversely affect farmers (who rely on diesel fuel for their equipment, particularly during the spring planting season). Refineries produced more gasoline because they could get a better return; the result was a nationwide shortage of diesel. It was only at the end of May that NDRC allowed refined diesel prices to rise.

According to the director of NDRC's Energy Research Institute, the central government must monitor the price of refined petroleum because allowing domestic prices to fluctuate with the international market would have negative consequences for economic development. The Chinese leadership is fundamentally committed to pursuing a course of expansive economic growth to maintain social stability. The director's remark goes to the heart of the fact that central planning authorities are seriously worried that allowing more market-determined prices for energy could trigger inflation, which would hurt important constituencies and threaten social stability. Inefficient SOEs, many of which rely upon regular cash injections, and disgruntled urban residents (often those laid off from crumbling SOEs) are vulnerable to any increase in energy or electricity prices. In May, NDRC prohibited local governments from raising electricity rates if local inflation rises more than 4 percent year on year for three consecutive months.

At the same time, the government is acutely aware of the need to reflect supply and demand signals in energy prices. To this end, just before it imposed the inflation limits, NDRC allowed power producers to pass along 70 percent of coal cost increases to distributors and consumers if coal prices jump more than 5 percent in six months.

Such conflicting directives neither protect consumers nor aid the development of genuine market-based solutions. Allowing generators to pass on input price increases in full would benefit the whole industry, ensure a steadier power supply, and, one hopes, improve safety throughout the electricity supply chain because companies would have more money to spend on maintenance and upgrades. China could then provide direct subsidies to its poorest endusers, as is done in other countries.

The tight rein on pricing, together with a general inability to enforce contracts, deters foreign companies from participating in various segments of China's energy market. Most foreign independent power producers have left the market because local governments have refused to pay the electricity price to which they originally agreed. And foreign companies pulled out of the West-East Natural Gas Pipeline project in part because of PetroChina's refusal to recognize internationally accepted pricing practices.

The coal question

Though coal prices have been rising, coal is still the cheapest type of fuel in China. China's substantial coal reserves fuel the thermal power plants that supply almost 70 percent of the country's energy. In comparison, electric power from all other energy sources—including natural gas shipped through the West-East Pipeline—is more expensive. Consequently, central planners offer tax breaks and price caps to make electricity from other sources competitive with coal. Domestic price caps that limit returns on investment, combined with the large supply of inexpensive (but sometimes low-quality) coal, discourage diversification into other areas of energy production.

Nevertheless, China's vast coal reserves—114,500 million metric tons at the end of 2004, according to *BP Statistical Review of World Energy*—could provide valuable alternative energy options, if they were priced according to market principles. Because the country has so much coal, national energy policy in recent years has focused on adopting new technologies and management practices to use domestic coal resources more efficiently, rather than on reducing the overall reliance on coal.

One such effort is a coal liquefaction project in Inner Mongolia (coal liquefaction turns coal into oil). Although debate exists about the true cost competitiveness of coal liquefaction, industry analysts believe that it is cost competitive for China if crude oil remains above $30 a barrel. Others caution that the technology is immature, expensive, and requires coal of a certain quality. Nevertheless, NDRC is working with a South African company to pursue coal liquefaction technology. Development of such alternative coal technologies will only succeed if regulators are willing to pass on the true cost of energy to the enduser.

Recent electricity price reforms

China's regulators are, however, trying to address the mismatch between the price that endusers pay for their energy and the cost to the producer. In addition to raising gasoline prices, in March 2005 NDRC took an important step forward in electricity price reform when it published three regulations that set out specific electricity pricing measures for three stages of electricity generation and transmission: sales from generators to grid companies; electricity transmission and distribution; and sales from grid companies to endusers (see p.16).

Significantly, the rules link prices at each stage and allow some electricity generators to raise prices when fuel costs rise. For the sale of electricity from generators to grid operators, the government sets a base price, which reflects the generators' average fixed cost and market demand and applies to every generator in the same region. The generators are free to charge as much or as little as they like over that price. The regulations for pricing of electricity distribution and transmission take the reforms one step further by permitting distribution and transmission companies to incorporate more of the electricity cost into their pricing. The final set of regulations—governing enduser price—may not be as progressive as the other two. NDRC still sets electricity prices but promises to establish a mechanism to ensure that the electricity price for endusers floats with the price the grid companies pay to generators. The mechanism has not yet been made public.

Price reforms since these regulations took effect on May 1 have varied across regions and sectors. NDRC increased electricity prices by an average of ¥0.022 ($0.0027) per kilowatt-hour in mid-June, but the rate hike did not apply to the country's northwestern or northeastern regions and excluded all agriculture and fertilizer-related industries. Many localities have introduced peak and off-peak pricing for commercial and industrial applications; Beijing, Hebei, and Shanghai will introduce seasonal differential pricing for the third quarter of 2005, during which peak pricing is likely to be 11 percent higher than during peak times throughout the rest of the year. Residential rates remain in the hands of local governments throughout the country, but raising them is always contentious.

A New Energy Leading Group

China's power sector is plagued by insufficient coordination among multiple regulatory agencies. Currently, the State Asset Supervision and Administration Commission oversees the management of state-owned power plants and energy companies, while the State Electricity Regulatory Commission supervises the power sector from the plant to the consumer. The National Development and Reform Commission's (NDRC) Energy Bureau monitors the energy sector and approves projects, while NDRC's price bureau sets electricity and gasoline prices. Over the years, various ministries have attempted to craft and implement a nationwide energy policy, but none has had enough clout to push one through.

The government announced in May 2005 the formation of a new interagency task force to improve regulation and guidance of the country's fragmented energy industry. Premier Wen Jiabao now heads up the State Council Energy Leading Group, with Vice Premiers Huang Ju and Zeng Peiyan serving as vice chairs. To promote interagency coordination, the group also includes leaders from 13 top government agencies, including NDRC Minister Ma Kai, Minister of Commerce Bo Xilai, Minister of Foreign Affairs Li Zhaoxing, Minister of the State Commission on Science, Technology, and Industry for National Defense Zhang Yunchuan, and Minister of Finance Jin Renqing. The leading group is responsible for formulating the country's energy strategy and for providing policy suggestions to the State Council regarding energy exploitation, conservation, security, and international cooperation within the energy sector.

NDRC Minister Ma Kai heads the 24-person, vice-ministry-level State Energy Office, which is charged with overseeing day-to-day affairs for the leading group. Ma Fucai, former president of China National Petroleum Corp., and Xu Dingming, director of NDRC's Energy Bureau, are vice directors. The office reports directly to the leading group, monitors energy security, organizes energy-related research, and aids the group's decisionmaking.

Company responses to the formation of the leading group have been mixed. Some believe that the leading group's high-level leadership will finally be able to force policy coordination and change. Others, however, look at the heads of the implementation office—NDRC personnel—and argue that policy implementation will be a problem because NDRC is still where most of the bottlenecks lie. Nearly everyone agrees on one point, however: Unless the leading group is willing to tackle the fundamental question of energy pricing, no amount of agency reform and policy coordination will improve China's energy prospects.

—Julie Walton

Foreign investors' concerns

As more sectors open to foreign investment, China's regulation of its energy markets—either through price controls or government edicts—is a growing concern for foreign companies. The Catalogue Guiding Foreign Investment in Industry encourages investment in coal-gas integrated gasification combined cycle plant technology and equipment, as well as in the construction and management of a variety of power stations. In addition, China's World Trade Organization (WTO) entry agreement includes phased liberalizations for wholesale and retail sales of crude and refined petroleum (upstream oil and gas exploration and production was not covered in the WTO agreement).

China's commitments to open wholesale and retail distribution of crude and processed oil are of particular interest to foreign companies. On December 11, 2006, foreign companies will be allowed to distribute wholesale imported crude and processed oil. This could be a significant market opening because, in theory, it means that foreign oil companies can sell their product directly to a customer of their choosing. Yet many foreign companies remain skeptical about the willingness of PRC authorities to implement this commitment according to the letter and the spirit of the WTO. The bulk of China's imported refined and processed oil currently flows through four designated state-trading companies: China National Chemical Import and Export Co., China International United Petroleum and Chemicals Co., China National United Oil Co., and Zhuhai Zhenrong Co., with a limited quota volume allocated to nonstate-trading entities.

As a sign of a potential opening at the end of 2004, 16 PRC companies received licenses to import crude and processed petroleum. All of

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China's National Oil Companies

China's oil and gas sector has experienced significant institutional and structural change in the past half century. After 1949, the central government nationalized the industry under the Ministry of Petroleum Industry (MOPI). In addition to being responsible for administrative and commercial aspects of upstream and downstream operations, MOPI assumed the role of industry regulator and responsibility for the welfare of all sector employees. By the early 1980s, lack of technology and capital led to declining exploration and production. As part of a set of broader reforms taking place in China, the government in 1981 began a two-tiered reorganization program to rejuvenate the industry.

First, the government contracted with MOPI for an annual production target and allowed oil produced in excess of this target to be sold in domestic markets. This worked as an incentive for further exploration and production and provided funds for investment in much-needed technology. Second, to separate the regulatory and social functions from commercial functions, the government established national oil companies focused exclusively on oil exploration, production, and marketing. By 1988, China had established three national oil companies: China National Offshore Oil Corp. (CNOOC), China Petrochemical (Group) Corp. (Sinopec Group), and China National Petroleum Corp. (CNPC). As a result, the ministry was shut down. The government further restructured the industry in 1998 to encourage overseas exploration, investment, acquisition, and stock market listings.

● CNOOC

In February 1982, MOPI created CNOOC as the first of the new national oil companies. The company assumed complete responsibility for exploration, development, and production of oil and gas in China's territorial waters. In an attempt to boost investment in China's oil and gas industry, the government encouraged CNOOC to engage with foreign parties in production sharing contracts and joint ventures.

A main goal of the government-led restructuring was to create globally competitive oil and gas companies. Accordingly, in 1999 CNOOC created and transferred all of its valuable commercial assets to a subsidiary, CNOOC Ltd., which listed on global markets in 2001. Nearly 70 percent of CNOOC Ltd.'s share capital belongs to its parent company. Its largest production area is Bohai Bay. Today, the company engages independently and with foreign partners in upstream offshore operations. Major partners include Chevron Corp., ConocoPhillips, and Devon Energy Corp. Under US-educated CEO Fu Chengyu, the company has gained a reputation as a fairly nimble, internationally savvy oil company.

CNOOC Ltd.'s parent company was the first of the national oil companies to pursue liquefied natural gas (LNG) operations and is developing China's LNG infrastructure in Guangdong, Fujian, Shanghai, and Zhejiang. CNOOC Ltd. has interests in Indonesian and Australian LNG production and development and is on track to supply its parent company's terminals with LNG from these endeavors.

● Sinopec

MOPI created the second national oil company, Sinopec Group, in 1983, which assumed a dominant position in petroleum refining and petrochemical production. By the late 1990s, Sinopec Group owned more than 90 percent of China's refining capacity. Shortly before the 1998 industry restructuring, the government decided that China's oil and gas companies needed to develop integrated upstream and downstream operations to be globally competitive. To this end, in 1998 Sinopec Group was instructed to swap assets with CNPC along regional lines. After the swap, Sinopec Group held both upstream and downstream assets in the mainland's southern and eastern regions. In February 2000, Sinopec Group created and transferred most performing assets to its subsidiary Sinopec Corp. Sinopec Corp. was listed on global markets in 2000, and its parent company retains about 68 percent of the company's share capital. Sinopec Group's background in downstream operations has allowed Sinopec Corp. to become the mainland's largest producer and distributor of oil products. The company's preeminence in downstream operations is aided by its more recent upstream efforts, with the company producing the second-largest amount of crude oil in China.

Sinopec's LNG operations have only just begun. Under Chair Chen Tonghai, the company recently secured rights to build an LNG terminal in Shandong, and the company has created a new unit, China Petroleum and Chemical Corp. Gas Co., to assume all gas-related operations of both the company and its parent. Sinopec Corp. has set up a number of joint venture operations with multinational oil companies including BP plc, Royal Dutch Shell plc and, most recently, Exxon Mobil Corp.

● CNPC

In 1988, MOPI's remaining commercial operations were transformed into CNPC, and the ministry was abolished. This national oil company assumed all assets and some regulatory and social responsibilities previously belonging to MOPI. It was tasked with upstream development of onshore oil and gas, both domestically and internationally. In 1998, Sinopec Group transferred all assets held in the northern and western part of China to CNPC. To turn itself into a company that could compete globally, CNPC created a subsidiary, PetroChina Co. Ltd. focused entirely on commercial interests. As with the other subsidiaries, parent company CNPC handed over most of its performing assets in March 2000. One month later, PetroChina listed on global markets. CNPC holds roughly 90 percent of PetroChina's issued stock.

Today, PetroChina is responsible for the largest and most lucrative oil and gas field in China, Daqing. In terms of production, PetroChina is the largest oil and gas company in China. The company is also the sponsor of the 2,500 mile West-East Pipeline from Xinjiang to Shanghai. Though PetroChina is an integrated company, its strengths lie in upstream operations. The chair of the subsidiary and the parent company is Chen Geng. Last month, PetroChina established a 50-50 joint venture with its parent company for control of CNPC's non-contentious global oil reserves. (The venture excludes reserves in contentious areas, such as Sudan.) This includes stakes in oil and gas field ventures in Algeria, Azerbaijan, Canada, Ecuador, Kazakhstan, Oman, Peru, and Venezuela. Before the joint venture was announced, PetroChina's offshore assets were confined to Indonesia. The company has formed retail joint ventures with Shell and BP and has a cooperation agreement with Shell for development of the Changbei gas field, which straddles the Inner Mongolia-Shaanxi border.

—Teresa Finn

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Although it is unclear how China will regulate the wholesale market, there are signs that authorities will not make entry easy for foreign companies.

the licensed companies were endusers rather than distributors, however, thus preserving the China Petrochemical Corp. (Sinopec) and PetroChina Co. Ltd. distribution duopoly. Moreover, as the two Chinese companies control the vast majority of China's refineries, the newly licensed nonstate crude importers can only sell crude to the duopoly for refining. Finally, the licenses restrict imported processed petroleum to fuel oil, such as kerosene, and do not cover the highly regulated market of refined petroleum products such as gasoline and diesel, which stay under the four state trading entities. (In a positive development, China recently broke the jet fuel monopoly, though foreign investment is still not permitted.)

Foreign companies see these restrictions as examples of measures that regulators might use to limit future foreign investment. Although it is unclear how China will regulate the wholesale market, there are signs that authorities will not make entry easy. For example, the idea of setting up an importer registration system with strict qualifications such as minimum earnings, domestic storage capacity, and port infrastructure is under serious consideration, according to industry insiders. This last point is particularly contentious because Sinopec and PetroChina currently control most of the coastal tanks and storage facilities. It is unlikely that either company would be willing to surrender space to foreign entrants.

Foreign companies want to import, refine, and sell their own branded products, but many industry analysts believe that the central government is willing to allow only limited foreign participation, to ensure the clear market leadership of state-owned giants Sinopec and PetroChina (see p.12). As evidence, they point to the manner in which China has implemented its WTO commitments for foreign investment in retail gas stations. China agreed to allow wholly foreign-owned retail distribution enterprises by December 11, 2004, but companies with more than 30 outlets are restricted to minority shares in joint ventures, according to China's WTO commitments. Foreign companies believe that if this is interpreted as 30 stores nationwide, they will be effectively shut out of the retail market because it is terribly expensive to supply only 30 stores with imported gasoline.

Several foreign companies have chosen to go the joint-venture route to access more than 30 outlets and must co-brand their products. For example, at gas stations run by Sinopec and Shell (Jiangsu) Petroleum Marketing Co., a joint venture between Royal Dutch Shell plc and Sinopec, Sinopec appears at the top of the sign and Shell at the bottom. Other companies with retail joint ventures include BP plc with two joint ventures, BP PetroChina Petroleum Co. Ltd. and BP Sinopec Zhejiang Petroleum Co. Ltd., and Chevron Corp., parent company of Caltex South China Investments Ltd., which has several retail joint ventures. As for refining, foreign companies cannot own and operate their own refineries, but may and do refine through JV partners. The ultimate goal for all foreign retailers, not just oil companies, is to operate wholly foreign-owned retail outlets in China with the same access that Chinese companies have in the United States. The trick will be to get China to agree to an interpretation of "30 retail outlets" that would allow foreign companies to establish enough outlets to achieve economies of scale, though prospects of this being ironed out in the near future are dim.

In addition to market access, pricing, again, is a concern. Currently, NDRC adjusts the benchmark price for retail gasoline and diesel when the average crude prices in Singapore, Rotterdam, and New York change by a classified margin. Such poor transparency makes it extremely difficult for foreign companies to formulate effective pricing models or business plans. Many companies argue that market access means little unless pricing mechanisms, along with licensing and import procedures, are transparent and liberalized. Transparency is important in the granting of oil import licenses, which ideally would allow a full range of product services. Companies should be able to obtain import privileges without high capitalization or other requirements, such as having to own storage capacity.

Though PRC regulators are unlikely to move quickly to reform pricing, different reform proposals have circulated among the state oil companies and relevant ministries. In one scenario, regulators would regulate factory and cost, insurance, and freight prices, while freeing wholesale and retail prices. In another proposal, regulators would free wholesale prices but continue to regulate retail prices, which is similar to what the three electricity pricing regulations do. Of course, foreign companies would prefer the third option, which would be the complete liberalization of retail and wholesale prices.

Avoiding a candlelit future

China's energy situation is highly complex and exacerbated by understandable fears that true market reform would harm the economy. But the longer energy reform is postponed, the more painful economic dislocations and severe energy shortages will be. China needs more transparency, better law enforcement, and fewer restrictive regulations in the energy sector. Transparency is needed particularly in bidding; in determining pricing for the generation and transmission of electricity to commercial, industrial, and residential users; and in setting the cost of oil and natural gas for importation, transmission, and distribution. (Some companies acknowledge that they can operate with limited price controls as long as they know how and why the prices are set.) Improving the general business environment—by allowing companies to access reserve history data and choose their own suppliers and partners and by enforcing contracts—would go a long way to improving China's energy sector.

China needs a comprehensive energy policy, rather than ad hoc reactions to periodic crises. Otherwise, the blackouts will keep rolling across the country for summers to come. 完

Electricity Woes

Shortages will continue for another year—or more

Songbin Zhu and Xiaolin Li

China has experienced severe energy shortages since the summer of 2002. Power shaving—managed blackouts or brownouts—caused huge economic losses in more than 20 provinces and cities in 2003 and 2004. This year, State Power Corp. Grid Co., which covers most of the country, predicted another 30 gigawatt (GW) power shortfall during the summer. China's second grid operator, Southern Power Grid Co., which covers Guangdong, Guangxi, Guizhou, Hainan, and Yunnan, had a similarly gloomy outlook: The maximum power shortfall this summer on the southern grid would be as much as 7.8 GW, officials predicted, of which Guangdong would account for 4 GW (see p.24).

These shortfalls are the result of insufficient generation capacity (particularly at peak periods), a weak transmission system, and bottlenecks in the coal supply chain. Most coal mines are producing 20 percent above capacity—well beyond safety limits—and coal quality has been declining sharply. Transportation bottlenecks in both rail and water will likely persist for some time to come because of a dearth of investment due, in part, to government-imposed central control that discourages investment in the sector. In previous years, lack of generation capacity was the main cause of power shortages; this year, insufficient coal supply at reasonable prices and quality, as well as shipping capacity, are the main culprits. (The government halted production at 5,290 coal mines on July 21 for safety recertification).

Government efforts to minimize shortages

In 2005, for the second year in a row, the government adopted administrative measures to deal with energy shortages, particularly during the summer peak demand period. In two cases last year, the central government ordered emergency shipments of coal by train, bumping scheduled shipments of other cargoes to a lower priority and, at least in some cases, commandeering coal that had been destined for a specific location and sending it instead to large plants that were particularly short of fuel.

More orchestrated efforts have taken place to deal with the crisis this year, including the linking of coal and power prices and the

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establishment of the State Council Energy Leading Group to better coordinate national energy policy. The leading group, headed by Premier Wen Jiabao, is supported by an office at the Energy Bureau of the National Development and Reform Commission (NDRC). This is a temporary measure before the eventual formation of a national energy commission or ministry in several years.

The government is also

- Increasing energy production capacity
- Consolidating coal-mining facilities
- Increasing the railway's coal-shipping capacity
- Upgrading coal facilities at ports
- Giving priority to shipments of coal, fuel oil, and other strategic goods
- Enhancing demand-side management in the electricity market
- Implementing peak and off-peak power tariffs
- Emphasizing energy conservation policy
- Lowering barriers to market entry
- Terminating illegally operated, high-energy consuming, and highly polluting enterprises

New tariff rules

Among the most significant of the new changes the government has made recently are changes to power prices and pricing methods. In 2002 and 2003, the State Council issued circulars on power and power price reform (Circular on Promulgation of the Plan for Electric Power System Reform [*Guo Fa* (2002) No. 5] and the Circular on Promulgation of the Electric Power Tariff Reform Plan [*Guo Ban Fa* (2003) No. 62]) and charged NDRC with issuing implementing measures (see right). NDRC finally issued a circular (*Fa Gai Jia Ge* [2005] No. 514) on March 28, 2005, which laid out interim measures for three types of power tariff: on-grid, transmission and distribution, and retail. The key points of these three documents are as follows:

- The on-grid tariff will have capacity and energy components. The capacity tariff will reflect capital (or fixed) costs and be based on the regional average investment cost for power generation assets. The energy tariff will reflect the variable operating cost.
- Coal and power prices will be linked.
- The market will play a role in determining prices.
- Large industrial endusers may buy power directly from generators with "direct supply" contracts. NDRC issued a direct power supply regulation in May 2004, and a pilot project started in Jilin in March 2005.
- NDRC and the State Electricity Regulatory Commission (SERC) will determine the level of transmission and distribution tariff following a "cost-plus-profit" principle.
- Classification of retail tariffs will be simplified and eventually reduced to three major categories: agricultural, residential, and commercial and others.
- Transmission and distribution tariffs will be further separated in the future. The retail market will determine distribution tariffs, while the government will control transmission tariffs.

These measures are interim in nature. The ultimate goal of power reform, not expected until there is adequate supply, is to establish a power pooling system in which some of the electricity sold onto the grid would be subject to bidding.

Adjusting rates

To integrate the new tariff system, SERC must streamline the current system and make other adjustments to make the final switch as smooth as possible. SERC must then test and debug the new system.

Since early 2004, the government has raised retail tariffs to allow higher on-grid tariffs and transmission and distribution tariffs. First, the government increased the retail tariff by an average of ¥0.006 ($0.0007) (¥0.008 [$0.0010] for industrial and commercial sectors) at the beginning of 2004 and on-grid

Foot-Dragging on Price Reform

In 2002 and 2003, the State Council charged the National Development and Reform Commission (NDRC) with issuing implementing measures for its circulars on price reforms. Criticized for dragging its feet and pressured by all players in the market, including other central government agencies, NDRC finally released implementing measures in March 2005. Normally, ministry-level agencies take one to two months to issue implementing measures after the State Council makes and announces a major decision. Severe energy shortages in the past two years and turf battles over electricity tariffs between NDRC and the State Electricity Regulatory Commission (SERC) slowed the process, largely because leading players at relevant organizations—which include state-owned transport, grid, and generation companies as well as government agencies—have been too busy dealing with various crises to meet and hammer out a consensus. Complicating matters is the fact that top officials at these state-owned companies are powerful government appointees. For instance, the president of the State Grid Co. carries the rank of deputy minister, placing him even higher than a SERC vice chair.

—*Songbin Zhu* and *Xiaolin Li*

tariffs of all coal-fired power generators nationwide by ¥0.007 ($0.0008) (see Table). Then, SERC raised retail tariffs by an average of ¥0.022 ($0.0027) in June 2004, for a total retail tariff increase of ¥0.028/kWh ($0.0039).

On the enduser side, the government established a "differential retail tariff" mechanism to curb investment in illegally operated enterprises and those in high-energy-consuming and highly polluting industries, such as aluminum, cement, and steel. Endusers will also be subject to two different time-based tariffs: peak- and off-peak tariffs and seasonal tariffs.

On the power generation side, on-grid tariffs will be unified and set for regular annual operating hours, as well as for extra operating hours for all newly installed coal-fired power generators in each regional and provincial power market.

Testing the new system

SERC has already tested a two-part on-grid tariff mechanism on the Northeast China power market for more than a year with positive results, but the scale has been quite limited. The regulator has also been testing

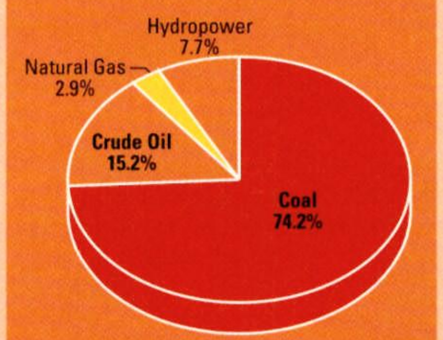
Forecasting Supply and Demand

Mismatches in supply and demand have been the main cause of China's power shortages in recent years. These mismatches result, in part, from unreliable forecasts.

Demand

China consumed 2,175 terawatt-hours (TWh) of electricity in 2004, up 15 percent from 2003. The China Electricity Council predicts that national electricity consumption will top 2,400 TWh in 2005, reflecting 12 percent year-on-year growth, while Songlin Group predicts 13 percent growth. Songlin also believes that demand will remain strong, but that consumption will grow more slowly than in 2004. This is because actual demand will remain constrained by demand-side management, such as scheduled blackouts, the implementation of peak and off-peak power tariffs, and administrative macro controls to slow the growth of industries that consume electricity heavily. The central government has also taken measures to emphasize energy conservation, such as limiting air conditioning in government buildings and encouraging staggered hours of operation. These measures will ease summer peak load but a long-term solution is to increase capacity and construct efficient, integrated networks nationwide.

China's Energy Mix, 2003



Source: *China's Statistical Yearbook, 2004*

Installation and generation

By the end of 2004, China's total installed capacity reached 441 gigawatts (GW), and China generated a total of 2,187 TWh, up 14.79 percent from 2003 (see Table). The average annual operating hours for former State Power Corp.'s thermal generation plants reached 5,988 last year, leaving little room for further extension of operating hours. (Normally, coal-fired plants in China operate 5,000 to 5,500 hours per year). The National Bureau of Statistics reported 545 TWh generated in the first quarter of 2005, reflecting 13 percent year-on-year growth.

China's energy mix is heavily weighted toward coal (see Figure). Two-thirds of coal and hydropower resources are located in western China, but two-thirds of electricity demand comes from the eastern coastal areas. Only 35 percent of generating units have a capacity of 300 megawatts and above. Of these, less than 4 percent can transmit 500 kilovolts.

Forecast

China's annual generation installation expanded nearly 10 percent in 2003, almost 13 percent in 2004, and will approach 15 percent this year. In other words, about 65 GW will come online this year alone. China's power supply is predicted to hit 2,470 TWh this year, up 13 percent from 2004, due to new capacity. A new tariff system introduced earlier this year and sufficient coal, thanks to government attention to rail and water shipments, could boost growth even further. China linked all six regional grids on July 13, 2005, which will significantly improve transmission (only Tibet, Xinjiang, Hainan, and Taiwan are not on the national grid).

By 2007, new capacity in both generation and transmission, steadier supplies of fuel, and the government's emphasis on more balanced economic growth should help match demand and supply.

—*Songbin Zhu* and *Xiaolin Li*

Energy Production, Transportation Capacity, and Sector Profits, 2003-04

Category	2003	2004	Year-on-Year Growth (%)
Production			
Coal (million tons)	1,650	1,900	15.15
Electricity (terawatt-hours)	1,905	2,187	14.80
Crude (million tons)	170	175	2.94
Total Length of: (1,000 km)			
Railway	73	74	1.92
Highway	1,810	1,856	2.54
Coal Delivery by: (million tons)			
Rail	876	990	13.01
Ship	290	340	17.24
Annual Profit for: (¥ billion)			
Coal Sector	14.4	30.7	113.00
Electricity Sector	63.6	71.6	12.60
Petroleum Sector	173.7	278.1	60.10

Source: Local statistics reports

transmission and distribution tariff and retail tariff mechanisms in East China and Guangdong.

It is still too early to judge the impact of the new system, but players in all market segments have felt the challenge. On-grid tariffs in most areas were raised according to the new NDRC rule, but at different rates (see p.8). Such rate increases ease pressures on some of the generators, but they do not cover the entire coal price increase.

With on-grid tariffs rising, residential tariffs must follow sooner or later, especially as rates for industrial and other nonresidential users will likely rise again in the near future.

The government has cautioned that changes in residential power tariffs are determined by public hearings. But with on-grid tariffs rising, residential tariffs must follow sooner or later, especially as rates for industrial and other non-residential users will likely rise again in the near future. The average retail power tariff rose ¥0.024/kWh ($0.0029) nationwide starting May 1, 2005, as mandated by six NDRC documents issued on April 25, 2005.

Coal concerns: Price, supply, and delivery

Despite these moves to improve the system, many participants still have concerns, among them the declining quality of steam coal. At Laiyang power plant in Hunan, for example, the heat rate of coal supplied to the 1,000 MW plant is normally more than 5,000 Kcal/kg, but the plant recently received coal with a heat rate of only 4,000 Kcal/kg, and sometimes as low as 2,000 Kcal/kg. To maintain normal operations, the plant has had to supplement with fuel oil. In the first quarter of 2005 alone, the plant consumed 2,000 tons of fuel oil, 60 percent of normal annual usage. Because the generators can provide only 80 percent of normal output with fuel oil, the plant is producing well below capacity.

Some power professionals also worry that many power plants will be unable to absorb one-third of coal price rises, as well as rising water fees and environmental protection costs. In addition, some power plants were given a "zero-profit" on-grid tariff when they were split from the former State Power system two years ago (see the *CBR* May–June 2003, p.18).

A related concern is possible coal price manipulation. Coal enterprises, particularly the privately owned ones, could collude to keep prices high. If this happens, the coal-power tariff linkage could eventually hurt downstream industries and other endusers.

Since the coal-power price linkage is only for contracted steam coal supply—only half of the coal sold on the market—coal producers will not benefit much. Of China's annual coal output of 1.9 billion tons, China's state-owned power plants, which account for more than 90 percent of the country's power plants, consume about 600 million tons of steam coal a year. Half of this amount is contracted at an annual steam coal ordering conference at NDRC-regulated, below-market prices.

By the end of the year, the government plans to close coal mines that produce less than 90,000 tons per year and that do not meet safety standards. This has added to the uncertainty about whether this year's demand for coal—more than 100 million tons more than last year—can be met. Most state-owned coal mines are already producing at maximum capacity, or even above capacity. Between 2002 and 2004, China's coal output rose 200 million tons per year.

Average Unified On-Grid Tariff for New Coal-Fired Generators

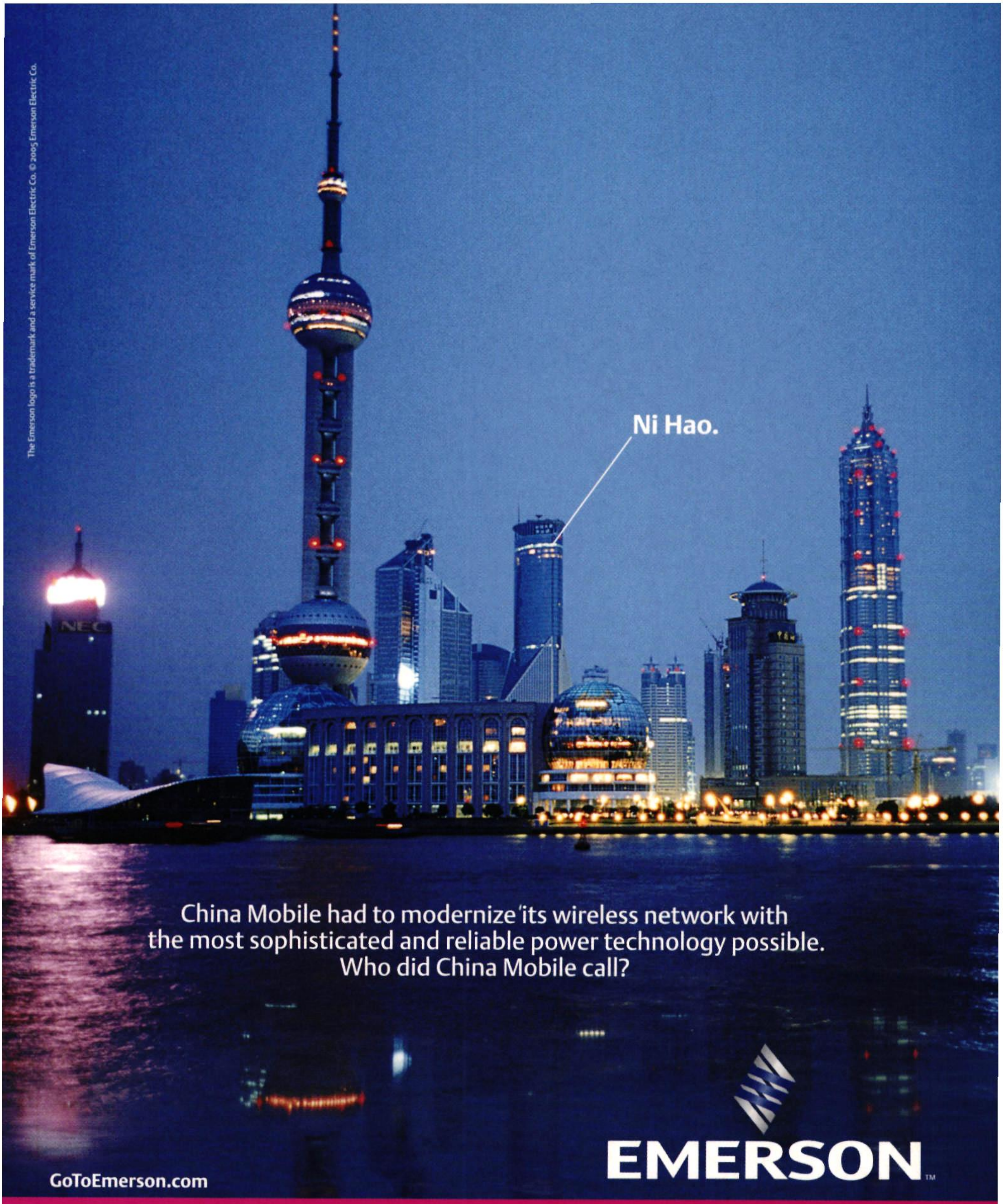
Regional Power Market	With Desulphurization Facility (¥/KWh)	Without Desulphurization Facility (¥/KWh)
Northern	0.2970	0.2820
Northeast	0.3217	0.3067
Eastern	0.3740	0.3590
Central	0.3330	0.3133
Northwest	0.2518	0.2368
Southern	0.3250	0.2983
Average	**0.3171**	**0.2993**

Note: KWh=kilowatt-hour
Source: National Development and Reform Commission

Power investment in 2004

In response to shortages, investment in power-generating infrastructure is growing rapidly, raising questions about the return on these investments. According to the National Bureau of Statistics (NBS), total fixed asset investment in 2004 for power and heating infrastructure reached ¥480.90 billion ($58.17 billion), reflecting 45.5 percent year-on-year annual growth.

Because it is difficult to track actual, as opposed to planned, investment, Songlin Group has developed a power asset investment model based on how much actual industrial



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capacity has been built in a fiscal year and the estimated project cost. The figure shows annual national power investment from 1998 to 2004 according to this model.

The data indicate that total power investment for 2004 was about ¥487 billion ($58.91 billion), up 41 percent from 2003. Because our estimate excludes heating assets, it is lower than the NBS figure. Total power investment for 2005 will be around ¥500 billion ($60.49 billion), up 30 percent from 2004, according to our calculations. Investment in grid construction by the two grid operators last year reached ¥150 billion ($18.15 billion), a historical record.

Some power professionals worry that many power plants will be unable to absorb one-third of coal price rises, as well as rising water fees and environmental protection costs.

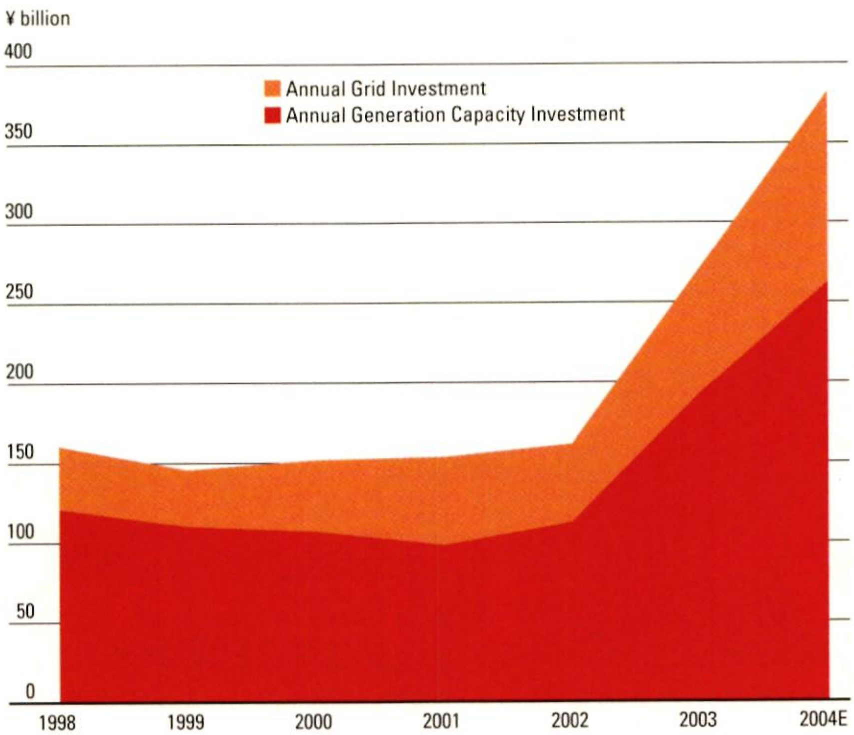
A total of 50.6 GW capacity was commissioned in 2004. Because of the rapid growth of new construction, these projects could create a power glut when they come online. In addition, the cost of power equipment and coal has risen significantly, and financing costs have also started to rise. The average annual operating hours for coal-fired power plants in 2004 reached 5,460 nationwide, 215 hours more than in 2003 and the highest since 1990. (Anywhere between 5,000 to 5,500 hours per year are considered normal in China.) With about 65 GW of new capacity expected to come online this year, average annual operating hours could fall, reducing generators' revenue.

Vicious cycle?

Some observers worry that the sector is caught in a vicious cycle, swinging from glut to shortage and back again. As one NDRC official put it: The current shortage was caused by overinvestment by local governments, which led to fast and unsustainable economic growth and an energy shortage, which in turn spurred another bout of overinvestment in power infrastructure. In an effort to break the cycle, the government on July 15 halted 32 power plant projects with a total generation capacity of 17,114 MW—despite the fact that ¥20 billion ($2.42 billion) of a planned ¥85.5 billion ($10.33) had already been invested. But administrative measures are not enough; further reform is crucial to escape this cycle.

One important reform that must continue is ownership reform, so that shareholders and project sponsors, not the government, can make investment decisions. Bank reform must also proceed, to build up the basic risk management capacity of all major Chinese lenders for infrastructure development. Finally, the government at all levels must improve its market forecasting and long-term planning capability so that investors can make better decisions. 完

Annual National Power Investment 1998–2004



E=estimate
Source: Songlin Group

Correction

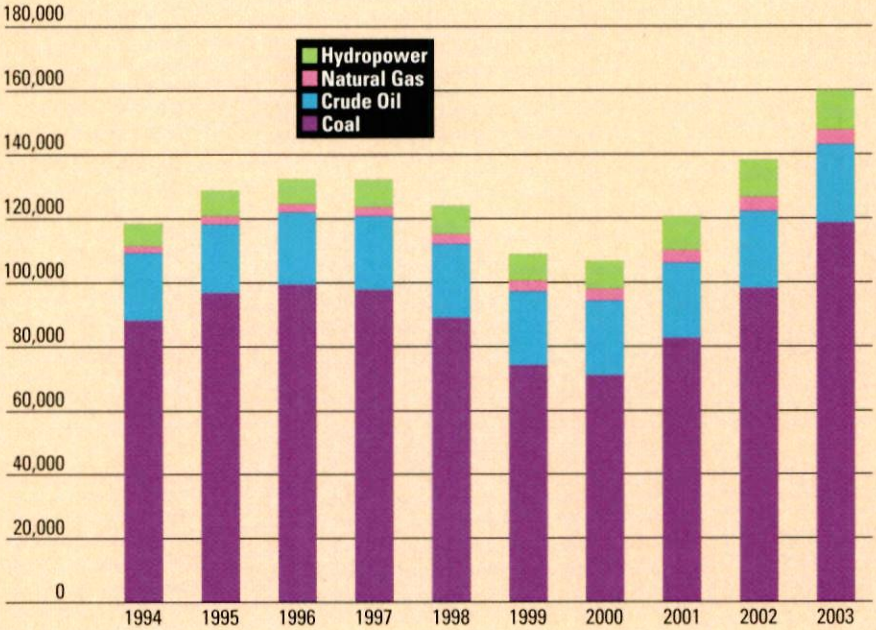
Major Intermodal Hub Terminals and Container Handling Stations Planned by China Railway Transport Co. Ltd.

Note: The legend for this map, which was published on p.12 in our July-August issue (in the article "Going Intermodal," by Asil Gezen) was incorrect. The corrected legend is printed here and has been corrected on our website, www.chinabusinessreview.com. We apologize for the error.

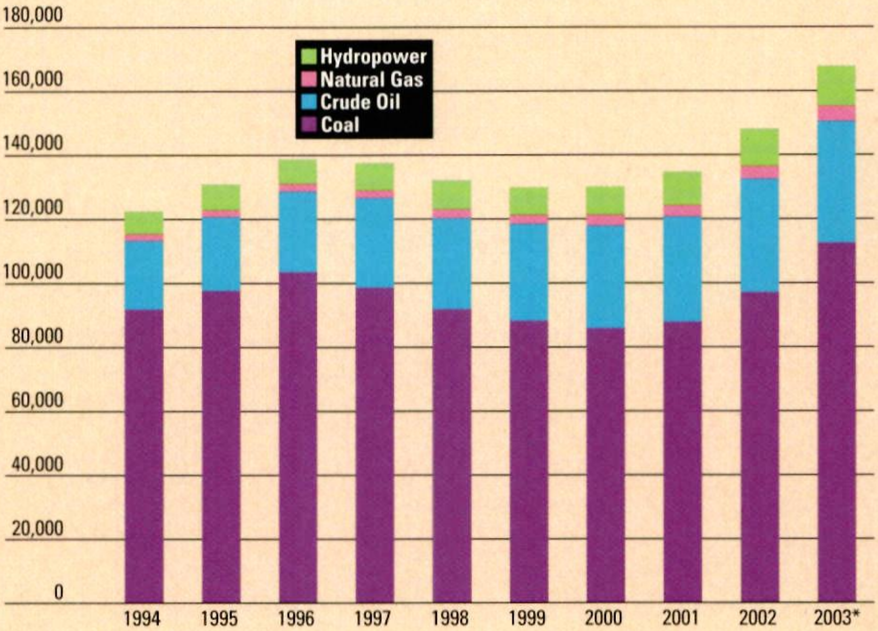
Source: Asil Gezen

CHINA DATA: Energy

China's Energy Production



China's Energy Consumption

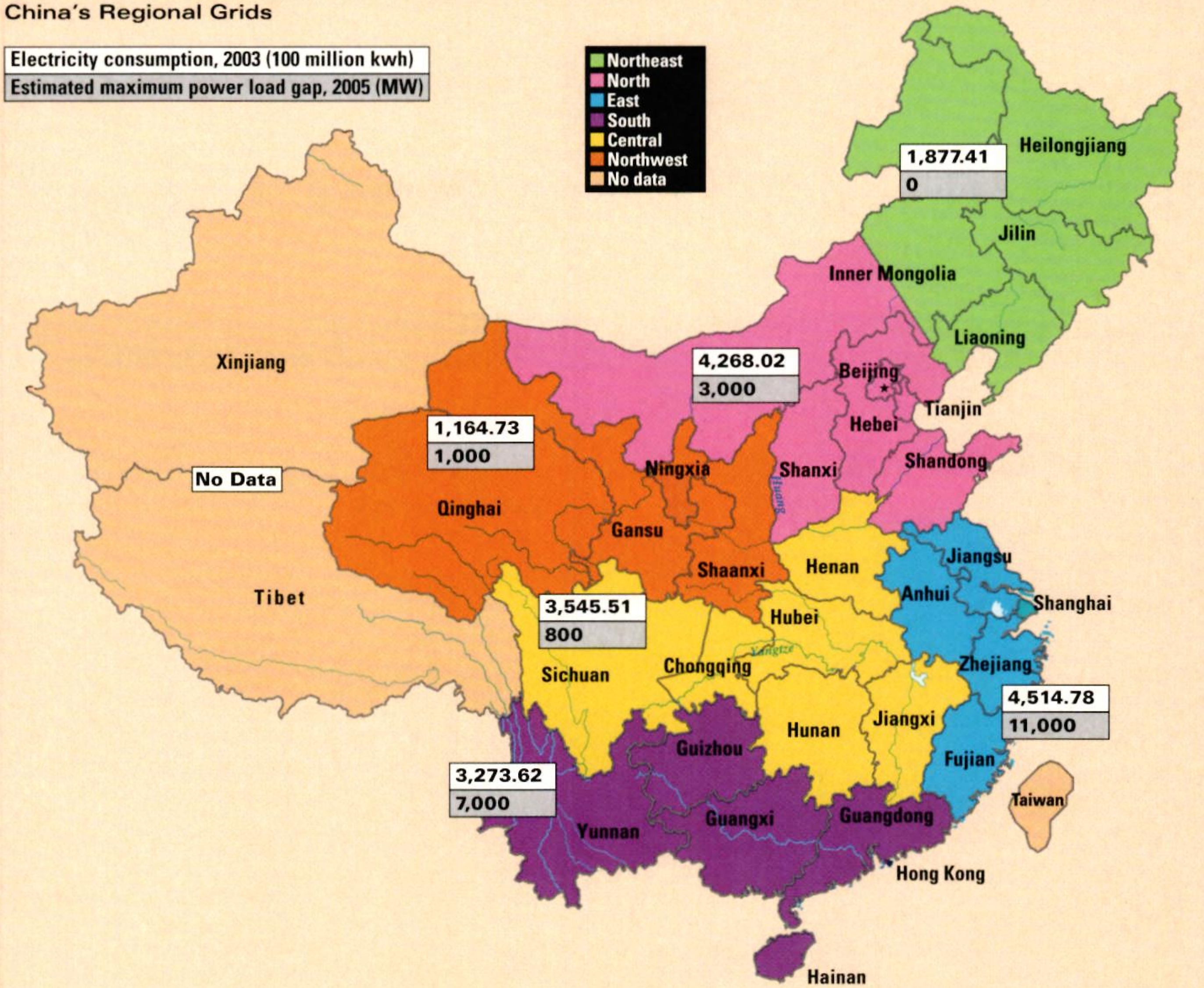


* Estimate

Note: The coefficient for conversion of electric power into standard coal equivalent (SCE) is calculated based on data on average coal consumption in electric power generation in the same year.

Julie Walton

China's Regional Grids



China's Energy Balance Sheet (10,000 tons of SCE)

Item	1990	1995	2000	2001	2002
Total Energy Available for Consumption	96,138	129,535	115,150	125,310	144,319
Total Energy Consumption	98,703	131,176	130,297	134,915	148,222
Total Energy Balance	**-2,565**	**-1,641**	**-15,147**	**-9,605**	**-3,903**
Total Petroleum Energy Available for Consumption	11,435.0	16,072.7	22,631.8	23,204.7	24,925.1
Total Petroleum Energy Consumption	11,485.6	16,064.9	22,439.3	22,838.3	24,779.8
Petroleum Balance	**-50.6**	**7.8**	**192.5**	**366.4**	**145.3**
Total Coal Energy Available for Consumption	102,221.0	133,461.7	98,176.1	108,480.0	129,604.8
Total Coal Energy Consumption	105,523.0	137,676.5	124,537.4	126,211.3	136,605.5
Coal Balance	**-3,302.0**	**-4,214.8**	**-26,361.3**	**-17,731.3**	**-7,000.8**
Total Electric Energy Available for Consumption	6,230.4	10,023.4	13,472.7	14,632.6	16,330.7
Total Electric Energy Consumption	6,230.4	10,023.4	13,471.4	14,633.5	16,331.5
Electricity balance*	**0.0**	**0.0**	**1.3**	**-0.8**	**-0.8**

Notes: *Calculated by USCBC

Sources: PRC National Bureau of Statistics *China Statistical Yearbook 2004*, The China Electricity Council

Chinese M&A: Green Light or Red Flag?

Why one would-be investor walked away from a deal

Nancy T. Avedissian

Most US companies that are relatively inexperienced in Chinese business transactions tend to follow the same negotiation strategy when they seek to acquire the assets of a Chinese company as they would in the acquisition of a US company. Buyers insist, at least initially, on terms and conditions that they would expect in a domestic transaction in the United States. Inevitably, such demands rarely align with what is standard or even possible in China. Therefore, buyers are forced to weigh the risks of unknown liabilities against the possible economic rewards of a particular transaction. Such an analysis can be difficult in China, where local practices muddy the waters. As a result, buyers often must either accept a higher level of risk than they would in the United States or walk away from the deal.

A case in point: Not long ago, a US private equity firm entered into negotiations to acquire the assets of a Chinese manufacturer in a city just north of Hong Kong. With the target company located in an emerging marketplace peppered with opportunities, the deal seemed ripe for success.

Red flags

At first, everything looked good to the prospective buyer. The target company made products that were popular in the United States and had annual revenues of about $25 million and EBITDA (earnings before interest, tax, depreciation, and amortization) of some $6 million. On the basis of these numbers, the seller asked for about $31 million—a reasonable price by the relevant market valuation methods.

But it did not take long for the buyer, experienced in US merger and acquisition (M&A) transactions, to become uncomfortable when several pieces of relatively unsavory information about the seller surfaced during negotiations. The buyer's negotiating positions hardened as uncertainties in the application and enforcement of Chinese laws became apparent.

- **Zoning and land**

One stumbling block was the company's location: the manufacturing operation was in an area zoned only for agricultural use. In the United States and many other countries, that would certainly raise a red flag. It became apparent that such zoning violations are common in China, but the buyer was still wary. The seller attempted to assure the buyer that there was no need for concern; many other manufacturers operated in agricultural zones in China, the seller said, and had experienced no problems with the local authorities.

The target company's real estate also included many long-term ground leases, some of which were due to expire within the next year and for which no contingency plan existed. The seller contended that no contingency plan was necessary because renewing the leases would not pose a problem. The buyer was not so sure and demanded that the seller covenant to locate new land to which the operation could move if the leases were not renewed.

Because of these concerns, the buyer tried to get the seller to lower the price. The seller refused, arguing that it had done nothing that other companies had not done, and insisted that the zoning violation and lack of contingency planning would not cause the buyer any difficulties.

- **Financials**

Another notable hurdle—one that did not crop up until midway through the negotiations—was that the seller's financials were audited based on generally accepted accounting

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practices (GAAP) in Hong Kong. Those standards and practices are not official and differ from US GAAP, which the buyer had used to evaluate the company. The differences were not considerable, but the buyer demanded that the seller represent and warrant that the company's financials were in accordance with US GAAP. A more reasonable request would have been to ask that the financials adhere to International Financial Reporting Standards. Claiming that the demand for US GAAP was futile (this was, after all, not a high-tech company or a company on the verge of going public in the United States), the seller refused to reconcile or restate the financials.

● **Taxes**

Still another deterrent to the deal: The Chinese company had not paid certain employment taxes levied by the government. Once again, the seller argued that this point should not be a deal killer because many other companies in the area avoided paying these taxes. The seller's attitude was, "If a local official knocks on our door and demands payment, we will negotiate and reach a compromise on the amount owed." Though negotiating taxes with local authorities is common in China, the buyer was uneasy with the response because it did not comport with general US business practices.

Unknowns scuttle the deal

As the seller's legal counsel, I came to the negotiations from my firm's Los Angeles office, along with some help from local counsel and a colleague in our Hong Kong office. In essence, we learned that what is and what is not an acceptable legal risk is not always entirely clear when it comes to Chinese business operations. Moreover, the law may be more strictly enforced against a business bought by foreign investors in China than it had been against the PRC seller. Buyers are frequently uncomfortable with that unknown: They are unlikely to accept the uncertainty of whether local officials will treat them as they treated the company under local ownership—even if the new owners operate the business in the same manner.

The net result of these and other similar considerations was that the buyer backed away from the deal. In doing so, it may have lost an opportunity to acquire a company that had an excellent chance to appreciate considerably in value. On the other hand, the buyer may have avoided future headaches, as few foreign investors have yet been able to exit successfully from investments in China.

As in most M&A transactions, the buyer performed a risk-versus-reward analysis: What is the best case scenario, and what could be the reward? What is the worst case scenario, and how much could it cost? Obviously, different buyers would come to different conclusions. Some buyers are aggressive and willing to take risks, while others, such as the buyer in this deal, are more conservative and risk averse. One of the reasons that international M&A transactions are complicated is that the risks themselves are frequently unclear and uncertain. This, in turn, makes balancing them tricky.

In China, buyers should take local practices into consideration and obtain the advice of experienced legal counsel in weighing possible risks and rewards. Practices that would be questionable in the United States are common in China, but buyers should be aware that the enforcement of laws can vary with the whims of local officials. 完

Commentary

The Sources of China's Economic Growth

Why has China grown so rapidly? Will it continue to grow?

Hu Angang

China's economy took off around 1980 and has maintained rapid growth for more than a generation. What sources have driven China's economic growth—and what do they mean for China's future?

Living up to the nation's potential

"Potential economic growth" is an estimate of the potential productivity of an economy. It represents the normal growth capability of an economy during a given period of time and is associated with certain conditions, such as a country's capital stock, technology level, and economic structure.

China's potential annual economic growth was 9.5 percent from 1978 to 1997, in constant prices, according to my calculations. Real economic growth from 1998 to 2002 undershot potential growth by 1.5 to 1.8 percent, reflecting inadequate domestic demand, especially in consumer spending. Economic growth was 9.3 percent in 2003 and 9.5 percent in 2004—edging back up toward potential economic growth because the government stimulus spending policies, which began in 1998, boosted domestic demand, especially investment.

The elements of growth

Traditionally, economists break down economic growth into changes in capital, labor, technology, and total factor productivity (TFP). Domestic and foreign studies show that a surge in TFP was responsible for higher PRC economic growth from 1978 to 1995. My analysis shows that there were four major sources of growth during this period: 2.6 percent growth of labor annually; 9.3 percent annual growth of capital stock (impressive, though slower than the 11.5 percent growth from 1952 to 1978); annual 2.2 percent growth in human capital, as calculated by the average years of education of workers above the age of 15; and a rise in TFP from -1.9 percent before reform to 3.3–4.5 percent. These calculations match the conclusions of international studies, such as those by the World Bank and economist Angus Maddison, professor at the University of Groningen, the Netherlands, and author of *Chinese Economic Performance in the Long Run* (Organization for Economic Cooperation and Development [OECD] 1998).

Economic growth between 1978 and 1995 was largely driven by the rise in annual TFP growth. Growth in overall productivity during this period contributed somewhere between one-third to one-half of economic growth. Fast

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economic and TFP growth, however, did not last. Between 1995 and 2001, China's economic growth changed substantially:

- Annual employment growth dropped significantly, to 1.2 percent, despite high overall economic growth, indicating that the economy's ability to absorb labor weakened.
- The capital stock growth rate reached new highs. Capital growth per unit of labor hit 10.6 percent—a growth rate never seen before in the world. But as a result, capital productivity (economic growth minus capital growth) turned from positive (0.5 percent) to negative (-3.6 percent).

Economic growth from 1995 to 2001 was marked by high capital input, low labor inputs, and low productivity.

- Human capital grew as much as 2.8 percent. During this period, more students enrolled in high schools and institutions of higher education in China. China now boasts more tertiary school students than any other country.
- TFP dropped 2 to 3 percent, to 0.3–2.3 percent.

Economic growth from 1995 to 2001 was thus marked by high capital input, low labor inputs, and low productivity.

Characterizations of PRC growth

The sustained growth that China has enjoyed during the reform period displays five development patterns:

1. The speed effect The speed effect describes what happens when an industrializing latecomer closes the per capita GDP gap by achieving higher economic growth. China is the fifth example of this effect in recent history (see Table 1). The four "dragons"—South Korea, Taiwan, Singapore, and Hong Kong—experienced 30 years of high-speed growth after World War II, the highest and the longest-lasting growth performance among less-advanced countries since the Industrial Revolution.

Table 1: Closing the Gap with Advanced Economies

			Per capita GDP as a % of forerunners	
Catch-Up Period	**Years**	**GDP growth (%)**	**Start of period**	**End of period**
First	1871–1913			
Britain		1.9	100.0	100.0
United States		3.9	75.3	105.5
Second	1928–1939			
United States		0.8	100.0	100.0
Soviet Union		5.6	20.8	31.4
Third	1953–1992			
United States		3.0	100.0	100.0
Japan		6.5	19.6	90.1
Fourth	1965–1992			
Western Europe (12 countries)		100.0	100.0	
South Korea		8.8	24.3	57.5
Taiwan		8.8	31.4	66.6
Fifth	1978–1995			
Western Europe (12 countries)		1.74	100.0	100.0
China		7.49	9.1	19.0

Note: Calculation based on 1990 Geary-Khamis dollars
Source: Organization for Economic Cooperation and Development, Angus Maddison, *Monitoring the World Economy, 1820–1992*

Table 2: China's Economic Structural Changes, 1952–2003

	1952	**1978**	**2003**
Population (% of total)			
Urban population	12.5	17.9	40.5
Rural population	87.5	82.1	59.5
Employment (% of total employed)			
Agriculture	83.5	70.5	49.1
Manufacturing	7.4	17.3	21.6
Services	9.1	12.2	29.3
Production (% of total)			
Primary industry	50.5	28.1	14.6
Secondary industry	20.9	48.2	52.3
Tertiary industry	28.6	23.7	33.1
GDP by expenditure (% of total)			
Household consumption	65.4	48.8	43.2
Government consumption	13.5	13.3	12.2
Capital formation	22.2	38.2	42.9
Net exports	-1.1	-0.3	1.8
Spending on food (% of disposable income)			
Cities and towns		57.5	37.1
Rural areas		67.7	45.6
Trade ratio (% of GDP)			
Exports	4.0	4.6	31.1
Imports	5.5	5.2	29.3

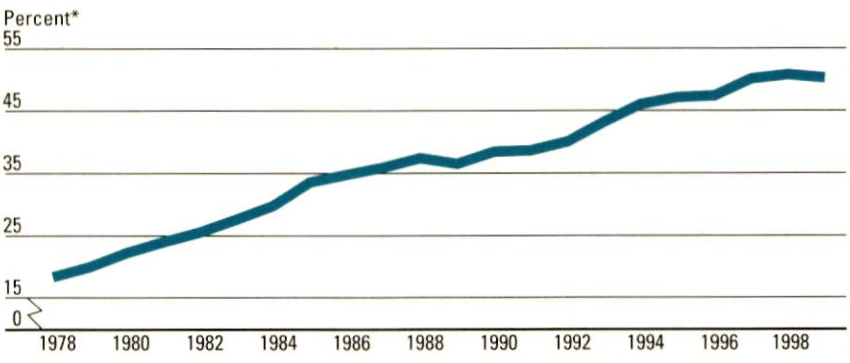
Sources: PRC National Bureau of Statistics, *Collection of Statistical Data of the 50 Years of New China*, *China Statistical Abstract 2004*

2. Structural effects The speed effect is linked to structural effects. That is, in a given period of time, the economic structure of latecomers changes more quickly than that of advanced countries. For example, it took Japan 80 years to reduce the percentage of its agricultural labor in total employment from 70 to 50 percent. It took the United States 50 years and the former Soviet Union 33 years. China took only 17 years. The post-reform era witnessed major changes in the structure of the population, employment, production, demand, consumption, and trade, with 11 of 16 indicators showing more rapid change than in the pre-reform era (see Table 2). Accelerated growth pushes labor into high-value production, which goes hand-in-hand with the growth of material capital stock, the improvement of workers' skills, development of education, structural improvements, and more openness in international trade.

In the future, China needs to shift from a capital-driven to a technology-driven economy.

3. Participation in trade Historically, less-developed economies rapidly increased their participation in international trade as they started to grow. Exports as a share of GDP rose significantly in all of the "catch-up" economies, such as Japan, South Korea, Thailand, and Taiwan. China began to open up in the late 1970s, shifting from an isolated model that was completely cut off from the world to a partially open model of socioeconomic development. Total imports and exports in 1978 were $20.6 billion, accounting for 13 percent of GDP. By 2004, they topped $1.1 trillion, 56 times that of 1978, and accounted for 70 percent of GDP. China accounted for only 0.66 percent of world trade in 1975, but topped 6.5 percent in 2004. China is now the world's fourth-largest exporter. (One caveat is that about half of China's exports are goods processed with imported materials. If such processing trade is deducted, China's global trade is less significant than the GDP/trade ratio indicates.)

Figure 1: Marketization Development Index (MDI) in China, 1978–99



Note: MDI is the weighted sum of nine indicators (see Box). *Full marketization=100%
Source: Wu Qungang, *Impact of Institutional Changes on Long-Term Economic Performance: Theories, Models, and Application*, 2002. PhD dissertation, School of Public Management, Qinghua University, Advisor: Hu Angang

4. Effects of institutional changes China's economy has shifted toward market mechanisms that have played an increasingly important role in the allocation of resources. The market infrastructure has been established and improved, institutional market rules have been implemented, and the behavior of market players has been standardized. Wu Qungang, deputy director general at the Beijing Municipal Commission of Population and

Measures of the Market's Influence

The criteria Wu Qungang, deputy director general at the Beijing Municipal Commission of Population and Family Planning, and I created for measuring the liberalization of China's institutions fit into nine areas and are weighted differently in compiling the Market Development Indicator (see Figure 1). The criteria are

- Adaptability of government behavior to the market, including the behavior, size, and type of government participation; how far the government has withdrawn from the microeconomic arena and the degree to which it has moved from direct to indirect macroeconomic control; and the changes in the government's ability to accumulate revenue.
- Manifestation of the market in the economy, as reflected by income distribution, industrial output, and distribution of consumer goods.
- Competitiveness of price and market, including changes in rural consumption of commodities and the deepening role of market supply and demand in price determination.
- Market orientation of investment (nonstate investment and changes in ownership patterns).
- Market orientation of banking and insurance, including changes in the ownership of banks and the accommodation of negotiable securities.
- Level of openness to the international economy, including dependency on trade, dependency on production (share of domestic sales revenue from foreign funded firms in GDP), and tariff levels.
- Market orientation of production factors, including the structure of employment in urban and rural areas and the shrinkage of the agricultural sector.
- Adaptability of the social environment to market evolution, including the evolution of education and human capital input mechanisms, public welfare, and social relief.
- Rules and the legal system, including the establishment of legal infrastructure, evolution of the legal system, and popularization of the rule of law among economic players.

—Hu Angang

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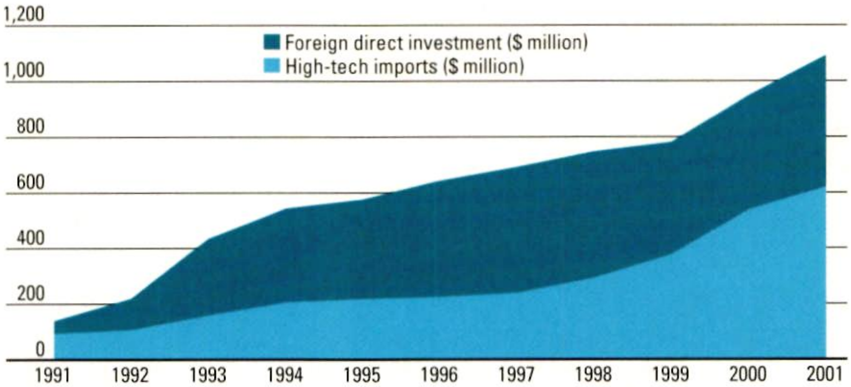
Family Planning, and I selected 9 areas and designed 24 indicators to measure the degree of market evolution and liberalization in China's economy (see Figure 1).

5. The technology catch-up effect Since technology diffusion is quicker and cheaper than innovation, technologically lagging countries can, under certain conditions, catch up with technologically advanced countries. Furthermore, technological imports can lower the costs of innovation for developing countries, shortening the time for new products to enter the market. It is these two effects that make it possible for less-developed countries to close the technological gap and raise their labor productivity, which in turn, stimulates economic catch-up. Japan and the Asian "four small dragons" are examples of this effect. Mainland China, India, and Southeast Asian countries are a potential second generation of successful paradigms.

But where does China's technology come from? There are three sources: One is direct import of new technology or import of capital goods containing new technology. Another is direct acquisition of new technology through foreign direct investment (FDI), though, of course, not all FDI is spent on research and development (R&D). The third is direct financing of R&D innovation by Chinese enterprises and institutions, which is expressed as a proportion of GDP. Together, the total spending on R&D as a share of GDP rose from 4.1 percent in 1991 to 13.58 percent in 2003 (see Figures 2 and 3).

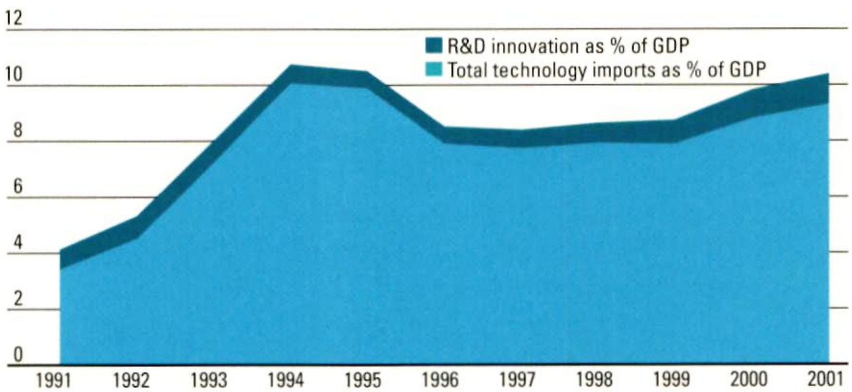
The entire process of catching up with developed countries is one of economic and knowledge expansion, with knowledge and economic growth mutually reinforcing each other. In the future, China needs to shift from a capital-driven to a technology-driven economy.

Figure 2: China's Technology Sources, 1991–2001



Sources: Hu Angang; PRC Ministry of Science and Technology, *China Science and Technology Indicators, 2000*; *China Statistical Yearbook*, 1999 and 2002

Figure 3: Technology and R&D as a Percentage of GDP, 1991–2001



Sources: Hu Angang; PRC Ministry of Science and Technology, *China Science and Technology Indicators, 2000*; *China Statistical Yearbook*, 1999 and 2002

Table 3: Long-Term Economic Growth Trends, 1998–2020

	GDP ($ billion, 1998)			% of World Total		
Country	**1998**	**2010**	**2020**	**1998**	**2010**	**2020**
China	3,850	9,803	17,057	10.23	17.66	22.20
India	2,030	3,482	5,460	5.41	6.27	7.11
Japan	2,940	4,762	7,116	7.82	8.58	9.27
Russia	948	1,202	1,466	2.52	2.17	1.90
USA	8,000	11,406	15,329	21.29	20.55	19.96
World Total	37,595	55,505	76,796	100.0	100.0	100.0

Sources: Hu Angang; World Bank, *World Development Indicators 2000*

Rising through the global ranks

We measure China's economic rise by looking at GDP. According to international prices, GDP levels show China's percentage of global economic resources rising swiftly, with the gap with the United States narrowing significantly. China is the most rapidly expanding economy in the world and is on track to become the largest economic entity in absolute terms by 2020.

According to the PRC National Bureau of Statistics, China's GDP in 2004 was 10.3 times that of 1978, averaging annual growth of 9.4 percent between 1978 and 2004. In 1978, China's GDP, on a purchasing power parity basis, accounted for 4.9 percent of the world's total. Maddison's estimates show it shooting up 6.6 percent to 12 percent in 2001, while the shares of the United States and Japan barely budged from 1978 to 2001 and Russia's share dropped. From 1978 to 2000, China's GDP as a share of US GDP rose from 22.7 to 52.5 percent.

China also has more economic growth potential than most other countries. China's GDP growth potential from 1965 to 1999, according to World Bank estimates, was more than double the world's growth potential. If it lives up to its potential, China could become the biggest economic entity in the world by 2020, with its GDP making up 22.2 percent of the world's total, higher than the 20 percent of the United States (see Table 3). Maddison confirms these estimates, noting that China's GDP could exceed that of the United States by 2015. All of these estimates depend on whether China maintains social stability and realizes sustainable economic growth.

The growth to come

I estimate that China will have quadrupled its GDP by 2020, with the average annual GDP growth rate topping 7 percent from 2001 to 2020. By that time, China's GDP will account for one-fifth of the world's total, while its per capita GDP will reach or approach the international level. China's trade volume will make up about 10 percent of the world total, and the country will rise through the ranks to be the second-largest trading country from its third-place position in 2004.

Though China's economy has strong growth momentum and clearly can generate growth, the country still faces many structural challenges, including rising rural-urban and regional disparities and conflicts between growth and employment, and development and the environment. If China can successfully address these challenges, the country can expect to enjoy many more years of strong growth. 完

Economic Views

Continued from page 4

Implications

Analysts have pointed to a number of other consequences of the move:

- **Wider foreign exchange reform** The change in the exchange rate determining mechanism appears to have spurred other reforms to China's foreign exchange regime. PBOC in early August issued rules for the interbank foreign exchange market, which took effect immediately. And the State Administration of Foreign Exchange (SAFE) again raised the amount of foreign currency Chinese companies may keep for current account transactions. PBOC also broadened the use of currency forward contracts and swaps to a wider range of institutions and clients and for a greater number of purposes.
- **Winners and losers** Deutsche Bank predicted that PRC airlines, autos, and utilities, along with the Hong Kong tourism sector, would benefit from the move, in part because imported oil and imports of components denominated in foreign currency will cost less. The bank also predicted that the move will help multinational corporations (MNCs) that export to China or produce in China for the local market, since exports to China are now slightly less expensive. On the other hand, the change may negatively affect PRC exporters—including export-oriented MNCs—especially of textiles and electronics, which operate on thin margins. But if future appreciation is gradual, and if other (particularly Asian) currencies start to recalibrate to the new RMB/dollar rate, the negative effects could be minimal.
- **An easing of US political pressure—but for how long?** In Washington, it is unclear whether pressures in Congress to act on China's currency practices will ease as a result of these latest moves. If the RMB fails to appreciate, even if in small increments, over the next few months, Congress may give greater consideration to China trade legislation and again press the US Treasury to designate China as a currency manipulator in Treasury's October currency report.

—Catherine Gelb and Virginia A. Hulme

For Immediate Release:

In China's increasingly competitive business climate, companies find they need to make full use of the media

Janet Carmosky

As China's commercial landscape matures, the nation's business environment grows more competitive and offers more choices to increasingly sophisticated audiences. Now more than ever, media, consumers, current and potential employees, and prospective partners and industry allies need to know what companies stand for, what the companies bring to the table, and why they should do business with these companies. Regulators, too, are increasingly influenced by media portrayal of domestic and foreign firms.

Media reform

In recent years, China's media sector has changed profoundly. For example, the Chinese Communist Party phased out compulsory subscription and subsidization of most newspapers and magazines in 2003. This forced publications to compete for readers and advertising dollars and thus, in many instances, to change their editorial content. Today the central government is the major source of funding for only three media outlets: China Central Television (CCTV), the People's Daily, and Xinhua News Agency (though local governments provide smaller subsidies to some local media).

Independent media have blossomed in the space left by the retreating state and now, in some cases, wield as much or even more influence than the government-sponsored publications. A regulator is now as likely to read the Chinese edition of the Harvard Business Review as the Xinhua-produced Jingji Cankao (Economic Information Daily), and to get news from the online news source Sina.com before reading the government flagship People's Daily. Trade media, few of which ever experienced direct government supervisory control, also wield significant power in their industries.

Though there are areas in which journalists tread carefully—for example, in matters of public policy, international relations, and local issues, especially in the interior—most Chinese have access to independent media, and they trust these independent sources more than state-sponsored media outlets.

Janet Carmosky
is a marketing strategist providing counsel to PR Newswire and other US companies doing business in China.

Corporate demands spark PR industry growth

Just as China's media sector is changing, China's public relations (PR) industry is growing. PR agencies such as Edelman and WPP Group companies Ogilvy, Burson-Marsteller, and Hill & Knowlton, have passed the 15- if not the 20-year mark in China, while newer entrants, such as Ruder Finn Inc., Ketchum Newscan, Weber Shandwick Worldwide, Fleischmann Link, and the Hoffman Group, bid for the China business of their global accounts. Local PR agencies have proliferated, particularly specialist firms that focus on a single region, such as the Pearl River Delta, or a single sector, such as personal computers, mobile phones, or pharmaceuticals. According to the Chinese International Public Relations Association, in 2004 PR billings totaled nearly ¥4.5 billion ($543 million), up 36 percent from 2003, and China had more than 2,000 PR agencies that employed roughly 20,000. Rising corporate demand for communications services underlies the expansion.

In response to this new demand, and to capitalize on changes in media and media relations services, foreign media firms are paying close attention to opportunities in China. One company, PR Newswire Association LLC, established a China operating company—Xinhua PR Newswire (XPRN)—in 2002. The company set up news distribution circuits that cover the whole country, reach important trade and industry media circles, and access Internet and web-based news archives. XPRN aims to supplement the existing domestic reach of multinational corporations (MNCs) and Chinese companies, help China-based headquarters coordinate their global communications initiatives, and allow US-based clients with limited or no media relations capability in China to reach audiences in China through Chinese media. XPRN has several hundred clients, including Continental Airlines, Inc., which recently took advantage of PR Newswire's global reach to support the June 16 launch of Continental's daily Newark-Beijing service. The launch was announced to audiences in the United States and China through American media, general and trade media in China, and Chinese-language media serving the North American Chinese population.

Media pointers

At a two-day conference on media relations in Shanghai this May, the head communications managers of several MNCs and large Chinese companies presented their top suggestions for media relations in China.

- **Prevent and defend against bad press**

Mature businesses in China often face similar challenges. Companies must hold market share in the face of lower-priced competition, strengthen relationships with government, partners, and employees—and defend against negative press, which can undermine these goals.

Negative press is a consequence of an increasingly sophisticated and competitive business and media environment. Because big brands are so visible, they are often targeted in negative stories, especially tabloids, fiercely nationalistic media, and the relatively free and aggressive media in Guangdong. In the first six months of 2005 alone, several MNCs had to work quickly to repair damaged reputations. For example, Procter and Gamble Co. initiated a major face-saving campaign after consumer activists, supported by Chinese-language media, disputed advertising claims for Pantene V shampoo, which claimed to make hair 10 times more resilient than normal. Extensive media coverage also accompanied the recall of two Nestlé baby milk formula products that had iodine levels above PRC government safety standards. And General Mills brand Häagen-Dazs felt the heat after being investigated for sanitation violations in the production of ice-cream cakes in Shenzhen.

According to the Chinese International Public Relations Association, in 2004 PR billings totaled nearly ¥4.5 billion ($543 million), up 36 percent from 2003, and China had more than 2,000 PR agencies that employed roughly 20,000. Rising corporate demand for communications services underlies the expansion.

But even companies innocent of any wrongdoing can face PR crises and thus would do well to prepare crisis communications plans. Because news is so accessible on the Internet, negative news in the international media easily enters and spreads in China. When the banned food-coloring agent Sudan I was found in some sauces used by McDonald's Corp. in the United Kingdom earlier this year, the news traveled through the Internet to China before McDonald's could clarify that none of the sauces were ever used in China. PRC health authorities subsequently found Sudan I in sauces distributed by KFC Corp. and H. J. Heinz Co., further fueling the media frenzy. Though the ingredient was not used in any McDonald's foods in China, the company mobilized a team to respond to media inquiries and to distribute statements on the Sudan I issue. A good crisis plan includes training spokespersons to handle crisis communication and to cultivate media relationships to preserve a channel for positive news during crises.

One strategy to maintain or enhance a brand's image is to develop a comprehensive corporate social responsibility (CSR) program. Giving back to the community, coupled with communications, helps both localities and the corporation. Bayer AG, which has emerged as a champion of CSR in China, manages a program of a dozen CSR initiatives that range from university partnerships to nongovernmental organization-building programs to providing leadership in China's AIDS forums. In partnership with Mercy Corps, the China

Foundation for Poverty Alleviation, and other corporate sponsors, Bayer also funds a microfinance program in rural Fujian.

Extend the life of your press release

XPRN's Managing Director Chen Yujie shed some light on media relations tactics that other market leaders use. "While there is such a thing as communicating too much, more often companies communicate far too little. Our China-based clients all have in-house communications teams, and often PR agency relationships as well, where messaging, strategy, and key media relationships are handled. We simply deliver news releases, in text and multimedia format, to databases like Lexis-Nexis and Factiva, news portals and archives, and to the broader cohort of industry influencers and observers. All of these services extend the life of a news release and expand the reach of any organization beyond the privileged 'key' media group. This strategy is more similar to those used in a media market such as the United States, where a news release is sent to thousands, not just a handful, of media."

Monitor media coverage

If best-practice use of PR resources involves high-volume media relations efforts that articulate successes, industry leadership, thought leadership, and other justifications for premium pricing, monitoring media coverage is the most common best-practice tool to justify the PR department's budget. Some companies, like Sony-Ericsson Mobile Communications AB, have in-house resources to log, track, and analyze their China media contacts and coverage. Alcatel Asia Pacific uses the analytic services of the media-measurement company CARMA International, Inc. Alcatel's Shanghai-

Tips for Successful Media Relations in China

Many foreign companies find it difficult to manage media relations in China. Following these tips can help.

1. Respect journalists

Though China has been liberalizing its media gradually over the years, some censorship mechanisms remain in place. Nevertheless, publications, websites, and television programs in China earn readers and advertising revenues only to the extent that audiences view them as truthful, authoritative, and readable. Journalists in China are looking for newsworthy stories, interesting angles, and straight information. Publishers may be happy to sell "advertorials," but journalists and editors want accurate, significant stories.

2. Respect China

Companies should ground their press releases with angles that highlight the value and strength of the assets they bring to China. Releases should also reflect a company's support for China's continued development.

3. Do your homework

Foreign companies must improve the relevance of their releases by learning what is on the minds of people in China. Companies should scan Chinese websites and print media—at a minimum, by checking independent sites such as www.cbiz.com and English-language versions of PRC government media such as http://english.cctv.com, http://english.peopledaily.com.cn, www.chinadaily.com.cn, and http://english.eastday.com. To sample what a news release for a Chinese audience looks like, companies can visit the English version of the Xinhua PR Newswire site (www.xprn.com).

4. Trust professionals on the ground

It is impossible to understand how things get done in China—let alone to actually get them done—from Hong Kong, Singapore, Taiwan, Japan, or anywhere else. If your public relations (PR) agency is running China programs out of Singapore, find out how and why.

5. Use targeted messaging

It is important to pay attention to the different audiences of China's diverse media outlets. Trade media are interested in new product releases and features, changes in distribution, and recent industry awards. Regulators and industry analysts are more interested in corporate news: announcements related to developments in an organization's technology, management, and financial circumstances. Job seekers look for features that provide some sense of an organization's identity and culture, as well as a direction for the future. Companies should also be aware that these audiences may be seeking more than just China-specific information and may want to consider translating headquarters' press releases into Chinese.

6. Set the stage

Is your president or CEO planning a trip to China? Will your products be featured at an upcoming trade show? Were significant contracts just signed with Chinese organizations? Will an office or other operation soon be opened or expanded? If an event is coming up, your company should consider a mini-campaign of three to five targeted releases to prepare media, trade, consumer, regulatory, and other audiences.

7. Match the tool to the job

When in-house PR staff, an agency, and a newswire service such as PR Newswire get involved in a project, separate the work sensibly. In-house PR employees need to be involved in the information-intensive, relationship-intensive tasks of obtaining feature stories, planning media briefings, and managing press conferences. Agencies—assuming they are on the ground in China—excel at supporting in-house PR staff, developing creative angles and tactics, VIP handholding, and sometimes, government relations. A newswire service exists solely to deliver releases to media, quickly and economically.

8. Review geography

Aside from the top portals, China has very few nationwide media. Print, radio, and even TV media influence is quite local. Company outreach to key media groups naturally tends to focus on a few cities where operations or markets are most concentrated. Still, when and if developing a national reputation becomes important, companies should consider using a news distribution sorted by geography, to extend media reach to neglected but strategically important parts of the country.

9. Release. Rinse. Repeat.

One release is a flash in the pan. To win and keep the attention of important audiences—usually trade audiences—companies should send at least one release a month. If a company's expectations are not met in one instance, it should not give up on the idea of reaching audiences in China. Get some advice and try again. Some international organizations send three releases a week in China, and the releases do generate coverage. Keep trying.

—Janet Carmosky

based team manages all of Alcatel's Asia-Pacific communications, so it needs to monitor multiple languages, which is where a regional company such as CARMA comes into the picture.

- **Beef up your brand's reputation**

Companies with limited physical presence or minimal in-country communications staff face the same highly competitive landscape as companies with a larger presence and staff, but they have fewer resources. It is nearly impossible for an unknown entity to achieve satisfactory market share, especially considering the vast scale and competitive nature of China's economy. But as many examples in the United States demonstrate, small and medium-sized enterprises can build their businesses through trade shows, customer referrals, and informal networking. In these cases, however, building a dedicated communications function can be a significant challenge.

Fortunately, media relations is an accessible discipline, and counsel is readily available. Newcomers can quickly learn the basics: map your audiences and compile a message template that articulates not only your company's value in the industry overall, but its importance to industry, customers, and the PRC government. This would normally be the first task of any PR agency. The next tasks are to find opportunities for coverage, maintain communication channels with members of the media, and adjust messages and delivery with new developments.

For companies building a reputation in China, having a Chinese-language press kit—with a company summary, backgrounder, product or service information, and relevant press releases archived on the company website—is a milestone in the journey toward credibility and influence. Investment in a virtual presence, that is, use of a Chinese-language website and periodic press releases distributed to Chinese media, will greatly magnify the effectiveness of a company's physical presence such as events, planned executive visits, trade show appearances, and partner announcements. Media are more inclined to cover companies they can easily research than those about which it is difficult to find information.

The National Football League's (NFL) attempt to build brand franchises in China provides an interesting example of how good communication is needed for a brand to succeed. Though well known in the United States, the NFL was essentially unknown in China when it first entered the country in 2004. According to David Turchetti, CEO of the Shanghai-based, Internet and mobile communications marketing agency 21 Communications, "The NFL was smart enough to know that success in China was going to be a much taller order than just getting their games into distribution on Chinese TV, which of course they did. They also knew, as did the NBA [National Basketball

Association], that there would have to be plenty of grassroots work, so they paired up with Zou Marketing, a sports promotion company, to send teams of Americans to teach flag football to Chinese kids. Still, without communications, it could all be money down the drain. They knew they would need an effective Chinese-language website to educate media as well as fans. They knew [NFL Commissioner] Paul Tagliabue would need to

Every serious China communications program needs a few reliable partners fluent in Chinese: a strategist, a translator, and a spokesperson.

lend a high-profile face to their entry, so they not only set him up to speak with AmChams [American Chamber of Commerce offices], they sent our press releases to Chinese media, organized lots of media lunches and interviews, and hired a Chinese-language spokesperson."

If the NFL, with its huge brand recognition and its fun, sporty message, knows it needs a serious media relations campaign to attract attention in China, why do so many industrial and service companies assume they do not? The problem may lie in budget concerns. But, done with the right partners, sending a press release in Chinese in China may cost only a few hundred dollars, while translating a website, designing a message template, or organizing an executive visit around a trade show need not surpass a few thousand.

When resources are tight, companies should, at a minimum, consider using diagnostic tools that will arm sales and marketing people in China. For example, a company can benefit from a third-party "perception audit" to show how its brand and competing brands are seen by customers, distributors, suppliers, potential employees, or any other audience important to success. A media audit can review coverage of the company's brand and key competitor brands. When companies know where a brand stands, they can clarify how to get the brand where it is wanted and can define what messages they need to deliver. An audit can also demonstrate to management why the PR department needs a strong budget and how it will be used.

Strengthen local and global communication

No matter how strong a company's China-based presence is, headquarters always has a role to play. But because there tends to be a split between marketing and sales communications, which are usually driven entirely by local teams, and corporate initiatives—such as research and development, personnel or financial announcements, and major sponsorships, such as the 2008 Olympics—best practice in global communications always involves well-designed internal coordination. For example, Motorola, Inc. has a global communications management system based on Vignette Corp. software in which all releases and events in any location where Motorola operates are uploaded and available to all Motorola communications managers worldwide. Thus, a marketing manager in China may decide to localize and distribute a release about a new product in Europe that would be interesting to media in China, or an investor relations manager in the United States may edit and release news about a sales increase in China.

Translation is a necessary step in global communication, but a good translation needs more than fine language skills; as with all marketing materials, translations need internal review to ensure consistent tone, manner, voice, and language. An inexpensive translation agency should be able to quickly render a draft that is technically consistent with the original meaning in English. Wordsmithing and fine-tuning are best left for a PRC-born and -educated, Mandarin-speaking, full-time employee who understands the company's communication objectives, technology, and values. At minimum, companies must avoid dated or regionally inappropriate language, which can creep in when an employee who has been abroad for many years, or an overseas Chinese from another country, is involved in the editing process.

Map and message

At some point, every serious China communications program needs a few reliable partners fluent in Chinese: a strategist, a translator, and a spokesperson. Companies should begin by focusing on strategy. To develop a successful strategy, companies should first observe and then address existing consumer and industry perceptions. No matter how well known a brand may be at home, in China the brand could start with a blank slate or be perceived differently. Second, messaging and delivery should be based on the culture in China. Companies should map out, then articulate the elements of their brand, product, or culture that resonate in China. Third, companies should find the right channels for media outreach—whether web, print, or video releases; media briefings; dinners; or seminars—and commit to keeping them open. Companies must also recognize the need to continually educate media. And to receive optimal funding and internal support, PR departments should design a communications program that measures results.

Regardless of a company's stage of development in China, communicating about its brands' values, assets, heritage, and philosophy will benefit its business objectives. Whether a business is defending a leading brand from cut-rate competition, building a brand to gain a market share that supports economies of scale, strengthening a new foundation, or supporting a search for partners or regulatory support, companies will achieve their goals faster and maintain their desired position for a longer period if they support their efforts with strong media relations. 完

CRITICAL EYE ON LANZHOU

Eager to attract foreign investment, Gansu's capital dusts itself off

Rebecca Karnak and Lin Jun

Once a major stop along the Silk Road, Lanzhou has remained a hub of trade and commerce in Northwest China. The capital of Gansu offers investors reliable and relatively inexpensive energy supplies and a good transportation network in and out of the city. It also has lower costs of living than those of rival cities such as Xi'an in Shaanxi and Chengdu in Sichuan and many second-tier cities along the coast. Yet although Lanzhou is at the center of trade activity in China's Northwest, the city feels remote, both in terms of geography and attitude.

Lay of the land...

Sandwiched between mountains in the north and south, Lanzhou's position both helps and hurts it. While the Yellow River runs through the city, providing it with abundant water, the surrounding area remains dry and difficult to cultivate. The hour-long ride from Lanzhou Airport into the city reveals Lanzhou's efforts to landscape the area—the brown mountainsides that line the road have been terraced and planted with trees.

In terms of transportation, Lanzhou is well connected to the rest of the country. Four major national rail lines converge at Lanzhou, including one that runs to the port at Lianyungang, Jiangsu. The city is a transfer center for containers being shipped along the Euro-Asian continental line, and the Lanzhou Western Railway Station is home to the largest cargo marshalling yard in China's Northwest. Six national highways stretch out from Lanzhou, connecting it to nearby Xining, Tianshui, and other Gansu cities, and west to Urumqi in Xinjiang and east to Xi'an. Airlines fly in and out of about 35 cities from the Lanzhou Airport.

The larger of Lanzhou's two state-level economic zones—both in terms of area and number of registered companies—sits to the west of the city. The Lanzhou New- and High-Technology Development Zone, approved by the State Council in 1991, spans more than 29 km^2 and hosts more than 1,000 enterprises, 35 of

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Lanzhou at a Glance

National-Level Development Zones

Lanzhou Economic & Technological Development Zone
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Fax: 86-931-217-5639
E-mail: info@lzeda.com
www.lzeda.com

Lanzhou New- and High-Technology Development Zone
Tel: 86-931-216-0601
Investment Office Tel: 86-931-877-2830
E-mail: webmaster@lzgxq.com
www.lzhtp.gov.cn

Useful Websites

Lanzhou City Government
www.lz.gansu.gov.cn

Lanzhou Commerce and Trade Commission
www.lxkc.com.cn

Lanzhou Industry Net
www.lzec.gov.cn

Lanzhou Information Port
www.lzxxg.com

Contacts

Government and Chinese Communist Party Leadership
Party Secretary: Chen Baosheng
Mayor: Zhang Jinliang
Vice Mayor (in charge of foreign trade and investment): Chen Dongzhi

Lanzhou Commerce and Trade Commission
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China Council for Promotion of International Trade, Lanzhou
Vice Secretary General: Zhang Qiuxing
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Lanzhou Administration for Industry and Commerce
Director: Cheng Shuyin
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Lanzhou Development and Reform Commission
Director: Zhang Yixiang
Tel: 86-931-877-2926

Lanzhou Environmental Protection Bureau
Director: Wang Deming
Tel: 86-931-213-0836

Source: Lanzhou Government

By the Numbers

Lanzhou	2004	Increase over 2003
GDP	$6.10 billion	11.4%
Population	3.14 million	NA
Urban	2.07 million	NA
Rural	1.07 million	NA
Urban per capita disposable income	$929	8.3%
Rural per capita net income	$308	6.0%
Mobile phones in use	697,000	NA
Value-added industrial output	$2.44 billion	14.6%
Fixed-asset investment	$2.80 billion	10.1%
Retail sales	$2.76 billion	12.0%
Foreign trade (exports & imports)	$600 million	-20.0%
Foreign direct investment (FDI)		
Projects	29	-17.1%
Contracted FDI	$203 million	7.3%

Note: NA = not available
Source: Lanzhou Commerce and Trade Commission

which were foreign-invested at the end of 2004. One of the newest foreign arrivals is the Gansu China National Cereals, Oils, and Foodstuffs Corp.-Coca-Cola Beverages Co. Ltd. bottling plant, a $12 million joint venture (JV) built to supply Gansu, Ningxia, Qinghai, Tibet, and Xinjiang with beverages. In 2004, the zone's economy reached $1.45 billion. This figure dwarfs the funds generated by Lanzhou's other state-level development zone.

The Lanzhou Economic and Technological Development Zone lies in Anning District just north of the Yellow River. Lanzhou is building a new residential area near the zone, as well as a bridge to create a faster connection between Anning and the rest of the city. The zone's economy grew 38 percent in 2004, reaching $423 million. With 21 large and medium-sized state-owned enterprises (SOEs), which mainly manufacture aeronautic materials, electronic instruments, and information technology products, zone officials hope to lure more foreign investors with preferential policies, cheap energy prices, and an eagerness to accommodate. After several months of negotiation, Wal-Mart Stores, Inc. recently decided to invest $12 million to open a 30,000 m^2 shopping mall and a 50,000 m^2 logistics center in the zone. Zone officials marked the arrival of the Fortune 500 enterprise as a breakthrough, since before the Wal-Mart deal, the zone was home to only three foreign enterprises.

As part of its effort to attract investors, Lanzhou has been developing entertainment areas along the banks of the Yellow River since 1999. One advertisement proclaims that the Yellow River Baili Scenic Strip will become Lanzhou's own version of Shanghai's Bund, complete with riverside parks and plazas, restaurants and bars, and cruise operators.

...And the sky

Lanzhou residents are well-aware of the city's reputation as one of the most polluted in China, and the city has taken some steps to remedy the situation. In a recent interview with development zone officials about the type of industries they want to attract, one official replied, "Ones that don't pollute." Though zone officials did not elaborate on currently active or planned pollution control measures, local Environmental Protection Bureau officials expressed interest in learning how cities in other countries regulate polluting manufacturers.

Over the next two years, local environmental protection officials will spend more than $128 million to replace roughly 1,100 coal-burning furnaces in industrial and residential buildings with natural gas furnaces. A similar plan is in place for buses and taxis.

Economic landscape

In 2004, Lanzhou's GDP reached $6.1 billion, an 11 percent increase over 2003. Local officials attributed the growth to more infrastructure projects such as road and cloverleaf-junctions upgrades, Yellow River Baili Scenic Strip developments, and natural gas, water supply, and water treatment networks. Since 2001, the city has received about $242 million annually from the central government as part of China's Great Western Development Strategy (see the *CBR*, March–April 2004, p.8). The funds have gone toward these projects as well as toward pollution abatement. Expansion of China's national retailing giant, Beijing Hualian Group, which recently opened a 66,000 m^2 shopping mall in Lanzhou, has also contributed to the city's growth. The city's major industries include nonferrous metallurgy, machinery manufacturing, pharmaceuticals, and textiles. Agriculture makes up only 4 percent of Lanzhou's economy.

Lanzhou is a petrochemical base and home to PetroChina Co. Ltd.'s largest refinery in western China, which started up in the 1950s. Indeed, certain parts of the western edge of the city feel like an old, industrial town, with dusty roads and a faint chemical smell in the air. PetroChina set up Lanzhou's oil additive manufacturing facility in 1963—the same year the city completed the nearly 2,000 km of rail that connect Lanzhou and Urumqi.

Oil and gas supplies in Xinjiang have driven the development of the sector in Lanzhou and have attracted the attention of several foreign investors. Lubrizol Corp., the partner of Lanzhou PetroChemical Co., is one of the largest foreign investors registered in Lanzhou's New- and High-Technology Development Zone. The JV, Lubrizol Lanlian Additive Co., Ltd., now operates the city's original oil additive facility. Lanzhou Petrochemical Machinery and Engineering Group, the top manufacturer of oil drilling rigs and refining equipment in China, has partnered with National Oilwell International to form the Lanzhou LS-National Oilwell Petroleum Engineering Co., Ltd., a JV with $17.3 million in registered capital.

Business environment

These investors stepped into existing facilities and administrative structures, bringing along their technology and management know-how. For these investors and others that are building from scratch, the Lanzhou municipal government has tried to streamline administrative procedures and improve transparency. Lanzhou's new one-stop shop in the city hall is designed to help investors navigate the local bureaucracy. One local businessperson confirmed that Lanzhou officials are increasingly accessible but said that they do not always understand their role as service providers. He reported that the city recently lost a large potential investor to a city in Hunan after the two sides could not agree on reasonable terms for a new facility.

Another difficulty investors face in Lanzhou is the city's shortage of skilled technicians, managerial talent, and competitive workers with strong communication skills. In recent interviews, more than one JV manager expressed frustration over finding qualified personnel among Lanzhou's 3.14 million residents. Lanzhou is home to 19 universities and research institutes, including Lanzhou University, which years ago ranked among the nation's top 10 (many view it as northwestern China's top university now). But with a relatively small number of foreign companies in the region, Lanzhou's educated workforce has little opportunity to gain critical cross-cultural communication and management experience without leaving the city. A few of Lanzhou's young and talented are doing just that—after studying and working in Beijing, Shanghai, and other eastern cities, they return home to fill positions in JVs and government offices.

What's next for Lanzhou?

Lanzhou officials are enormously eager to attract foreign investment in virtually any sector. As one official stated during a recent visit, "*Ni zhuan qian, wo fazhan.*" ("You [the foreign investor] make money, and I [Lanzhou] develop.")

But Lanzhou faces a chicken-and-egg problem: With little experience courting and maintaining relationships with foreign investors, Lanzhou officials, while eager for investment, may not always understand what it takes to seal the deal. Yet until more foreign enterprises invest in Lanzhou, the city has little opportunity to gain this experience. In the near term, Lanzhou will likely continue efforts to reduce pollution and improve infrastructure, while hoping to inch higher on the list of top destinations for foreign investors looking at central and western China. 完

The Soybean Trade

Julie Walton/Paula M. Miller

Though US soybean trade with China has its rough spots, the future of soy trade looks bright—at least in the short run

Paula M. Miller

The United States is the world's largest producer and exporter of soybeans; China is the world's largest importer of soybeans. According to the US Department of Agriculture (USDA), from September 2003 to October 2004, US soybean exports to China totaled nearly 8.3 million metric tons and accounted for almost half of China's total soybean imports (see Figure 1). From September 2004 to May 2005, US soybean exports to China reached a new record of 11.7 million tons, worth $2.7 billion, exceeding the previous year's performance. It is no wonder US soybean trade with China is a high priority for the US agricultural sector—and the US and PRC governments are working hard to make the trade relationship work. But how long will soybeans be a US-China trade success story?

Cash crop

Though the soybean is botanically classified as a legume, for trade purposes, it is defined as an oilseed since it shares the same major production and marketing processes as oilseeds. While unprocessed soybeans have limited use and economic value, processed soybeans are used in a variety of ways and are highly valued for their soybean meal and oil (see p.46).

In 2004, US farmers harvested roughly 85.5 million metric tons of soybeans, compared to China's 18 million metric tons. Planted on 28 percent of total US crop area, soybeans are the country's second-largest crop by cash sales after corn. Thirty-one states grew soybeans on 75.1 million acres, mostly in the Midwest and the lower Mississippi valley (see Table 1). Last year the United States grew 40 percent of the world's soybeans and accounted for 48 percent of the world's soybean trade (see Figure 2).

According to David Kiefner, trade policy analyst at the USDA Foreign Agricultural Service,

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Table 1: Top 10 Soy-Producing US States, 2004

State	Million metric tons
Illinois	13.61
Iowa	13.54
Indiana	7.81
Minnesota	6.43
Missouri	6.08
Nebraska	6.01
Ohio	5.65
South Dakota	3.81
Arkansas	3.39
Kansas	3.02

Source: American Soybean Association (ASA), *Soybean Stats*

Table 2: US Soybean Exports, million metric tons

Year	Global	China	China as % of Total*
2000	27.0	5.2	19.3
2001	27.6	5.7	20.7
2002	29.9	4.6	15.4
2003	29.1	7.7	26.5
2004	24.2	8.2	33.9

* Note: Calculated by the US-China Business Council
Source: US Department of Agriculture (USDA) Foreign Agriculture Service

US soybean exports to China totaled roughly $2.5 billion in fiscal year 2004. "USDA's Economic Research Service estimates that these exports supported 46,000 jobs throughout the US economy—both on and off the farm." Kiefner went on to explain that off-farm jobs include those in transportation, marketing, financing, and related activities. This employment effect, in turn, created additional supporting economic activity worth an estimated $3.5 billion in 2004. "This means," he says, "that soybean exports to China in 2004 created more than $6 billion in overall economic activity throughout the US economy."

The United States has been a leading supplier of soybeans to China since the mid-1990s, when China emerged as the world's largest importer. US soybean exports to China have been rising since then, and Kiefner expects this trend to continue. He points to the July USDA World Agriculture Supply and Demand Estimates report, which calculates that China's soybean imports from the world will hit 23.2 million metric tons in the 2004–05 fiscal year and 27 million metric tons in 2005–06.

A symbiotic trade relationship?

China was self-sufficient in, and a key net exporter of, soybeans until the mid-1990s. Two developments are largely responsible for the change in its trade patterns. First, as income levels in China rose, the population's diet changed. China's growing middle class, which has higher incomes than ever before, now spends more on meats, sweets, and fats and oils. The increased demand for meat and oil has led to a rise in demand for soybeans, which are a main ingredient in animal feed.

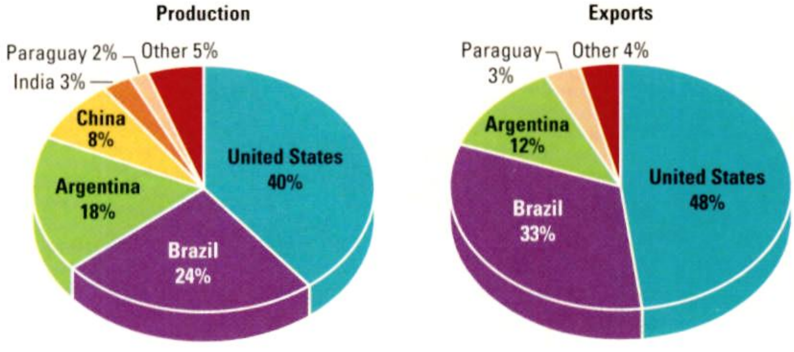
Second, given China's shortage of arable land (the United States has roughly one-third more cropland than China, yet China's population is more than four times greater than America's), it is more efficient for China to rely on other countries to supply land-intensive crops and products. For China to achieve even its current level of food production, it must double- and triple-crop its land, which requires heavy fertilizer and labor use. Soybeans are an inefficient crop to grow in large quantities because the yield per unit of land is low

Figure 1: China's Soybean Imports

October 2003–September 2004

Note: Other countries account for less than 1 percent of China's soybean imports
Sources: USDA; PRC General Administration of Customs

Figure 2: World Soybean Production, 2004



Source: ASA, *Soybean Stats*

> "Soybean exports to China in 2004 created more than $6 billion in overall economic activity throughout the US economy."
>
> —David Kiefner, US Department of Agriculture

(unlike many vegetables and melons) and because of China's water and land shortages. Most experts do not expect these circumstances to change radically in the future. According to American Soybean Association (ASA) China Country Director Phil Laney, "China's arable land is already fully utilized. While improved technology could produce better yields for some crops, in general, China can only grow more of something by reducing the land devoted to something else."

Laney believes the United States holds a strong position in the world markets for soybeans and soybean products in part because of the uniform quality of its products and efficient trade and marketing. US soybean and soybean products are governed by contract specifications and a government-regulated inspection, sampling, grading, and weighing system. The Federal Grain Inspection Service—a division of USDA's Grain Inspection, Packers, and Stockyards Administration—establishes most standards for soybeans and provides inspection services. The National Oilseeds Processors Association, which works with the US departments of Agriculture, State, and Commerce, administers soybean meal and oil trade through trading rules and certifications.

Top issues for US soy exporters to China

When asked to list the top difficulties in US-China soybean trade, many Americans in the field mentioned the same issues, though the angle varied slightly depending on whether the person was involved in growing, processing, or exporting soybeans; lobbying for increased soy trade; or working for the US government.

- **Phytosanitary concerns**

In August 2003, China's Administration for Quality Supervision, Inspection, and Quarantine

Soy Wonder

Often labeled the "miracle crop" for its versatility and high-protein meal and oil content, soybeans are a hot commodity.

According to the American Soybean Association's China Country Director Phil Laney, all imported soybeans in China and about half of China's domestic soybean crop are crushed into soybean meal and oil. The meal is used to produce high-protein animal feed for poultry, swine, cattle, and fish, while the oil is used for cooking. Most of the remaining domestic crop is used for traditional soy foods, such as bean curd, soy sauce, and soy milk.

But globally, soybeans are used to make many products. Produced from whole soybeans, full-fat soy flour is used to make breads, pie crusts, frozen desserts, and instant milk drinks; roasted soybeans can be used in candies, cookies, crackers, soynut butter, and soy coffee, among other products. Produced from soybean protein, soy flour concentrates and isolates are used to make baby food, beer and ale, cereals, meat products, prepared mixes, and yeast. Soybean oil—the world's leading vegetable oil—is used to produce baking and frying fats, salad dressing and cooking oil, margarine, and coffee creamers. Soybean lecithin is used as an emulsifying agent in bakery products, candy and chocolate coatings, and pharmaceuticals.

Refined soybean oil also has industrial uses. It is used in diesel fuel, disinfectants, epoxy, ink, plastics, paint, putty, soaps and shampoos, varnishes, and more. Adhesives, antibiotics, cosmetics, inks, plastics, polyesters, and textiles can all be made from soybean protein products.

Products to watch

Two soy products, biodiesel and cloth, are worth watching in the near future.

Biodiesel is a renewable, clean-burning fuel for diesel engines produced from natural oils, such as soybean oil. It is created through a chemical process that removes glycerin from oil; methyl esters (biodiesel) and glycerin (which is used to make soap) remain. The product is generally blended with petroleum diesel to create a biodiesel blend and is sold across Europe, the United States, and many other countries.

Shanghai native Li Guanqi invented a silk-style underwear spun out of soybean fiber in 1999. Li's company, the Shanghai Winshow Soybeanfiber Industry Co., made $7 million in soy garment sales in China in 2004. He plans to start exporting finished products to the United States and Europe in 2006. A few foreign companies that supply retailers are purchasing Li's soy yarn and weaving it into finished garments. In early 2005, the cloth ran roughly $8 per pound, about 20 percent more than wool and about the same price as silk.

—*Paula M. Miller*

(AQSIQ) announced that soybean shipments from four major trading companies would be blocked because some of their soybeans were found to possess excess levels of *phytophthora sojae*, a soy-borne fungal disease that leads to seed and root rot. Because China delayed the announcement (AQSIQ officials said they first spotted the disease in spring 2003), did not specify when the suspension would take effect, and because the disease had long been present in China and most other soy-exporting countries, it appeared that the PRC government was unofficially capping soybean imports. International traders began to worry that PRC quarantine officials were providing Chinese soybean buyers with a pretext to renege on contracts signed when the soybean price per bushel was high. US and PRC officials eventually met to discuss the problem, and China agreed not to impose the import suspensions.

A second phytosanitary incident resulted in massive losses to international exporters, though no US soybeans were affected. In 2004, the PRC government rejected soybean shipments from Brazil after finding soybeans covered with the fungicide carboxin. The rejection of cargoes led to massive defaults which, according to industry insiders, ended up costing the trade an estimated $300 million in cancelled contracts.

● Decree 73

In June 2004 AQSIQ issued Items on Handling the Review and Approval for Animal and Plant Entry Quarantine, otherwise known as "Decree 73." Fulfilling one of China's commitments at the 2004 US-China Joint Commission on Commerce and Trade (JCCT), the decree extended the validity of China's quarantine inspection permits from three to six months, thus giving importers more time to purchase, transport, and release their goods. Yet the decree also requires that all contracts for soybean imports include Chinese quarantine requirements as a contract term. Chinese quarantine standards, however, are often opaque and therefore subject to interpretation. The provision that requires exporters to comply with Chinese standards is inconsistent with international practices for commercial contracts and shifts all of the economic risks associated with complying with Chinese quarantine and food safety requirements to the exporter—instead of the importer. Furthermore, under Decree 73, PRC authorities can determine that the product does not comply with PRC laws. China failed to notify the World Trade Organization (WTO) of the decree before its release and did not allow WTO members to comment on it, as WTO rules require. In meetings with US government and international trade officials, PRC officials stated that the decree would not disrupt soybean exports to China. Though China has not yet enforced the requirements in Decree 73, the risk of trade restrictions remains, and soybean traders feel vulnerable.

● Limitations on genetically modified crops

The PRC government is slowly warming up to genetically modified (GM) crops. The Ministry of Agriculture (MOA) and AQSIQ issued regulations in 2002 that required shippers to obtain temporary safety certificates to import grain derived from GM crops. The rules essentially set up a technical barrier that slowed GM imports. This temporary approval regime existed until February 2004, when MOA issued permanent rules on importing GM soybeans (and other crops) and granted permanent import safety certificates to US bio-seed giant Monsanto Co. China is currently one of the world's largest importers of GM crops, though it processes most soybean imports into animal feed.

In 2004 China ranked fifth in the world in terms of GM cultivated acreage, primarily for cotton, but the PRC government generally forbids Chinese farmers to plant GM seeds for human consumption. In international trade, China promotes itself as a producer of non-GM soybeans, which are warmly welcomed in Europe. China also ratified the United Nations Cartagena Protocol on Biosafety—which regulates international trade of GM crops—this spring. More than 120 countries have ratified the protocol since it took effect in September 2003, though the United States and other major GM exporters, such as Argentina and Canada, have not yet signed the protocol. Regardless of whether the United States signs the protocol, US exporters will need to follow it to export GM products to China. This means exporters must fully document GM soybeans and obtain approval from PRC authorities before exporting the products.

● Competition from South America

South American soybean production has expanded rapidly since the 1970s. For example, in 1970 Brazil produced 1.3 million tons of soybeans; last year it produced roughly 53 million tons. Over the years, Brazil's infrastructure advancements have enabled farmland to expand from coastal ports to the country's interior—opening up vast regions to crops, often at the expense of the country's Amazon rainforest. Brazil, Argentina, and Paraguay are the largest soybean exporters after the United States. Many large grain-trading companies ship soybeans from the United States, Brazil, and Argentina; their different harvest schedules allow traders to ship soybeans year round.

ASA's Laney commented, "One important problem in soy trade [from the US farmer's point of view] is that the main international grain trading companies export from both the United States and from South America. Their overseas representatives are neutral about the source of the exports and aren't as aggressive about exporting US-origin soybeans as one would hope." (ASA, a private, nonprofit organization, helps develop export markets on behalf of US soybean farmers in China and around the world.)

Soybean Futures

The Chicago Board of Trade, the world's largest grain market, is also the world's primary market for soybean futures. Soybean futures are also traded on a much smaller scale on exchanges in Argentina, Brazil, China, and Japan. The Dalian Commodity Exchange in Liaoning opened to foreign-grown genetically modified soybeans in December 2004.

- **Animal illnesses reduce demand for feed**

When outbreaks of avian influenza or foot-and-mouth disease strike China's poultry and swine and cattle stock, as they have in recent years, demand for animal feed slows, and imports can quickly outpace feed demand. Because it is harder for soybean crushers to make a profit in this situation, traders begin to worry about possible defaults.

- **Drought and fungus**

The US Midwest has been experiencing drought conditions this year, and authorities have found Asian soybean rust, caused by the *phakopsora pachyrhizi* fungus, in a few US states for a second consecutive year. The rust fungus causes plants to yellow and defoliate prematurely, reducing yields. US soybeans have little or no resistance to the fungus, which is more harmful to crops that are already weakened by drought.

Improving soy trade

Though some trade problems are easier to solve than others, the US and PRC governments can take steps to maintain a healthy soy trade.

Nor Coquillard, president of Cargill China, listed some ways to improve soybean trade: "China's government essentially lets the market rule the soybean import market, except when it believes that imports might depress local prices. Most soybean processors are private companies. The PRC government should let them live and die by the market. Additionally, importers must also become more integrated into the world-trading environment, for example, by meeting contract specifications. We see improvement in this area."

Coquillard continued, "Also, Decree 73 allows China to reject any soybean cargo based on very simplistic phytosanitary rules [under the decree, AQSIQ can void an import permit whenever the PRC government chooses, without citing generally accepted scientific principles]. This particular rule is not in compliance with international trading standards and creates unnecessary risks." Coquillard added that the industry urges AQSIQ to modify this regulation to meet international standards. He went on to note another important WTO deadline that agriculture traders are watching—the elimination of the tariff-rate quotas (TRQs) on soybean oil due by December 2006. Though China has complied with TRQ obligations to date, it has often been less than transparent in the administration of the quotas.

USDA's David Kiefner observes, "On many occasions during the past several years, soybean trade with China appeared threatened." In addition to Decree 73, he lists the detections of *phytophthora sojae* and delays in biotech approvals, among other issues. "In each of these cases, the US government immediately raised serious concerns with regard to technical grounds for China's positions, engaged China in high-level meetings, and subsequently helped to avert trade disruptions," he says.

Kiefner added that USDA has also set up consultative mechanisms with China to address issues before they become problems. These include the Joint Committee on Cooperation in Agriculture, the JCCT, the US-China High-Level Biotechnology Working Group, and regular Animal and Plant Health Inspection Service Plant Health bilateral meetings.

A short-term trade success story?

Though there will undoubtedly be ups and downs in the years ahead, most industry specialists agree that the future of US-China soy trade looks good. Yet although China's demand for soy is expected to grow, USDA's 2005–14 baseline projections for soybeans suggest that US soybean exports and global market share will both likely decline. The projections show that South American exporters will continue to gain much of the expansion of global soybean trade. The US soybean industry could, according to the projections, become more domestically oriented; the majority of US soybeans will likely be used for animal feed to support the country's increasing meat exports. Furthermore, because of soybeans' slower yield growth and rising production costs, American farmers may eventually find corn more profitable than soybeans.

But there is still hope for US soybean exporters. ASA's Laney remarked, "At the moment, the PRC government has stopped trying to manage trade and is letting market forces decide what they will import, from where, and at what price. Let's hope that continues." Laney expressed optimism about China's future need for US soy exports and US farmers' ability to rise to increasingly complex and competitive international challenges. But he believes the key challenges will lie in whether the United States and its trading partners continue to refrain from trade disputes and other actions that could restrict market access and whether the Doha Round of WTO negotiations will lead to freer trade and less governmental intervention in international markets. 完

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Bursting at the Seams

Adam Ross

The textile trading world collectively held its breath as January 1, 2005 approached, but in no place was anticipation greater than in China. With the elimination of worldwide textile trading quotas on that day, Chinese manufacturers became eligible for new orders in previously restricted markets. A major transition began in the global textile trade and within the Chinese textile industry.

Predictably, exports from China jumped at the beginning of 2005. From January through May 2005, US imports of Chinese-made textile products that were previously covered by the trading quotas surged 61.6 percent year-on-year (see Table 1). Chinese manufacturers, many of whom had imported new equipment to expand production capacity, were well prepared for the removal of quotas and the emergence of new business opportunities. But the resulting increase in Chinese exports aroused significant concern in many countries, including the United States, which has implemented several one-year "safeguard" quotas to stem the flood of imports.

Facing this international pressure, the PRC government has held talks with the United States and the European Union to reach comprehensive agreements on Chinese textile exports. An agreement between the PRC and the European Union was reached in mid-June, and as the *CBR* went to press, the United States and China were in active consultation.

At the same time, in the midst of a nationwide transition away from state-controlled manufacturing, PRC policymakers have engaged in a deliberate, two-way communication process with domestic textile companies. These discussions, vetted by key intermediaries such as industry associations, have resulted in policies agreeable to both domestic manufacturers and policymakers. As new textile policies continue to emerge, foreign investors in China would do well to note the active role played by industry associations and the level of consultation and compromise within the manufacturing sector, as well as the growing influence of private-sector Chinese manufacturers on PRC government policy.

Adam Ross, formerly a research associate at the US-China Business Council in Shanghai, is currently in Japan and will enter the JD program at Columbia Law School in 2006.

China's competitive textile manufacturers adapt to a new global climate

Jesse Marth

Table 1: US Imports of Textile Products from China, 2004–05

Type	January–May 2004 ($ billion)	January–May 2005 ($ billion)	% Change
Apparel MFA	2.96	5.50	85.9
Non-Apparel MFA	2.10	2.67	27.3
Total MFA	5.05	8.16	61.6

Note: Figures are rounded and may not add up. MFA refers to textile products previously covered by the Multifiber Arrangement, which expired January 1, 2005.
Source: Office of Textiles and Apparel, International Trade Administration, US Department of Commerce

Table 2: US and China Textile and Apparel Trade, 2001–04

Year	Total China Exports ($ billion)	Total US Imports ($ billion)	Total US Imports from China ($ billion)
2001	53.3	70.2	6.5
2002	61.8	72.2	8.7
2003	80.5	77.4	11.6
2004	97.4	83.3	14.6

Note: Figures refer to the value of products covered by the Multifiber Arrangement.
Sources: China National Textile and Apparel Council; International Textiles and Clothing Bureau

US safeguard measures

The January 1, 2005 end to the worldwide textile quota regime, the Multifiber Arrangement (MFA), was decided more than a decade earlier, during the Uruguay Round of global trade talks that created the World Trade Organization (WTO). The decision was made before China's textile manufacturing strength had clearly emerged. Yet by 2004, Chinese companies had developed unparalleled efficiency in textiles through favorable cost fundamentals and efficient supply chains. Chinese manufacturers had become leaders in fiber and cloth production, sewing and assembly, design, and shipping, with these operations often clustered geographically. Textile manufacturers have flourished in Fujian, Guangdong, and Zhejiang, provinces with robust private-sector economies and easy access to ports.

Since China's 2001 WTO entry, the country's textile industry has enjoyed particularly rapid growth, recording an 83 percent jump in textile and clothing exports from 2001 to 2004 (see Table 2). Reflecting widespread transitions in the Chinese economy, private companies, which do not enjoy state bank guarantees or national-level government protection, generated most of this growth.

In the United States, the end of the quota system and the resulting surge in foreign textile imports prompted domestic US textile manufacturers to seek intervention from the Committee for the Implementation of Textile Agreements (CITA), an interagency commission consisting of the US departments of Commerce, State, Labor, and Treasury and the Office of the US Trade Representative. As of August 5, 2005, the committee has instituted 11 year-long safeguard measures, 3 of which were not renewed (see Table 3), and is formally investigating Chinese imports in several product categories.

In December 2004, an injunction from the US Court of International Trade halted safeguard procedures, limiting the US government's use of safeguard measures in blocking *threats* of excessive imports. But on appeal, the US Court of Appeals for the Federal Circuit stayed the injunction on April 27, 2005, allowing resumption of the safeguard measures.

Chinese government reaction

The PRC government is genuinely concerned about worldwide backlash against Chinese-made textiles and apparel. With nearly 20 million Chinese employed in the textile industry, the labor-intensive sector helps China combat unemployment. And with textile manufacturers anchoring local economies in key areas of the country, especially in southeastern coastal provinces, the government is keen to protect the manufacturers' interests—including access to world markets.

In response to US and European challenges, China has instituted measures to slow exports. At the end of 2004, Beijing introduced a textile export tax designed to target low-cost goods, which added a fixed tariff, ranging mostly from ¥0.2 ($0.024) to ¥0.3 ($0.036), to each unit of exports for 148 product categories. The tax was designed to discourage Chinese companies from exporting low-margin products.

On May 20, 2005, China substantially raised the tariff on 74 categories of textile products, mostly to ¥1 ($0.121), though on June 1, China removed export tariffs on 81 types of textile products, in part due to domestic pressure. In mid-June, the PRC and EU governments reached a comprehensive agreement under which China pledges to maintain limits of 8 to 12.5 percent on the growth of certain exports to the European Union until the end of 2007.

To meet the agreement, China reinstituted a quota-allocation system in late July, under which firms exporting to countries that have imposed limits on Chinese textile imports must apply for temporary export permits. In addition, citing the agreement's quantity control, China scrapped export tariffs for products in 17 textile categories subject to EU restrictions on August 1, 2005. As the *CBR* went to press, China was seeking to reach a similar, comprehensive textiles agreement with the United States.

The back-and-forth in the implementation of export tariffs reflects the PRC government's struggle to balance the interests of domestic manufacturers with its goal of maintaining cordial relations with the United States and the European Union. It also underlines the fact that domestic manufacturers have an important voice in shaping PRC government policy. Despite international pressure to stem the flow of textile exports, China's policymakers have clearly been taking into account the interests of domestic manufacturers, who are naturally wary of export controls.

Table 3: US Safeguard Measures on Chinese Exports*

Date Issued	Products	Quota
May 27, 2005	Men's and boys' cotton and synthetic fiber shirts, not knit	2,213,126 dozen
May 27, 2005	Synthetic fiber knit shirts and blouses	2,844,383 dozen
May 27, 2005	Synthetic fiber trousers	2,260,678 dozen
May 27, 2005	Combed cotton yarn	1,450,777 kg
May 23, 2005	Cotton knit shirts and blouses	4,704,115 dozen
May 23, 2005	Cotton trousers	4,340,638 dozen
May 23, 2005	Cotton and synthetic fiber underwear	5,062,892 dozen
October 28, 2004	Cotton, wool, and synthetic fiber socks	42,433,990 pairs
December 23, 2003	Knit fabric	9,664,477 kg**
December 23, 2003	Cotton and synthetic fiber brassieres	201,947,652 units**
December 23, 2003	Cotton and synthetic fiber dressing gowns and robes	49,132,584 units**

Note: * As of August 5, 2005; ** Expired
Source: Office of Textiles and Apparel, International Trade Administration, US Department of Commerce

Chinese Manufacturers and Local Officials

To better understand the effects of US safeguard measures, such as the quotas imposed in October 2004 on Chinese-made socks, I visited Zhuji, Zhejiang, the center of sock production in China. Located about 200 km south of Shanghai, Zhuji boasts the largest concentration of sockmakers in the world, with local companies producing about 9 billion pairs in 2004.

While there, I met with local government officials and managers from manufacturing and trading companies, including the Zhejiang Socks Co., Ltd., Zhejiang Furun Import and Export Co., Ltd., and Zhejiang Provincial Light and Textile Industry Import and Export Co., Ltd. Conversations with these individuals revealed frustrations about US barriers but optimism about new business opportunities. Company executives and government officials showed great confidence in local manufacturing fundamentals, such as sustainable low costs, strong relationships with foreign purchasers, and world-class manufacturing processes and equipment.

Their main concern about the US sock quota was the instability it has created. Indeed, when US safeguard quotas were reached in May 2005, more than four months before the renewal date, purchaser relationships were disrupted, and thousands of workers were reportedly laid off. In the United States, the main losers under the new rules have been retailers, who have been unable to maintain trading relationships with Chinese manufacturers.

- **Main goals** The main goals of Chinese textile producers and officials are to boost production in the post-quota era and to establish long-term trade relationships with international retailers.
- **Attitude toward safeguard measures** Chinese manufacturers are frustrated by their inability to maintain robust relations with US and European retailers. On the other hand, they remain optimistic about markets in South Korea and Japan, where safeguard measures have not been publicly considered.
- **Attitude toward export taxes** Chinese manufacturers are skeptical of the PRC government's motives in instituting export taxes but support limited action designed to smooth trade frictions.

—Adam Ross

Chinese Industry Associations

Conversations with leading officials from China's Textile Industry Chamber of Commerce (www.ccpittex.com) and the China Chamber of Commerce for Import and Export of Textiles (www.ccct.org.cn) revealed the important role that these organizations play in steering the government and the largely privately owned textile industry toward common ground. With Chinese companies desiring moderate but effective government action and with the PRC government looking to avoid negative trade repercussions, trade groups have had unprecedented opportunitites to become active players in the policymaking process.

The associations, which represent different segments of the textile industry, obtain their revenue to some extent from membership fees but more substantially by hosting trade fairs and running quality certification services. They also offer extensive consultation and support on matters of foreign trade. Though they do not receive significant government funding, they serve as important information channels between industry and government, communicate government messages when asked, and maintain a non-adversarial relationship with policymakers.

- **Main goals** The textile industry associations offer various services to manufacturers and other industry players and act as reliable communication channels between industry and government.
- **Attitude toward safeguard measures** While trade friction is a problem for both the government and textile manufacturers, it is precisely the reason for the rise in the importance and profile of these organizations. Thus, they have refrained from making judgments against foreign governments and instead focused on working with their domestic constituents.
- **Attitude toward export taxes** The associations fully support the export taxes. Both organizations have had significant input in formulating the tax decisions by consulting with officials and industry leaders.

—Adam Ross

CITA

The Committee for the Implementation of Textile Agreements (CITA) is an interagency commission that consists of the US departments of Commerce, State, Labor, and Treasury and the Office of the US Trade Representative. Its responsibilities include supervising the implementation of all textile-related trade agreements to which the United States has acceded and ensuring the legality and competitiveness of textile trade. Created in 1972, CITA is staffed by the Office of Textiles and Apparel at the US Department of Commerce, which falls under the Import Administration division of the International Trade Administration.

Prior to the end of the Multifiber Arrangement (MFA) on January 1, 2005, CITA began accepting petitions from domestic industry groups for protection against Chinese imports, including the American Manufacturing Trade Action Coalition, the National Council of Textile Organizations, the National Textile Association, and UNITE HERE. Many product categories have been investigated, and as of August 5, 2005, 11 year-long safeguard measures have been implemented, 3 of which were not renewed.

These measures are controversial under World Trade Organization rules because they protect domestic industries on the grounds of a potential, though not necessarily actual, foreign threat. The safeguard action procedure was successfully challenged by the US Association of Importers of Textiles and Apparel in the US Court of International Trade in December 2004. That decision, however, was suspended following an appeal in April 2005.

- **Main goals** The main goal of CITA is to support US domestic manufacturing, as well as free trade principles, while following overall US trade policy.
- **Attitude toward safeguard measures** CITA is quick to consider but hesitant to implement safeguard measures. It experienced a significant setback with the December 2004 US Court of International Trade decision but has regained momentum following its successful appeal in the US Court of Appeals for the Federal Circuit. Investigations remain open in several import categories, leaving the door open to swift, widespread safeguard actions in the future.
- **Attitude toward export taxes** CITA is skeptical of the PRC government's sincerity in its pledge to slow export flows but welcomes the export taxes as a step in the right direction.

—Adam Ross

Industry associations

Chinese textile industry associations have played an important role in shaping government policy throughout the quota transition process. Organizations such as the Textile Industry Chamber of Commerce and the China Chamber of Commerce for Import and Export of Textiles have assumed influential positions as key intermediaries between private companies and government trade and planning departments.

Industry associations in China are different from such groups in the United States because the Chinese political system offers fewer opportunities for direct government advocacy. Nevertheless, the Chinese textile groups have served as important communication channels between the largely private textile industry and government bureaucracies. These associations have helped the industry lobby the government, in part by organizing conferences for manufacturers and traders that allow industry players to consolidate their viewpoints. Industry associations have also been commissioned by government offices to perform manufacturing surveys and to communicate new government policies and regulations.

Lessons for foreign companies

The communication and decisionmaking processes in the textile sector are relevant to other areas of the Chinese economy, where alternate channels of influence, such as industry associations, are also displacing direct government control. Maintaining ties to these associations is an efficient way for foreign investors to keep an ear to the ground with regard to both government and industry developments. In times of rapid growth and regulatory transition, access to emerging trends can be difficult to obtain, and these connections can be valuable. In the end, foreign investors, like those in information technology, that recognize the diminished role of government and its replacement by new actors such as industry associations will improve their chances of investment success (see the *CBR*, March–April 2005, p.32). As China's manufacturing sector continues to mature and as the economy increasingly becomes more privatized, the importance of industry associations will certainly grow. 完

Opportunities

News of China-related educational, cultural, and charitable projects

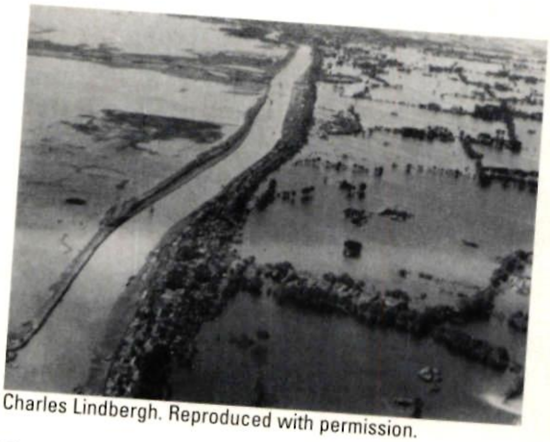
Opportunities introduces significant charitable, cultural, and educational projects that seek American business support and aims to help companies identify programs that merit their assistance. The materials contained in *Opportunities* are boiled down; our goal is to provide contact information and only a brief description of each organization's interests. We strongly encourage interested companies to contact the programs contained here directly, so that each firm can review the more-detailed materials that individual organizations can provide.

American companies participate in a broad range of programs that bring benefit to the people of China and strengthen the bonds of US-China friendship beyond the commercial realm. *Opportunities* is intended to help companies explore new ways of making a difference.

(Note: Neither the US-China Business Council nor the *CBR* is a sponsor of any project listed in *Opportunities* and makes no recommendation with regard to corporate assistance to any specific project.)

US Institution: **China Connection**
PRC Institution: **Gaoyou City Municipal Government, Jiangsu**
Project Description: **The Forgotten Flood of China, 1931, a traveling photo exhibit, featuring never-before displayed aerial photos by Charles Lindbergh of the Grand Canal dike bursts at Gaoyou**

China's forgotten flood of 1931 ranks as the single greatest water-related disaster worldwide in the last 100 years. In Gaoyou, six Grand Canal dikes burst on August 26, after three big summer storms and a typhoon, flooding 10,000 square miles of the Jiangsu plain 10-12 feet deep for six months. Across China, there were more than 800 dike breaks, and nearly 3.7 million Chinese died, almost 15 times the number killed by the 2004 tsunamis.


Charles Lindbergh. Reproduced with permission.

The exhibit will feature US aviator Charles Lindbergh's aerial photos of the flood and the rebuilding of the dikes together with Anne Morrow Lindbergh's eloquent descriptions of their flood survey flights. In an early example of US-China cooperation, the rebuilding project was jointly led by an American Presbyterian missionary and a Chinese engineer. The two men, with the support of the International Famine Relief Commission and an anonymous donor, oversaw the reconstruction of Gaoyou's six broken dikes on schedule, under budget, and in the face of constant threats and corruption from the local warlords. The dike project records were recovered from the Nanjing Archives in 2004 and brought to the attention of the Gaoyou government, which has undertaken to stage this exhibit of this lost piece of Chinese history.

The exhibit is seeking support from American businesses to sponsor the 1931 Forgotten China Flood Exhibit for the fall of 2005 in Gaoyou, with a second exhibit planned for 2006 in Shanghai. The first project has a budget of ¥500,000 (about $60,000), of which the city of Gaoyou will provide ¥200,000 ($25,000). A corporate sponsorship and attribution program is available to any company contributing $5,000 or more. China Connection, based in Pasadena, CA, provides clean water and builds medical clinics and rural schools in China. It often works through the Amity Foundation (www.amityfoundation.org.cn) in Nanjing.

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US Institution: **Ecologia**
Chinese Institution: **The Circular Economy Office of Guiyang Municipality**
Project Description: **Promoting realistic first steps toward sustainable development for Chinese businesses and communities**

Ecologia is an international nonprofit environmental organization that works with Chinese leaders from government, business, and civil society to develop practical and replicable examples of implementing sustainable development principles. Ecologia helps communities design local projects that can be implemented primarily with existing resources and helps companies develop business plans that identify opportunities for combining pollution avoidance and reduction with increased profitability. Ecologia is looking for corporate support and local partnering opportunities.

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US Institution: **EPI EcoPlan International, Inc.**
PRC Institution: **Municipal governments of Wuhan, Hubei; Liuzhou, Guangxi; and Jiangmen, Guangdong**
Project Description: **To provide short-term technical assistance to improve the investment environment**

EcoPlan International, Inc. has been approached by the city of Wuhan and several other cities in China to provide short-term technical assistance to improve the investment climate, with a core focus on poverty reduction. Specifically, EcoPlan has been asked to provide training to local government officials on Strategic Planning for Local Economic Development based on materials and an approach developed jointly with the United Nations Human Settlement Programme (UN-HABITAT). This training has been peer-reviewed by development agencies and field tested in Africa, Asia, and Eastern Europe. Underpinned by the concepts of good governance, inclusion of the private sector, and the creation of a good business environment, EcoPlan's approach focuses on sustainable development and poverty reduction through participatory methods.

EcoPlan has secured partial funding from UN-HABITAT and counterpart funding from Wuhan and seeks additional technical assistance funds before October 2005.

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US Institution: **The Philip Hayden Foundation**
PRC Institution: **Langfang and Shepherd's Field Children's Villages, Hebei**
Project Description: **Assist in the building of a new children's village for special-needs orphans and assist in the care of these orphans**

The Philip Hayden Foundation (PHF), a US-based 501(c)(3) nonprofit organization, has been providing hope for special-needs orphans of China since 1995. The primary work of PHF is the establishment of children's villages in China. These villages take in at-risk and special-needs orphans, love them, provide the medical treatment needed to correct their special-needs conditions, and find loving families to adopt them.

PHF is currently expanding its capacity to care for orphans by building Shepherd's Field Children's Village, which will eventually add 150 orphans to the 90 currently being cared for at Langfang Children's Village. In addition to the children's homes, a medical clinic, guest inn, and multi-purpose center will also be included in Shepherd's Field Children's Village. PHF is currently seeking charitable and in-kind donations to continue with this project.

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Sales and Investment

May 16–July 15, 2005

Compiled by Maria Repnikova

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*.

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.

Advertising, Marketing & PR

CHINA'S IMPORTS

Barco N.V. (Belgium)
Will install outdoor LED display solutions for Chongqing International Convention & Exhibition Center and for Chongqing Dahe Advertising Co. Ltd. $1.8 million. 06/05.

Agriculture

INVESTMENTS IN CHINA

Bunge Ltd. (US)
Will buy controlling interest in soybean crushing and refining plant in Rizhao, Shandong, from Sanwei Group Ltd. 07/05.

Architecture, Construction & Engineering

CHINA'S IMPORTS

AVEVA Group plc (UK)
Signed agreements with Dongfang Boiler Group Co. Ltd., Harbin Boiler Co. Ltd., and Shanghai Boiler Works Ltd. to provide them with engineering IT solutions. 05/05.

Automotive

INVESTMENTS IN CHINA

DaimlerChrysler AG (Germany), China Motor Corp. (Taiwan)/Fujian Motor Industry Corp.
Formed joint venture to produce Mercedes-Benz vans in Fuzhou, Fujian. $235 million. 06/05.

Denso Corp. (Japan)/Tianjin TEDA Group Co. Ltd.
Formed joint venture, DENSO Tianjin ITS Co., Ltd., to produce car navigation systems in Tianjin. (Japan:95%-PRC:5%). $700,000. 06/05.

Federal Signal Corp. (US), United Motor Works (Siam) Public Co., Ltd. (Malaysia)/Shanghai Environmental Sanitary Vehicle & Equipment Factory
Formed joint venture, Federal Signal (Shanghai) Environmental & Sanitary Vehicle Co. Ltd., to make compact refuse trucks for the Asian market. (US:50%-Malaysia:15%-PRC:35%). 06/05.

Hyundai Motor Co. (South Korea)/Guangzhou Automobile Group
Will form joint venture to produce buses and trucks in Guangzhou. $430 million. 06/05.

Pirelli & C. SpA (Italy)/Roadone Tyre Co., Ltd. (Shandong)
Formed joint venture to produce radial tires for trucks in Shandong. 06/05.

TRW Automotive Holdings Corp. (US)/China South Industries Group Corp. (Chongqing)
Formed joint venture, CSG TRW Chassis Systems Co., Ltd., to manufacture advanced braking and steering systems in Chongqing for the domestic automotive market. (US:50%-PRC:50%). 06/05.

TS Tech Co., Ltd. (Japan), GSK Corp. (Taiwan)
Formed car-seat and -door manufacturing joint venture in Wuhan, Hubei. (Japan:60%-Taiwan:40%). $11.8 million. 06/05.

ArvinMeritor Inc. (US)/First Auto Works (FAW) Sichuan Axle Brake Group, a unit of FAW (Jilin)
Formed joint venture to make brakes for commercial vehicles. 05/05.

OTHER

Ford Motor Credit Co. (US)
Gained approval to provide auto financing services in China. 05/05.

Aviation/Aerospace

CHINA'S IMPORTS

China Cargo Airlines, a subsidiary of China Eastern Airlines (Shanghai)
Will buy two 747-400ER freighters from the Boeing Co. $430 million. 07/05.

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

Telephonics Corp., a subsidiary of Griffon Corp. (US)
Won two air traffic control contracts from CAAC to supply air traffic management systems in Zhangjiang, Guangdong; and Zhengzhou, Henan. $3.25 million. 06/05.

OTHER

Continental Airlines Inc. (US)
Introduced daily non-stop services between Beijing and New York. 06/05.

Banking & Finance

INVESTMENTS IN CHINA

Credit Suisse First Boston, Inc. (US)/ICBC, COSCO (Beijing)
Formed first bank-run fund management company, ICBC Credit Suisse Asset Management Co. (US:25%-PRC:75%). 07/05.

Bank of America Corp. (US)
Bought 9% stake in CCB. $3 billion. 06/05.

DBS Group Holdings Ltd. (Singapore)
Launched consumer banking business in Shenzhen. 06/05.

Shroder Investment Management Ltd. (UK)/Bank of Communications Co. (Shanghai), China International Marine Containers Group Co. Ltd. (Guangdong)
Established a joint venture fund-management company, Bank of Communications Schroders Fund Management Co., in Shanghai. (UK:30%-PRC:70%). 06/05.

Temasek Holdings (Pte) Ltd. (Singapore)
Signed agreement with Central Huijin Investment Co., Ltd. to buy 5.1% stake in CCB. $1.4 billion. 06/05.

Fuji Xerox Co., Ltd. (Japan)
Established a leasing company, Fuji Xerox Leasing (China) Ltd. $20 million. 05/05.

OTHER

Discover Financial Services Inc., the credit card unit of Morgan Stanley & Co., Inc. (US)/China UnionPay (Shanghai)
Formed alliance to allow automated teller machines (ATMs) and merchants in China that accept China UnionPay credit cards to accept Discover credit cards and to allow Discover merchants and cash machines in North America to accept Chinese cards. 06/05

The Eastern Asia Bank (Vietnam)/China UnionPay (Shanghai)
Signed a card-facilitation agreement under which Chinese cardholders can use ATMs in Vietnam and Vietnamese visitors can use ATMs in China. 06/05.

Chemicals, Petrochemicals & Related Equipment

INVESTMENTS IN CHINA

Bayer MaterialScience AG (Germany)
Will set up a trading company, Bayer MaterialScience Trading (Shanghai) Co. Ltd., to distribute products of polycarbonate compounds produced at the Bayer site in Shanghai. $3 million. 07/05.

Degussa AG (Germany), ENAX INC (Japan)
Will form joint venture, Degussa Enax (Anqiu) Power Lion Technologies Co., Ltd. in Anqiu, Shandong, to develop and manufacture lithium-ion battery electrodes. (Japan:50%-Germany:50%). 07/05.

Air Products and Chemicals Inc. (US)/Changzhou Shangfeng Chemical Industry Co. Ltd. (Jiangsu)
Formed joint venture, Air Products Shanfeng, to produce triethylenediamine in Changzhou, Jiangsu. 06/05.

Degussa AG (Germany)/Jilin University
Formed joint venture, JIDA Degussa High Performance Polymers Changchun Co. Ltd., to develop and manufacture polyetheretherketone and polyethersulfone in Jilin. (Germany:80%-PRC:20%). 06/05.

Sasol Olefins & Surfactants GmbH (South Africa), Wilmar Holdings Pte Ltd. (Singapore)
Will jointly construct a fatty alcohols plant in Lianyungang, Jiangsu. 06/05.

Unifi Inc. (US)/Sinopec Yizheng Chemical Fibre Co., Ltd., a subsidiary of China Petroleum & Chemical Corp. (Jiangsu)
Will form joint venture, Yihua Unifi Fibre Industry Co. Ltd., in Yizheng, Jiangsu, to manufacture, process, and market polyester filament yarn. (US:50%-PRC:50%). $30 million. 06/05.

Distribution, Logistics & Related Services

CHINA'S IMPORTS

UPS Inc. (US)
Signed MOU with the Shanghai Airport Group to build express hub. 07/05.

OTHER

Federal Express Corp. (US)
Will move its Asia-Pacific transport and distribution center to Guangzhou from the Philippines. 07/05.

Electronics, Hardware & Software

CHINA'S IMPORTS

Agfa Gevaert NV (Belgium)
Won the first order in China for Azura chemical-free printing system from Zhejiang-based BDF Printing Co. 07/05.

INVESTMENTS IN CHINA

Microsoft Corp. (US)
Will build technological center in Hunan to conduct research, technological innovation, and staff training. 07/05.

Pasco Corp. (Japan)/Beijing Lingtu Software Corp.
Will form joint venture in Beijing. (Japan:50%-PRC:50%). $604,105. 07/05.

Tata Consultancy Services Ltd. (India), Microsoft Corp. (US)/Beijing Zhongguancun Software Park Development Co. Ltd., Uniware Co. Ltd., and Tianjin Huayuan Software Park Construction and Development Co. Ltd.
Will form joint venture in Beijing's Zhongguancun software park to provide IT outsourcing services and solutions. 06/05.

Energy & Electric Power

CHINA'S IMPORTS

ABB Huadian High-Voltage Switchgear (Xiamen) Co. Ltd., a subsidiary of ABB Ltd. (Switzerland)
Won power contract in Jiangsu to supply 110 kilovolt gas-insulated switchgear apparatus. $10.3 million. 07/05

Gamesa Corporación Tecnológica S.A. (Spain)
Won two wind turbine contracts from HNEEP-CLP Changdao Wind Power Co., Ltd. and Fujian Putian Nanridao Houshanzai Wind Power Co., Ltd. $24.2 million. 06/05.

ALSTOM (France)
Will supply two 1,000-MW steam turbine-generator sets for Dongfang Electric Group Corp. $101 million. 05/05.

AREVA Group (France)
Won contracts to supply power generation equipment for the third and fourth reactors of the Ling Ao nuclear power plant in Guangdong. $505.4 million. 05/05.

INVESTMENTS IN CHINA

Acciona, SA, Inceisa (Spain)/China Aerospace and Technology Corp. (Beijing)
Formed joint venture to produce, sell, and install in-house designed wind turbines in Nantong, Jiangsu. (Spain:55%-PRC:45%). $30.2 million. 06/05.

Cheung Kong Infrastructure Holdings Ltd. (Hong Kong)/ Guangdong Yudean Group Co. Ltd.
Signed joint investment agreement for the extension of Units 3 and 4 of Phase 1 of the Zhuhai Power Plant. $725 million. 06/05.

Eaton Corp. (US)/Zhongshan Mingyang Electrical Appliances Co., Ltd. (Guangdong)
Will form joint venture, Eaton Electrical (Zhongshan) Co., Ltd., to manufacture and market switchgear components in Guangdong. (US:51%-PRC:49%). 06/05.

Enerchina Holdings Ltd. (Hong Kong)
Bought the remaining 30% stake in Shenzhen Fuhuade Power Plant. $30.2 million. 06/05.

Siemens PTD, a subsidiary of Siemens AG (Germany)/Shenzhen Baochang Power Supply Co., Ltd. (Guangdong)
Formed joint venture, Siemens Medium Voltage Switchgear Co. Ltd., to build a medium-voltage switchgear manufacturing facility in Shenzhen. 06/05.

Siemens Automation and Drives (Germany)/Jingyi Electrical Apparatus Co. Ltd. (Shanghai)
Will establish joint venture, Siemens Low-Voltage Circuit Breaker Co. Ltd., to develop and manufacture low-voltage circuit breakers in Shanghai and market them worldwide. 05/05.

Environmental Equipment & Technology

INVESTMENTS IN CHINA

SembCorp Industries Ltd. (Singapore)/Zhangbao Industry Co. Ltd. (Jiangsu)
Formed joint venture to acquire, expand, and operate a wastewater treatment facility in Zhangjiagang, Jiangsu. (Singapore:80%-PRC:20%). $24 million. 06/05.

Food & Food Processing

INVESTMENTS IN CHINA

QAF Ltd. (Singapore)
Invested $36.2 million in Shaanxi Hengxing Fruit Juice Co., Ltd. 07/05.

Uni-President Enterprises Corp. (Taiwan)
Bought 15% stake in Heilongjiang Wondersun Dairy Co. $36.2 million. 07/05.

Xinjiang Bluesword Brewing Investment Co., a joint venture between Carlsberg Breweries A/S (Denmark) and Sichuan Bluesword Group
Bought 46% stake in Xinjiang Hops Co. $1.5 million. 06/05.

Healthcare Services & Investment

INVESTMENTS IN CHINA

Parkway Group Healthcare Pte Ltd., a subsidiary of Parkway Holdings Ltd. (Singapore)/Shanghai Huashan Health Development Co., Ltd., a subsidiary of Shanghai Huashan Hospital
Will form joint venture, Shanghai Gleneagles Huashan International Hospital Management Co., Ltd., to provide hospital management and consulting services and sell pharmaceutical and medical products and devices in China. $5 million. 05/05.

Infrastructure

CHINA'S IMPORTS

Unisys Corp. (US)
Won masters system integration contract for core operational systems at the new international terminal of Beijing Capital International Airport. 07/05.

Dirickx China Co., Ltd., a subsidiary of Dirickx Groupe (France)
Will provide closures for the Jingshi motorway and install delimitation signs on the new motorway connecting the cities of Nantong and Yancheng, both in Jiangsu. $862,000. 06/05.

Siemens Logistics and Assembly Systems Group (Germany)
Won contract from Beijing Capital International Airport to build a baggage handling system in Terminal 3. $205.8 million. 05/05.

INVESTMENTS IN CHINA

Yellow Roadway Corp. (US)/Shanghai Jinjiang International Industrial Investment Co. Ltd.
Formed freight forwarding joint venture, JHJ International Transportation Co., Ltd., in Shanghai. (US:50%-PRC:50%). 06/05

Insurance

INVESTMENTS IN CHINA

Pacific Century Insurance Holdings Ltd. (Hong Kong)
Bought 22.09% stake in Shanghai-based Sino Life Insurance Co. 06/05

OTHER

Prudential plc (UK)
Gained two new licenses to sell life-insurance products in Nanjing, Jiangsu; and Shenzhen. 07/05.

Samsung Group (South Korea)
Opened wholly owned property insurance firm, Samsung Fire & Marine Insurance Co. (China) Ltd. $24.2 million. 06/05.

Internet/E-Commerce

OTHER

NetCert Inc. (US)
Signed partnership agreement to provide online services for BOC (Beijing). 06/05.

Media, Publishing & Entertainment

CHINA'S EXPORTS

Sing-Gium International Pte Ltd. (Singapore)
Acquired multiplayer online role playing game, "Zero Online," from Fuzhou-based NetDragon Websoft Inc. $440,000. 06/05.

DigiStream Alliance, composed of Unify Engineering Pte Ltd., SCM Microsystems Pte Ltd., ComSOC Technology Pte Ltd., and NOW Media Pte Ltd. (Singapore)
Will provide a suite of digital television-related services for broadcasters in Changsha, Hunan; Taiyuan, Shanxi; and Guiyang, Guizhou. $12 million. 06/05.

Nortel Networks Corp. (Canada)
Signed contract with the broadcast and television bureaus of Jiuquan, Tianshui, and Zhangye, all in Gansu, to deploy digital cable television solutions. $12 million. 06/05.

IMAX Corp. (Canada)
Signed agreement with Suzhou Science and Cultural Art Center Co. Ltd., to install an IMAX MPX theater system at an art, science, and commerce center in Suzhou, Jiangsu. 05/05.

INVESTMENTS IN CHINA

Bertelsmann China Direct Group, a subsidiary of Bertelsmann AG (Germany)/Liaoning Publishing Group
Formed a book distribution joint venture, Liaoning Bertelsmann Book Distribution Co., Ltd. in Liaoning. (Germany:49%-PRC:51%). $3.7 million. 05/05.

OTHER

ProvisionX Ltd. (Singapore)/EBT Mobile Ltd. (Shanghai)
Will jointly distribute mobile games in EBT stores in Shanghai. 05/05.

Tabcorp Holdings Ltd. (Australia), China Lotsynergy Ltd., a subsidiary of Worldmetal Holdings Ltd. (Hong Kong)
Will form joint venture to provide systems and support services to the lottery market in China. 06/05.

Metals, Minerals & Mining

CHINA'S INVESTMENTS ABROAD

China Minmetals Corp. (Beijing)
Signed $2 billion investment deal with Codelco, Inc. (Chile) for a long-term copper supply contract. 05/05.

INVESTMENTS IN CHINA

NGM Resources Ltd. (Australia)/Guangxi Longtaushan Gold Mine, a wholly owned subsidiary of China Gold Guangxi Co.
Formed joint venture, Guangxi Golden Prospects Mining Co. Ltd., to operate Longtaushan Gold Mine. (Australia:80%-PRC:20%). 07/05.

Anglo American plc (UK)
Will invest $150 million in the initial public offering of China Shenhua Energy Co. Ltd. 06/05.

Companhia Vale do Rio Doce (Brazil)/Shanghai Baosteel Group Corp., Yongcheng Coal & Electricity Group (Henan)
Will form joint venture to produce anthracite and coal in Henan. 06/05.

Banpu China Pte., a wholly owned subsidiary of Banpu Plc (Indonesia)/Hebi Coal and Electricity Co., Ltd. (Henan)
Will form joint venture, Hebi Zhong Tai Mining Co., to operate the Hebi coal mine in Henan. (Indonesia:40%-PRC:60%). 05/05.

Kobe Steel, Ltd., Mitsui Coal Ltd., Sojitz Corp. (Japan)/Shijiazhuang Iron & Steel Co. Ltd. (Hebei)
Signed letter of intent to form joint venture to produce direct reduced iron using a coal-based process in Hebei. 05/05.

Petroleum, Natural Gas & Related Equipment

CHINA'S INVESTMENTS ABROAD

SinoCanada, a subsidiary of Sinopec Group
Bought 40% stake in Canada-based Synenco Energy Inc. $83 million. 05/05.

INVESTMENTS IN CHINA

BP plc (UK)/Dongfeng Motor Corp. (Hubei)
Formed joint venture, Dongfeng Castrol Lubricant Co. Ltd., to produce lubricants in Shiyan, Hubei. (UK:50%-PRC:50%). $14.5 million. 06/05.

OTHER

OAO Rosneft Oil Co. (Russia)/China National Petroleum Corp. (Beijing)
Signed agreement to study possibility of increase of oil supply to China and a possible partnership in exploration and production of oil on Sakhalin Island. 07/05.

OAO Rosneft Oil Co. (Russia)/China Petroleum and Chemical Corp. (Beijing)
Signed cooperation agreement on joint exploration of the Veninsky Block as part of the Sakhalin-3 project. 07/05.

Pharmaceuticals

INVESTMENTS IN CHINA

Bausch & Lomb Inc. (US)
Will buy 55% stake in Shandong Chia Tai Freda Pharmaceutical Group from Sino Biopharmaceutical Ltd. $200 million. 07/05.

Luxottica Group SpA (Italy)
Will buy Beijing Xueliang Optical Technology Co. Ltd. $20.5 million plus $4.86 million in assumed liabilities. 07/05.

Ports & Shipping

INVESTMENTS IN CHINA

Wärstilä Corp. (Sweden)
Established wholly owned production venture, Wärtsilä Propulsion (Wuxi) Co. Ltd., to manufacture tunnel thrusters used in vessels to help maneuvering at low ship speeds. $7.9 million. 06/05.

Rail

CHINA'S IMPORTS

Bombardier Inc. (Canada)
Won $89 million contract to build an automated train system at the new terminal of Beijing's international airport. 05/05.

OTHER

Bombardier Inc. (Canada)
Signed 20-year deal with China's Ministry of Railways covering strategic cooperation, supply of high-speed electric trains, and creation of a maintenance center. 06/05.

Research & Development

INVESTMENTS IN CHINA

Rohm and Haas Co. (US)
Started building R&D center to conduct product research and provide technical service support. $30 million. 06/05.

Telefonaktiebolaget LM Ericsson (Sweden)
Will establish new R&D center in Nanjing, Jiangsu, to focus on the development of TD-SCDMA product offerings. 05/05.

Retail/Wholesale

CHINA'S INVESTMENTS ABROAD

Shanghai Yongle Electronics
Will buy retail sector of Taiwan-based Tsann Kuen Enterprise Co., Ltd. $17.4 million. 07/05.

INVESTMENTS IN CHINA

Ito-Yokado Co. (Japan)
Will raise stake in Hua Tang Yokado Commercial Co., from 36.75% to 51.75%. $24.38 million. 05/05.

Metro AG (Germany)
Will increase stake in Metro Jinjiang Cash & Carry Co., Ltd. from 60% to 90%. 05/05.

OTHER

Wal-Mart Stores, Inc. (US)
Will open first store in Shanghai. 07/05.

Telecommunications

CHINA'S EXPORTS

Huawei Technologies Co., Ltd. (Guangdong)
Signed European Frame Supply Agreement with Tele2 to supply SDH optical transmission equipment. 06/05.

Huawei Technologies Co., Ltd. (Guangdong)
Won two contracts from Thailand's CAT Telecom Plc. to expand its cellular network. $10.5 million. 06/05.

Al-Mugairin Group (Saudi Arabia), Ephyra Networks Inc. (US)/China Putian Corp. (Beijing)
Will form joint venture, Putian International (Middle East) LLC, in Dubai, to provide advanced telecom products and services to Saudi Arabia and the neighboring region. 05/05.

Huawei Technology Co., Ltd. (Guangdong)
Will provide MA5300 IP DSLAM equipment for Tiscali UK Ltd. to enable it to roll out local loop unbundling in the United Kingdom. 05/05.

CHINA'S IMPORTS

Lucent Technologies Inc. (US)
Won contract to supply Qingdao Netcom, a subsidiary of China Netcom, with Lucent's Metropolis ADM Multiservice Transport Platform. $1.2 million. 07/05.

UTStarcom Inc. (US)
Signed infrastructure contracts with China Netcom Group to expand its existing IP-based PAS networks in Beijing, Heilongjiang, Inner Mongolia, and Liaoning. $67 million. 07/05.

Lucent Technologies Inc. (US)
Will supply optical equipment to Guangdong unit of China Telecom. 06/05.

Nortel Networks Corp. (Canada)
Will upgrade optical network backbone for Zhejiang Mobile, a provincial affiliate of China Mobile. 06/05.

CHINA'S INVESTMENTS ABROAD

ZTE Kangxun Telecom Co., Ltd. (Guangdong)
Opened new US corporate headquarters in Dallas, Texas. 06/05.

INVESTMENTS IN CHINA

Guangzhou Ariane Telecom Technology, a unit of ArianeCorp Ltd. (Singapore)/China Satellite Communication Corp. (Beijing)
Signed MOU to develop and operate a digital trunking mobile communication system via a new joint venture firm. (Singapore:49%-PRC:51%). 07/05.

NEC Corp. (Japan)/Fiberhome Telecommunication Technologies Co., Ltd. (Wuhan)
Formed joint venture, Wuhan Fiberhome Mobile Co. Ltd., to focus on development, production, and sales of equipment for wideband CDMA. $15 million. 06/05.

OTHER

LM Ericsson (Sweden)/ZTE Kangxun Telecom Co., Ltd. (Guangdong)
Signed strategic alliance agreement to participate in the TD-SCDMA trials in China. 05/05.

Marconi Corp. plc (UK)/Huawei Technologies Co., Ltd. (Guangdong)
Signed distribution agreement to resell parts of each other's product portfolio. 05/05.

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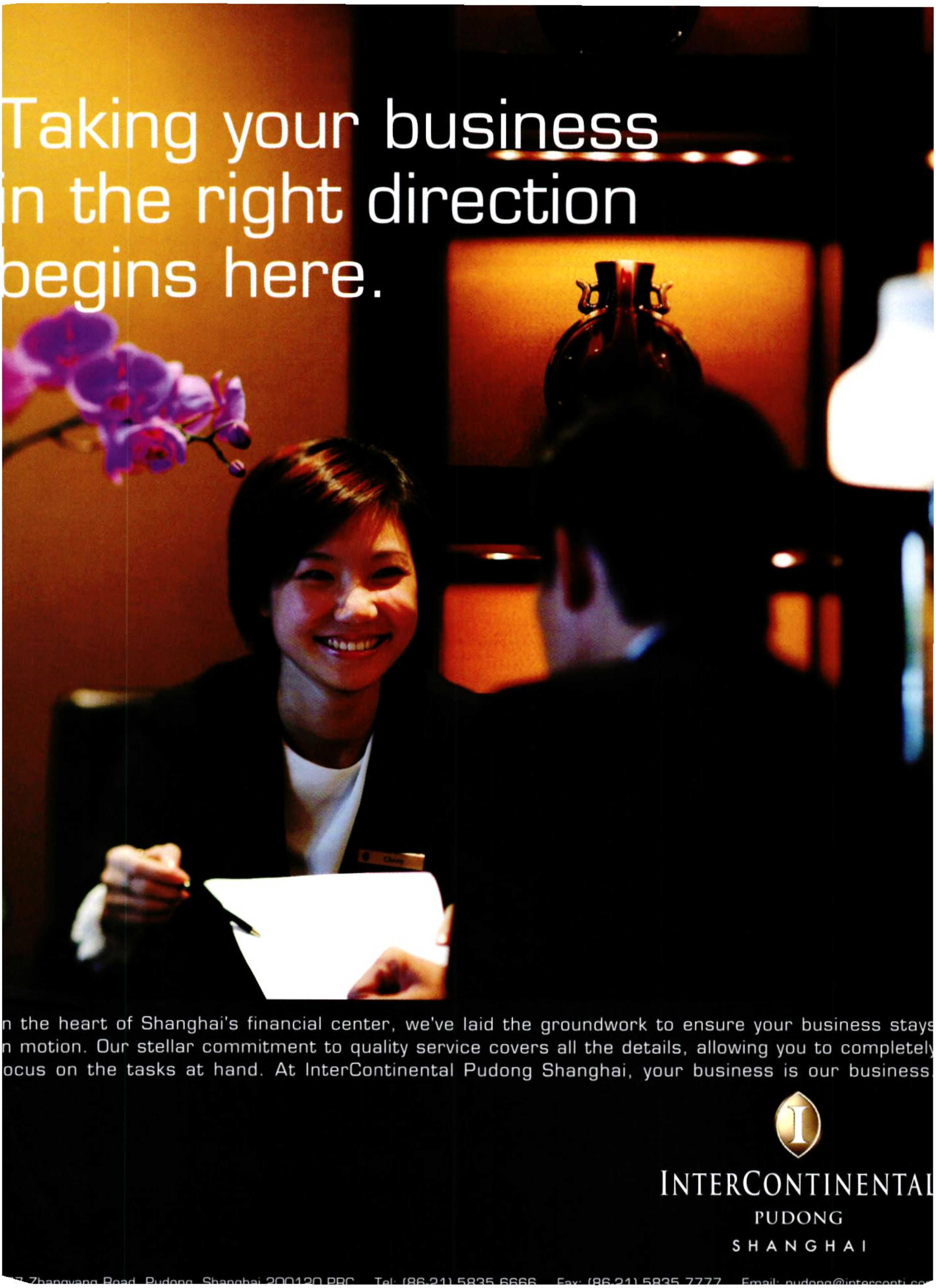
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tariffs of all coal-fired power generators nationwide by ¥0.007 ($0.0008) (see Table). Then, SERC raised retail tariffs by an average of ¥0.022 ($0.0027) in June 2004, for a total retail tariff increase of ¥0.028/kWh ($0.0039).

On the enduser side, the government established a "differential retail tariff" mechanism to curb investment in illegally operated enterprises and those in high-energy-consuming and highly polluting industries, such as aluminum, cement, and steel. Endusers will also be subject to two different time-based tariffs: peak- and off-peak tariffs and seasonal tariffs.

On the power generation side, on-grid tariffs will be unified and set for regular annual operating hours, as well as for extra operating hours for all newly installed coal-fired power generators in each regional and provincial power market.

Testing the new system

SERC has already tested a two-part on-grid tariff mechanism on the Northeast China power market for more than a year with positive results, but the scale has been quite limited. The regulator has also been testing

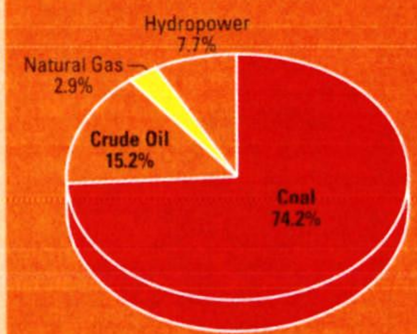
Forecasting Supply and Demand

Mismatches in supply and demand have been the main cause of China's power shortages in recent years. These mismatches result, in part, from unreliable forecasts.

Demand

China consumed 2,175 terawatt-hours (TWh) of electricity in 2004, up 15 percent from 2003. The China Electricity Council predicts that national electricity consumption will top 2,400 TWh in 2005, reflecting 12 percent year-on-year growth, while Songlin Group predicts 13 percent growth. Songlin also believes that demand will remain strong, but that consumption will grow more slowly than in 2004. This is because actual demand will remain constrained by demand-side management, such as scheduled blackouts, the implementation of peak and off-peak power tariffs, and administrative macro controls to slow the growth of industries that consume electricity heavily. The central government has also taken measures to emphasize energy conservation, such as limiting air conditioning in government buildings and encouraging staggered hours of operation. These measures will ease summer peak load but a long-term solution is to increase capacity and construct efficient, integrated networks nationwide.

China's Energy Mix, 2003



Source: *China's Statistical Yearbook, 2004*

Installation and generation

By the end of 2004, China's total installed capacity reached 441 gigawatts (GW), and China generated a total of 2,187 TWh, up 14.79 percent from 2003 (see Table). The average annual operating hours for former State Power Corp.'s thermal generation plants reached 5,988 last year, leaving little room for further extension of operating hours. (Normally, coal-fired plants in China operate 5,000 to 5,500 hours per year). The National Bureau of Statistics reported 545 TWh generated in the first quarter of 2005, reflecting 13 percent year-on-year growth.

China's energy mix is heavily weighted toward coal (see Figure). Two-thirds of coal and hydropower resources are located in western China, but two-thirds of electricity demand comes from the eastern coastal areas. Only 35 percent of generating units have a capacity of 300 megawatts and above. Of these, less than 4 percent can transmit 500 kilovolts.

Forecast

China's annual generation installation expanded nearly 10 percent in 2003, almost 13 percent in 2004, and will approach 15 percent this year. In other words, about 65 GW will come online this year alone. China's power supply is predicted to hit 2,470 TWh this year, up 13 percent from 2004, due to new capacity. A new tariff system introduced earlier this year and sufficient coal, thanks to government attention to rail and water shipments, could boost growth even further. China linked all six regional grids on July 13, 2005, which will significantly improve transmission (only Tibet, Xinjiang, Hainan, and Taiwan are not on the national grid).

By 2007, new capacity in both generation and transmission, steadier supplies of fuel, and the government's emphasis on more balanced economic growth should help match demand and supply.

—*Songbin Zhu* and *Xiaolin Li*

Energy Production, Transportation Capacity, and Sector Profits, 2003-04

Category	2003	2004	Year-on-Year Growth (%)
Production			
Coal (million tons)	1,650	1,900	15.15
Electricity (terawatt-hours)	1,905	2,187	14.80
Crude (million tons)	170	175	2.94
Total Length of: (1,000 km)			
Railway	73	74	1.92
Highway	1,810	1,856	2.54
Coal Delivery by: (million tons)			
Rail	876	990	13.01
Ship	290	340	17.24
Annual Profit for: (¥ billion)			
Coal Sector	14.4	30.7	113.00
Electricity Sector	63.6	71.6	12.60
Petroleum Sector	173.7	278.1	60.10

Source: Local statistics reports