Economist Intelligence Unit
The Economist

Business China

Fortnightly report to managers of China operations

January 21st 2008
Vol XXXIV, No. 2

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Legal obligations

The Chinese government is introducing a spate of new laws in 2008 that will significantly affect the country's business environment, but fears for the worst may be overblown

If 2007 was a landmark year for business law in China, then 2008 will be the year that all the legal changes hit the boardroom. On January 1st foreign executives in China woke up to a 10% tax hike and stronger legal rights for their employees. Later in the year they should brace for a new competition regime. In addition, a new investment guide will open the door to some sectors and close it to others. Meanwhile, for the first time private property now enjoys the same legal protection as public property. A lot of balls in the air to keep an eye on, for sure. But it is not all bad news for foreign investors.

Taxed by equal treatment

Under the old regime, foreign companies in China benefited from a bewildering array of effective tax rates and enticing benefits. While foreign enterprises paid as little as 15% and could exploit a variety of tax holidays, Chinese firms were taxed at the headline rate of 33%. The Corporate Income Tax law, approved in March 2007, has done away with the former tax regime's complexity and discrimination. As of January 1st foreign and domestic firms face a common rate of 25%. The change amounts to a substantial tax increase for many foreign firms and a rate eight percentage points lower for Chinese ones. As a result, The Chinese government estimates that foreign firms will pay Rmb41bn (US$5.7bn) a year more in taxes while domestic firms will pay Rmb134bn less.

It is a bitter pill for foreign firms to swallow. But sweeteners are at hand. High-tech and research-focused companies will continue to benefit from incentives as will firms investing in China's priority sectors, such as environmental conservation, or in the country's most impoverished provinces. Implementation at the local level is likely to remain uneven, as some provincial and municipal governments may continue to offer various investment incentives. A grandfathering scheme should further soften the blow by phasing in changes over a five-year period.

Still, foreign firms should pay attention to the detail. For example, the Chinese tax net can now snare firms based overseas but with substantial management time spent in mainland China under a "place of effective management" clause. The headline message, though, is that China's tax regime is maturing with the economy. The new law increases transparency by bringing all enterprises within the scope of a single tax regime. And it closely tracks the government's broader economic, social and environmental objectives of moving towards encouraging business that is sustainable, that meets development needs, or that helps upgrade the economy's technology base.

Labouring on

The second headache for foreign managers waking up on January 1st was the Labour Contract Law. The new regulation significantly strengthens employees' position vis-à-vis management, reducing the grey areas that some low-wage firms have exploited to avoid compliance with the spirit of existing legislation. The law promotes greater unionisation of workers. It also lays down specific lengths for new employees' probationary periods. It restricts employers' use of "non-compete" clauses—which proscribe employees from working in competition with their employers after leaving the firm. Most importantly, the law prohibits the repeated use of short-term contracts that previously allowed employers to fire workers without stating a cause.

Many uncertainties remain, especially how all the changes will be implemented. With the new law allowing employees to sue employers, the courts look likely to play a major role. The statute has been widely publicised, and workers are likely to be well informed about their rights. Their main target will undoubtedly be foreign companies, which are blessed with deep pockets.

In some respects, all this will make running a business in China harder. But again, the law is a step forward for the country's economic development. Dan Harris, a partner at Seattle-based international law firm Harris & Moure, notes that for firms

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already operating above board in China, the costs of compliance will be limited. Some companies might even benefit as their less scrupulous competitors scramble to get in line. The Chinese government's priority has shifted from job creation to improving workers' quality of life, especially in the prosperous coastal areas. Higher levels of employment protection are the price that foreign firms will have to pay for an increasingly skilled and productive workforce. After concerns about early drafts, which many foreign firms felt were too heavily weighted towards employee rights, both the EU and US chambers of commerce have praised the unusually transparent consultation process that accompanied the drafting of the final law.

EU and US chambers of commerce were pleased with consultation

Competitive pressure

Potentially more troubling news looms in the second half of the year for foreign executives. On August 1st the Anti-Monopoly Law will come into effect. Foreign fears of this regulation have centred on three areas. One clause will trigger government reviews of foreign takeovers of domestic companies, especially larger deals, to determine whether they infringe upon China's "national security". Some observers also fear that more liberal interpretations of the law could provide a legal basis for the infringement of intellectual-property rights (IPR). With IPR protection already a concern for many foreign companies operating in China, the threat that this legislation might tip the balance to their disadvantage is a significant one. These concerns also must be viewed in the light of the Chinese government's demonstrated preference for promoting national corporate champions. Authorities could very well use the Anti-Monopoly Law to push back any foreign investor who might get in the way of their goal.

Like so many of China's regulations, much will depend on how the new law is enforced. One concern is that there will not be clarity any time soon, because the National Development and Reform Commission (NDRC), State Administration for Industry and Commerce, and commerce ministry are all jostling to take charge. But there are also welcome elements. The law brings together the patchwork consumer protection and competition laws that already exist into a single, more coherent package. There are hopes that the new law will also pave the way for greater competition in energy, natural resources, telecoms and other sectors currently dominated by state-owned companies. Largely impervious to pressure for reform from within and immune to competitive pressures, these state companies with effective monopoly power damage Chinese consumers' interests and the country's economic performance. The new law could spark much-needed reform in this area, although some observers believe it simply signals an assertion of government control over key industries.

There are hopes for greater competition in certain state-dominated sectors

A catalogue of woe?

The second major change to the investment regime in China in 2007 came from the NDRC's and commerce ministry's revised "Catalogue for the Guidance of Foreign Investment". This update to the 2004 catalogue divides the economy into "encouraged", "restricted" and "prohibited" sectors. Local governments can approve foreign investment in the encouraged category without recourse to the central government. For investments in the restricted or prohibited category, Beijing's permission is both required and routinely denied.

The updated guides, which went into effect at the beginning of December, introduces substantial restrictions in particular on investment in property, reflecting popular concerns about foreign developers profiting at the expense of ordinary Chinese people. Curbs on foreign investment in publishing, media, and market and social research also continue and have been expanded to cover Internet publishing. Investment in manufacturing solely for export, heavily polluting or energy-intensive industry, and sectors that Chinese producers have already mastered faces restrictions, too.

On the positive side, the services sector has been opened wider to foreign investment, including logistics and outsourcing. The move reflects the government's desire for China to catch up with India as an outsourcing destination. The updated guidelines' overall message is clear: only investment that serves to upgrade the economy or that does not encroach on the government's social control is welcome.

The message, on the whole, may be sound. But a policy more in line with international best practices would let foreign investors presume markets open unless the government declares some to be closed. Restrictions on foreign investment in polluting industries will not mean that these sectors will cease to exist, but simply that Chinese firms will continue to dominate them. If there is one consolation, however, it is that details contained in the new guidelines match closely the stated policies of the government. This will reduce policy uncertainty for investors.

The long march

Firms reeling from the tax hike or facing a wave of employee lawsuits should find some solace in the Property Law, which went into force on October 1st. The result of a protracted debate within the Communist Party, the law gives equal protection to public and private property for the first time since the establishment of the People's Republic in 1949. More than anything, the law is an affirmation that China's long march towards a modern market economy continues. This has to be good news for foreign companies.

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Work in progress

For many foreign companies, China's latest pension reform has not gone far enough to encourage their participation

The second half of 2007 witnessed a flurry of activity in China's pension sector. The State Asset Supervision and Administration Commission (SASAC) has ordered every one of the 150-odd state-owned enterprises (SOEs) that it directly controls to take existing staff-pension schemes and convert them to a fledgling programme known as Enterprise Annuities (EAs) by the end of this year. Some of these firms have hundreds of thousands of employees. In Shanghai, meanwhile, a conversion of some 6,000 company funds now managed by the city government into EAs is now underway. This transfer was ordered after the municipality's pension scandal in 2006, in which local Communist Party bosses were found to have misappropriated more than Rmb3bn (US$415m) in social security funds.

Watson Wyatt, a human resources consultancy, reckons that more than 1,700 companies have so far adopted EA schemes. Given the escalating war for talent in China, is all this action over a key employee benefit something that foreign employers should be joining? The short answer is "no". As they now stand, EA regulations contain too few incentives, too many restrictions and not enough clarity for the schemes to make sense for foreign employers. Barring a massive shift in government priorities, this picture is likely to remain fuzzy for the next few years.

The greying of China

EAs were created as a replacement for China's earlier, failed round of pension reform. Once it became clear that Deng Xiaoping's one-child policy was steering China towards an early "greying" of its population with not enough young people to support old ones, the government in the mid-1990s enlisted the World Bank to attempt a major overhaul of the country's pension provision. The existing work-unit-based, pay-as-you-go system (the so-called "iron rice bowl") was clearly unsustainable and was scrapped. In the main, it was replaced by mandatory staff plans for all employers in urban areas. But many companies simply ignored the requirement, or "borrowed" from the schemes and maintained a pension fund in name only. (In rural areas, no formal pension provisions exist even today, and only a small fraction of farmers participate in voluntary plans.)

In 2005 and 2006 the government had another go, bringing in foreign experts to put together a new Western-style defined-contributions programme to replace the leaky mandatory staff plans. Like 401(k) plans in the US, each EA scheme has its own independent trustee to ensure full funding. The trustee in turn appoints a plan administrator, a custodian and an investment manager to manage the assets separately from those of the company. China's EAs look Western in their structure. But the take-up of the programme has hardly been universal, because it is being managed in a very Chinese way. The central government is relying on decrees to force companies, rather than providing constructive regulations and positive incentives, to phase in EAs.

Looking closer at Watson Wyatt's figure of 1,700, more than 90% of firms setting up EA schemes so far have been SOEs, such as Industrial and Commercial Bank of China, Dongfeng Motor, Baosteel and China Netcom. True, the workers at these companies tend to be older and nearer to retirement, so they have more to gain from newfangled pension plans than their counterparts in the sprightlier private sector. Nevertheless, the real reason why SOEs make up the bulk of EA participants is the fact that the government has ordered them to do so. As for the remaining 10% or so that now have EA schemes, fewer than 20 are foreign multinationals. The reason they have opted in invariably has been because they have a global philosophy of pension coverage for staff, rather than because it made sense to provide EA pensions for their Chinese employees.

So far, SOEs have led the adoption of EA schemes

Indeed, China does not provide the biggest incentive that would attract more companies to EA schemes: tax relief. Under current regulations, only employer contributions to EA plans are tax deductible, and not those made by employees. The contribution rate is also not fixed across China but varies by province—from a meagre 4% of annual salary in Beijing to 8.3% in Hubei and Jiangsu—making book-keeping a headache. And no regulations have yet been issued for tax on capital gains or disbursements. This makes it impossible for firms to know what their future obligations will be.

Another major concern is that investment options for EA plans are highly restricted, and yields are therefore low. Only 30% of funds can be placed in equities, which must be those of mainland-listed companies. The remainder must go in to bonds or cash. Although such limits clearly indicate a lack of faith in the domestic stockmarket, the government does not permit investment in foreign assets.

Then there are the administrative hurdles. EA schemes are still comparatively new, and in many localities no dedicated bureaucracy yet exists to handle applications. Putting together all the documents and getting approval from the labour ministry and every local tax bureau is an enormously complicated process that can take more than a year. As with so many things where licences are required in China, the rules are still quite arbitrary and allow for a lot of discretion on the part of civil servants. "In our

No bureaucracy yet exists to handle EA applications in many localities

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experience, you really need to have a good relationship with the labour ministry to make sure your plan is approved in a speedy way," says Joseph Yip, Watson Wyatt's head of China employee benefits.

More changes are coming, but slowly

For companies thinking about signing up for the EA scheme, they should look for greater choice of investment, clearer rules and swifter administrative approval before they do so. Change is slow—but coming. In November the labour ministry licensed 20 new EA players (trustees, record-keepers, custodians and investment managers) to add to the 37 it approved at the outset. Legislation enabling "master trusts"—essentially pre-existing scheme packages that companies can buy into—is also under consideration. By increasing competition, new entrants and products should bring down the cost and time of setting up schemes, making them viable for smaller and medium-sized companies. Once the SASAC and Shanghai mass conversions of company plans are complete, many existing procedural problems for EA-scheme approval will have been ironed out as well.

One thing that will not happen any time soon is allowing EA schemes to invest in overseas assets. The Chinese government is keen to build up institutional stakes in the country's highly unstable stockmarket first, observes Allen Wu, an actuary at Mercer consulting. It wants to see millions of new EA plans imposing much-needed discipline on China's retail-investor-dominated bourses. When and only when the stockmarket feels real influence from long-term, institutional investing will the government think about raising the 30% limit for equities in EA funds.

Not urgent enough

Industry insiders say that labour ministry officials hope to establish uniform tax relief on employer contributions nationwide and clearer regulations on tax overall. But no official announcements have been made, and they too are unlikely for at least five years. China's demographic time bomb may be an urgent issue, but so are its environmental problems and preparing for the Beijing Olympics in August. Given the government's array of spending requirements, the finance ministry will always oppose tax cuts of any kind.

To put it differently, the labour ministry will have to convince the State Council that heading off the pensions crunch deserves a higher place on the list of national priorities to secure higher tax relief on EAs. This will be hard, however, given that more tax relief on EAs amounts to a subsidy on China's relatively affluent urbanites. After all, reducing the wealth gap between China's countryside and its cities under the slogan of building a "harmonious society" is now the highest national priority of all.

Survival guide

The Chinese government has published its first risk ratings on 191 countries to alert mainland businesses investing abroad

Chen Xiangdan, chairman of the Suifenhe Friendship Group in Heilongjiang, started to do business in Russia in the early 1990s. The country that was just emerging from the wreckage of the Soviet Union was not for the faint-hearted. In June 1993 the Russian central bank announced that any currency issued before 1992 would no longer be valid, and each person could change no more than Rb35,000, worth US$35 then. "I had the equivalent of Rmb1m which became worthless," says Mr Chen, who runs an import-export business in the province that shares a long border with the Russian Far East. "I wept as I saw the three flax sacks with the money being thrown away. On the street, everyone was burning roubles. Some lost hope and killed themselves." Then in 1998 he lost another US$100,000 deposited in a Russian bank, when it suddenly closed.

Many Chinese businessmen lost big money in Russia in the 1990s

Mr Chen is one of tens of thousands of Chinese entrepreneurs who have ridden their country's flood of exports to do business abroad. Alas, many have learned, often at a heavy cost, that the rules of the game are different from those they knew at home. China's investment abroad has risen spectacularly over the past five years. According to Goldman Sachs, it reached US$10bn in 2005, US$21bn in 2006 and an estimated US$30bn in 2007, surpassing that of Japan for the first time. In the largest overseas deal so far, Industrial and Commercial Bank of China in October paid US$5.4bn for a 20% stake in South Africa's Standard Bank Group.

Insurance against ignorance

To help intrepid but ill-informed compatriots venturing abroad, the China Export & Credit Insurance Corp (Sinosure) on December 17th published a table evaluating the risk of doing business in 191 countries, ranking their politics, economy, finance and society, on a nine-step scale. It is the first such comprehensive rating published by a Chinese state institution. Set up in December 2001 with Rmb4bn (US$553m) in registered capital, Sinosure is a non-profit insurance firm with headquarters in Beijing, 19 branches nationwide and an office in London. It offers Chinese companies cover against political and commercial risks, including war, nationalisation, expropriation, restrictions on transfer and remittance of foreign exchange, and default, bankruptcy and rejection of goods on the part of buyers.

The two countries in the bottom ninth rank are

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Zimbabwe and Burundi. In the eighth rank are several of China's neighbours, with whom it has extensive trade, including Burma, Nepal, Uzbekistan, Turkmenistan and Tajikistan. Also in this lowly rank are Sri Lanka, Bangladesh and three countries that are major oil suppliers to China—Iran, Angola and Sudan. Interestingly, no country makes it into the No.1 rank, perhaps because the bar has been set too high. There are 13 countries in the second rank, including Singapore, Japan, Australia, Canada, the US and eight countries in Western Europe.

The report contains some good news for overseas Chinese businessmen. "In the last two years the risks faced by Chinese investors abroad have diminished in some emerging markets, including Russia and some Middle East and African countries," it says. "South Korea has risen from the fourth to the third rank, Thailand and Kazakhstan are in the sixth rank, and Laos, Mongolia and Pakistan the seventh." But the report's editor, Chen Xiaowei, assistant to the general manager of Sinosure's risk management department, says that in 2007 risks increased in nearly 30% of the countries where Chinese firms operate, especially those with natural resources. Such risks included high levels of debt, rising nationalism, local armed conflicts, and sudden changes in government policy and protectionism often related to the record price of oil.

In Ethiopia, nine Chinese workers were killed, along with 65 Ethiopians, in April 2007 when anti-government rebels attacked an oil installation near the Eritrean border. That was not an isolated incident. Rebels in Niger abducted a Chinese mining executive looking for uranium, and Islamic radicals in Pakistan have killed Chinese working there. "Facing these new threats, Chinese companies and individuals cannot rely on the traditional methods of risk avoidance and treat all the countries the same way," Mr Chen says.

Chinese are particularly at risk because they go to the most dangerous countries avoided by other nationals for fear of political or personal danger. Their oil companies did business with Saddam Hussein's Iraq and are now active in Iran, Sudan and Venezuela, sworn enemies of the US. Take also the plucky Chinese textile traders of Lome, capital of the tiny West African state of Togo. They built up a thriving business there in the 1990s, until the government raised import taxes and cut the profit margin so low that in 2000 they moved en masse to Porto Novo, capital of neighbouring Benin. They prospered there until 2003, when the Benin government did the same thing, raising import taxes and restricting the operations of foreign traders, Indians and Chinese. At the same time, Togo eased its restrictions—so most of the Chinese have returned to Lome.

A top priority

Chinese workers are heading to Africa in droves

As Beijing increases its trade and investment in the continent, more Chinese will put their lives on the line in Africa. According to official Chinese figures, trade between China and Africa in 2006 was worth US$55bn and will reach US$100bn by 2010, making China the continent's largest trading partner. At the Sino-African summit in Beijing in November 2006, attended by 48 African heads of state, Hu Jintao, China's president, promised to double aid in the next three years over the pre-2006 level and offered US$5bn in low-interest loans and credits for the purchase of Chinese goods.

Three of the biggest Chinese projects will be in Nigeria, Zambia and Tanzania, each ranked in the seventh category by Sinosure. One involves a US$250m copper smelter in Chambishi, Zambia, and another, the expansion of the port of Dar-es-Salaam in Tanzania, where China has already constructed a new customs building. Exports of copper from Chambishi will go through the port. The China Non-ferrous Metals Group, operator of the Chambishi copper mine, plans to double its output to 100,000 tonnes a year by the end of 2008 and is building a smelter with a capacity to refine 150,000 tonnes of the mineral with the Yunnan Copper Group, also due for completion by the end of the year. In Nigeria, China will spend US$2bn on infrastructure projects. And in 2006 China National Offshore Oil Corp announced an investment of US$2.3bn for a 45% of an offshore field, which can produce 180,000 barrels of crude oil per day.

These investments should bring substantial economic benefit to China. But the Chinese working on them are taking a big risk, including kidnapping for ransom and death from local violence. Mr Chen and his colleagues at Sinosure will be busy in the coming year—and beyond.

A looming hangover?

Bulls are not yet ready to end the Chinese stockmarket's party, but beware of the morning after

Chinese shares finished 2007 strongly

While many stockmarkets throughout the US and Europe saw only limited gains during 2007, Chinese shares performed extremely well. The Shenzhen composite index almost tripled, and the Shanghai index nearly doubled. Despite suffering a sell-off during much of the fourth quarter, as stocks throughout the world felt the spreading pressure from the US credit crunch, the Chinese domestic market rebounded strongly in December. (As of January 16th, the Shanghai index was up 0.55%, year to date.)

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Stockmarket

Risk of China's stockmarket overheating is rising

With investor confidence in China spilling over to other Asian bourses—the MSCI index for Asia grew 38% in 2007—the country may prove to be a steady anchor for wobbly global stockmarkets this year. But, of course, there is a risk the market will overheat, thanks to the Chinese government's reluctance to spoil the good times.

The Chinese economy has been growing by around 11% year on year. And the rising tide of its insatiable demand—especially for commodity imports—has lifted many economic boats throughout Latin America, Africa and Asia. More importantly, even though export growth remains very rapid, it is domestic demand that increasingly powers the Chinese economy. Unlike other Asian economies that came to prosperity by means of an export-led development model, China has an enormous domestic market with powerful pent-up demand.

Domestic strengths

To be sure, there is a concern that Chinese exports may start to slow in 2008 should the subprime-mortgage crisis hurt consumer spending in the US and Europe—China's two largest trading partners. Additionally, the country's currency, the renminbi, has been appreciating at an accelerating pace, putting further pressure on exports. However, there are growing signs that China's huge domestic market is starting to take up some of the slack. Retail sales rose 16.4% year on year in the first nine months of 2007, sparked by wage growth that pushed up inflation-adjusted urban incomes by 13.2% and rural earnings by 14.8%.

The strong economic performance in China has resulted in rising investor optimism and sky-high stock valuations. Chinese shares, which trade in Hong Kong as well as the two domestic markets in Shanghai and Shenzhen, are expensive. When the markets were at their peak in October 2007, stocks traded at 65 times earnings in Shanghai. Valuations are so high in China because Chinese authorities limit investment opportunities for domestic investors. With few other options, Chinese citizens have piled into the stockmarket, driving up share prices. But the fact that Hong Kong share prices also surged suggests that China's overall positive economic picture partly justifies the move higher.

Chinese share prices hit a five-year low before rocketing

This turnaround in investor sentiment is a relatively recent development. The Chinese economic miracle has been gathering momentum for over a decade, but the stockmarket had consistently lagged behind GDP growth. In fact, even as global stock indices took off in the 2003-05 period, the Chinese stockmarket even dropped to a five-year low before rocketing in the past two years. At the time, investors were apprehensive about excess supply of shares in the market. The Chinese government, which controls the country's industrial and financial crown jewels, had far-reaching plans to recapitalise its banks, utilities, insurers, and infrastructure and transport companies by selling minority stakes in them through initial public offerings (IPOs).

The flood of IPOs has duly arrived and shows no sign of abating. In the end, the market easily absorbed all these new issues, and stock prices have continued to rally. Moreover, while many Chinese companies still list in New York and London—two even tapped Frankfurt in 2007—the bulk of funds raised over the past two years has been through dual listings domestically in Hong Kong and Shanghai.

The behemoth Chinese bank IPOs in 2006—Bank of China, and Industrial and Commercial Bank of China raised over US$35bn between them—were followed in 2007 by more of the same. Industrial Bank raised US$2.1bn in January and China Citic Bank saw a US$5.4bn capital infusion in April. The latter was one of the five largest deals globally last year. More recent IPOs, coming in the final months of the year, included a nearly US$1bn offering by BYD Electronic (International), a maker of handset casings and keypads; US$1.2bn by Sinotruk (Hong Kong), a truckmaker; and US$5.5bn by China Railway Group, the third largest construction contractor in the world in terms of revenue. China Pacific Insurance, a small insurer in which the Carlyle Group of the US owns a stake, is expected to debut early this year. Even though Sinotruk initially saw its price drop below the IPO level, recent issues have been well-received. China Railway, for instance, has seen its share price nearly double in the first month of trading.

Nothing lasts forever

Nevertheless, analysts are increasingly warning that the Chinese stockmarket is overheated and that the buying frenzy cannot be sustained forever. By restricting their access to international markets, the government ensures Chinese investors will continue to buy domestic shares. Worse, the authorities are deliberately creating a buying frenzy. Many IPOs—the recent one by China Railway was no exception—are priced so as to make sure share prices rocket in early trading. Investors now see all IPOs as a one-way bet, notwithstanding the temporary setback in the case of Sinotruk.

The authorities are well aware of what they are doing and what the eventual consequences are likely to be. But don't count on any serious measures to prevent a crash. In late February 2007, when the Shanghai index stood at about one-half its current level, the government made an attempt to rein in market speculation. The result was a precipitous 10% drop in Chinese shares, which sent shivers through equity markets around the world. It is unlikely to try again in the first half of the year. China will be hosting the 2008 Olympics this summer, and the government is determined to make the games a showcase of its recent economic success and political stability. Count on the bulls to lead the domestic stockmarket through mid-year.

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A win for the mainland

The KMT's emphatic victory in Taiwan's parliamentary elections bodes well for its chances in the presidential contest in March—and for cross-Strait relations in the next few years

Taiwan's main opposition party, the Kuomintang (KMT, Nationalist Party), won a landslide in legislative elections on January 12th. The KMT picked up 81 seats, compared with just 27 for its main rival, the ruling Democratic Progressive Party (DPP). The one-sidedness of the result partly reflects changes to the electoral system, including a reduction in the number of parliamentary seats from 225 to 113. But more importantly, it is a clear sign that Taiwan's voters are eager for the government to focus on the economy after several years of partisan paralysis under the DPP. Given that the KMT is also expected to win the presidential election in March, Taiwan appears to be moving towards an easing of tensions with China that will significantly improve the self-ruled island's economic prospects.

The KMT had been expected to retain its majority in parliament. But the size of its new majority is surprising. The Nationalists will now control some 72% of parliamentary seats, compared with its earlier tally of around 52%. Meanwhile, the pro-independence DPP's share of seats has plunged to 24% from the 42% earlier held by the party and its "pan-green" allies.

Why did the KMT do so well? The party's prospects were buoyed by a high-court ruling on December 28th that cleared Ma Ying-jeou, the KMT's presidential candidate, of corruption charges. The KMT has also gained momentum from the paralysing effect that corruption allegations against Taiwan's president, Chen Shui-bian, and his DPP entourage have had on the government's ability to govern effectively. A more prosaic but equally important cause of the government's problems was the fact that the KMT and its allies have repeatedly used their small majority in parliament to obstruct the government's economic initiatives and accused Mr Chen of focusing on controversial issues related to Taiwan's sovereignty and national identity.

The election results were not all bad news for the DPP. Despite the KMT's landslide in terms of seats won, other indicators suggest the DPP retains significant support of the electorate. The DPP actually won a slightly higher proportion of the popular vote than in the last legislative election (38% v 36%). That the KMT's percentage of the popular vote was 51%—about the proportion of seats it held in the previous parliament—also suggests that the Nationalists have not made major gains in overall public support.

The scale of the KMT's triumph augurs well for the party's chances of winning the presidential contest in March, which will pit Mr Ma against the DPP's Frank Hsieh, a former mayor of Taipei who is widely seen as more moderate than Mr Chen. Still, the DPP's large losses in the parliamentary election may be an inaccurate guide to the outcome of the presidential election. The DPP has a small window in which to change its electoral strategy. Mr Hsieh will win more votes if he distances himself from Mr Chen's plan to hold a controversial referendum on applying to the UN under the name of Taiwan. Mr Chen has also stepped down as DPP chairman to take responsibility for the party's defeat, giving Mr Hsieh more latitude to shape his campaign platform.

Mr Chen has stepped down as DPP chairman to take responsibility for the loss

In the end, however, the DPP needs everything to go right to have even a marginal chance of winning the presidency, whereas the KMT only needs nothing to go dramatically wrong. If the KMT wins the presidential election, it will have significant implications for both economic policy and relations with China. Taiwan is increasingly economically dependent on the mainland: China is Taiwan's largest export market, Taiwan firms have made investments worth tens of billions of US dollars on the mainland and an estimated 4% of Taiwan's citizens live there. This dependence is mutual: a significant proportion of China's exports, especially of electronic goods, are manufactured by Taiwan firms operating on the mainland. The KMT can be expected to boost these reciprocal ties by accelerating the pace of cross-Strait economic integration. Mr Ma's proposed initiatives include allowing direct travel links with China and permitting Taiwan firms to invest more than 40% of their assets in China.

The bigger prize

However, while China will welcome the KMT's return to power, the Nationalists' electoral success should not be misunderstood as a vote in favour of reunification. The KMT takes a far less confrontational approach to China than the DPP, but Mr Ma has said that reunification would only be possible with a democratic China. As this suggests, the real impediment to reunification is not Taiwan pro-independence sentiment, but rather the mainland's political backwardness. (Taiwan is closely watching China's foot-dragging on democratisation in Hong Kong.)

The KMT's election victory was also possible because China has developed a far more sophisticated approach to influencing Taiwan's political development. In 1996 China fired dozens of missiles into Taiwan waters in an effort to deter the island's population from voting for pro-independence candidates. In 2008 China has largely kept its views on Taiwan's elections to itself—although, bizarrely, several delegates ostensibly from Taiwan were appointed to the mainland's National People's Congress on the same day as Taiwan's parliamentary elections.

China has become more sophisticated in dealing with Taiwan politics

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What's new in your industry

Automotive

Ankai Automobile reaches deal to send buses to Iran. Arg Diesel of Iran agreed to terms on January 9th with Anhui Ankai Automobile Company to purchase Rmb549m (US$75.9m) worth of city buses. Ankai will deliver 100 18-metre and 100 12-metre full-size buses, as well as 200 18-metre and 200 12-metre pre-assembled buses to Arg Diesel, a 60:40 joint venture between Kerman Automobile Manufacturing and Vertoon Automotive Company. The contract will be completed by October.

Aviation

Air China to partner with China Eastern as counter-offer to Singapore Airlines bid. China National Aviation Holding Company (CNAC), the parent company of Air China, has pledged to purchase 24-30% of China Eastern Airlines' outstanding shares at HK$5 (US$0.64) per share, a 32% increase from the HK$3.8 per share offer tendered by Singapore Airlines (SIA) and Lentor Investment in late 2007. The attempted 24% stake purchase by SIA and Lentor, an arm of Temasek Holdings, a Singapore state-owned investment company, touched off a protectionist backlash from China Eastern's domestic investors, who widely criticised the deal as not reflecting the company's fair value. CNAC may look to Cathay Pacific of Hong Kong for support in funding the proposed acquisition.

Energy & power

Himin Solar Energy receives US$100m capital injection. Himin Solar Energy, a Shandong-based producer of solar water heaters and vacuum tubes, approved on January 10th a US$100m capital injection from Goldman Sachs of the US and CDH Investments of China. Himin will use the capital, which will amount to a roughly 20% stake, to speed up its proposed initial public offering after posting a 50% year-on-year increase in sales revenue in 2007.

NDRC gives nod to Shenhua Energy's first overseas venture in Indonesia. The National Development and Reform Commission approved on January 8th Shenhua Energy's proposed acquisition of PT Adaro Indonesia, the country's second largest coal-mining company. Financial terms have not yet been reached, but Shenhua plans to ship Adaro's coal to China for use in domestic power generation.

Food, beverages & tobacco

Government releases results of US$68.8m campaign to upgrade slaughterhouses. Amid growing concern over domestic food safety in the wake of a December outbreak of blue ear pig disease, the commerce ministry unveiled on January 9th the results of a nationwide campaign to upgrade domestic slaughterhouses and shut down unqualified operators. Over 7,700 slaughterhouses operating without licences or using unsanitary practices were shut down in December. The commerce ministry promised subsidies for the industry, following a 56% year-on-year price increase for pork as of November.

Financial services

Gold futures debut on Shanghai Futures Exchange, live-pig futures to follow. On January 9th trading in gold bullion began on the Shanghai Futures Exchange after the China Securities Regulatory Commission (CSRC) granted approval. CSRC officials hope trading in gold futures will improve the domestic market by providing gold producers with a hedging tool while removing excess liquidity from the economy. Upon its China debut, gold climbed over 2% to US$880 per troy ounce. The Dalian Commodity Exchange (DCE), meanwhile, has completed initial investigations into the introduction of live-pig futures. Initially proposed in 2004, live-pig futures have been stalled by instability in the domestic market. The DCE did not specify when live-pig-futures products would become available.

China Development Bank to jointly operate Sino-Israel investment fund. China Development Bank agreed on January 13th to jointly operate a Sino-Israel investment fund with Infinity, an Israel-based venture-capital company. The new fund will have an initial capitalisation of US$350m and will invest mainly in technology-development enterprises.

Goldman Sachs purchases 20% stake in China shipbuilding company. Yangfan Group, a Chinese shipbuilding enterprise, agreed on January 9th to sell a 20% stake to GS Pereclus Holdings, a wholly-owned subsidiary of US-based investment firm Goldman Sachs. Yangfan currently operates two major manufacturing facilities in Zhoushan, a city in Zhejiang province. In late 2007 Yangfan announced plans to build its own fleet to meet global demand with the construction of 100 ships between 100,000 dwt and 170,000 dwt.

Grameen Trust plans two microfinance ventures in China's western provinces. Grameen Trust, a microlending institution based in Bangladesh, announced to the China Academy of Social Sciences on January 8th its plans to register two new China-based microlending ventures in the first quarter of 2008. The two not-for-profit ventures will be located in Sichuan province and the Xinjiang Uyghur Autonomous Region, and will provide lending services to low-income households with no mortgages. The announcement follows a co-operative agreement between Grameen Trust and the Hainan Rural Credit Union in late December to jointly launch microlending initiatives based on the Grameen model.

Metals & mining

Jinchuan Group proposes buyout of Canadian copper-mining firm. On January 9th Jinchuan Group tendered an offer to purchase Tyler Resources, a Canada-based mining enterprise. The offer amounts to a 116% premium on the closing price of Tyler Group's shares on October 18th, when Mercator Minerals of the US offered US$125m to purchase the company. When that offer expired on January 8th, Jinchuan proposed a US$214m takeover of Tyler Group, whose enterprise is mainly engaged in the development and operation of a mineralised porphyry deposit in Mexico.

Telecoms & technology

Ministry denies report of merger between mainland telecoms-service providers. A spokesman with the information industry ministry denied early January reports in Hong Kong media that China Telecom, the mainland's largest fix-line telecoms-service provider, and China Unicom, its second-largest mobile-telecoms provider, would merge. The media reports cited an internal source at China Telecom, and also speculated that China Mobile and China Netcom would merge to form one company. China Netcom was spun-off from China Mobile in 2002.

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Joint ventures, contracts, MoUs and other agreements, Jan 8th to Jan 21st 2008

Agreement (date reported)	Participants (equity stake)	Value	Additional details
Financial services			
JV established (Jan 14th)	**Credit Suisse** (33) of Switzerland and **Founder Securities** (67) of China	—	The new JV will underwrite new A-shares, and run a brokerage for the purchase of foreign stocks as well as corporate and government bonds
LoI signed (Jan 10th)	By **Caitong Securities Brokerage**, **Hangzhou Industrial Assets Management** and **Zhejiang Shenghua Biok Biology**, all of China	—	Shenghua Biok, a producer of pesticides and veterinary drugs, will partner with the two Chinese financial institutions to establish a JV fund firm, pending application and regulatory approval
JV established (Jan 8th)	**China Minsheng Banking** (60) of China and **Royal Bank of Canada** (30) of Canada	—	The two companies will form a fund-management firm, Minsheng Royal Fund Management, with China's Three Gorges Financial to take the remaining 10% stake
LoI signed (Jan 7th)	By **Sichuan Xinhua Winshare Chainstore** and **Chengdu City Commercial Bank**, both of China	—	Xinhua Winshare, a book and audio/visual products retailer, will purchase a 2.46% stake in Chengdu City Commercial through the purchase of 80m shares at Rmb3 per share
Healthcare & pharmaceuticals			
Agreement signed (Jan 9th)	By **Wuxi PharmaTech** of China and **AppTec Laboratory Services** of the US	US$160m	Expected to close within the first quarter of 2008, NYSE-listed Wuxi PharmaTech will acquire 100% of AppTec, including US$12m in outstanding debt
Materials & manufacturing			
Agreement signed (Jan 9th)	By **China National Building Material Group (CNBM)** and three Huzhou-based cement producers, all of China	US$82.8m	In order to establish a large cement-production base in the region, CNBM will acquire three cement producers in the Zhejiang provincial city of Huzhou: Zhejiang Xingbaolong Building Materials, Zhejiang Shanying Cement and Zhejiang Yulang Cement
Media & entertainment			
Agreement signed (Jan 15th)	By **Bank of China**, **China Merchant's Bank** and **Legend Holdings**, all of China, and **National Basketball Association** and **Walt Disney,** both of the US	US$253m	ESPN, a Walt Disney subsidiary, will partner with the three Chinese institutions and Li Ka-Shing of Hong Kong to purchase an 11% stake in the soon-to-be-formed NBA China
Agreement signed (Jan 9th)	By **Shanghai Jielong Industry Group Corp** and **China International Publishing Group**, both of China	US$41.4m	The two companies will establish a JV for the publication of books and periodicals, as well as set aside Rmb10m for the creation of an agency to provide pre-printing design solutions
Agreement signed (Jan 8th)	By **Shunya Communications Group** of China and **Omnicom Group** of the US	—	Shunya will integrate its four major components, Shunya International Ad, Shunya Profuture Events Marketing, Shunya International PR and Shunya PR into Omnicom's worldwide operations, including subsidiaries BBDO, Proximity, Porter Novelli and Pleon
Metals & mining			
Agreement signed (Jan 15th)	By **Aluminum Corp of China (Chinalco)** and the **Saudi Arabian General Investment Authority** of Saudi Arabia	US$3bn	Chinalco received approval from the Saudi investment authority to partner with MMC Corp and Saudi Binladin Group to construct an electrolytic aluminium plant, in which Chinalco will hold a 40% stake worth US$1.2bn
Agreement signed (Jan 14th)	By **Shanxi Antai Group** and **Xintai Iron & Steel**, both of China	—	Antai will acquire a 100% stake in Xintai Iron & Steel, to which Antai currently supplies most of its molten-iron products, with funds raised from private-share placement
Agreement signed (Jan 14th)	By **Shanxi Lu'an Environmental Energy Development** and **Shanxi Zuoqian Jiaxin Energy**, both of China	US$22.6m	Lu'an Environmental will acquire a 68% stake in Jiaxin Energy, which owns the rights to two coal mines in Zuoqian county with 48.8m tonnes of coal recoverable at a 450,000-tonne annual clip
JV established (Jan 7th)	**Jiangxi Black Cat Carbon Black** (50), **Taihe Clan** (25) and **Jingda Coke & Coal** (25), all of China	US$6.9m	The three companies will partner to form a JV in Wuhai in Inner Mongolia to create a 150,000-tonne carbon-black project with all products branded with the Black Cat trademark
Property			
Agreement signed (Jan 7th)	By **Jiangsu Yongding** and the Suzhou municipal government, both of China	—	Jiangsu Yongding will acquire two plots of land in the city of Suzhou, one commercial plot covering over 20,000 sq metres and one residential plot covering over 200,000 sq metres
Transport & logistics			
Contract awarded (Jan 10th)	To **Jiangsu Eastern Shipyard** of China by **PT Pertamina** of Indonesia	US$400m	Pertamina has set aside US$120m for the purchase of eight 85,000-dwt tankers and will raise the remaining funds through a loan or bond issuance

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Regulatory watch

Consumer goods & retailing

Chinese premier promises price freezes to curb inflation. During a cabinet meeting on January 9th Wen Jiabao, the Chinese premier, announced that the government would step in more aggressively to control the price of basic commodities. Food prices rose 18.2% year on year in November, driving inflation to an 11-year high of 6.9%. Mr Wen promised that public-utility prices, as well as education and public-transportation fees, would be frozen for the next few months. Enterprises that flaunt China's Price Law will face fines and possible imprisonment for executives. The premier also promised that government inspections would increase ahead of Chinese New Year to limit price fixing.

Environment

Government legislates to limit the use of plastic bags. Beginning on June 1st the central government will enforce a ban on the production and sale of ultra-thin plastic bags, defined as being less than 0.025 mm in thickness. The campaign will also prohibit supermarkets or retailers from handing out free plastic bags. The new regulations will be accompanied by a nationwide campaign to encourage consumers to use fewer plastic bags in favour of cloth bags when shopping. The China Plastics Processing Industry Association believes eliminating the bag's use will improve recycling and landfill stress. Before the June 1st deadline the commerce ministry and the National Development and Reform Commission will jointly issue specific regulations on fines for violating the new ban.

Financial services

Securities watchdog plans public-education seminars to raise risk awareness among investors. The China Securities Regulatory Commission (CSRC) announced in mid-January the formation of a new department, the Securities Association of China (SAC), to raise risk awareness among domestic investors. The SAC will be charged with developing education initiatives to aid first-time investors' understanding of the risk involved in stock trading. The number of trading accounts on the Shanghai and Shenzhen bourses swelled to nearly 138m in 2007, up some 77% from 78m in 2006. The SAC will also be responsible for determining how risk awareness might be integrated into the national education curriculum.

Banking watchdog releases regulatory fees for financial institutions. The China Banking Regulatory Commission (CBRC) announced on January 3rd new institutional fees for financial institutions based on an assigned risk coefficient. Institutional fees will be determined by a given enterprise's real capital at the end of the previous year. The CBRC will assess fees based on 0.05% of an enterprise's total assets minus real capital, which will then be multiplied by the institution's risk coefficient: 0.9 for level one, 0.95 for level two, 1 for level three, 1.05 for level four and 1.1 for level five (level one being the lowest risk). Companies can then subtract the fees paid to domestic regulators from overseas branches from the resultant amount to determine their final annual fees. The CBRC did not specify how the risk coefficient level would be assigned. According to its announcement, fees for 2008 and 2009 will be reduced from the 2007 level by 10%. Rural commercial banks are liable for only 50% of the fee rate of other financial institutions.

State planner eases path for corporate-bond issue. The National Development and Reform Commission issued on January 7th a circular that will simplify the procedure for companies to issue corporate bonds. The NDRC will consider applications for bond issuance by immediately verifying only relevant sections of the application as opposed to the former system, which required the entire application to be verified before being approved. The NDRC has pledged to approve or deny applications within three months of receipt.

Insurance watchdog to institute new regulations for CFO qualification. The China Insurance Regulatory Commission published in early January draft regulations for the requirements to serve as insurance enterprises' chief financial officer (CFO). All insurance companies' CFOs will be required to abide by the draft Administration Regulations on Qualification of CFO of Insurance Companies, including stipulations that require the CFO to demonstrate mastery of the Chinese language. The draft regulations further invest the CFO with veto power during executive meetings.

Government

Discipline committee established to oversee corruption investigation. In an effort to centralise the management and oversight of corruption investigations, China's provincial-level discipline committees on January 8th established the Central Committee for Discipline Inspection (CCDI) as a division of the Communist Party. The new committee will also be in charge of intra-party disciplinary and anti-corruption education. The CCDI will advise the State Council on matters of anti-corruption legislation.

Labour

Central government issues new workplace safety regulations. The State Administration of Work Safety will put new regulations in place on February 1st to better ensure the rights of Chinese labourers, particularly those at work in China's mines. All enterprises will be required to submit quarterly workplace safety reports and will be subject to possible annual inspection. Companies are also required to educate employees about the availability of the State Administration of Work Safety to report potential dangers and safety concerns. Those failing to file quarterly reports or submit to regular inspections will face fines up to Rmb30,000 (US$4,149).

Tax

Authorities to unveil new scheme for resource taxation. The State Administration of Taxation (SAT) announced on January 10th that a new system for resource taxation is being finalised. It would shift the taxation from one based on volume to one based on price. The State Council has charged the SAT to revise the taxation regime to reflect the government's increased emphasis on cutting energy intensity and promoting greener industry. Resource taxes had been frozen at the levels set in 1994 until late 2007, when the SAT raised taxes on lead, zinc, tungsten, copper and coking coal. To promote fuel efficiency, the SAT is also considering the introduction of a fuel tax, first proposed in 1994 but delayed due to concerns from the National Development and Reform Commission that fuel-price rises at the pump would have a disproportionately large impact on rural farmers.

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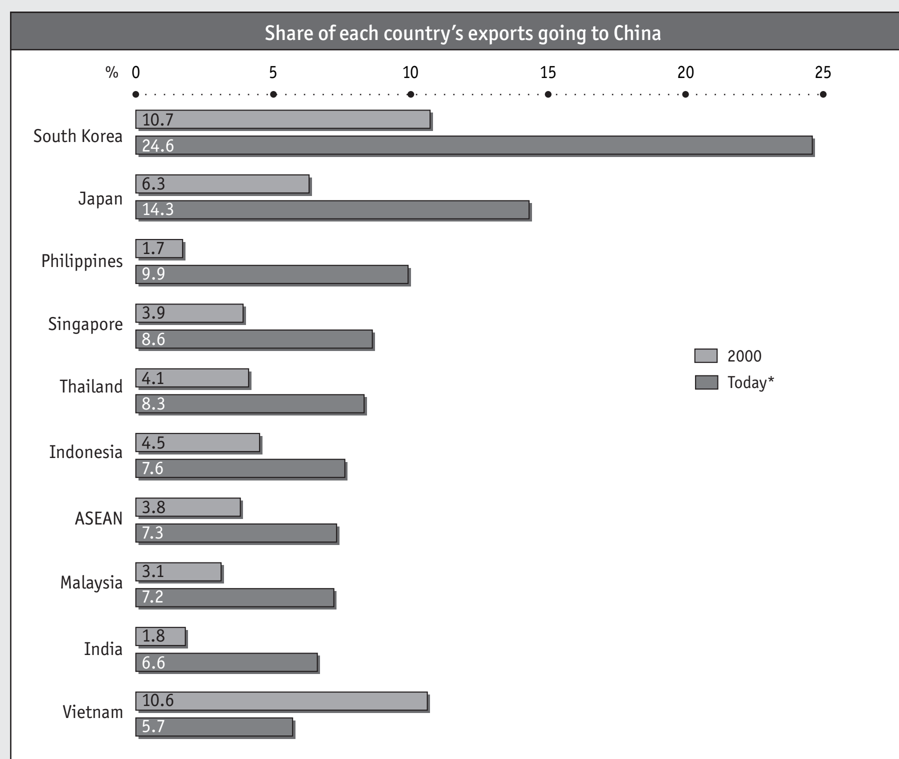
Engine of growth

China's importance as a destination for exports from its Asian neighbours has risen sharply. In just six years China's share of South Korea's exports has risen from 10.7% in 2000 to 24.6% in 2006. Over the same period China's share of Japan's exports has grown from 6.3% to 14.3%. The same picture is true right across the region, except Vietnam.

A number of explanations lie behind China's increasing importance as a destination for Asian exports. The most obvious is China's rapid economic growth. As a domestic market, Chinese demand for the region's exports is soaring. Another major trend affecting trade flows in Asia is China's changing role in the global pattern of manufacturing. China has emerged as the destination of choice for final assembly and processing of goods. Parts and components produced across the region are shipped to China for the last stages of production before being shipped to markets in the West. As such, China has become an export platform for the region.

Selected indicators



* Today = latest year for available data (in most cases 2006, but in some cases 2005)

Source: Economist Intelligence Unit

Production and trade—monthly indicators

	Currency	Units	2/2007	3/2007	4/2007	5/2007	6/2007	7/2007
Production and demand indicators								
Industrial production (% change pa)*			12.60	17.60	17.40	18.10	19.40	18.00
Retail sales (volume)	Rmb	100m	7,013.70	6,686.00	6,672.50	7,157.50	7,026.00	6,998.20
Retail sales (% pa)			16.86	15.34	15.55	15.90	15.98	16.40
External trade								
Trade balance (fob-cif basis)	US$	bn	23.70	6.79	16.79	22.44	26.87	24.36
Total exports fob	US$	bn	82.04	83.38	97.41	94.04	103.27	107.74
Total imports cif	US$	bn	58.34	76.59	80.62	71.60	76.40	83.39
Exchange rate								
Exchange rate Rmb: US$ (av)			7.76	7.74	7.73	7.67	7.63	7.58
Exchange rate Rmb: US$ (end-period)			7.74	7.73	7.71	7.65	7.62	7.57
Real effective exchange rate**			97.30	96.74	96.45	97.68	99.36	100.11
International reserves								
International reserves	US$	bn	1,163.44	1,208.11	1,252.64	1,298.71	1,338.66	1,391.26
Foreign-exchange reserves	US$	bn	1,159.37	1,204.04	1,248.57	1,294.64	1,334.59	1,387.19
Gold, national valuation	US$	bn	4.07	4.07	4.07	4.07	4.07	4.07
Commercial banks' foreign assets	US$	bn	275.08	264.09	260.59	263.53	264.88	254.09
Commercial banks' foreign liabilities	US$	bn	69.19	67.63	66.55	70.15	68.25	71.09
Commercial banks' net foreign assets	US$	bn	205.89	196.46	194.04	193.38	196.62	183.00

*Percentage change in value added of industrial production over previous year.

**Trade-weighted basket of currencies converted to an index (1997=100) and adjusted for relative price movements.

Sources: IMF, China National Bureau of Statistics, China Statistical Information Center, People's Bank of China, China Stock Exchange, Economist Intelligence Unit

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Commentary

Economist Intelligence Unit

Not so fast

Why the renminbi may appreciate less in 2008 than the market expectation

By Steven Sitao Xu

These days almost everyone seems to think that in 2008 the Chinese currency will appreciate faster against the US dollar than in previous years. The arguments for a much stronger renminbi seem compelling. China's foreign-exchange reserves—US$1.5trn and counting—have roughly doubled in less than three years. Inflation, too, is rising. A stronger currency would be a powerful tool to counter these trends, as it would lower both China's export earnings and import prices. And in this year of US presidential election, a faster appreciation of the renminbi would provide China some political cover from shriller accusations that cheap Chinese exports are destroying American jobs. But the consensus view does not always prove to be right.

Chinese policymakers never cease to be amazed by outsiders' growing criticism that China's forex reform has been "too little, too slow". The renminbi, after all, has gained about 12.5% since it was de-pegged from the US dollar in July 2005. But recently another, more worrying trend has caught them by surprise. Amid mounting expectations of a faster appreciation, the People's Bank of China (PBC, the central bank) is having difficulty maintaining its policy of a gradual rise of the renminbi. The real problem, though, is that China's economic cycle is increasingly diverging from that of the global economy.

Out of sync

While Chinese authorities are forced to tighten their monetary stance amid concerns about economic overheating, central banks in most developed countries are worried about the ongoing US subprime-mortgage crisis and are easing policy. When the global economy was booming, interest rates in the US were about 3% higher than in China. That meant the PBC could set the pace of renminbi appreciation at 3-5% per year, because speculators' gains from the exchange rate would be offset by the interest rate differentials. But this blissful condition disappeared when, in the last quarter of 2007, the US Federal Reserve and the PBC found themselves moving in opposite directions. Now, if you bet on a stronger renminbi, you could be doubly rewarded with higher exchange *and* interest rates. People who had been deterred by the interest rate gap previously are jumping on the speculation bandwagon. That is why the consensus is that the Chinese currency will appreciate faster this year.

The popular view that "trend is your friend" is often wrong, however. Otherwise, it would be too easy to speculate in currencies. In fact, the one-year exchange rate on the so-called offshore non-deliverable-forward market was recently at around Rmb6.85:US$1. But as of mid-January the spot rate already stands at Rmb7.24:US$1. Is the market getting ahead of itself? Speculators should remember that China can cool the economy by clamping down on bank lending, as well as by hiking interest rates.

All the same, the PBC must do some serious soul searching about its forex reform. The simple fact is that China's annual current-account surplus is about 8-10% of GDP, or at least US$200bn. Even foreign politicians demanding a 30% appreciation of the renminbi agree that China's high savings rate, rather than a hugely undervalued currency, is more responsible for such immense imbalances. Meanwhile, the rapid build-up in China's forex reserves reflects the relative dearth of capital outflows. Because of draconian capital controls, the PBC is the main buyer and seller of foreign currency in the market. The problem is, Chinese central bankers are not any better than Chinese firms or individuals at this. For better management of the country's capital inflows and outflows, the PBC should allow the renminbi's value to be more market-determined. A deficit in China's capital account then would offset the surplus in its current account, as economic theory says.

What about adopting a stronger-currency policy to fight rising inflation? Again, contrary to market consensus, the PBC perhaps should not do that. If the US economy slides into recession, that could help check inflation in China. To compensate for falling exports, Chinese firms—many of which have over-expanded capacity in recent years—would rather lower prices than cut production. And if export growth decelerates, the PBC will become more wary of a faster currency appreciation. In any case, the rising consumer prices in China have been driven mainly by food, which disproportionately have hurt lower-income earners. To counter what seems to be a temporary jump in food prices from a supply-demand imbalance, it might make more sense to cut their income taxes, instead of making the renminbi dearer.

Ultimately, the question that Chinese policymakers are asking themselves is: will China be better off with Rmb6.5:US$1 and the Shanghai A-shares at 8,000? Restricting domestic savers' ability to invest abroad, while pursuing a faster currency appreciation (hence encouraging more capital inflows), is a sure recipe for a bigger asset bubble. So the more critical task for Chinese policymakers in 2008 is to allow a genuine relaxation of capital controls. If they do that, the exchange rate will not appreciate much beyond Rmb7:US$1 by year-end.

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January 21st 2008
Vol XXXIV No. 2
ISSN: 1016-9766

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Published fortnightly for subscribers only
Annual subscription: £825/US$1,260

As well as being available to subscribers in print, *Business China* is available electronically via the Internet. For more information please visit **www.store.eiu.com** or contact your nearest Economist Intelligence Unit office.

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