

# Business China

Fortnightly report to managers of China operations

## Unwelcome export

Western watchdogs are increasingly concerned about some Chinese corporations' dubious conduct abroad

As Chinese companies rapidly become global players, fear is rising that they are exporting their environmental and labour abuses at home to their host countries, while their uninhibited dealings with despotic regimes are undermining the global effort to promote corporate social responsibility. However, the best way to mitigate Chinese firms' bad influence lies in urging them to globalise faster. This is because, ultimately, the more they compete in the global market, the more they will be exposed to international standards and pressures to improve their behaviour.

Reports of Chinese companies' unscrupulous actions come from almost every corner of the world. In Peru, protests by miners and local environmental groups have erupted at the Hierro iron-ore mine, operated by steel-maker Shougang Group. The protestors accuse the Chinese company of polluting the environment and abusing workers, and Peruvian officials have urged the steel-maker to change its behaviour. A Shougang spokesman in Beijing says the company operates in accordance with both Chinese and Peruvian laws.

### Troublesome trend

Meanwhile, in Africa a number of Chinese businesses are accused of propping up some of the continent's most corrupt and brutal regimes. There are more than 700 Chinese firms operating in 49 African countries, with a total contracted investment of over US\$1.36bn and actual investment of US\$625m, according to the Chinese foreign ministry's latest figures from 2004. For example, China National Petroleum Corp and Sinopec are part of the reportedly more than US\$2bn Chinese investment in Sudan's oil industry. (According to the US energy department, Sudan supplies 7% of China's oil imports). In Zimbabwe, Chinese firms like China National Aero-Technology Import and Export Corp are also doing brisk business, such as exporting Chinese-made aircraft to the country, even as Western firms steer clear of the racially polarised and diplomatically isolated country.

The unprincipled behaviour of these Chinese

firms, as well as their propensity to pursue business however politically incorrect it may be, is setting off alarm bells among both Western governments and non-governmental organisations (NGOs) which scrutinise multinational corporations' activities. The US, which faces growing competition from China for global oil reserves, views Chinese corporate actions overseas, particularly the energy deals in Africa, as increasingly troublesome. "As a long-term trend, China's behaviour in this respect runs counter to key strategic goals," said the recently released US energy department report on Chinese firms. "China's tolerance for despotic regimes may undermine [US] efforts" to spread democracy and free trade.

Meanwhile, an article in the December 2005 edition of *Ethical Corporation*, a UK-based monthly magazine that keeps tabs on corporate responsibility, said: "This [Chinese] model of international development, which eschews any 'interference' in the internal affairs of foreign states, is of increasing concern to NGOs, international financial institutions, and Western companies" trying to improve transparency and human rights in poor countries.

The article describes how a US\$2bn loan by China's Export-Import Bank to Angola in 2004 undermined the IMF's efforts to combat that African country's ingrained corruption and financial mismanagement. Before the Chinese money materialised, the Angolan government had been in tough negotiations with the IMF to obtain its strict rule-based loan package. The article quoted a corporate-responsibility manager at a European oil firm in Angola as saying the Chinese loan—which came with few strings attached—made it harder for Western companies and governments to demand that Angolan authorities pass anti-corruption measures.

The Chinese are certainly no role models for responsible business. The National Corporate Responsibility Index, which is produced by the London-based think-tank AccountAbility and the Brazilian business school Fundação Dom Cabral, found in November that China ranked 66 out of 80 countries in terms of corruption, environmental management and corporate governance.

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# Corporate ethics/Biotechnology

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Transparency International, an anti-corruption group based in Berlin, also ranked Chinese firms as the second worst culprits (the worst were Russians) in terms of giving bribes in developing nations.

Chinese companies, of course, are not the world's only corporate miscreants. "There are problems with Chinese firms, but this must be viewed within the global context," says Peter Rooke, director of Asia programmes at Transparency International. He notes that bribery-giving by companies from Italy and South Korea is only marginally less than by those from China, and corporate misbehaviour such as fraud and embezzlement remains rampant even among American companies.

## Unique situation

If there is one thing unique about Chinese companies, it is the fact that never before have so many firms from a developing country ventured abroad with so little inkling of global business standards. The root of Chinese firms' bad behaviour abroad lies in the weak corporate-governance infrastructure and managerial transparency at home. "Corporate governance is new in China, with low disclosure requirements, as well as legal and accounting standards," says Stephen Cheung, an expert on Asian corporate governance at the City University of Hong Kong. Despite significant institutional reforms, an OECD report in September 2005 found that Chinese corporate governance continues to suffer because many state-owned companies are unincorporated and therefore lack a board of directors. No less a problem is ineffective enforcement of existing rules and regulations.

Performance among Chinese firms, however, varies widely. It is worth noting that firms with better corporate-governance records tend to be those with foreign investments, according to Lu Tong, director of the Chinese Academy of Social Science's Center for Corporate Governance. Among the better performers are China Ocean Shipping Group and New Hope Group, both of which have extensive international operations. "The top executives of international Chinese companies realise that their foreign-investments risks are very high," says Ms Lu. "They know they have to be more careful and perform better."

Indeed, this may be the best way to make Chinese companies better global corporate citizens. As more of them enter the international market, they

become subject to global guidelines and pressures. One powerful force for change is overseas bourses such as the New York Stock Exchange and Hong Kong Stock Exchange. Chinese companies' desire to seek foreign capital has forced many of them to—or at least attempt to—clean up their acts in financial disclosure and operational transparency in order to meet stringent listing requirements. In addition, as international institutional investors become shareholders in Chinese firms, they will demand better corporate governance and social responsibility from management, experts say.

But international pressure is only half the solution. There must also be constructive engagement to educate Chinese firms and government officials on the financial and social benefits of good corporate behaviour. Transparency International is now working with the Chinese Ministry of Supervision and the State Assets Supervision and Administration Commission to crack down on bribery among state-owned enterprises. Such efforts are starting to grab Chinese executives' attention: in November the CEOs of some of the largest Chinese companies attended the United Nations Global Compact Summit in Shanghai, which was the biggest corporate-responsibility conference in China to date.

## Foundation for reform

China has begun to build the institutional foundation for reform. Transparency International's Mr Rooke points out that China is already operating inside the international legal architecture for better corporate governance. China ratified the UN Convention Against Corruption, which contains strict provisions against foreign bribery, in October. During this year's National People's Congress session the government also proposed amendments to the country's corporate law, containing new measures to improve board management and shareholder rights.

To be sure, Chinese companies will not become more responsible international players overnight. With their expansion into world markets set to continue, their scope for misdeeds will only increase. But the mere fact that Chinese firms are globalising—being forced, like it or not, to benchmark themselves against the world's best-behaved corporations—means they have already taken the crucial first steps towards becoming more socially responsible businesses.

Chinese firms behave not much worse than Italian or South Korean ones

Highly internationalised Chinese companies behave better abroad

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## Healthy industry

### China's biotechnology sector shows great promise

Buoyed by rising healthcare spending, China's biotechnology sector is hotting up. Although still low compared with OECD countries, China's healthcare spending has exceeded its GDP growth rate since

2001. The outlay is partly prompted by the government's recognition of the opportunity to drive the sector into a leading position internationally, and partly by its need to proactively combat SARS, bird

flu, HIV/AIDS and other potential epidemics.

Official figures show government spending on biotechnology reached US\$325m in 2004, but some analysts estimate China's current funding initiatives to be in excess of US\$600m. "If the trend continues, [China's biotechnology spending] will catch up to us in 2009 or 2010," says Janez Potocnik, the EU's commissioner for research. China is home to more than 20 biotechnology parks and approximately 300 biotechnology companies focusing on cures for human diseases. There are over 150 experimental drugs in clinical trials. But perhaps the most eye-catching news has been the licence granted SiBiono GeneTech, a Shenzhen company, in 2003 for a gene-therapy medication—the world's first such licence.

## Affordable innovation

Until recently Chinese biotechnology companies focused largely on generic manufacturing. But now the focus is on innovation. And the name of the game is affordable innovation. Lower costs in China motivated Eli Lilly to open a research centre near Shanghai operated by a separate Chinese company, ChemExplorer. In the co-operative plan, Lilly provides funding and technical support, while ChemExplorer organises staff to implement pharmaceuticals research focused mainly on neuropathy, diabetes and cancer. Lilly claims it is saving 40% on the cost of basic research. Wang Hongguang, director-general of the China National Center for Biotechnology Development, believes the cost of conducting biomedical research in China is about 20% of that in the West because Chinese scientists' salaries are 10% of their Western counterparts. Pre-clinical and clinical trials are also much less expensive. Mr Wang claims the cost of bringing a new drug to market in China could be as little as US\$5.9m, compared with the more than US\$800m some Western drug companies claim.

At the same time as leveraging low costs, Chinese biotechnology companies continue to move up the value chain, thanks in part to many overseas-trained Chinese, who are returning to start businesses or take up managerial positions. "There is a culture of entrepreneurialism, a culture of risk taking here that doesn't exist in a lot of other East Asian countries," says Matthew Chervenak, president and founder of General Biologic, a Shanghai-based pharmaceutical research and consulting firm. "The sheer number of graduates and recent returnees provides a mix that is hard to match elsewhere."

But despite the government backing, the biotechnology industry faces growth constraints. For one, Chinese banks are still reluctant to lend to private companies, and the local venture-capital market is underdeveloped. Attracting foreign investment is even more of a challenge because investors are wary of China's woeful record in intellectual-property (IP) protection and the lack of viable exits out of the mar-

ket. A partner in a New York biotechnology-focused venture capital firm says: "The reason that we would not invest in China is because ... at the end of the day, the Chinese will find a way to make the same drug more cheaply, without having to deal with paying any royalties to the innovator." There have, of course, been exceptions, such as Invitrogen's purchase of BioAsia in 2004 for US\$8m, and Qiagen of the Netherlands' acquisition of Shenzhen PG Biotechnology for US\$14.5m in October 2005—but these are few and far between.

## Flexible strategies

Biotechnology firms in China have to adopt flexible strategies to succeed in such an environment. Take the case of Bio-Cubed Corp, a pre-clinical contract research organisation headquartered in California with laboratory facilities in Shanghai. Keting Chu, the company's chairman and CEO, says three characteristics of Bio-Cubed's operations reassure global clients when they entrust it with their IP. The most important is to have good references from past customers: "The studies you have carried out [in China] for others are definitely the best evidence of how you have done," she says. Second, Bio-Cubed has found it easier to make inroads with foreign customers by hiring its key managers and technical experts from the pool of overseas Chinese in the US. These employees were educated in American schools and have worked extensively in US firms. Ms Chu, herself an overseas Chinese with more than ten years of management experience in prominent US companies—including Chiron Corp—explains that such hires are more easily trusted by the company's US and European clients. Last, she emphasises that Bio-Cubed has gone to great lengths to be extra sensitive to clients' IP concerns. "Some clients want their own scientists on site to monitor experiments or want experiments arranged according to their time schedules," she says.

Winning the trust of foreign venture-capital firms, however, was more difficult. Ms Chu courted a number of foreign investors when the company opened in 2004, but like many biotechnology entrepreneurs, she was unable to close a deal. Yet numerous associates warned her not to take Chinese government money. That is because the government seems only interested in funding to set up new biotechnology businesses, but unwilling to provide further support needed to make the companies successful. When a fledgling biotechnology firm then approaches outside investors, it finds that they are reluctant to fund a business that the government still owns a significant part of. "Investing in a partly government owned company makes it too difficult for them to exit," says Ms Chu. In the end, her start-up capital came from a network of friend and family investors.

Still, for many companies, the government remains the only available source of capital. The

The importance of good references from past customers

Foreign investors are not rushing in to fund Chinese biotechnology start-ups

Government funds are easier to obtain than foreign capital

upsides are that the capital cost is relatively low and that the government is not as concerned as private investors are about maximising returns. One company that has taken off with official funding is Guangzhou Ascend Biotechnology, which produces products that allow pathologists to diagnose cancer and tumours. Brad Lee, the company's Beijing-born CEO and vice-chairman, explains that the Guangzhou government was not hesitant to establish Guangzhou Ascend as "a collaborative enterprise"—a non-joint-venture undertaking with foreign partners in which the government, despite providing the majority share of the start-up capital, will share the profit in a manner that is more favourable to the foreigners in the enterprise.

## Local mission

The government agreed to this because Guangzhou Ascend's mission is to locally produce the diagnostic products. "Basically the immunohistochemistry market is completely dominated by imported products," says Mr Lee. "There is a great need to have a local product that yields a solution tailored for the Chinese market at significantly lower prices so that hospitals can afford to use it in greater volumes." Guangzhou Ascend has licensed proprietary products from American biotechnology companies, such

as California-based Epitomics, and plans to commercialise them for China's domestic market.

Mr Lee recognises that if Guangzhou Ascend is successful, copycat companies will quickly appear. He aims to stay ahead by utilising his connections with Chinese and American partners to rapidly develop and commercialise new products for the market. As for the piracy issue, because immunohistochemistry products are sold to a relatively narrow group of customers, he is certain that he could quickly find out and take action on any competitors illegally reproducing proprietary products owned or licensed by Guangzhou Ascend.

Indeed, such niche strategies may be the best way forward for entrepreneurs like Mr Lee and Ms Chu in the short-term. Problems with intellectual-property protection and funding will continue to weigh on the Chinese biotechnology sector before the situation improves. In the longer term, however, the market could surge, especially if regulatory reform allowed investors to cash out more easily in the local or foreign markets. Given the growth potential of the country's healthcare sector and cost advantages enjoyed by its biotechnology firms, General Biologic's Mr Chervenak has no doubt that "over the next ten years, there will be an explosion of innovation in China."

## Flying high

### China is emerging as a regional hub for aeroplane maintenance

In Michael Crichton's 1996 book *Airframe*, a global firm agrees to relocate wide-body passenger-jet frame manufacturing to China in exchange for a Chinese commitment to purchase its aircraft. But yesterday's fiction is becoming today's reality. Airbus will likely announce a mainland China-based assembly line for its A320 aircraft—a best-seller among low-cost carriers in Asia—in the coming weeks. China is also about to start production of its first domestically developed commercial jet, the ARJ21. The future, however, has already arrived for China's MRO industry: that is, maintenance, repair and overhaul of aeroplanes in service.

Singapore remains Asia's MRO hub, but China's big four—Ameco Beijing, Gameco Guangzhou, Haeco Hong Kong and Taikoo Xiamen—share a significant piece of a market that was valued at about US\$8bn in 2005. The regional market is expected to reach US\$16bn in ten years, while the world figure will rise to around US\$62bn by then, according to AeroStrategy, a UK-based consulting firm.

The industry is driven mainly by cost pressures on Western airlines suffering from reduced profitability, and deregulation in the region which has given birth to a host of new low-cost carriers. Air New Zealand is the latest in a long line of airlines willing

to swallow the loss of jobs and union problems at home and outsource maintenance to save NZ\$53m (US\$32.6m) over the next five years. Australia's Qantas, too, is determined to reduce MRO costs, and management says it is considering a China location. Meanwhile, China is expected to buy hundreds or even thousands of new planes in the next five years, and intensifying competition among the country's carriers is expected to provide more fuel for the MROs' growth.

The Chinese players, though, have not yet reached comfortable cruising altitude. For one, hiring highly trained technicians and engineers without driving up their labour costs remains a tough act to pull off. Due to the shortage of skilled labour, as well as the negative perception about the quality and efficiency of Asian shops, a lot of top-engine work, for instance, is still sent to Western manufacturers such as Rolls Royce, GE and Snecma. According to senior consultants at AeroStrategy, three China-based MROs—Ameco, Haeco and Taikoo—are particularly strong in airframe maintenance, although two Singapore-based firms, ST Aerospace and SIAEC, lead the pack. Another increasingly important area for Asian MROs is in-flight entertainment, but it represents a much smaller segment of the industry than

Chinese MROs are taking a significant piece of a US\$8bn market

other services. Cheap labour is a factor in aerospace, but obviously not as big a one as in, say, textiles or consumer electronics.

Still, the agreement between Ameco Beijing and United Airlines, the world's second largest airlines, in mid-2005 shows that cost saving is winning over other considerations. The two parties signed a five-year package for the heavy-duty maintenance of United's entire fleet of 52 Boeing 777s. Ameco's other non-Asian customers include, Lufthansa Cargo, Condor, Lauda Air and Air Atlanta Icelandic, accounting for 12% of its 2004 revenue. The company has also performed airframe or engine maintenance for Southern Air, El-Al, Kenya Airways and Transaero. Ameco executives say they have made controlling labour costs a top priority. "We have already set up our internal training facility and closely collaborate with universities," says Zheng Yan, an executive director of the company. "We also set up a three-year retention programme and a competitive salary system to keep our workers."

## One-stop solutions

And to address structural deficiencies that have kept the market inefficient, Ameco and other MROs are investing in the expansion of their facilities. Maintenance is a major cost item in airlines' budgets and, as such, carriers increasingly prefer to outsource to operators that can provide one-stop solutions. The ability to offer a wide range of services, therefore, is key to sharpening an MRO's competitive edge, according to a report from Frost & Sullivan, a US consultancy.

Ameco Beijing, a 60-40 joint venture between Air China and Lufthansa Technik, has recently launched a US\$100m expansion programme on the heels of the partners' 25-year extension of the agreement in 2004. The first phase of the plan involves the construction of a new four-bay hangar at Beijing International Airport, close to the new Terminal Three, which will be able to simultaneously accommodate two Airbus "superjumbo" A380s, two

Boeing 747-400s and two Boeing 777-300ERs.

Other players like Taikoo Xiamen—a joint venture between Haeco (54%), Boeing (9%), Cathay Pacific (9%), Japan Airlines (9%), Xiamen Aviation Industry (9%) and a subsidiary of CAAC (8%)—are working on freight conversion. In December the company delivered the world's first Boeing 747-400 converted into a cargo plane to Cathay Pacific. It was the first time that Boeing had completed a major flight-test programme outside the US and obtained certification for a modified aeroplane under the new US Federal Aviation Administration's (FAA) Changed Product Rule.

Like Ameco, Taikoo is also building a new hangar, its fifth, in Xiamen Gaoqi International Airport, which will be capable of housing up to two wide-body jets at a time. Meanwhile, another, smaller company, Shanghai Technologies Aerospace, a joint venture between China Eastern Airlines and Singapore's ST Aerospace, is erecting a new facility at Pudong International Airport, capable of housing the A380, which will start commercial operations with Singapore Airlines in November.

So how does all this activity affect China's dream of nurturing an internationally competitive passenger-aircraft industry of its own? The country will soon roll out two indigenously developed regional commuter aircraft: the so-called "Chinese modern ark" MA-60, an FAA-certified 70-seat turboprop developed by Xi'an Aircraft; and the ARJ21 a 100-seat passenger jet, which is being built by AVIC I Commercial Aircraft. Despite such milestones, experts say there is little direct link between the growth of a healthy MRO industry and the development of aircraft manufacturing. "The latter needs design skills," says David Stewart, a co-founder of AeroStrategy. "MRO is a service, not production, which requires very different skill sets. The main positive aspect would be the availability of technically skilled labour." As they say, you have to learn to first crawl, walk and run before you can fly. But China seems to have already mastered the running.

Boeing has turned to a Chinese firm to convert a 747 into a cargo plane

## Friends again?

**The economic and strategic basis of the Sino-Russian relationship, though deepening, is still quite limited**

The theme of the fourth official visit to China by Russia's president, Vladimir Putin, on March 21st-22nd was the increasing breadth of common interests between the two countries. Bilateral diplomatic and economic relations are better now than at any point since the early 1950s. But while the two do share some common aims, the relationship is still largely based on limited economic and strategic factors—specifically energy resources, and a mutual desire to constrain the US's global influence.

Mr Putin's substantial entourage included diplo-

rats, ministers, cultural representatives and businesspeople. The last group are particularly interested in securing closer ties with China. Two-way trade reached US\$29.1bn in 2005 (according to Chinese customs statistics), the highest ever total, up 37.5% from the previous year. At first glance the expansion of bilateral trade appears to be mutually beneficial. China's rapidly growing demand for raw materials and energy complements Russia's ample resources of both. But the one-sided nature of China's demand has led to skewed trade flows that do not sit easily

Mr Putin was accompanied by a group of Russian businesspeople

# Foreign relations

with Mr Putin's desire to reduce Russia's reliance on the export of raw materials and hydrocarbons, and to promote instead value-added production for export. China's largest exports to Russia, on the other hand, were the usual assortment of textiles, machinery and electrical equipment.

There is not much sign that Mr Putin's visit has contributed to a broadening of the bilateral economic relationship. China's imports of Russian machinery will continue to focus on military or energy-related fields. But the principal focus is China's desire to gain access to Russia's energy reserves. Currently, over one-third of China's oil imports come from the Middle East, and four-fifths must pass through the Malacca Straits. Securing overland supplies from Russia (the world's second largest oil exporter) would fulfil a key strategic goal.

## Much fanfare

China also wants to diversify the sources of its energy supply. Currently natural gas provides only around 3% of its total primary energy supply (oil constitutes around 20%). Russia has the world's largest supplies of natural gas but exports none to China. It was therefore with much fanfare that a deal was announced during Mr Putin's trip for Gazprom (which owns a monopoly on Russia's gas exports) to supply China with vast amounts of natural gas via two pipelines from Siberia. This colossal project, estimated to cost around US\$10bn, is aimed at eventually supplying 60bn-80bn cu metres of gas to the Asia-Pacific region—double China's total gas consumption in 2004.

There are serious doubts as to whether Russia will be able to follow through with the plan, given the enormous cost of building these pipelines and doubts over whether Russia will have sufficient gas production capacity in the next decade to provide large quantities of gas to China while also meeting domestic demand and its existing European export obligations. Russia is not averse to playing potential customers off against each other—maximising its negotiating power by refusing to make concrete commitments—as Chinese oil negotiators well know.

Currently, China's imports of Russian oil—which constitute only around 5% of its total oil imports—are constrained by the fact that they must be transported by rail. China has long been angling to get Russia to build a pipeline from its eastern Siberian oilfields to the city of Daqing, in Heilongjiang province. Such a pipeline, it is estimated, could supply 600,000 barrels per day (b/d), just over a quarter of China's net crude-oil imports of 2.35m b/d in 2005.

However, as China has discovered, current conditions make it a seller's market. Russia's general wariness about China's breakneck economic expansion, and its desire to extract concessions from other would-be purchasers (such as Japan), have prevented it from making a quick decision. The lack of a definite decision over the pipeline has certainly under-

cut some of the recent goodwill in Sino-Russian relations. Yet Mr Putin was not persuaded to make any more definite promises on his latest trip, agreeing only to another feasibility study (which China must finance).

## Strategic concerns

Arguments over energy aside, there are clear signs that diplomatic relations between China and Russia are better now than in past decades. Border issues have been resolved, and the mutual animosity that soured bilateral relations after the Sino-Soviet split in the late 1950s is a thing of the past. In fact, there are many compelling reasons for co-operation.

The extent of the improved relationship was demonstrated most obviously last August, when Russian and Chinese military forces participated in the first ever joint exercises. This marked the culmination of closer strategic ties in recent years, manifested most obviously in the six-member Shanghai Co-operation Organisation (SCO), a security-oriented international body comprising China, Russia, Kazakhstan, Kyrgyz Republic, Tajikistan and Uzbekistan. The SCO was launched formally in 2001, taking over from an informal alliance with similar membership (minus Uzbekistan) that China and Russia founded in 1996.

Although the SCO's declared mission is to curb terrorism and Islamist militancy in central Asia, amongst other things, China and Russia both see the wisdom of using the group to protect their influence in this strategically crucial region, by preventing the spread of destabilising democratic agitation (from eastern Europe's "colour revolutions") and limiting the US's global power. These goals were made explicit in July 2005, during Mr Putin's previous summit with Mr Hu, after which they issued a statement calling for an end to hegemony in international affairs, including "attempts to divide states between leaders and led". Shortly thereafter Uzbekistan, which Russia and China had declined to criticise in the aftermath of its crackdown on pro-democracy campaigners in Andizhan, decided to expel US forces from its Karshi-Khanabad base.

There are other focal points for this strategic alliance, notably efforts to contain nuclear proliferation in North Korea and Iran. In both cases, acting as counterpoint to the US, China and Russia have supported the use of dialogue and conciliation over threats for military action.

However, the Sino-Russian relationship is not a factor of a simple anti-US calculation, and both will be wary of the need to maintain good working relations with Washington, over and above the need to cleave closer to each other. This suggests that the future development of the strategic relationship, as with the development of economic ties, will be based on soundly pragmatic principles.

China's principal focus is to gain access to Russia's energy reserves

Russia likes to play potential customers off against each other

## Temporary truce

**US politicians' decision to put off a vote on punitive tariffs does not mean the pressure on China to revalue the renminbi is also off**

The hospitality China showed two US senators, Charles Schumer and Lindsey Graham, during their recent visit to Beijing appears to have paid off. The two have decided to postpone a vote in the Senate on legislation they had co-sponsored that threatened to impose a 27.5% tariff on all Chinese imports unless China allowed its currency to appreciate substantially. Carlos Guetierrez, the US commerce secretary, who visited Beijing a few days later, welcomed the move and reiterated the importance of resolving trade disputes through dialogue (but he warned the Chinese that protectionist sentiment is rising among Americans, and that China must do more to address US concerns over the renminbi and piracy).

In the context of Sino-US trade relations the senators' decision is a minor victory: American criticism over China's tight control of the value of the renminbi is not likely to diminish in the coming months, as political pressure builds ahead of mid-term Congressional elections. Punitive legislation of one sort or another is still a real possibility. Indeed on March 28th senators Charles Grassley, Republican head of the Senate Finance Committee, and Max Baucus, the senior Democrat on the committee, outlined the provisions of another bill that would put more pressure on their government to take action, if China did not allow its currency to appreciate.

The glacial pace of the renminbi's movement since July 2005, when its ten-year-old peg to the US dollar was removed, is not encouraging in this regard. Although it was probably not coincidental that the currency rose to its strongest point against the US dollar since last year's revaluation during the senators' trip (hitting Rmb8.021:US\$1), this still constitutes a gain of only 1.1% in eight months. Some legislators and lobbyists in the US claim that the renminbi is as much as 40% undervalued against the dollar.

### Colossal trade deficit

US complaints about China's currency regime stem from its colossal bilateral trade deficit, which rose 24% year on year in 2005 to US\$202bn. Some claim that China controls the renminbi to make its exports artificially cheap, costing American producers sales and leading to job losses. This is a politically convenient argument, but pressuring China to revalue its currency is economically unsound. For one thing, the overall US trade deficit would not be reduced if the renminbi appreciated substantially, as US importers would turn instead to other (mostly Asian) producers that could provide similar cost savings. The current value of the renminbi also has several advantages for the US, including cost savings for American producers (many of which have facilities

in China) and consumers (who benefit from cheaper retail prices).

Moreover, pressure on China to revalue might lead to a reduction in its large purchases of US debt—which help fund America's deficits. Data released on March 28th show China's foreign-exchange reserves are the largest in the world, totalling US\$853.7bn at end-February, surpassing the US\$850.1bn held by Japan. If China were to liberalise its currency it would no longer need to make such substantial dollar purchases, or it might decide to rebalance the reserves it holds away from the dollar—either of which could drive up US interest rates in the long term, stalling economic growth.

For these reasons the US government has been reluctant to take action against China, even though demands for action from Congress have been increasing in intensity. For its part, China's response to US pressure has been consistent: that although in the long run a liberalised currency is in its best interests, such steps as necessary to reach this goal will be small, gradual, and implemented exclusively according to domestic conditions. Senator Schumer got this message during his trip, saying afterwards: "Among Chinese leaders there is a view that China has to change its economic policies for its own good."

There are some good reasons for China to allow the currency to strengthen—including to give it greater flexibility in monetary policy and autonomy in macroeconomic policymaking, to reduce political tensions with its major trade partners, and to limit the competitiveness of its exports. A stronger currency would also make imports cheaper, potentially boosting consumer spending and domestic demand—helping the government's longer-term aim of promoting more balanced economic growth.

The Economist Intelligence Unit expects the renminbi's appreciation to accelerate in 2006, as much of the institutional structure for more flexible trading is already in place, and the People's Bank of China (the central bank) has gained a reputation for willingness to defend the stability of the new system against speculators. While US pressure on China is unlikely to yield a further revaluation, gradual upward movements of the currency are likely as part of a broader policy of rebalancing the Chinese economy. A substantial realignment in the currencies would only be likely if the US economy ran into difficulties and the dollar started to decline dramatically against the euro and the yen. We forecast that the renminbi will reach Rmb7.68:US\$1 by the end of the year and average Rmb7.57:US\$1 in 2007.

**A more flexible renminbi could drive up US interest rates**

**China already has the structure for more flexible foreign-exchange trading**

# What's new in your industry

## Aviation

**Lufthansa** expects to launch the inaugural flight of its freight-airline joint venture **Jade Cargo International** at the end of July. Delivery of the first of six new **Boeing 747-400ERF** freight airliners is scheduled for the end of May and the second in November, with the balance to be delivered by the end of 2008. Jade Cargo, a joint venture with **Shenzhen Airlines** (50%) and **Deutsche Investitions und Entwicklungsgesellschaft** (24%) has yet to announce its first routes or flight frequencies.

On April 2nd the inaugural flight of **American Airlines'** non-stop Chicago-to-Shanghai route landed in Pudong International Airport. American will offer cargo and passenger transport utilising its 245-seat Boeing 777-200 aircraft, the largest in its fleet. Flights leave daily from Chicago's O'Hare International Airport at 11:05 am and arrive in Shanghai's Pudong International Airport at 2:15 pm the next day—return flights leave Shanghai at 4:25 pm and arrive in Chicago at 5:00 pm the same day.

## Consumer goods & retailing

On March 31st US electronics retail giant **Best Buy**, which operates sourcing offices in Beijing, Shanghai and Shenzhen, announced plans to open its first store in mainland China. It will occupy 8,000 sq metres on four floors of the Jiang Shan Building in Xujiahui district of Shanghai. The purchase price of the retail space and the store's official opening date remain undisclosed.

## Financial services

On March 28th **Bank of Communications (BoCom)** reported earnings of Rmb9.2bn (US\$1.15bn) for 2005, up 477% from Rmb1.6bn in 2004. BoCom is the first state-owned Chinese bank that made an initial public offering (IPO) in 2005 to report its net profits for the year. Its IPO on the Hong Kong Stock Exchange in June 2005 netted US\$2.19bn.

**Citigroup** officially launched its first private-banking branch in mainland China on March 29th. The Shanghai Private Bank office will operate as a unit of **Citibank's** Shanghai branch office, offering wealth-management services for China's growing ranks of the very rich. Citigroup expects to

include Private Bank offices in its other mainland Chinese branches, pending regulatory approval from the China Banking Regulatory Commission (CBRC).

**CITIC Securities**, China's largest brokerage in terms of gross profits and the brokerage arm of **CITIC Group**, announced on March 29th that it will acquire a 40.7% stake in fund-management company **China Asset Management (Huaxia)**, which accounted for 8.56% of domestic market share in 2005. The acquisition makes CITIC Securities China's second largest fund manager. Investment regulations set by the China Securities Regulatory Commission (CSRC) do not allow finance institutions to be the controlling shareholder in more than one fund-management firm, and as CITIC Securities already possesses a 49% stake in **CITIC Fund Management**, the company is expected to press for a merger between the two funds.

Beginning April 1st customers of **Bank of America (BoA)** and **China Construction Bank (CCB)** can reap the rewards of a new strategic partnership between the two banks. BoA customers will be able to withdraw cash, free of charge, from more than 11,000 foreign-enabled CCB ATM machines in China, while CCB participants in its "Happy Investors" programme will enjoy free access to the over-17,000 ATM network that BoA maintains in the US. The partnership is a result of BoA's 9% stake in CCB, purchased in 2005 for US\$3b.

**HSBC** was awarded a US\$881m mandate to provide lease financing to deliver 14 aircraft to **Air China** in 2006. The ten-year lease deal will supply Air China with six Airbus A330-200s, five Airbus A319-100s and three Boeing 737-700s. HSBC also obtained approval from the CBRC in March to open its 13th mainland branch in Hangzhou, Zhejiang province. HSBC currently operates 12 branches (Beijing, Chengdu, Chongqing, Dalian, Guangzhou, Qingdao, Shanghai, Shenzhen, Suzhou, Tianjin, Wuhan and Xiamen) and nine sub-branches (Beijing, Guangzhou, Shanghai, Shenzhen and Tianjin) in mainland China.

## Media & entertainment

Less than a month after the release of the inaugural issue of **Rolling Stone's** Chinese-language publication, the magazine's relationship with its local publishing partner **Audiovisual World** was dissolved by gov-

ernment officials for unspecified reasons. China does not license foreign media to publish domestically—international publications must partner with established local publishers in order to obtain a licence for distribution. **Rolling Stone's** first Chinese-language edition hit newsstands on March 6th and sold out a run of more than 100,000 copies in less than a week. But the iconic US music magazine will now be unable to circulate a second edition until another publishing partnership is formed.

In late March South Korean game developer **NCSOFT** acquired the remaining 51% stake in its **NC Sina** joint venture with **Sina Corp** for an undisclosed sum. The buyout triggered speculation about NCSOFT's plans to release its new **Guild Wars** subscription gaming platform to Chinese audiences sometime after the April 28th release date for Europe and North America. The leading candidate to operate NCSOFT's new massive multiplayer online (MMO) game is **The9**, the Chinese company responsible for hosting and operating **Blizzard Entertainment's** **World of Warcraft** MMO on the mainland. Private-sector telecoms research firm **BDA China** estimates that industry revenue from online gaming in China will rise 44% year on year to US\$655m in 2006 and reach US\$1.8bn by 2010.

## Petroleum & petrochemicals

**China National Offshore Oil Company (CNOOC)** announced the beginning of formal production at its petrochemical production plant off the coast in Huizhou, Guangdong province. A 50:45:5 joint venture with **Royal-Dutch Shell** and Guangdong province respectively, the new plant is China's largest joint venture, valued at US\$4.2bn, and the world's largest PO/SM production facility with a production capacity of 550,000 tonnes of styrene monomer and 250,000 tonnes of propylene oxide per year. CNOOC posted a net income of Rmb25.23bn (US\$3.15bn) in 2005, a 57% year-on-year increase. Net oil production also reached an all-time high for CNOOC in 2005, up 10.6% from 2004 to 141m barrels. High oil prices—a 2005 average of US\$47.31 a barrel—were the driving force behind soaring profits.

On March 28th, **CNOOC Ltd**, a 70.64%-held subsidiary of CNOOC, announced the discovery of oil deposits in Bohai Bay, China's largest internal sea. With oil and gas deposits of 85m and 8m thickness

# What's new in your industry

respectively, Bozhong (BZ) 28-2S-1 is CNOOC Ltd's largest discovery in the area in recent years, capable of producing 1,900m barrels of crude oil and 2m cu ft of natural gas per day.

In late March **China National Petrochemical Corp (Sinopec)**, Asia's largest oil refiner, announced a 23% on-year rise in profits to Rmb39.6bn in 2005, up from Rmb32.3bn in 2004. Sinopec supplied 77% of the fuel sold in mainland China during 2005 and received US\$1.2bn in government subsidies for losses accrued because of government price controls. According to the International Energy Agency, an independent advisor to oil-consuming nations, Chinese oil consumption is set to rise 6% in 2006—nearly double the increase in consumption of 2005.

**PetroChina Pipeline** awarded Spanish IT-systems company **Telvent GIT** a Rmb16.5m contract on March 30th to monitor and perform remote-control activities along PetroChina's 600-km Dagang-Jinan-Zaozhuang oil pipeline. Telvent will also establish a control centre in Langfang, Hebei province, and a transportation management station in Shandong province.

## Telecoms & technology

**Nokia**, the best-selling mobile-phone manufacturer among Chinese consumers, will introduce three low-cost handsets in the second quarter of 2006. The Nokia 1112, 2310 and 2610 are aimed at first-time mobile-phone users and rural markets. The Nokia 1112, which will be offered at an initial price of Rmb422 (US\$53), offers speaking clock and alarm functions and will be available in a range of colours. The 2310 and 2610 offer higher functionality, such as FM radio and e-mail support, for initial prices of Rmb630 and Rmb730 respectively.

US-based **TechnoConcepts** announced in late-March the formation of a subsidiary, **China Jinshilin Techno (CJT)**, in Shanghai. CJT will provide support and marketing for TechnoConcepts' True Software Radio service, which allows mobile devices operating on different frequencies or protocols to communicate across otherwise incompatible networks. CJT will also serve as the design, distribution and technical support centre for its Internet-protocol TV set-top boxes (IPTV-STB), which deliver digital TV programming via the Internet to conventional audio/video TV-set inputs. CJT expects to distribute over 100,000 IPTV-STB

units in 2006, which would result in revenue in excess of US\$15m.

## Transport & logistics

**China Shipping Development**, mainland China's largest dry-bulk shipping and tanker operator, announced in mid-March that its fleet would grow 12% in 2006, with a 23% total increase in fleet size by 2010, including the addition of eight very large crude carriers to its existing two. In 2005 China Shipping posted a 46% year-on-year increase in net profits to Rmb2.29bn (US\$286m).

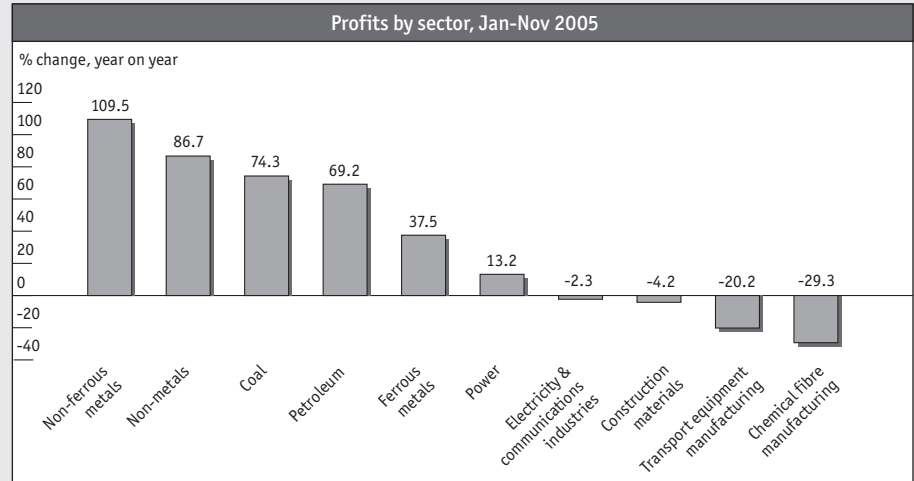
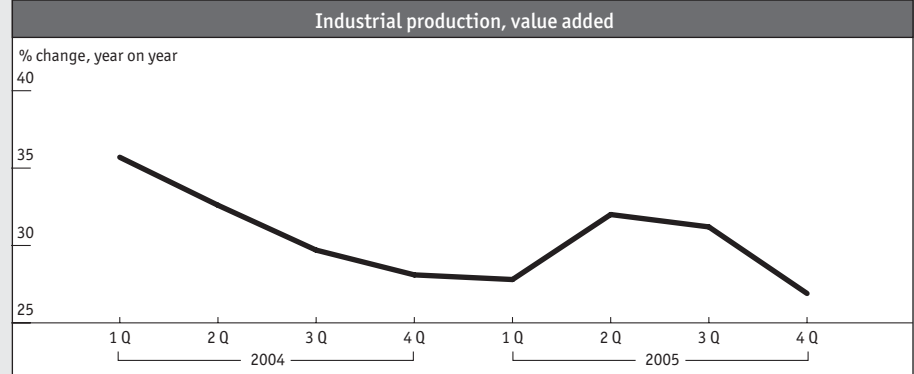
China Shipping has also received board approval for US\$557.2m in transport purchases for eight new tankers. The approved purchase includes deals with two shipbuilders: US\$408.8m for four 298,000-dwt very large crude tankers from **Dalian Shipbuilding**; and US\$148.5m for four 42,000-dwt handy-size tankers from **Guangzhou Shipyard International**. The first of Gunagzhou Shipyard's tankers will

be delivered in 2007, while Dalian Shipbuilding, which completed five vessels for China Shipping in 2005, will deliver its four tankers in 2009.

**CSC Nanjing Freighter**, China's second largest sea freight company, placed orders in late March for ten new vessels. CSC Nanjing signed the building order with **Jiangnan Shipyard**, valued at US\$498.3m, for two 300,000-dwt tankers and eight 50,000-dwt tankers, with all ten vessels to be incorporated into CSC Nanjing's fleet by 2009.

**Caterpillar Logistics Services**, a wholly owned subsidiary of US-based **Caterpillar**, announced on March 30th the opening of its first mainland China distribution centre in the Lingang Industrial Area of Shanghai. The distribution centre, covering over 21,000 sq metres, will supply parts to 34 licensed Chinese Caterpillar dealers, with plans to expand its distribution scope to South Korea and Mongolia in the second half of 2006.

## Selected economic indicators



Source: National Bureau of Statistics

# Deal watch

## Joint ventures, contracts, MoUs and other agreements, Mar 28th to Apr 10th 2006

Agreement (date reported)	Participants (equity stake)	Value	Additional details
<b>Automotive</b>			
Agreement signed (Apr 4th)	By Mazda Motor Corp of Japan and Changan Ford Automobile of China	—	Mazda will acquire a 15% stake in the JV between Ford and Changan, which will be renamed Changan Ford Mazda Automobile
Agreement signed (Mar 30th)	By Proton of Malaysia and Jinan Youngman Group of China	—	The strategic alliance will allow Jinan Youngman to begin producing Proton vehicles as early as June, with an initial capacity of 50,000 units at Jinan Youngman's plant in Jinhua, Zhejiang province
<b>Chemicals</b>			
Agreement signed (Apr 3rd)	By ChemChina of China and Qenos of Australia	—	ChemChina, China's largest chemicals producer, will acquire 100% of Qenos, Australia's largest ethylene producer with an annual output of 500,000 tonnes
<b>Construction</b>			
JV established (Apr 3rd)	Armstrong World Industries of the US and Yingbin Wood Industry of Hong Kong	US\$17.6m	The 50-50 JV will establish an 80,000-sq-metre factory in Kunshan, Jiangsu province, designed to have an annual wood-flooring output of 3m sq metres and will begin operation in the second quarter
Contract awarded (Apr 5th)	By Lafarge SA of France to Sinoma International Engineering of China	US\$74.3m	Sinoma will build a cement-production line in Zambia for Lafarge, the world's largest cement producer. The construction work will last approximately 30 months
<b>Energy &amp; power</b>			
LoI signed (Mar 31st)	By Vitasti of Canada and Welwind Energy International of Australia	—	Vitasti will acquire all of the assets of Welwind and plans to follow Welwind's business model for development of wind power in Liaoning and Guangdong provinces
<b>Financial services</b>			
Agreement signed (Mar 31st)	By Cathay General Bancorp of the US and First Sino Bank of China	US\$52.2m	Cathay Bank will purchase a 20% stake in First Sino and will appoint two members to First Sino's board of directors
<b>Healthcare &amp; pharmaceuticals</b>			
Agreement signed (Mar 30th)	By Calypte Biomedical of the US and Beijing Marr Bio-pharmaceutical, a China-Netherlands JV	—	Calypte will acquire a 51% stake in the JV, giving Calypte the rights to all manufacturing facilities and other assets necessary to produce a series of rapid HIV tests. The remaining 49% will be held by Marr Technologies BV
<b>Metals &amp; mining</b>			
Agreement signed (Apr 2nd)	By Mineralogy of Australia and CITIC Pacific of Hong Kong	US\$5.15bn	Mineralogy and CITIC Pacific will co-develop a mine in the Pibara region of Western Australia, but CITIC will retain the rights to the iron produced in the mine, estimated at 120m tonnes per year over its estimated 30-year life
Agreement signed (Mar 31st)	By Ginadalbie of Australia and Anshan Iron and Steel of China	—	Ansteel will finance the development of the Karara magnetite and pellet operation in Western Australia, an investment worth up to US\$672m. Ansteel retains the rights to the operation's complete production, estimated at 10m tonnes per year
<b>Property</b>			
JV established (Mar 30th)	Sun Hung Kai Properties of Hong Kong and China Resources of China	US\$130m	The JV will develop a residential and commercial project on a 1.12-sq-km plot near Lake Taihu in Wuxi, Jiangsu province. China Resources will hold 60% of the JV through its wholly owned subsidiary, VikWood Investment
<b>Telecoms &amp; technology</b>			
JV agreed (Apr 4th)	By Syntax-Brilliant of the US and China South Industries Group of China	—	The agreement will establish a JV, Sino-Brilliant Display Technology, which will use Syntax-Brilliant's LCoS technology to construct light-TV engines for sale to Chinese TV manufacturers
<b>Transport &amp; logistics</b>			
JV established (Apr 3rd)	Midas Holdings of Singapore and CSR Nanjing Rolling Stock Works of China	US\$49.7m	Midas will hold a 32.5% stake in the JV to CSR Nanjing's 42.5%. Nanjing Metro will hold 10%, as will Nanjing New and High Tech, and Pukou Holding the remaining 5% of the JV, which will design, develop and produce subway trains
<b>Utilities</b>			
Agreement signed (Apr 3rd)	By CNA Group of Singapore and Beijing Herocan Environmental Engineering of China	US\$7.4m	CNA will acquire a 51% stake in the Beijing-based water-and-waste-treatment company, Herocan

## Automotive

**Regulators to control car-production capacity.** The State Council announced in March that the market threshold will be increased to avoid excess capacity in car production. In 2005 Chinese car-production capacity hit 8m units, 2m units more than demand, which has driven down prices, increased stockpiles and resulted in thin profit margins for carmakers. After analysing projections for the 11th Five-Year Plan from 32 vehicle manufacturers, the State Development and Reform Commission forecasts that China's car-production capacity will reach 18m units in 2010, while projected sales in the Chinese market are only expected to hit 10m units that same year. Currently, carmakers must reach a sales threshold of 80% of production capacity in order to qualify for approval to build new production facilities.

**EU, US take China to the WTO to increase market access for auto parts.** Hoping to lower restrictive tariffs on the import of car parts into China, the EU and US submitted a complaint over discriminatory tariff measures to the World Trade Organisation (WTO) on March 30th. The issue at hand is a stipulation in Chinese law that considers imported car parts as a "whole vehicle", should those parts account for 60% or more of the vehicle's final makeup. Considering parts as a whole vehicle allows China to place higher tariffs on car-part imports, which the EU and US claim amounts to the imposition of "local content" rules, as domestic carmakers and automotive joint ventures must source over 40% of their car parts domestically to avoid paying the higher tariff. The submission of this complaint marks the first time that the EU has taken China to the WTO since China joined the global trade body in 2001.

## Financial services

**Banking regulator to improve supervision of special banks, postal savings.** The China Banking Regulatory Commission (CBRC) will establish a fourth branch to supervise policy-oriented banks and postal savings. Policy-oriented banks, such as China Development Bank, the Export-Import Bank of China and the Agricultural Development Bank of China, are defined as banks that are under the direct leadership of the State Council. In addition to its mon-

itoring of policy-oriented lending institutions, this fourth division of the CBRC will govern the establishment of the new postal savings bank, expected in the second half of this year. Upon formation, the postal savings bank will be China's fifth biggest lender by deposit. In July 2005 the State Council effectively divided China Post into three branches: a post regulatory company, a postal service company, and a postal savings bank.

**The securities watchdog to eliminate threshold for foreign takeovers.** The China Securities Regulatory Commission (CSRC) will formalise rules it has been following since the beginning of 2006 that will loosen restrictions on mergers and acquisitions for foreign companies. Under the previous regime, foreign companies which crossed the 30%-stake threshold were forced to bid for the rest of the company. Furthermore, 20% of the bid's value, in cash, had to be placed in the hands of the CSRC at the time of the bid's announcement. The new regulations eliminate the mandatory buy-out bid for 30% shareholders as well as the 20% cash deposit upon a buy-out bid's announcement.

**Insurance regulator to require third-party insurance for all drivers.** The China Insurance Regulatory Commission (CIRC) announced that all motor-vehicle drivers must possess third-party liability insurance policies, effective June 1st. Compulsory insurance will be required to cover personal and property damage—the CIRC also mandated that yearly premiums be prorated to a driver's record, offering better drivers lower rates. After receiving approval from the CIRC, domestic insurance companies can provide the new compulsory insurance; however, the general terms of liability and premium rates will be controlled by the CIRC. Compulsory insurance will not be open to foreign competition, as the CIRC said compulsory insurance was not part of China's WTO agreement with foreign countries.

## Healthcare & pharmaceuticals

**Food regulator approves use of new radiation therapy system.** The State Food and Drug Administration (SFDA) approved new image-guided radiation therapy (IGRT) system technology for use in March, paving the way for North American Scientific

(NAS) to begin distribution to mainland healthcare-service providers immediately. The IGRT system allows oncologists to provide fast ultrasound localisation, eliminating the need for invasive surgery or target margins prior to the delivery of radiation treatment. NAS's IGRT system, called B-mode Acquisition and Targeting (BAT), combines ultrasound and 3D imaging to pinpoint tumours with rapid and accurate results, allowing for radiation treatment targeting adjustments on a daily basis.

## Law

**Hong Kong activists debate new mainland detention notification policy.** According to the Law on Penalties for Offences Against Public Order, which went into effect on March 1st, mainland authorities are responsible for notifying citizens within 24 hours if a family member has been detained for public-order offences. The ostensible purpose of the new provisions that require notification is to improve transparency of the justice system, but some Hong Kong residents say the new law is an invasion of privacy. At the heart of the matter is a discussion of the rights to privacy and presumed innocence, as stipulated by the UN's Universal Declaration of Human Rights. Rights activists point out that a number of the 238 offences, including drug trafficking and soliciting a prostitute, could irreparably damage a citizen's standing and reputation if family members are notified of detention but charges are dropped or the detainee is found to be innocent.

## Media & entertainment

**Beijing bans commercial advertisements on main thoroughfare.** The Beijing Municipal Administration Committee (BMAC) publicised regulations on March 22nd to ban commercial advertisements in Tiananmen Square and along the Jianguomen-Fuxingmen section of Chang'an Avenue. The ban will also cover Beijing West Railway Station and Capital Airport. The new regulations require companies to submit their proposals for advertisements in public places to the BMAC for approval. Similarly, companies seeking to advertise in major venues under BMAC jurisdiction will need approval from the BMAC or State Council.

# Commentary

## Poor spin

**New consumption taxes will hardly remedy income inequality or environmental destruction in China, but they are a step in the right direction**

By Duncan Innes-Ker

By an odd coincidence, at about the time Gordon Brown, the UK chancellor, was announcing new taxes in March to penalise drivers of sports-utility vehicles, the Chinese authorities were announcing their own new taxes on gas-guzzling cars. China's consumption taxes on the most polluting vehicles will now reach up to 20%, while those on smaller cars will remain unchanged or be cut. Doubtless the drivers of 4x4s will be aggrieved that governments the world over feel it convenient to score cheap environmental points by targeting them at a time when rising petrol prices are already hitting them in the pocket. But at least in China's case they can take comfort from the fact that they are not the only targets of the government's green agenda.

Producers of wood products were hit by a 5% tax on sales of disposable chopsticks and wooden-floor panels. Consumption taxes are also set to be broadened to encompass a range of refined oil products, such as aviation fuel, fuel oil and naphtha. Both steps have been portrayed as environmentally friendly. The first should help conserve the country's timber resources, while the second should help encourage energy efficiency. These moves were combined with a series of "pro-poor" adjustments to the consumption-tax regime. Some levies on luxury products, such as golf equipment and yachts, were raised, while others on goods used by the general public, such as shampoo, were abolished.

Some officials billed the measures as the most dramatic changes to the consumption-tax regime in a decade. However, on closer examination, the reforms look more like spin. In line with the government's increasingly populist agenda, the taxes on luxury products and big vehicles (which, by fortunate coincidence, are mostly foreign-produced) allow officials to claim that they are soaking the rich for taxes to deliver welfare to the poor. Meanwhile, the environmental taxes chime with the administration's campaign for more balanced and less destructive development. Yet on all these fronts the government has tended to disappoint when faced with opportunities to grasp problems by the horns.

The chopsticks tax presents a good example. It is heartening to see the government becoming receptive to the concerns of environmentalists, both foreign and domestic, who have expressed concern over the impact China's economic development has had on its forests. However, a more practical move might have been to tighten controls on illegal logging and illegal wood imports (China's hunger for timber has led to massive illegal deforestation in numerous countries, such as Indonesia, Papua New Guinea

and Myanmar). Moreover, some may regard the announcement with a touch of cynicism—in early 2005 the government claimed to have halted illegal logging in Yunnan by Singapore-based Asia Pulp & Paper following a campaign by Greenpeace, but months later environmental groups claimed that trees were still being felled as before.

The argument that the luxury taxes represent a genuine redistributive effort must also be taken with a fistful of salt. The amount of money raised through these taxes is likely to be tiny, given how few people in the country can afford to buy the products concerned. Like a host of similar moves, such as restrictions on the construction of golf courses and expensive villas, they may serve some purpose in curbing the trend towards extravagant consumption that has exacerbated social tensions between China's new rich and the many who have fallen behind during the economic boom. However, they will do little to help improve the lot of those at the bottom of the social pile.

### Welcome commitments

For this issue people were looking instead to the budget announcements made during the March session of the National People's Congress. Overall, these were underwhelming, although there were some welcome commitments to increase spending on rural education and to prioritise the construction of rural infrastructure. Against a background of its strengthening fiscal position, the central government remains wary of providing the sort of funds to the regions that might have a real short-term impact on the chronically underfunded health and education systems. Arguably, serious problems with corruption at the regional levels of government, which is related to the difficulty of instituting accountability in a one-party state, make the government's caution quite justified.

Although the changes to the consumption tax regime should not be received uncritically, it is nevertheless possible to see them as a link in a strengthening chain of government policy. While the new consumption taxes on oil products would be unlikely to have a massive impact on their own, in March the government also raised the price of refined products like petrol and diesel for the first time in eight months. These incremental steps together are moving in the right direction. But as with the budget's extra funding for rural development, the government still needs to go further.

*Duncan Innes-Ker is the Economist Intelligence Unit's London-based editor and economist covering China*

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PUBLISHER  
Henry Luk

EDITORIAL DIRECTOR, ASIA  
Charles Goddard

EDITOR  
Charles S. Lee  
[charleslee@eiu.com](mailto:charleslee@eiu.com)

PRODUCTION  
Gaddi Tam

CORRESPONDENTS  
Ray Cheung  
Matthew Jaskol  
Michele Travierso

EDITORIAL QUERIES  
Tel: (86.21) 6473 7128  
Fax: (86.21) 6473 9268

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London: Cynthia Armand-Khant  
26 Red Lion Square  
London WC1R 4HQ  
United Kingdom  
Tel: (44-20) 7576 8000  
Fax: (44-20) 7576 8500  
E-mail: [london@eiu.com](mailto:london@eiu.com)

New York: Rosemary Didomizio  
Tel: (1.212) 698 9745  
Fax: (1.212) 586 0248  
E-mail: [newyork@eiu.com](mailto:newyork@eiu.com)

Hong Kong: Amy Ha  
Tel: (852) 2802 7288/2585 3888  
Fax: (852) 2802 7368/7720  
E-mail: [hongkong@eiu.com](mailto:hongkong@eiu.com)

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