

# Business China

Fortnightly report to managers of China operations

## Let's go global

In global terms, car maker Chery is a tiddler—except when it comes to expansion plans

Few in China's automotive industry believe in half measures—and no one less so than those pulling the strings at fledgling car maker Chery Automobile. With barely seven years experience under its car wings, the Anhui-based business has decided it is time to get big. Although the company made barely 100,000 cars in 2004, making it one of the world's smallest producers, and although its sales have fallen heavily in the last 12 months (by as much as 50% for some models) while the market has grown, the company has always been ambitious. A few years ago it surprised industry watchers when it announced plans to build assembly plants in Pakistan and Iran. Since then it has started to develop exports to markets including Syria, Egypt, Bangladesh and Cuba. It now exports about 10,000 cars a year.

Now though, Chery's plans have taken on an entirely different dimension. Not only does the company plan a major assault on the world's biggest and most competitive car market—in North America—it intends to launch simultaneous attacks in Eastern and Western Europe as well and in South America.

In the US, Chery has teamed up with Malcolm Bricklin, of Visionary Vehicles in New York. Mr Bricklin brought both Subaru to America in the 1960s and, in the 1980s, Yugo. He is currently raising the US\$200m needed to build a dealer network, describing Chery as the "next Toyota". For South America, Chery is to team up with Spain's largest private car importer, Berge. It is also in talks with Berge and other companies about distribution rights in Western Europe and says it will have European production facilities there within five years. Both Poland and Romania are known to be under consideration.

### And there's more

Yet even such bold geographic expansion plans are not enough. Chery plans simultaneous product and marketing line growth too. As well as 17 all-new engines, the company wants to establish a new brand for itself in the US. This month, it revealed plans to build five completely new models for over-

seas markets adding to those it claims to have under development for the domestic market.

Nor is the company willing to wait. Chery plans to launch its assaults in Western Europe and the US within two years—from the start of 2007—with a quarter of a million cars slated to be shipped to America in the first year alone. (This would give it a share of the US market greater than Mitsubishi today.)

Is the company spreading itself too thinly? It certainly looks that way. Although Chery is owned by the Anhui provincial government and has access to plenty of investment cash, including, it says, from Beijing, the most obvious question is how it can finance all its growth plans. As well as the investment needed to add all these new models and engines (and for established players the costs of what Chery is planning would run to something close to US\$10bn), the company wants to triple its capacity to 750,000 cars a year. For the big names in the industry, the costs of building new plants, developing the tooling, designing the robotics and ironing out problems in paint-shops typically run into billions of dollars too. Establishing dealer networks and repair shops in foreign lands with a new and unproven brand is a highly costly business as well. How can Chery afford to do all this when it claims that it will investing not much more than US\$1bn in total?

Another issue is the company's claims for cost competitiveness. Given its intention of making ten or so lower-market models with a total volume of 750,000 units a year, it would defy the usual laws of economics in the industry if it could do this cost efficiently. Chery's mass-market rivals typically make 5m or more cars a year and yet the Chinese say they will undercut them by 30% on price. With industry leaders Ford and GM unable to make any money on their cars in the US, even with incentives of up to US\$6,000 a vehicle, the threat of the Chinese is not just causing ripples in Detroit, it is raising eye-brows too. The auto sector is notoriously scale-driven (contrary to popular belief, it is not very labour-cost dependent—the most efficient plants in the world,

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## Squealing brakes

Having thundered along in the fast lane for most of the last few years, and become the third biggest auto market in the world, China's hunger for cars and trucks has suddenly shifted into the crawlers lane. Although headline sales volumes were up by a 15% in 2004, that masks the true picture. Sales have been almost static since May while some market segments have declined steadily.

The reasons are clear: constraints in consumer credit needed to cool the overheated economy and buyers holding off in anticipation of price cuts. A hike in fuel prices has not helped either. But it is the prospects, the implications and the head-in-the-sand attitudes of many executives that should be of greatest concern.

In a market that is notoriously difficult to predict, and which is often characterised by wild swings that few can reasonably explain, hardly any industry analysts are making firm predictions about sales volumes for 2005. Most of those that are willing to stick their necks out agree, however, that the outlook will not be worse than in the last few years. The continuing limitations on consumer spending are likely to keep buyers away and anticipated price reductions mean others will continue to hold off.

Merrill Lynch, one of the more bullish forecasters, expects growth of 22% this year. But that looks especially optimistic. Most analysts are predicting rates of expansion of less than half that. If oil prices rise sharply again this year, sales may even fall.

Moreover, the implications of the slow-

down are becoming more apparent week by week, with the trickle of bad news growing. The year started with the admission by Shanghai Automotive Industry Corp (SAIC) that although its sales were up in 2004, they were 21% lower than its forecast goal at the start of the year. Then came a new wave of price cuts by local and foreign joint venture firms and announcements that inventories were rising faster than sales. French tyre maker Michelin said it would suspend production at its Shanghai plant for up to two months because of the drastic slowdown. GM, while boasting a 27% hike in sales volume in 2004, said its third-quarter Asia-Pacific profit shrank by 38% from a year ago, mainly because of price pressures in China. VW and Peugeot-Citroën said their market shares had declined, while forecasts for Brilliance Automotive, which has a joint venture with BMW in the north-eastern city of Shenyang, are now for a drop in profits of 28-29% in 2005, according to JP Morgan. Dongfeng, one of the local champions, also delayed its Hong Kong IPO in the light of waning investor sentiment.

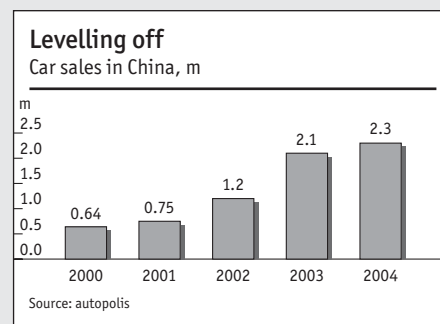
Even if sales recover soon, production capacity is expected to exceed demand by 100% in 2007, according to Chinese government forecasts. This means that there will be factories capable of building 7m more cars and trucks than are needed. This will increase the pressure to develop exports (see main story). And even if the export push is successful, prices and profits will continue to fall while competitive pressures will rise.

Most sobering is a prediction by Michael Dunne, of Automotive Resources

Asia, a marketing-support firm based in Bangkok. "China's sensational run of growth and fat profits in the auto sector in the last few years were most likely a one-off phenomenon", he says.

Sadly, this does not sit easily beside the statements still being made by most of those working in the industry. In just the first ten days of 2005, the flurry of optimistic pronouncements continued unabated. Ford announced new investments in capacity and General Motors said it would roll out another 20 new models. On the Chinese side, Chery said it planned to triple its output, Geely said it would increase capacity five-fold and Great Wall increase its volumes three-fold. Bridgestone announced plans to spend another US\$500m, and new investments were announced by Avis and Safety Components International.

While many of these companies readily acknowledge that there is something of a problem in China they claim it is either a short term hiccup or an issue that is only of a concern to their rivals. That may prove to be foolhardy. Certainly, if Mr Dunne is right, many of them will have to think through their plans again.



by far, are in Japan). How, many are asking, is Chery able to compete like this?

Other than the endless background humming of trade barriers, which Europe and America's struggling carmakers are usually especially adept at getting raised, there is also the issue of intellectual property. This could scupper Chery's plans swiftly. If the company's new models really are "all-new", that would be a refreshing change. Its current models bear uncanny resemblances to those built by Volkswagen and GM in China and have resulted in well-publicised legal disputes. While these have been rejected by the courts in China, most of those in the industry believe that European or US courts would take a far less favourable view.

### Thinking different?

But it is also possible that these worries are simply "old-school" thinking, and that Chery will achieve its goals in different ways from its rivals. After all it has defied their economics so far. Its plans include a great deal of "outsourcing"—something that most of the industry does on a much smaller scale. It has hired Italian design studios Pininfarina and Bertone to develop the new saloons for export. It has brought in Austria's AVL to work on its new engine family of 2-litre fours, 3-litre V6s, 4-litre V8s and turbo-diesels. And it has commissioned British car engineering consultancy Ricardo to develop a hybrid powertrain. Together with the use of partners for sales and distribution, Chery should be able to cut out many of the

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# Automotive/Intellectual property

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conventional costs of setting up a global car business. It may even teach a few of its established rivals a thing or two in the process.

But concerns remain. Perhaps the biggest is the hardest to define. It is experience, or rather the lack of it. Chery's history of making a wide range of vastly complex products to high standards and then shipping them to demanding foreign markets is almost zero. Before the Japanese and the Koreans moved into export markets they tested their new models

locally and then spent the best part of 20 years learning the business overseas. In contrast, Chery intends to offer its cars with a ten-year warranty in foreign markets almost from the start. That is risky. And while the company may be able to defy the industry's economics through clever tie-up deals, it would do well not to under-estimate the value of the decades of experience accumulated overseas by its rivals.

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## Ill protected

**A lack of intellectual property protection hinders the development of China's traditional Chinese medicine sector**

Thousands of years old, and considered a national treasure by many, the traditional Chinese medicine (TCM) industry in China is afflicted by a widespread failure to develop and protect intellectual property. The lack of respect for intellectual property rights (IPR) has left the indigenous TCM industry ailing on two fronts, making it difficult for Chinese TCM companies to gain market share overseas, as well as limiting their ability to differentiate products domestically. But a growing awareness among some government entities and TCM executives of the importance of innovation and protection has provided a start towards remedying the industry's IPR ills.

### Innovation deficiency

The majority of Chinese TCM companies are plagued by the same myopic approach to intellectual property pervasive in many Chinese industries. As with the rest of the pharmaceutical sector, the technological strength of Chinese TCM companies and research institutes is weak, making innovation difficult to achieve. As a recent report by the Tasly Group, a large Chinese TCM producer, explains, "the serious shortage of investment in technical innovation has been a chronic problem in the TCM industry for many years now, and as a result the technical development of the industry has remained very low." The report goes on to assert that the industry faces a "crisis of deficient momentum for further product development".

Though more sophisticated research efforts have been made in recent years, the level of innovation still lags far behind foreign competitors. "Some drug research has been initiated by Chinese entities, but followed up by other nations, with the patent rights granted to the follower, not the initiator," says Yuan Jing of Beijing-based law firm Lehman, Lee and Xu. Instead, Chinese TCM companies have watched as age-old herbal remedies endemic to China have been developed into successful pharmaceuticals overseas.

Perhaps the most famous case is that of Taxol, the most profitable cancer drug in history. Though

Taxol's development spanned more than three decades, its origins are in research conducted on camptothecin, an alkaloid derived from a Chinese tree, by the United States Department of Agriculture and the National Cancer Institute. Native only to China and Tibet, and known as *xi shu*, or "happy tree", *camptotheca acuminata* has been used in China for centuries to treat diseases of the liver, gall-bladder, spleen and stomach. Its anticancer properties were discovered in the United States in the late 1950s, and eventually harnessed by pharmaceutical giant Bristol-Myers Squibb, which introduced Taxol in 1993. Sales of Taxol totaled over US\$9bn between 1993 and 2002.

Official statistics show that the annual sales of Chinese herbal materials in the global market exceed US\$16bn. But because of China's limitations as a production center the export volume of TCM from China only accounts for 3-5% of this total in the world market. "This landscape is not likely to change in the near future given the current status of Chinese TCM companies' intellectual property rights" says Michael Dai, a Hong Kong-based intellectual property lawyer with law firm Baker and McKenzie.

Though regulatory hurdles currently impede some access to American and European markets, the failure by Chinese companies to develop and protect their intellectual property rights has significantly limited the industry's ability to sell abroad. "In the past years, the IPR protection in the domestic TCM industry has been shabby. As a result of this inadequate protection, domestic TCM companies seldom have their own patented products," says Helen Cheng, a patent attorney with law firm Jones Day.

Without ownership of the requisite intellectual property, many Chinese companies exporting their medicines are forced to pay patent licensing fees, a bitter pill to swallow for those involved in an industry which dates back to the Shang dynasty (1766-1122 BC). This is the case with the Chinese producers of Artemisinin, a traditional Chinese medicine used in the treatment of malaria. Because of a failure to apply for patent protection overseas, more than 20

The worldwide market for TCM is large, but China supplies little of it

foreign companies have imitated the main features of the medicine. The relevant patents have been registered overseas as well. In addition, patents relating to a number of different traditional Chinese therapeutic drugs, such as menthae folium, have been registered by German and French companies.

## Healthy reading

The lack of innovation by Chinese TCM companies has not helped an industry already rife with undifferentiated products. As Bill Liang, managing director of China Healthcare Consulting explains: "Most TCM formulas in China come from TCM bibles, which have been used publicly for over a thousand years." Thus, there is significant overlap among the estimated 8,000 products sold within the Chinese TCM industry, with very few exhibiting special features. This has forced companies to battle over price reduction and spend heavily on advertising, further limiting profit margins and keeping the majority of the Chinese companies in the industry small.

Product overlap leads to small, unprofitable companies

Given this competition, it should come as no surprise that of the 1,127 registered Chinese TCM companies in 2001, more than 70% had annual sales of less than Rmb30m (US\$3.6m), while around one-quarter were money-losing. The vicious cycle that many of these companies are caught in—a lack of innovation leading to undifferentiated products, triggering price wars, thus lowering profit margins—further compounds the industry's intellectual property woes by leaving most companies no capacity for raising research capital.

For this reason, some Chinese TCM companies are beginning to seek foreign capital for research and development. Most recently, Hong Kong based con-

glomerate Hutchinson Whampoa invested US\$239m to form a joint venture with the 350-year-old Chinese TCM manufacturer Tongrentang. Other companies, including Merck, Pfizer, and Johnson and Johnson, visited the State Administration of Traditional Chinese Medicine to express an interest in forming collaborative ventures with TCM companies in China.

## Aid injection

The government is looking to play a role. In May 2004, Xindong He, Secretary for Science Education at the State Administration of Traditional Chinese Medicine announced it would become official policy to develop a national IP strategy for the protection of traditional Chinese medicine. "Currently China can only hope to promote output in the area of traditional Chinese medicine if certain reforms to the administrative system are made, and if IP protection for existing patents is strengthened," he said. The State Administration of Traditional Chinese Medicine also recently announced plans to establish a special fund to facilitate the application of overseas patents for traditional Chinese medicine and high-tech projects.

"Only when we attach enough importance to an integrated protection of the intellectual property rights of traditional Chinese medicine, can the industry grow strong and become mature," says Hong Jing, a research fellow with the State Administration of Traditional Chinese Medicine. Certainly action along such lines is needed, as the failure to do so has placed the health of one of China's oldest and most revered industries at risk.

## Better bankers

**Efforts to clean up China's banking system are bringing rewards. A slowing economy, however, could lead to a new surge in non-performing loans**

China's largest commercial banks substantially reduced their non-performing loans (NPLs) in 2004, suggesting that an aggressive programme of NPL disposal and official pressure to improve management are having an effect. However, a slowing economy in 2005 could cause more loans to turn bad, and in broader terms it is far from clear that governance in the banking sector has improved sufficiently to prevent many new NPLs from accumulating even as existing ones are sold or written off.

The new NPL data were announced on January 13th by the China Banking Regulatory Commission (CBRC). They show that the combined NPLs of the country's 16 largest commercial banks—which consist of the so-called Big Four state banks and 12 joint-stock banks—fell sharply in 2004, both in absolute value and relative to overall lending. The value of

bad loans fell by Rmb395bn (US\$48bn) from the beginning of the year, while the NPL ratio—the share of bad loans in overall lending—declined to 13.2%, a fall of 4.6 percentage points.

These numbers are more than just superficially encouraging. Even though there is always the caveat with Chinese banks that official NPL numbers are likely to be far lower than the true amount, the financial health of the country's biggest lenders has improved compared with the situation even two years ago. At the start of 2003 the official NPL ratio of the Big Four banks was 26.2%, for example. According to the CBRC's latest statement, that ratio is now 15.6%.

## Environmental factors

How has this happened? Several factors have contributed. Most importantly is rapid economic growth.

This has made it easier for banks to recycle profits into improving their capital bases, and for borrowers to make loan repayments on time. The country's much-discussed investment boom has also, until quite recently, generated rapid rates of lending growth that have increased the overall stock of loans, in effect raising the denominator from which bad-loan ratios are calculated. In fairness, absolute NPL levels have also been falling steadily. However, the banks' positions would not have improved so much had lending not also been growing rapidly.

Other factors have helped the banks improve their capital bases. At the start of 2004 the government injected a combined US\$45bn into two of the Big Four banks—the Bank of China (BoC) and China Construction Bank (CCB). And the Big Four have also been active in selling NPLs to the state-owned asset-management companies (AMCs) specially established in 1999 to assist the clean-up of the banking sector. Of course, this is only a long-term solution if the AMCs in turn dispose of the non-performing assets they inherit from the banks, but for now at least the problem loans are off the banks' books.

Also significant have been efforts to improve the quality of internal supervision in banks aimed at limiting problematic lending in the future. The government continues to show it sees reform of the banking sector as a priority and is continuing a drive to improve the financial health of banks. It has repeatedly exhorted banks to improve their management and has broadly supported moves by the Big Four to prepare themselves for stockmarket listings either in China or overseas (plans that severely up the ante in requiring the banks to restructure, and to improve their balance sheets and governance). At least one innovation has resulted: in June last year all four AMCs took part in a competitive auction of NPLs from the BoC and CCB. Also importantly, for the first time NPLs are now being sold at a discount to book value, expediting their disposal.

In another sign that some banks are responding to government pressure to improve corporate governance, CCB in 2004 made Masamoto Yashiro, the then president of Japan's Shinsei Bank (itself a highly successful example of the turnaround of a previously weak bank by a foreign buyer), an independent director. Mr Yashiro was the first foreigner appointed to such a position in one of the Big Four banks. The BoC also now has two non-executive foreign directors.

Regulators have largely supported the entry of foreign banks into the market via the acquisition of minority stakes in Chinese banks. Foreign banks bring capital that can be used to write down NPLs as well as international-quality management expertise. Although HSBC's agreement last year to buy almost 20% of Bank of Communications, the fifth-largest lender, grabbed the headlines, there has also been a steady flow of deals or deals in the making involving smaller city-based commercial banks.

## Flattening out

Non-performing loans of all major commercial banks\*

	Rmb bn	Share of all loans
Mar 2004	2,078	16.6
Jun	1,663	13.3
Sep	1,700	13.4
Dec	1,718	13.2

\* State-owned commercial banks and joint stock commercial banks.

Source: China Banking Regulatory Commission

Acquisition targets for foreign investors have included Xian City Commercial Bank, Jinan City Commercial Bank, Hangzhou City Commercial Bank, Suzhou City Commercial Bank, Bank of Beijing and Minsheng Banking Corporation (see "Financial stakes", BC, January 17th, p12).

## Challenges ahead

Despite the improvement in their NPL situation, Chinese banks are likely to face a more challenging environment in the next two years. The first issue they will have to confront is that the government's efforts to cool the economy will slow GDP growth, reduce demand for loans and create a climate in which some borrowers will have more difficulty in meeting repayments. Annual lending growth has slowed markedly compared with the recent highs of 2003 and early 2004, and by October last year had fallen from over 20% to the glacial pace, by Chinese standards, of around 10%. As growth in overall lending slows, there is a risk that NPLs will rise as a proportion of loans outstanding once again. Already, as loan growth has slowed since the second half of 2004, the previously rapid fall in NPL ratios has halted. The substantial reduction in the NPL ratio in 2004 reported by the CBRC appears to have been achieved entirely in the first half of the year. The NPL ratio has barely moved since June 2004.

The introduction in 2004 of a more stringent, five-category loan classification system is also likely to have made it harder to maintain visible progress in reducing NPLs. Add to these much tighter capital-adequacy requirements being imposed by the CBRC, which banks must adopt by 2007, and many may find themselves badly squeezed. Of course, these are positive steps for long-term reform of the financial sector. So too, perhaps, is the prospect of greater foreign competition from the end of 2006, when World Trade Organisation obligations require China to open its banking industry substantially. This may not only encourage Chinese banks to pursue internal reforms but may also lead them to seek further tie-ups with foreign institutions. Thus, even as headline indicators of bank health may appear to worsen in the year ahead, many banks may be "importing" the skills, technology and business relationships needed to survive in a tougher environment.

**Stricter standards may bring NPL improvement to a halt**

## Staying power

**A new survey explores the question that all employers ask: what do Chinese employees want?**

Building companies in China takes a good bit of the country's most scarce resource—good staff. In interview after interview with the Economist Intelligence Unit, executives at foreign and domestic companies identify the recruitment and retention of talented employees as a central strategic challenge to their operations. Competition for skilled personnel is hotting up, as more companies arrive and existing ones expand. As a result, managers spend increasing amounts of time investigating what it takes to attract people to their organisations and keep them.

The results of a recent survey may go some way towards answering their questions. Since 2003, Watson Wyatt, a professional services firm based in the US and the UK, has asked more than 11,000 employees at 73 large multinationals and top domestic firms in China to describe their perceptions of their companies and their jobs. Published as part of *WorkAsia 2004/2005*, a survey of 115,000 participants at 519 companies in 11 economies, Watson Wyatt's *WorkChina* report sheds light on the thoughts and feelings of Chinese employees and reveals how they differ their counterparts across Asia. This article considers a few questions central to the issue of employee commitment.

### Satisfied?

According to Watson Wyatt, Chinese employees are more optimistic than the Asia average. Respondents in China rated eight of the ten surveyed areas more favourably than did employees in the region overall (see table, "Optimistic, but unsatisfied"). Just one area ranked clearly lower (albeit only slightly) than the Asia average—job satisfaction. This suggests that, although Chinese staff are relatively pleased with most aspects of their employer, they have higher expectations of their job.

Compared with their counterparts elsewhere in Asia, Chinese were especially more positive on questions related to supervision, innovation and leadership effectiveness at their companies. China participants rated these items 18, 12 and 9 percentage points more favourably, respectively, than did their Asia counterparts. More Asia employees, meanwhile, rated their sense of job satisfaction as favourable—although, at 60%, the Chinese sentiment is only 3 percentage points lower than the Asia average.

The disconnect between the overall optimism of China respondents and their job satisfaction levels reflects the unique situation of the country's workforce. Chinese employees in the 20-45 year-old age bracket are the first generation to have spent their entire working life under a broadly market-oriented economy. These people seem to have a more positive

assessment of the adaptability of their leadership and the ability of their companies to innovate than those of their parents who worked under a centrally planned system.

Compared only with their own high ambitions, however, Chinese employees' sense of job satisfaction is up against a tougher standard. While most of them feel they have an appropriate amount of work to do, fewer feel that they put all of their skills to use in their jobs or that they gain a sense of personal satisfaction from them (see chart, "Feeling under-utilised"). To engender commitment in their employees, managers will need to foster this sense of personal achievement.

### Show us more money

Although not as discontented with their pay as Asian employees in general, staff in China reported being least thrilled about their compensation than about any other item on the survey. Just 35% of respondents in China rated their compensation and benefits favourably, compared with an Asia average of 30%. Of the reasons cited for leaving their companies, Chinese respondents put higher compensation top of the list (see chart, "Why they leave"). This confirms what managers already know—that no amount of money is going to guarantee company loyalty. A firm with deeper pockets can always come along.

However, there may be some relative weaknesses in the area of compensation in China. In particular, Chinese staff reported greatest dissatisfaction with the availability of incentives. Only 33% of respondents felt satisfied with their opportunities for incentive pay and just 31% were happy with their benefits (see chart, "Lacking incentives"). To increase satisfaction, employers may want to increase benefits. Even those who do not, however, can improve employee satisfaction by improving communication. Only 30% of Chinese employees surveyed felt positively about their company's communication on benefits—compared to 74% in the US.

Moreover, while 70% of surveyed employees in Asia felt that their pay was tied to company performance, only about half of China respondents did. To bring staff more in line with company goals and to increase their sense of personal accomplishment in the job, companies may need to develop more ways to link Chinese employees' performance with their compensation. As Watson Wyatt points out, with stock options not yet a possibility in China employers could benefit from devising some creative solutions aimed at providing employees with the kind of incentivised remuneration they want.

Almost as important as employees' feelings about

Wage unhappiness is the biggest complaint of Chinese staff

*WorkAsia 2004/2005: The Keys to what makes Asian employees tick. Published by Watson Wyatt. For more information or to purchase a copy of this report, contact Karen Nip in Hong Kong at (852) 2820 0087, or by email at karen.nip@watsonwyatt.com. Or visit: [www.watsonwyatt.com/asia-pacific/workasia](http://www.watsonwyatt.com/asia-pacific/workasia).*

compensation, are those about career development. Belief that they will have better career opportunities is the second most common factor prompting Chinese employees to move to a new company or to stay with their current employer, according to the survey. To hold on to staff, clearly communicating the possibilities for development is key.

Survey results suggest that foreign companies do a better job at this than domestic firms. Some 44% of surveyed employees at foreign-invested firms in China feel satisfied with the potential for advancement in their companies. Only 35% of respondents working at domestic firms agreed (see chart, "Foreign planning"). Similarly, 51% of respondents at foreign companies said that procedures for promotion were generally fair, against only 43% at domestic firms.

Much communicating about potential advancement is being done—or not being done—by immediate supervisors. Only half of the China-based participants praised the career development assistance provided by their direct supervisors. Foreign companies do better here as well, with 51% of their employees (against 40% at domestic firms) reporting they were pleased with supervisors' help with career planning (see chart, "Supervisors' support"). Yet overall this is a strong relationship to build on: a healthy majority of respondents in China felt their supervisors treated them with respect.

## Dissatisfied with management

The survey rated trust in leadership and management as one of the highest drivers of commitment in China, as elsewhere. But it also found in China, as in Asia, leadership effectiveness had the second lowest favourable rating, with only 49% of those surveyed declaring themselves favourably satisfied with the effectiveness of the managers (China-based managers, however, can draw some solace from the fact that in Asia overall only 40% respondents ranked their management's leadership positively).

Chinese employees are positive about their companies' adaptive capabilities. Survey respondents rated their senior management's ability to make the changes necessary "to compete effectively" 22 percentage points higher than did Asia respondents on average (see chart, "Change-makers"). Similarly, Chinese respondents were significantly more positive about the timeliness of senior management's decision-making than were employees elsewhere in Asia.

With the market changing rapidly, companies in China are being required to develop and implement new strategies and products quickly. According to the Watson Wyatt survey, Chinese employees are eager participants in such an environment. Although their tendency to welcome change may make Chinese employees easy to lose, it also suggests that dynamic companies may have better luck hanging on to them.

## Optimistic, but unsatisfied

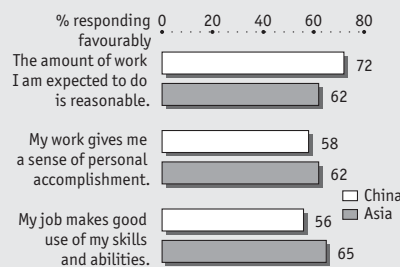
WorkChina survey results by category, % reporting favourable (and rank)

Category	China	Asia
Compensation and benefits	35% (10)	30% (10)
Leadership and management effectiveness	49% (9)	40% (9)
Training and development	52% (8)	45% (7)
Performance management	53% (7)	50% (5)
Supervision	59% (6)	41% (8)
Job satisfaction	60% (5)	63% (1)
Work environment	60.5% (4)	60% (2)
Innovation	61% (3)	49% (6)
Teamwork	62% (1)	54% (4)
Communication	62% (1)	56% (3)

Source: WorkAsia™ 2004/2005: The Keys to what makes Asian employees tick

## Feeling under-utilised

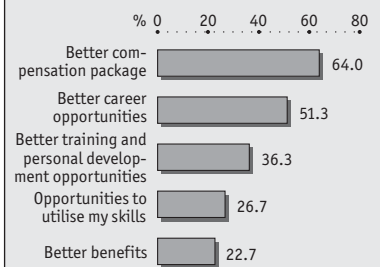
Comparing questions on job satisfaction



Source: WorkAsia™ 2004/2005: The Keys to what makes Asian employees tick

## Why they leave

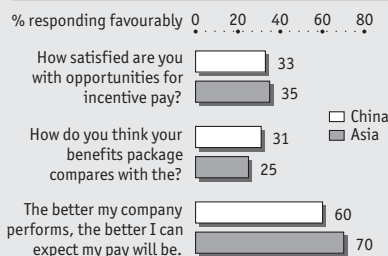
Reasons given for leaving an employer



Source: WorkAsia™ 2004/2005: The Keys to what makes Asian employees tick

## Lacking incentives

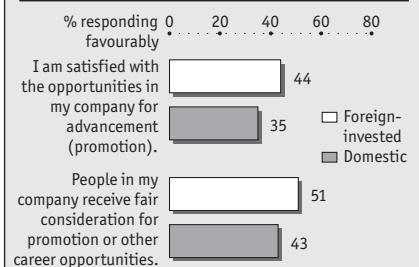
Comparing questions on compensation satisfaction



Source: WorkAsia™ 2004/2005: The Keys to what makes Asian employees tick

## Foreign planning

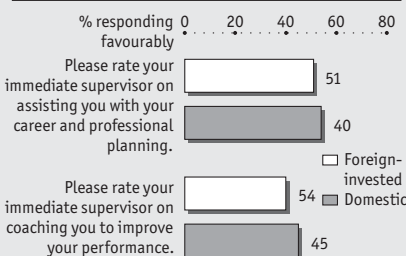
Comparing questions on career development



Source: WorkAsia™ 2004/2005: The Keys to what makes Asian employees tick

## Supervisors' support

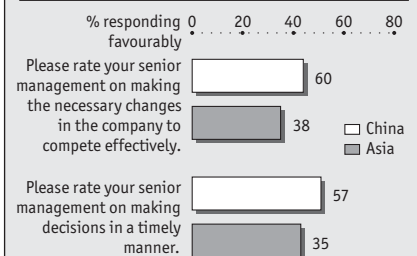
Comparing questions on career development



Source: WorkAsia™ 2004/2005: The Keys to what makes Asian employees tick

## Change-makers

Comparing questions on senior management



Source: WorkAsia™ 2004/2005: The Keys to what makes Asian employees tick

# What's new in your industry

## Corporate strategy

Three affiliated units of Chinese conglomerate **CITIC Group** announced major expansion plans in January—one each in core businesses of property and financial services, and one in the oil industry, in which CITIC has had little involvement to date. Hong Kong-listed **CITIC Pacific** announced on January 19th that it would partner with US retailing giant **Wal-Mart** to open several hundred stores in China over the next decade. Its parent company formed a joint venture (JV) with Wal-Mart in 2002, but the JV has only produced one store, in Nanjing, to date. CITIC Pacific will take over its parent's 35% stake in that venture and use its property assets throughout the country to expand the partnership more quickly than its parent did. The recent liberalisation of China's retail laws made the partnership between CITIC Pacific and Wal-Mart possible: since the beginning of this year, foreign firms (which CITIC Pacific is classified as, due to its Hong Kong listing) can operate retail ventures without a domestic partner.

**CITIC Securities** also announced earlier in the month that it would pay Rmb5bn-6bn (US\$604m-725m) to acquire troubled brokerage **Huaxia Securities**, which was reported last year to be on the verge of a multi-billion-renminbi bailout from **Cinda Asset Management**. CITIC Securities, the country's first brokerage to go public, was hit particularly hard by the poor performance last year of domestic stockmarkets. The firm warned in mid-January that its 2004 profits, to be released in full on April 20th, could be less than half what they were in 2003. But the firm is still one of the three brokerages that regulators have picked to help reform the loss-making industry. The acquisition of Huaxia by CITIC Securities, which will combine two of the nation's five largest brokerages, will no doubt be seen by regulators as a good step down that path.

Separately, **CITIC Resources Holdings** announced on January 14th that it would take a 50.5% stake in an oil retailing JV with **ChevronTexaco's** subsidiary **Caltex (Asia)** and **Star Concept Holdings**. As China's oil distribution sector is gradually liberalised, CITIC Resources appears to want to be able to compete with **Sinopec** and **PetroChina**, which currently dominate the market. Caltex, which operates 42 petrol stations in Guangdong, has fallen behind some of its

international competitors, who have announced huge expansion projects in partnership with one of the two domestic giants.

## Environment

On January 18th the State Environmental Protection Administration (SEPA), China's top environmental watchdog, ordered 30 large projects to cease construction immediately for failing to get their environmental impact assessment statements approved. SEPA said that the offending projects would either need to come into compliance with environmental standards before resuming, or be completely abandoned. Some 26 of the 30 projects are power plants, including the US\$5bn Xiluodu hydropower plant and two auxiliary power facilities connected to the Three Gorges Dam. Regulators and official media have trumpeted the work stoppage order as evidence that China is getting serious about environmental protection. They argued that China's environmental laws—such as 2003's *Law on Environmental Impact Assessment*, the one most relevant to the recent SEPA order—were sufficiently strong, but enforcement had been lax, and that a new era of vigorous oversight was beginning.

That may be. It would be hard to disagree with the claim that enforcement has been lax, as the January case illustrates. Upon issuing the order, SEPA noted that it lacked the authority to shut the projects down and would depend on the provincial and local governments in the 13 provinces and municipalities in which the projects are located to carry out the directives. As of January 24th, work had stopped at 22 of the 30 projects, according to SEPA, but several had shown no intention of complying. The Rmb200,000 (US\$24,000) fine that the offending companies were ordered to pay is laughably small for a multi-billion-dollar project.

There is reason to doubt that environmental concerns were primary in the government's decision to halt the projects. Though the country's frequent power shortages are well documented, the government has repeatedly expressed concern that, between authorised and unauthorised construction projects, China risks producing a severe power glut. According to official estimates last year, unauthorised projects then underway had aggregate production capacity of 120,000 mw, or roughly 30 times the

country's current capacity. Although, the government's concern for the environment may be sincere, a desire to slow construction on power-generating projects may also have been a major factor in SEPA's recent decision.

## Financial services

**China Construction Bank's** plan to launch the country's first asset-backed securitisation won approval from the People's Bank of China (PBoC, the central bank) in January, clearing a key hurdle in the path towards restructuring. The bank has also received approval from the China Securities Regulatory Commission and the China Banking Regulatory Commission (CBRC), and now only needs State Council backing to proceed. The PBoC has previously been reluctant to approve new and complex financial tools, such as an asset-backed securitisation, in which a pool of assets (in this case home mortgages) is sold to investors so that some of a bank's inflexible assets can be converted into cash. Due to the dearth of risk management data related to mortgage lending, the risk-averse PBoC's decision was something of a surprise.

While the development was good news for China Construction Bank (CCB), most of the other reports about Chinese banks in January, however, were rather bleak. The CBRC announced that Chinese banks handed out Rmb584bn (US\$70.6bn) in unapproved loans in 2004, up 70% on the previous year. According to regulators, the CBRC investigated 74,911 financial institutions in 2004, up from roughly 58,000 in 2003. But even last year's figure only represents 36% of China's total. Further expanded inspections combined with the continuation of restricted lending could cause even higher "irregular" loans next year, emphasising the fact that the CBRC's much-needed campaign to inject transparency into the banking sector could expose some ugly facts along the way.

The CBRC also announced that dozens of bankers and government officials had been charged with attempting to steal Rmb7.4bn (US\$894m) from **Industrial and Commercial Bank of China**, the country's biggest lender. **Bank of China** confirmed on January 23rd that the director of a sub-branch in Harbin had disappeared, along with nearly Rmb1bn (US\$120m) in deposits. And the CBRC announced a few days later that it is investigating nearly

# What's new in your industry

2,000 officials at 157 banks for allegedly violating market rules.

## Food, beverages & tobacco

Two foreign breweries, **Suntory** of Japan and **Heineken** of the Netherlands, appear close to expanding their presence in the huge but fragmented Chinese beer market. Suntory is planning to acquire a 70% stake in **Shanghai Donghai Brewery**, the municipality's second-largest beer maker. Suntory is already the area's largest brewer, with nearly a third of the market, and the purchase of Donghai, which sold roughly 110,000 kl of beer last year, would boost its market share to more than 50%. Shanghai accounts for over 80% of Suntory beer sales in China, exemplifying a typical expansion strategy of foreign brewers, who often prefer to focus efforts on a few areas.

Though active in more regions than Suntory, Heineken is trying to expand its share of the Pear River Delta market by boosting its 21% stake in Shenzhen-based **Kingway Brewery Holdings**. The Dutch firm is negotiating with majority shareholder **GDH**, an investment arm of the Guangdong provincial government, to buy the majority stake that it has long sought. The firms are reportedly discussing a deal with a price tag of between HK\$3.50 and HK\$4 (US\$0.45-0.51) per share, representing a mark-up of roughly a third on its current price. Heineken bought its 21% stake in Kingway last year for US\$71m. And while Kingway is not one of China's ten largest beer producers, its proximity to wealthy Pearl River Delta areas, including Hong Kong, make it an attractive investment for the Dutch firm.

Industry consolidation has cut the number of Chinese breweries from 500 four years ago to around 200 today. But due to the absence of a nationwide sales network and a history of regional brand loyalty, significant national market share for any one brand still appears far off. In the meantime, foreign firms will be happy to pursue province-specific strategies by buying up more domestic brewers.

## Telecoms & technology

Perhaps the declarations of China's emergence as an international technology heavyweight were a bit premature. Though much has been written about **Lenovo Group's** US\$1.75bn acquisition of **IBM's**

personal computer business, it now appears possible that the deal may be blocked. The US Treasury Department's Committee on Foreign Investments in the United States (CFIUS), whose approval is required for the deal to proceed, has expressed concerns that the purchase might be a threat to US national security.

As *Business China* went to press, the CFIUS had not stated whether or not it would launch a formal investigation, but its ruling was due on January 29th. The US government does not appear to be sufficiently dependent on IBM technology to warrant a full investigation, based on the CFIUS's normal criteria. But the inter-agency panel may be concerned that the Lenovo delegation, which will be in the US frequently to look after its investment, might contain spies.

In all likelihood, even the opening of a formal investigation would not scuttle the

deal entirely. From the perspective of some of Lenovo's shareholders and IBM's customers, that might be a pity. The announcement of the CFIUS's reservations about the deal caused a jump in Hong Kong-traded Lenovo's share price. For its part, IBM has met with thousands of customers to assure them that the transfer will not cause a disruption or degradation in service or product quality, telling them that they will be able to continue interacting with the same sales and support teams, for example. Despite these misgivings—and the CFIUS's apparent suspicion—the two principle parties insist that Lenovo will be able to find new efficiencies that will reverse the fortunes of the personal computer unit, which has lost roughly US\$1bn in the last four years. If that turns out to be the case, those early declarations of China's technology ascendance might look prophetic once again.

## Select economic indicators, Jan-Nov 2004

	Change on		Change on	
	Jan-Nov 2004	Jan-Nov 2003	Nov 2004	Nov 2003
Fixed-asset investment, Rmb bn*	4,927.4	28.9%	571.8	37.7%
In primary industry	52.9	24.0%	5.9	-40.4%
In secondary industry	1,965.9	40.5%	227.4	49.3%
In tertiary industry	2,908.4	22.2%	338.2	33.7%
By type of construction				
New construction	2,206.5	37.2%	258.4	—
Expansion	1,003.0	20.4%	115.8	—
By use of funds				
Construction & installation	3,099.3	29.1%	355.8	—
Purchase of equipment & instruments	1,021.7	36.4%	123.5	—
Value added of industry, Rmb bn	4,891.1	16.8%	508.4	14.8%
By type of industry				
Light industry	1,597.6	15.3%	164.4	13.0%
Heavy industry	3,293.5	18.3%	344.0	16.4%
By ownership				
State-owned	2,070.9	13.8%	210.6	12.5%
Foreign-invested	1,366.9	19.6%	138.1	15.1%
Foreign trade, US\$ bn	1,038.4	36.5%	112.0	42.3%
Imports	508.8	37.3%	60.9	65.0%
Exports	529.6	35.7%	51.0	22.0%
Balance	20.8	5.6%	-9.9	-402.0%
Foreign direct investment, US\$ bn				
Contracted FDI	136.0	34.4%	16.0	35.7%
Equity joint ventures	24.2	9.5%	3.0	29.8%
Co-operative joint ventures	6.9	5.5%	0.9	5.2%
Wholly foreign-owned enterprises	103.3	44.1%	12.1	40.8%
Utilised FDI	57.7	22.1%	3.8	4.8%
Equity joint ventures	15.6	17.9%	0.9	-16.7%
Co-operative joint ventures	3.0	-14.7%	0.3	-9.5%
Wholly foreign-owned enterprises	38.5	27.5%	2.6	20.9%

Sources: China's Latest Economic Statistics, China's Monthly Statistics

\*Figures for state-owned enterprises only

# Deal watch

## Joint ventures, contracts, MoUs and other agreements, January 10th through January 19th 2005

Agreement (location/date reported)	Participants (equity stake)	Value	Additional details
<b>Automotive</b>			
JV established (Changchun/Jan 18th)	Mazda Motor of Japan (25%), First Automotive Works (5%) and FAW Car (70%)	US\$12m	JV, based in Changchun, Jilin, to market all Mazdas sold in China beginning in March
<b>Aquaculture</b>			
JV established (Jan 11th)	Caviar Creator of the US and Tianxia Sturgeon	—	JV to create aquaculture facilities in Hubei to breed sturgeon to produce caviar, sturgeon meat, sturgeon leather and nutritional supplements
<b>Chemicals</b>			
JV established (Shanghai/Jan 13th)	Dow Corning of the US and Wacker-Chemie of Germany	—	JV to build a large siloxane and fumed silica production complex in Shanghai
<b>Electronics</b>			
JV established (Wuxi/Jan 11th)	Indesit of Italy (70%) and Wuxi Little Swan (30%)	US\$10m	Companies form JV to manufacture dishwashers for export at Little Swan's existing plant in Wuxi
<b>Education</b>			
Contracts awarded (Jan 10th)	To AMD of the US, Lenovo and Dawning by Hebei Long-Distance Education Project	—	Firms to supply the Hebei Education Bureau with 26,000 AMD processor-based personal computers, to be used in rural elementary and middle schools
<b>Financial services</b>			
Agreement signed (Jan 11th)	UBS of Switzerland and State Development Investment Corp (SDIC)	—	UBS to buy a 49% stake in SDIC-owned China Dragon Fund Management, which will be restructured as a JV between UBS and SDIC Hongtai Trust & Investment, an SDIC subsidiary
<b>Media &amp; entertainment</b>			
Contract awarded (Guangzhou/Jan 11th)	To Eagle River Mining of the US by Zhujiang Beer Group	US\$810,000	Media group Eagle River wins one-year contract to place advertisements for Zhujiang in the Guangzhou subway
<b>Metals &amp; mining</b>			
JV established (Jan 13th)	BOC of the UK (50%) and Ma'anshan Iron & Steel (50%)	US\$100m	JV, Ma'anshan BOC-Ma Steel Gases, to build and operate two air separation units in Ma'anshan, Anhui
JV established (Jan 13th)	Ashapura Minechem of India and Sichuan Aostaar Aluminium	—	JV to build alumina plant with production capacity of 1m tonnes, which will supply Ashapura's Kutch plant with 75% of its alumina needs for the next 30 years
<b>Petroleum &amp; petrochemicals</b>			
Agreement signed (Jan 10th)	Shell Exploration of the UK and the Netherlands and Jilin Bureau of Geological Exploration and Mineral Development	—	Shell to use its in-situ conversion process to exploit oil shale in Jilin
JV established (Erdos, Jan 10th)	Elion Resources Group (52%) and Shanghai Huayi (48%)	US\$483m	Firms form JV in Erdos, Inner Mongolia to produce PVC after Elion's original partner, Guangzhou Zhongkexin Group, quits the planned project
<b>Telecoms &amp; technology</b>			
Contracts awarded (Jan 19th)	To UTStarcom of the US by China Netcom Group	US\$40m	UTStarcom wins contracts to expand China Netcom's IP-based-based personal access system in Beijing, Henan and Shandong
MoU signed (Jan 14th)	China Telecom and Sichuan Changhong Electronics	—	Firms agree to co-operate on the development of 3G technology projects, particularly Internet protocol television
Contract awarded (Jan 13th)	To Alcatel of France by China Telecom	—	Alcatel to build 2,300-km optical backbone linking seven cities in south-eastern China
Contract awarded (Jan 12th)	To Qingdao HiSense Electric by China Unicom	—	HiSense to supply China Unicom with 600,000 CDMA C677 mobile phone handsets, which retail for around Rmb1,000 (US\$120) each
Agreement signed (Jan 10th)	Parlex of the US (51%) and Infineon Technologies of Germany (49%)	US\$3m	Firms agree to form Hong Kong-based JV that will manufacture substrates for secure mobile electronic identification products in China beginning in April
<b>Transportation &amp; logistics</b>			
MoU signed (Hangzhou/Jan 17th)	Hong Kong Airport Authority (HKAA) of Hong Kong and Hangzhou Xiaoshan International Airport (HXIA)	—	Parties agree to co-operate on air links between Hong Kong and Hangzhou, and the HKAA agrees to help HXIA plan a logistics park
JV established (Dalian/Jan 11th)	TTS Marine of Norway (50%) and Dalian New Shipbuilding Heavy Industry (50%)	US\$3.2m	JV, TTS Bohai, to build shipboard cranes for sale in China beginning by the end of 2005
<b>Utilities</b>			
Contract awarded (Jan 13th)	To China Evergreen Environmental Corp of Hong Kong by Hebei provincial government	US\$66m	China Evergreen wins 22-year contract to build, operate and transfer a waste water treatment facility with daily capacity of 90,000 cubic metres

## Financial services

**Trust companies to publish financial information.** China's 59 trust companies will be required to disclose their financial information regularly, according to rules issued in mid-January by the China Banking Regulatory Commission (CBRC). Of the industry's 59 firms, the first 30 that were re-licensed after the CBRC's 1999 consolidation campaign will be required to publish financial reports by April 30th this year. The remaining 29 companies, which were re-licensed later, will have until April 30th, 2008.

According to provisional disclosure guidelines, trust companies will have to release annual reports that include the firm's financial assets, as well as descriptions of major events and transactions from the previous year. Trust companies should also publish intermediate reports that alert the public to major developments, such as managerial changes or mergers and acquisitions. Regulators expect that the new disclosure rules, the first significant transparency guidelines for the trust industry, will encourage better development for trust firms through greater public scrutiny.

**CSRC orders audit of brokerages.** On January 21st the China Securities Regulatory Commission (CSRC) ordered an audit of China's more than 130 brokerages. The CSRC informed the brokerages by email that they would be required to submit financial reports by April 30th. Regulators and industry observers hope that greater financial transparency will buoy domestic stockmarkets by increasing investor confidence, as well as precipitating consolidation of the industry by exposing the shortcomings of the financially worst-off firms. To emphasise its commitment to cleaning up the sector, the CSRC has also dispatched its own auditors to begin a criminal investigation of eight brokerages that have had their licences revoked for submitting false financial data or conducting off-book transactions.

## Food, beverages & tobacco

**Foreign firms still banned from tobacco industry.** In mid-January the State Tobacco Monopoly (STM) reiterated its ban on foreign tobacco firms entering the Chinese market and said that no new cigarette factories, whether foreign or domestic, will be

approved in the near term. British American Tobacco announced last summer that it had won regulatory approval to build a joint-venture factory with an annual production capacity of 100bn cigarettes. The STM denied the company's announcement at the time, and used its recent annual press conference to reiterate that its position on foreign entry into the domestic tobacco market was unchanged. The STM also announced that tax revenues from the tobacco industry increased 27% in 2004 to Rmb210bn (US\$25.4bn), accounting for more than 10% of all national tax revenue. China's commitments to the WTO do not include liberalisation of its tobacco industry.

## Media & entertainment

**New restrictions for foreign media firms.** The State Administration of Radio, Film and Television (SARFT) unveiled market entry conditions in mid-January for foreign companies hoping to invest in China's media industry. Designed to protect domestic media companies from foreign competition, the rules allow foreign firms to enter no more than one film production joint venture (JV) and no more than one television JV. Additional investments in animated programmes, live shows and sports broadcasting will be permitted, though. The rules also stipulate that 65% of television content aired by a JV should focus on Chinese topics, such as history and philosophy. The shows are not required, however, to use Chinese actors or be filmed on the mainland. A Sino-foreign JV must also have its own unique logo, according to the regulations, in order to ensure that it is not too closely associated with an extant foreign brand.

**Cable operators barred from raising fees.** The State Development and Reform Commission and SARFT jointly issued interim regulations in mid-January prohibiting cable television network carriers from increasing licensing fees at their own discretion. The bodies said the government would set the licensing fees; if a carrier wanted the fees raised, it should submit a written petition to SARFT detailing the proposed price rise, the carrier's reasons for it and the expected effect on subscribers. The government would then hold a public hearing to allow customers to have their say about any proposed fee change.

## Stockmarkets

**Domestic IPOs cleared to resume.** On January 14th the CSRC approved the resumption of initial public offerings (IPOs) of A-shares on domestic stockmarkets, ending a ban that had been in place since late August 2004. IPOs will have to comply with new CSRC pricing guidelines that took effect at the beginning of this year (see "Regulatory Watch", BC, Jan 3rd, p11). Huadian Power International, a unit of state-owned energy concern China Huadian Group, became the first company to list shares after the resumption, with Baoshan Iron and Steel also likely to list shares before the Chinese New Year holiday, according to regulators.

## Trade

**Tariffs waived for 25 African nations.** The Ministry of Commerce announced on January 17th that imports of 190 items from 25 African nations began receiving tax exempt status at the beginning of this year. The countries on the list are: Benin, Burundi, Cape Verde, Central African Republic, the Comoros, the Democratic Republic of Congo, Djibouti, Eritrea, Ethiopia, Guinea, Guinea Bissau, Lesotho, Libya, Madagascar, Mali, Mauritania, Mozambique, Niger, Rwanda, Sierra Leone, Sudan, Tanzania, Togo, Uganda and Zimbabwe. The tax exemption, originally proposed by Chinese premier Wen Jiabao in 2003 at the China-African Co-operation Forum, was described as a goodwill gesture by China that also aimed at boosting trade between China and Africa, according to Mr Wen's statements.

## Transportation & logistics

**Fuel tax in the works.** According to a report released on January 22nd by the State Research Development Centre, China will soon replace its road maintenance fees, levied on a per vehicle basis, with a fuel tax. The forthcoming change is designed to reflect the fact that those who drive more have a greater impact on China's environment and road infrastructure than infrequent drivers. Regulators also expect that the fuel tax will provide an incentive for car buyers to purchase smaller and more fuel efficient vehicles. The exact fuel tax rate has not yet been made public.

# Foreign relations

## Off the radar

### Sino-US ties are set to strengthen in the next few years, to China's benefit

In his inaugural speech for a second term, US president George Bush gave notice that American foreign policy was to be every bit as radical in the coming four years as it has been in the past four. In particular, Mr Bush set at the heart of his agenda the goal of securing "freedom"—a much repeated word in his speech—for people under tyrannical regimes. In the same week, the president's closest aides amplified the message. His incoming Secretary of State, Condoleezza Rice, said that Mr Bush has broken with the American habit of "excusing and accommodating" the lack of democracy in such regions as the Middle East; promoting democracy was also to play a big part in relations with Russia.

#### More than talk?

Striking rhetoric, but what does it mean for relations with China? Colin Powell, the outgoing Secretary of State, says that US-China relations are "the best they have been in decades". To some, it is something of an anomaly that such strikingly warm relations exist with the antidemocratic regime of a country that the president once used openly to brand a "strategic competitor". With Mr Powell, the administration's last multilateralist, now going, these observers think, the US's unipolar instincts to attempt to reshape the world will cast a pall over the relationship.

Don't count on it. If anything, bilateral ties are more likely to deepen during Mr Bush's next four years. Simply, the war on terror and on weapons of mass destruction has, more than anything, contributed to closer ties between the two countries. In his second term, Iraq and rogue states remain Mr Bush's top foreign-policy priority. And in this fight, China is seen not as a threat or even as a rival, but as a partner—particularly since Beijing has adopted a more nuanced, if still assertive, diplomacy under President Hu Jintao.

Partnership is most in evidence in attempts to deal with North Korea, where the administration counts upon Beijing to make progress in defusing the nuclear threat. Both countries share the desire for a Korean peninsula free of nuclear weapons. If the two differ, it is over the best means. China says that North Korea's security concerns must be addressed if it is to be persuaded to disarm, while the United States says it will not "reward" bad behaviour. Still, American policy is to date a failure, with the North Korean situation worse than it was four years ago. Strong American attitudes about the crisis have not translated into clarity of purpose. Here, Ms Rice's appointment, the White House is likely to feel, will bring the State department to heel. A more hard-headed approach to dealing with North Korea is like-

ly now to be in evidence, including credible threats if Pyongyang makes no progress. The Chinese government will probably express dismay at such a hardening. Yet it knows that the key to getting North Korea to disarm is in China and the United States working together.

Over Taiwan, relations between Beijing and Washington are likely to be steady, and not just because China must be on best behaviour for the 2008 Olympics. Mr Bush has enough to think about without another crisis in the Taiwan Strait. Just over a year ago he made explicit the administration's opposition to attempts "unilaterally to change [Taiwan's] status quo". China may still be unhappy at American arms sales to Taiwan. Yet it can also see the extent to which the US has sought to temper Taiwan's rhetoric—President Chen Shui-bian even sends speeches to Washington for vetting. The poor showing of Mr Chen's Democratic Progressive Party in December's legislative polls can only help.

Finally, economic and trade relations—admittedly increasingly complex between the two countries—are unlikely to be a source of profound destabilisation. Though the US's trade deficit with China is politically contentious, its deficit with other countries has risen faster than that with China, which today accounts for a lower share of America's overall trade deficit than it did in 1997. A sizeable revaluation of the renminbi, the administration knows, would do little for America's trade balance. The real problem, of course, is the US's current-account deficit of over 5%, symptomatic of a lack of saving at home.

Trade frictions may increase somewhat, but strong US growth and job creation would moderate them. So would a Chinese economic slowdown. Nicholas Lardy and Morris Goldstein of the Institute of International Economics expect such a slowdown over the next two or more years, the consequence of phenomenal overinvestment in many sectors—such a "long landing", they anticipate, could knock up to four or five percentage points off Chinese growth.

#### So where's Asia?

The biggest problem for America, says Mr Lardy, is that it is not reacting sufficiently to trade and economic patterns in Asia that are evolving rapidly, with China becoming an engine of regional demand. "The administration has no overall coherent economic policy towards Asia. The United States seems to be not just on the sidelines, but not even in the game." Nothing in the president's speech, he says, even recognises a sea change that is underway.

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