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## China's Macro-Economy Revisited; Strategic Thinkings and Policy Directions of the Central Leadership

In this newsletter, we go through the latest economic issues in China in **Part One**, which covers:

1. The latest tightening measures by the Chinese central government to cool down the economy and the asset market bubble
2. Economic growth and income
3. Employment
4. Central government budget, fiscal and tax policies
5. Money supply, deposits and loans
6. Fixed asset investment
7. Consumption
8. Foreign trade
9. Foreign direct investment
10. Foreign exchange reserves and currency rate
11. Reforms of the central enterprises

**Part Two** analyzes and elaborates the philosophy, strategic thinkings and concerns of the Chinese central government. Only after we understand the leading ideology and guiding principles behind can we fully comprehend the country's development path, past and present.

**Part Three** discusses the challenges and worries addressed by the central leadership; and **Part Four** outlines the themes and focuses of the central government economic policies.

Finally, in the **Appendix**, we try to summarize the major economic directions and policies, designed for the year 2007 and beyond, discussed and announced in the most important central government working conferences, meetings and documents.

## Part One: Economic Updates

1. **A series of tightening measures to cool down the overheating economy, to curb the excessive liquidity and bank lending and, most importantly, to dampen the A-share market speculation**
  - (i) **At midnight, 30 May, the Ministry of Finance (MOF) made an unexpected announcement to triple the stamp duty (levied on two-way trading) from 0.1% to 0.3%, effective as of 30 May, 2007.**

Apparently this is a move targeted at the stock market craze among the Mainlanders. In the past few weeks before the announcement, daily turnover in the A-share market amounted to over 350 billion yuan, indicating extreme speculative activities. The move is sort of “unexpected” as just one week ago, the MOF and the State Administration of Taxation negated the possibility of raising the stamp duty.

We perceive the move as a switch in the government policy direction to intervene more directly in the A-share market. The government has been avoiding using this measure for quite a while (the last time it raised up the stamp duty was in 1997, when A-shares surged 300% between Jan 1996 and May 1997). Rather, it has tried to cool down stock market “indirectly” – through raising the cost of capital (higher interest rates) and discouraging bank lending (higher RRR and lower interest margin).

However, the series of RRR and interest rate increases seem not to be effective at all – A-shares are constantly reaching new highs ever! The Chinese government was so alarmed that they resorted to direct intervention in the A-share market. Immediately the Mainland stock markets saw their biggest falls in three months on 30 May.

Though we think that the move will not have big real impact on the stock market this time, it does signal government’s serious determination in curbing the asset market bubble. Tougher measures are yet to come, if the market craze persists, in the form of another rise in the stamp duty or even the levy of capital gain taxes.

- (ii) **China will raise RRR by 0.5 ppt as of 5 June, and as of 19 May, raised benchmark deposit interest rates by 0.27 ppt and lending interest rate by 0.18 ppt. The managed floating exchange rate regime was expanded from 0.3% to 0.5%, effective as of 19 May.**

On 18 May, 2007, China’s central bank announced a new set of tightening measures: beginning from 19 May, it raised the one-year benchmark deposit rate to 3.06% from 2.79%, while the one-year benchmark lending rate rose to 6.57% from 6.39%; From 5 June onwards, the required reserve ratio will be increased to 11.5%. This is the first time in a decade that the central bank has simultaneously raised the benchmark interest rates and the bank reserve ratio, showing the government’s determination to cool down the higher-than-expected economic growth and curb the excessive liquidity.

This is the fourth time since April 2006 China raises interest rates to curb inflation and reduce asset bubbles, and is the second interest rate rise in 2007 after the central bank had raised commercial banks’ deposit reserve ratio by 0.5 percentage points four times earlier this year to rein in excessive bank lending. This is also the eighth time in a year, and the fifth time in 2007 that PBOC increases required reserve ratio.

At the same time, PBOC announced the widening of the managed floating exchange rate band. Effective as of 19 May, the floating band of RMB trading prices against the US dollar in the inter-bank spot foreign exchange market was enlarged from 0.3% to 0.5%. The Chinese currency will then be able to respond to market changes more flexibly.

The recent wave of tightening measures largely reflect the central bank's concern over the trends shown by a series of latest economic indicators: China's economy expanded at the fastest pace in 11 years in 2006 and the GDP growth in 1Q07 was over 11%, much higher than many had estimated; China's trade surplus for the first four months of 2007 widened to US \$63.3 billion, 88% yoy more than a year earlier; In February, the trade surplus surged nine-fold from a year earlier to reach USD23.8 billion, the second-highest month on record; Money supply grew to 17.8% yoy in February, the most in six months – despite the fact that M2 growth later decelerated to 17.1 % in April, it still exceeded the central bank's 16 percent target set at this year for the third month in a row; Inflation accelerated to 3.3% yoy in March, the highest in more than 2 years and 3% yoy in April, up from 2.2% yoy in January and 2.7% yoy in February, driven by rising food prices. Industrial output also grew by 18.3% yoy in 1Q07, 1.6 pts higher than the same period last year, hitting a 10-year high and fueling a rebound in fixed asset investment growth.

Particularly noteworthy is that, investment growth in China has been gaining momentum since the beginning of 2007. In the first quarter, FAI growth grew by 23.7% yoy, actually rebounding from the 4Q06 growth rate, and was much higher than the 13.8% yoy growth in December 2006. Urban FAI also accelerated, growing by 25.5% yoy in Jan-Apr 07.

In fact, the government is also well aware of the serious problems that excess liquidity is causing in various aspects of the economy, and is determined to make use of monetary policy tools more actively to ensure the balanced development of the economy. According to the Premier's report to the NPC in March, "China will employ a full range of monetary policy tools to adjust money and credit supplies in order to address the problem of excess liquidity in the banking system". Premier Wen further commented at the closing day of the NPC that the national economy was "unstable, unbalanced, uncoordinated and environmentally unsustainable".

Central Bank Governor Zhou Xiaochuan earlier expressed his concern that liquidity generated from a record trade surplus was stoking excess investment, raising the risk of accelerating inflation and boom-and-bust cycles in asset prices. In the central bank's first quarterly monetary policy report in 2007 released on 10 May, it is warned that the country faced the risk of inflation and of a rebound in investment, and that it must prevent the economy from overheating through a variety of measures. In fact, the central bank further stated on its website (18 May) that raising interest rate and required ratio in one public announcement aim to "strengthen liquidity management in the banking system, rationalize the growth of lending and investment as well as maintaining price stability".

It seems that the central bank would opt to raise deposit reserve ratio when there is excess liquidity in the banking system and inflation pressures remain moderate, but would tend to adopt an interest rate rise once inflation pressures increase.

Thus, given the overwhelming liquidity in the market, it is generally believed that the latest rise in the interest rate as well as the series of reserve ratio hikes since 2007 did not herald the end of the central bank's macro-control policy. If the economy continues to be disproportionately driven by investment and production, and if the CPI continues to be at high numbers, it is likely to see at least one more interest rate rise by end-3Q07. It would be also of no surprise if the required reserve ratio further rises to 13%, from 11.5% currently.

However, an interest rate rise, or a narrowing interest rate gap between China and the US, will induce more funds flowing into China. This would put RMB under greater pressures to appreciate and, if RMB is not to appreciate faster, would necessitate more sterilization by the Central Bank in order not to create extra liquidity. Therefore, still, economic restructuring is the only way to solve the problems of excess liquidity and overheated investment at the root.

According to the central bank, besides monetary policies, China also uses other administrative measures to rein in investment. For example, the re-enforcement of land-appreciation taxes collection since 1 February this year; the demanding for accountability of local officials in maintaining an affordable housing price level in the region; the minimum prices for the sale of land to be used for industrial development; Stricter regulations and rigid controls on environmental protection to be imposed on factories; and heavy fines on illegal property construction, etc.

## 2. Economic Growth and Income

China's economy continued to grow strongly in 1Q07 and 2006 (the fastest rate since 1995), as investment and exports powered ahead despite a raft of government curbs to keep the pace of expansion in check.

According to the NBS, in 1Q07, the GDP was 5028.7 billion yuan, up by 11.1% yoy than a year earlier, higher than the general forecast in later 2006. The GDP of 2006 was 20,940.7 billion yuan, up by 10.7 % yoy over the previous year. The growth figures were 10.4% yoy for 1Q06, 11.5% yoy for 2Q06, 10.6% yoy for 3Q06 and 10.4% yoy for 4Q06.

In 1Q07, the growth rates of value-added was 4.4% yoy for primary industry, 13.2% yoy for secondary industry, 9.9% yoy for tertiary industry respectively. In 2006, the value-added of the primary industry was 2,470.0 billion yuan, up by 5.0 % yoy. Such a growth rate was 0.2 percentage point lower than the 2005 growth rate. The value-added of the secondary industry was 10,200.4 billion yuan, up by 12.5 % yoy, 1.1 percentage points higher than the 2005 growth rate. The value-added of the tertiary industry was 8,270.3 billion yuan, up by 10.3 % yoy, 0.7 ppts higher than the 2005 growth rate. The value added of the primary industry, secondary industry and the tertiary industry contributed 11.8 %, 48.7 % and 39.5 % respectively to the GDP in FY2006.

Industrial production of the industrial enterprises above designated size grew by 18.3% yoy in 1Q07 and 18.0% yoy in Jan-Apr 07. Such growth rates in the first quarter were higher than the market expectation, and could be explained by the strong exports of industrial enterprises – their exports value achieved 1,495.6 billion yuan in 1Q07, up by 23.7% yoy over the same period of the previous year.

Urban and rural residents both benefited from the fast growth of the economy, resulting in a relatively high growth in their income. In 1Q07, both urban and rural residents' income grew at an accelerating rate, posting double-digit growths for the fifth quarter in a row. In the first quarter of 2007, the per capita disposable income of urban households rose to 3,935 yuan, up by 16.6% yoy in real terms. It was 5.8 ppts higher than that of the same period last year. The per capita net income of rural residents was 1,260 yuan, an increase of 166 yuan, up by 12.1% yoy, 0.6 ppt higher than the yoy growth of 1Q06. The rural growth rate was the highest since 1997. In 2006, per capita disposable income of urban households rose to 11,759 yuan, up by 10.4% yoy in real terms, and 0.8 percentage points higher than that of 2005. Per capita net income of rural households rose to 3,587 yuan, up by 10.2% yoy, or a real increase of 7.4% yoy—the highest growth since 1997. Still, income growth in the rural areas lagged behind that in the urban areas.

The Engel coefficient, which refers to the proportion of expenditure on food to the total expenditure of households, 35.8 percent for urban households in FY2006, 0.9 ppt lower; and 43% for rural households, 2.5 ppts lower than the previous year.

The robust economy, the government's determination to develop the rural economy, and the policy-shift from "growth-centred" to "people-centred" have exerted effect on reducing the poverty, especially in the rural areas. The population in absolute poverty in rural areas (i.e. with annual per capita net income below 693 yuan) numbered 21.5 million at the end of 2006, a decline of 2.2 million over the previous year. The low-income population in rural areas (i.e. with annual per capita net income between 694 and 958 yuan) numbered 35.5 million, a decline of 5.2 million.

Given the higher-than-expected economic growth in the first quarter, we have adjusted our earlier forecast on China's economic performance in 2007. Earlier we thought that the 2007 GDP growth may be a bit lower than last year – probably slightly below 10% yoy, with inflation remaining mild, FAI growth declining to around 20% yoy, and M1 and M2 growth rates remaining stable. Now we have become more optimistic as it has been confirmed that China has rebounded from a slowdown in 3Q–4Q06. We now forecast the 2007 GDP growth to reach 10.5%. The inflation would stay high at around 3% throughout 1H07, driven by rising food prices. It is generally predicted that the rise in food process would alleviate in 2H07 and thus China's price level will be more stable then.

In the longer term, the rural income is likely to record a further improvement or even a great leap as more favorable policies, measures and resources inputs into the rural areas and agriculture are expected to continue during the 11<sup>th</sup> National People's Congress. These may include the extension of basic living allowances, increased funding in medicine, training and technology, development of rural infrastructure and the modernization of rural financial system, etc.

### 3. Employment

With 10.7% yoy growth in GDP, the government's targets in 2006 —to contain registered urban unemployment below 4.6% and to create over 9 million jobs for urban residents — have been easily achieved.

According to the NBS, at the end of 2006, the total number of employed people in China amounted to 764.00 million, or 5.75 million more than that at the end of 2005. Of this total, 283.10 million were employed in the urban areas, an increase of 11.84 million or a net increase of 9.79 million, the highest in 15 years. In 2006, the registered urban unemployment rate was 4.1% by the end of 2006, 0.1 ppts lower than that of end-2005.

A total of 9.32 million urban Chinese found employments in the first nine months of the year, exceeding the annual target of 9 million. This is the first time in recent years that China was able to meet its yearly target three months ahead of the schedule.

It is the fourth consecutive year China has fully accomplished its goal for employment. This is also the first time the number of newly employed urban people exceeded 10 million in a year.

The goals in 2006 also include helping 5 million of laid-off workers from state-owned enterprises to get re-employed. By the end of 2006 about 5.05 million unemployed found new jobs, one percent higher than the original target.

However, it should be noted that these employment figures do not cover the rural areas, where there are much 'hidden unemployment' in the form of redundant labour forces.

China still faces huge employment pressure. Most of the employment pressure comes from workers laid off from state or collectively-owned businesses, an increasing number of university graduates, mostly born in the early 1980s baby boom, migrant workers and farmers made landless by industrial development or urbanization. Tackling the unemployment problem has become one of the biggest challenges for the government in the years to come.

In fact, a study conducted by the NDRC in 2006 says, to accommodate all the new job seekers, China need to create 25 million new jobs each year. It is China's worst employment crisis ever, as the children of the baby boomers flood the job market seeking their first jobs – their parents were born in the early 1960s, and they themselves in the late 1980s. However, According to the NDRC, China can only generate an estimated 11 million new jobs this year.

Of the 25 million people who need urban jobs, claimed by the NDRC, 9 million will be those joining the job market, 3 million will be former rural residents who have recently moved to cities, and the remaining 13 million are workers let go or about to be retrenched by their employers, mainly as a result of the continuous restructuring of state-owned enterprises. And of the 9 million newcomers, 4.1 million will be graduates, more than at any time in China's history.

The mismatch between the supply and demand of jobs is likely to continue throughout the whole 11<sup>th</sup> Five-year program period. Official figures from the Ministry of Labour and Social Security suggest that labor supply is expected to top 830 million by 2010. In urban areas, an additional 50 million residents will have joined the labor force by then, but only 40 million jobs will have been created, leaving 10 million people without work.

The most effective way to create new jobs, as many economists have suggested, is to create a conducive business environment to small and medium-sized enterprises, especially those with labour-intensive operations. Besides, the unemployment problem in China is in fact a 'structural' and 'frictional' one, since labour shortages in some areas, especially the Pearl River Delta, do exist, mainly caused by the lack of skilled and experienced workers. Thus, job training and retraining are also important to alleviate the unemployment problem in China.

The employment targets for 2007 are to create a total of at least 9 million jobs, and to control the urban unemployment rate under 4.6%.

#### **4. Central government budget, fiscal and tax policies**

According to the Ministry of Finance, in 2006, national revenue reached 3.93 trillion yuan (excluding revenue generated through debt), up by 769.43 billion yuan, or 24.3% from 2005. Total revenue exceeded the budget target by 392.02 billion yuan, consisting of 254.25 billion yuan at the level of the central government and 137.78 billion yuan at the local level. The fiscal revenue broke the two-trillion-yuan mark for the first time in 2003, exceeding 2.5 trillion yuan in 2004 and hitting 3.2 trillion yuan in 2005.

National expenditures amounted to 4.02 trillion yuan, an increase of 628.29 billion yuan or 18.5% yoy over 2005, representing 104.8% of the budgeted figure.

The various taxes collected in the whole year reached 3,763.6 billion yuan (excluding tariffs, farm land taxes and deed taxes), up by 21.9% or an increase of 677.0 billion yuan over 2005. The enormous tax revenue in 2006 has led the government to think about setting up reserve in the good year, in order to prepare for the years of recession that would bring about tight fiscal budgets. 50 billion yuan will be allocated from last year's excess revenue to establish a central budget stability fund in 2007. The fund will keep the central government budget more stable and preserve the continuity of fiscal policy, echoing the government's "scientific and rational" view of development.

As for the central budget in 2006: Total revenue in the central budget came to 2.12 trillion yuan (excluding the 61.3 billion yuan that was used to clear up the longstanding arrears in export tax rebates), which was 397.18 billion yuan, or 23% higher than the figure for 2005, and representing 110.2% of the budgeted figure. Total expenditures in the central budget amounted to 2.35 trillion yuan, 322.23 billion yuan or 15.9% more than that for 2005, representing 105.7% of the budgeted figure.

The government will continue to follow a prudent fiscal policy this year. The central government budget deficit will be reduced, and the government will work harder on adjusting and optimizing the orientation and structure of government investment. Huge emphases of the fiscal and tax policies will be placed on supporting agriculture and benefiting farmers to accelerate the building of a new socialist countryside – the government plans to allocate 391.7 billion yuan from the central budget for agriculture, rural areas and farmers for 2007, 52 billion yuan or 15.3% more than 2006. Other priorities of the fiscal and tax policies include education; medical care; employment, reemployment and social security work; changing the pattern of economic growth through promoting innovation, science and technology; resources conservation and environmental protection; combining the two laws on corporate income tax; and increasing transfer payments to improve the ability of local governments to provide basic public services.

According to the report by Ministry of Finance to the NPC, total revenue in the 2007 central budget should reach 2.44 trillion yuan, an increase of 318.88 billion yuan or 15% over the amount for 2006. Total expenditures in the central budget should total 2.69 trillion yuan, a rise of 338.88 billion yuan or 14.4% over 2006. Expenditures still exceed revenue in the central budget this year, leaving a deficit of 245 billion yuan. Such a budgeted deficit is 50 billion yuan lower than that of 2006.

80.4 billion yuan from the central government budget would be allocated for investment in regular development projects, up by 25 billion yuan from the amount in the 2006 budget. The government also plans to issue 50 billion yuan of long-term development treasury bonds, down by 10 billion yuan from last year.

## 5. Money Supply, deposits and loans

In April 2007, for the third month in a row, China's broad measure of money supply growth (M2) exceeded the government target set at 16%. M2 rose by 17.1% yoy in April from a year earlier, after reaching 17.3% yoy in March and 17.8% yoy in February. At the end of April, the narrow measure of money supply, or M1, grew by 20.0% yoy.

At the end of 2006, money supply of broad sense (M2), which covers cash in circulation and all deposits, was 34.6 trillion yuan, reflecting a yoy increase of 16.9%, 0.7 ppt lower than the previous year. It exceeded the central bank's original target of 16% yoy. Money supply of narrow sense (M1) was 12.6 trillion yuan, up 17.5% yoy, 5.7 ppts higher than the growth rate of 2005. Cash in circulation (M0) was 2.7 trillion yuan, up 12.7% yoy, 0.8 ppt higher compared to the 2005 growth rate (See Exhibit 1). The central bank said in its report that the overall money supply growth was 'basically in line with the economic expansion'.

# China Distribution & Trading

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Outstanding renminbi-denominated loans climbed 16.5% yoy in April from a year earlier, up from 16.3% yoy in March, showing that tighter lending rules and higher borrowing costs failed to curb investments in factories and real estate. Banks extended 422 billion yuan of new loans in April, compared with 441.7 billion yuan in March and 413.8 billion yuan in February. The total new loans in yuan for the first four months of 2007 amounted to 1.8 trillion yuan, more than half the 2006 total.

## Exhibit 1: Money Supply at Year-end, in trillion yuan

Year	M0	M0 (%)	M1	M1 (%)	M2	M2 (%)	M0/M1	M1/M2
1999	1.3	20.1	4.6	17.7	12.0	14.7	0.294	0.38
2000	1.5	8.9	5.3	16	13.5	12.3	0.276	0.40
2001	1.6	7.1	6.0	12.7	15.8	14.4	0.267	0.38
2002	1.7	10.1	7.1	16.8	18.5	16.8	0.244	0.38
2003	2.0	14.3	8.4	18.7	22.1	19.6	0.235	0.38
2004	2.1	8.7	9.6	13.6	25.3	14.6	0.219	0.38
2005	2.4	14.3	10.7	11.5	29.9	18.2	0.224	0.36
2006	2.7	12.7	12.6	17.5	34.6	16.9	0.214	0.36

Source: National Bureau of Statistics, PRC.

Since the middle of last year, the central bank has tried a number of times to tighten liquidity through monetary policies, including raising banks' reserve requirements and interest rates, as soaring exports, direct foreign investment and inflows of funds had boosted domestic liquidity. As a result of these macroeconomic adjustment measures, excessive growth of money and credit has somehow been contained, and credit structure has been improved. The rapid growth momentum of medium-and long-term loans has started to moderate. It is also estimated that, in 2006, the three reserve ratio hikes froze 460 billion yuan while open market operations withdrew about 410 billion yuan from the lenders. However, still, banks extended 3.18 trillion yuan of new loans in 2006, significantly exceeding the central bank's original target of 2.5 trillion yuan.

At the end of 2006, the balance of savings deposit in Renminbi and foreign currencies in all items in all financial institutions totaled 34.8 trillion yuan at the end of 2006, up 16.0% yoy. The balance of loans in Renminbi and foreign currencies in all items in all financial institutions reached 23.9 trillion yuan, up 14.7% yoy, while renminbi loans in all financial institutions increased by 15.1% yoy to reach 22.5 trillion yuan. Again, the divergence between savings and loans continued to widen. See exhibit 2.

## Exhibit 2: Loan-Deposit Ratios

Year	Total Deposits (trillion yuan)	Total Loans (trillion yuan)	Loan-to-Deposit Ratio (%)
1999	10.9	9.4	0.862
2000	12.4	9.9	0.803
2001	14.4	11.2	0.778
2002	18.3	14.0	0.762
2003	22.0	17.0	0.770
2004	25.3	18.9	0.747
2005	30.0	20.7	0.690
2006	34.8	23.9	0.687

Source: National Bureau of Statistics, PRC.

Loans in Renminbi from rural financial cooperation institutions (i.e. rural credit cooperatives, rural cooperation banks, and rural commercial banks) totaled 2.6 trillion yuan by the end of 2006, an increase of 427.7 billion yuan as compared with the end of 2005. The loans in Renminbi for consumption use from all financial institutions totaled 2.4 trillion yuan, an increase of 206.8 billion yuan. Of all consumption loans, those for individual housing totaled 1.99 trillion yuan, an increase of 143.9 billion yuan.

### Exhibit 3: Savings Deposits and Loans in Renminbi and Foreign Currencies of all Financial Institutions, 2006

Item	Year-end figure (billion yuan)	Growth (%)
Balance of Saving Deposits	34,807	16.0
Of which: By enterprises	11,888	16.8
By urban and rural residents	16,662	13.3
Of which: Deposits in RMB	16,159	14.6
Balance of Loans	23,852	14.7
Of which: Short-term	10,176	10.9
Medium- and long-term	11,317	21.3

Source: National Bureau of Statistics, PRC.

It is noteworthy that the People's Bank of China has announced in its annual report that the targeted growth rate of M2 is 16% for 2007. However, the Bank did not set goals for the growth of narrow money supply (M1) or bank credit as it had done before, which were interpreted as a sign of more flexible monetary policies and macro-control measures to come. Given the rapid economic growth and a more market-oriented banking sector, it seems less practical to set goals for specific indices like new bank loans, especially when there are excessive liquidity and speculative activities in the stock and property market.

Given the higher-than-expected growth, excessive liquidity and asset market bubble since the beginning of the year, the PBOC has been adopting a series of tightening measures. On 18 May, 2007, China's central bank announced a new set of tightening measures: beginning from 19 May, it raised the one-year benchmark deposit rate to 3.06% from 2.79%, while the one-year benchmark lending rate rose to 6.57% from 6.39%; From 5 June onwards, the required reserve ratio will be increased to 11.5%. This is the first time in a decade that the central bank has simultaneously raised the benchmark interest rates and the bank reserve ratio, showing the government's determination to cool down the higher-than-expected economic growth and curb the excessive liquidity.

This is the fourth time since April 2006 China raises interest rates to curb inflation and reduce asset bubbles, and is the second interest rate rise in 2007 after the central bank had raised commercial banks' deposit reserve ratio by 0.5 percentage points four times earlier this year to rein in excessive bank lending. This is also the eighth time in a year, and the fifth time in 2007 that PBOC increases required reserve ratio.

The central bank stated on its website (18 May) that raising interest rate and required ratio in one public announcement aim to "strengthen liquidity management in the banking system, rationalize the growth of lending and investment as well as maintaining price stability".

The recent wave of tightening measures largely reflect the central bank's concern over the trends shown by a series of latest economic indicators: China's economy expanded at the fastest pace in 11 years in 2006 and the GDP growth in 1Q07 was over 11%, much higher than many had estimated; China's trade surplus for the first four months of 2007 widened to US \$63.3 billion, 88% yoy more than a year earlier; In February, the trade surplus surged nine-fold from a year earlier to reach USD23.8 billion, the second-highest month on record; Money supply grew to 17.8% yoy in February, the most in six months – despite the fact that M2 growth later decelerated to 17.1 % in April, it still exceeded the central bank's 16 percent target set at this year for the third month in a row; Inflation accelerated to 3.3% yoy in March, the highest in more than 2 years and 3% yoy in April, up from 2.2% yoy in January and 2.7% yoy in February, driven by rising food prices. Industrial output also grew by 18.3% yoy in 1Q07, 1.6 ppts higher than the same period last year, hitting a 10-year high and fueling a rebound in fixed asset investment growth.

It seems that the central bank would opt to raise deposit reserve ratio when there is excess liquidity in the banking system and inflation pressures remain moderate, but would tend to adopt an interest rate rise once inflation pressures increase.

Also, the central bank would closely monitor the property prices and the stock market, as both are believed to be fuelled by excessive liquidity in the country's banking system. Chinese households have been rushing into the stock markets, with the number of stock market participants reaching the 100 million level. And according to the NRDC and the NBS, property prices in the 70 surveyed cities grew by 5.6% yoy in January, 5.3% yoy in February, 5.9% yoy in March and 5.3% yoy in April. In April, both Beijing and Shenzhen's housing price growths surpassed 10% yoy level. Prices of new homes grew by an average 5.3% yoy on a yearly basis, 0.9 ppts lower than the yoy growth of April 06 and 0.7 ppts lower than yoy growth of March 07. The trend became more moderate and it was not high at all, in line with the economic growth that is running a little bit faster but not overheating.

In our view, we expect to see two or three more rises of the required reserve ratio in the rest of 2007, probably each time by 0.5 ppt, as we see the excessive liquidity problem persisting and not likely to be solved in the near future.

Besides, it is generally believed that the most recent 0.27 ppts rise in the interest rates and series of required reserve ratio hikes did not herald the end of the central bank's macro-control policy. If the economy continues to be disproportionately driven by investment and production, and if the CPI continues to be at high numbers, it is likely to see at least one more interest rate rise by end-3Q07. It would be also of no surprise if the required reserve ratio further rises to 13% by end-07, from 11.5% currently.

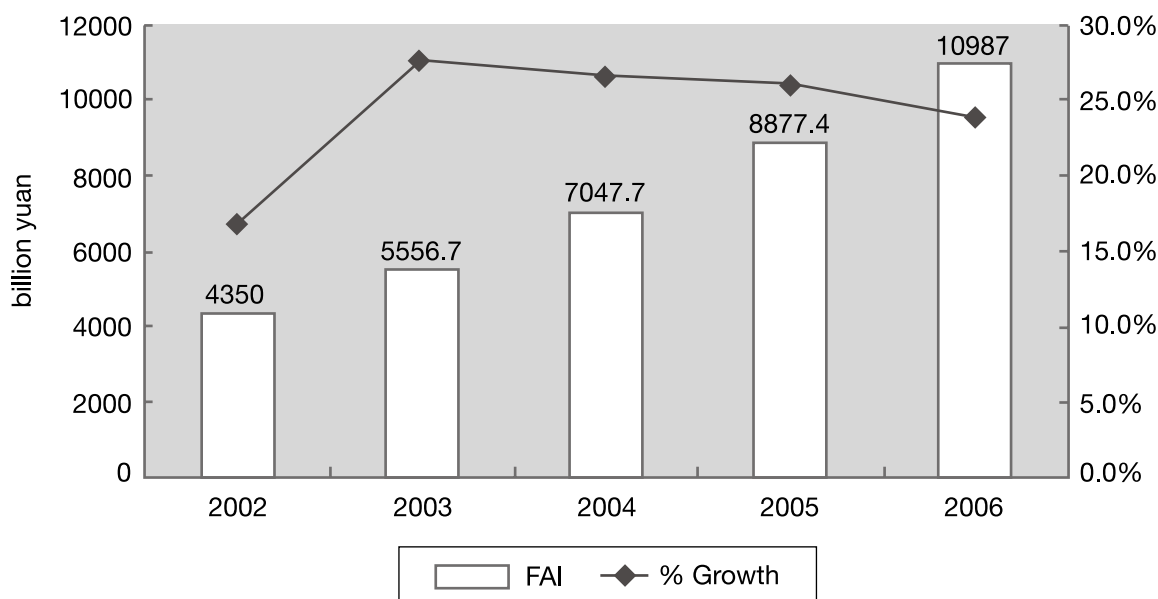
However, an interest rate rise, or a narrowing interest rate gap between China and the US, will induce more funds flowing into China. This would put RMB under greater pressures to appreciate and, if RMB is not to appreciate faster, would necessitate more sterilization by the Central Bank in order not to create extra liquidity. Therefore, still, economic restructuring is the only way to solve the problems of excess liquidity and overheated investment at the root.

## 6. Fixed Asset Investment

In 1Q07, FAI growth grew by 23.7% yoy, actually rebounding from the 4Q06 growth rate, and was much higher than the 13.8% yoy growth in December 2006. Urban FAI also accelerated, growing by 25.3% yoy in 1Q07 and by 25.5% yoy in Jan-Apr. Thus, the figures just reveal that investment growth in China has been gaining momentum in the beginning of the new year.

Investment in fixed assets (FAI) moderated in 2006. The completed investment in fixed assets of the country in 2006 was 10,987.0 billion yuan, up by 24% yoy over the previous year. Such a growth rate, compared with the 26.6% growth of 2004 and the 25.7% growth of 2005, suggests that the runaway FAI growth has gradually been under control. Of the overall FAI, the FAI in urban areas was 9,347.2 billion yuan, up by 24.5 % yoy; FAI in rural areas was 1,639.7 billion yuan, up by 21.3 % yoy. (See Exhibit 4 and 5)

**Exhibit 4: Investment in Fixed Assets, 2002-2006**



Source: National Bureau of Statistics, PRC

**Exhibit 5: Investment in Fixed Assets, 2006**

Item	Value (billion yuan)	yoy growth (%)
Investment in fixed assets	10987.0	24.0
By Location:		
Urban areas	9347.2	24.5
Of which: State-owned entities and others	4521.2	16.9
Rural areas	1,639.8	21.3

Source: National Bureau of Statistics, PRC.

In fact, the NDRC Director Ma Kai warned earlier that the risk for a rebound in FAI growth still existed, said that the government would keep growth drivers such as FAI under control. In his eyes, the FAI growth rates of 2006 or early-2007 are still too high. He also raised his concerns over some 'fundamental problems' which would retrigger rapid investment expansion. For example, local governments tend to seek rapid investment growth to boost local economies despite the central government directives to slow down investment. It should be noted that local FAI projects made up more than 88 percent of total national FAI in 2006.

This year, we expect to see government taking further actions to curb excessive investment and production capacity through tightening liquidity and bank loans, stepping up land controls, making project approvals harder, and raising market entry thresholds. Still, since many of the government projects to be carried out this year have been planned in advance, containing the FAI growth seems not an easy job.

## 7. Consumption

In 2006, China's retail sales rose 13.7% yoy in nominal terms to 7,641 billion yuan, from a growth of 12.8% yoy in 2005. It was mainly driven by higher petrol sales (36% yoy), car sales (26% yoy) and sales of housing materials (24% yoy).

In terms of different sectors, the sales of the wholesale and retail industry reached 6,432.6 billion yuan, up 13.7% yoy; the sales of the lodging and catering industry was 1,034.5 billion yuan, up 16.4% yoy, and the sales of the other industries was 173.9 billion yuan, up 2.3% yoy. In terms of different areas, the retail sales of consumer goods in cities reached 5,154.3 billion yuan, up by 14.3% yoy and the retail sales of consumer goods at and below county level was 2,486.7 billion yuan, up by 12.6% yoy.

The robust growth in retail sales suggests that domestic consumption is gradually becoming a more important growth engine of the Chinese economy – in line with the government's thinking that consumption, rather than investment, should become the major engine of economic growth by 2020.

In the first quarter of 2007, China's total retail sales accelerated and grew by 14.9% yoy in nominal terms to 2,118 billion yuan. The monthly growth rate marked a high of 16.9% yoy in February due to the Lunar New Year effect - higher than yoy growth in any single month during the past year. The strong growth in the domestic consumption market was an extension of the momentum in 4Q2006. In March, the growth of retail sales recorded 15.3% yoy and it further climbed to 15.5% yoy in April.

In 1Q07, in terms of different regions, the retail sales of consumer goods in urban areas was 1,433.3 billion yuan, up by 15.5% yoy; Retail sales at and below the county level was 685.5 billion yuan, up by 13.7% yoy. By sector, wholesale and retail business rose by 14.7% yoy to 1,784.2 billion yuan. Catering sector grew by 17.4% yoy to hit 298.36 billion yuan.

It is noteworthy that China's retail sales in the catering sector further jumped 17.6% yoy to 388.01 billion yuan in the first four months of 2007, accounting for 13.9% of total retail sales in China during this period. The figures revealed that people improved their living standards by spending more on things that they did not buy much before, such as tourism and entertainment. Higher income in the world's fastest-growing economy has prompted more people to travel and eat at restaurants.

Looking ahead, we expect to see robust consumption growth throughout 2007, with total retail sales growing by more than 14%. Economic development, income growth and consumption upgrading of the Chinese people, government policies (especially through rural development and boosting farmers' income, improving public services and social welfare) will give Chinese consumers the desire and confidence to save less and spend more in the upcoming future.

Consumer prices has also been picking up. Though the overall CPI in 2006 remained mild at 1.5% yoy, the CPI in December jumped remarkably to 2.8% yoy from 1.9% yoy in November. And after a brief dip to 2.2% yoy in January this year, the CPI growth rebounded to 2.7% yoy in February, and accelerated to 3.3% yoy in March and 3.0% yoy in April. The rise in CPI growth mainly stemmed from the increases from food prices, although the combined pass-through of rising wages and mid-stream heavy industrial prices would also add to the inflationary pressures. It is generally predicted that the rise in food process would alleviate in 2H07 and thus China's price level will be more stable then.

According to the latest report by the NDRC to the NPC, the Chinese government plans to keep the country's CPI under 3% this year. Thus, in the coming months the government should be closely monitoring the CPI numbers, and it is likely to see another interest rate rise in the second or third quarter if the CPI growth remains high, and if any sign of a spillover from food prices to the broader prices emerges.

## 8. Foreign trade

Contrary to earlier predictions that the growth of trade surplus would obviously slow down due to earlier export tax rebate policy since September 2006, China's trade surplus almost doubled in the first quarter over the same period last year – The quarterly surplus widened to USD 46.4 billion from USD 23.3 billion a year ago. Along the first four months of the year, there were dramatic ups-and-downs in the monthly records of trade surplus. In January, the trade surplus jumped 67% yoy to USD 15.9 billion. Even more surprising was the higher-than-expected increase in February that the trade surplus skyrocketed to USD 23.7 billion, almost tenfold from a year earlier. However, in March, the surplus plunged to USD 6.87 billion (-38% yoy), just about 29% of that recorded in February, much lower than many had estimated. The April surplus hit USD 16.88 billion, up 63% yoy. It brought the trade gap for the first four months to USD 63.3 billion, an increase of 88% yoy. The widening trade surplus stems from the fact that export growth continued to outpace import growth in the first four months of the year.

Despite the ballooning trade surplus in the first quarter (USD 46.4 billion) compared with 1Q06, it showed a moderate downward trend over 3Q06 (USD 48.7 billion) and 4Q06 (USD 67.7 billion). The trade surplus in March even went down to USD 6.8 billion, breaking the line below USD 10 billion for the first time since March 2006. The extraordinary increase in export in the first two months (33.0 % yoy in Jan; 51.7% yoy in Feb) of the year and the sharper-than-expected slowdown of yoy growth in March export was possibly a result of Chinese exporters' rushing to export their goods in January and February out of concerns over further reductions in export tax rebate.

The government has identified "promoting imports" as the key way to narrow the huge trade surplus, we expect to see import growth to accelerating for the rest of the year. From 1 April onward, Chinese firms would see formerly crucial import license lifted for imports in 338 categories. Moreover, in the Canton Fair (China Import and Export Fair), China's largest trade event held in April every year, the "imports section" was added in for the first time this year. In the past, the Canton Fair only focused on export. The government has also encouraged domestic companies to import state-of-the-art equipment and technologies. On the other hand, the government would continue to curb exports through discouraging low-end processing trade and upgrading the export structure. Since 20 May, China has applied export license management to 83 steel products to rein in the expanding steel exports and trade surplus. The above policy measures to encourage imports, while discourage exports (in particular, the low-end export processing trade) is likely to result in a decrease in trade surplus for the rest of the year.

## Exhibit 6: Foreign Trade monthly figures, Jan – Apr 2007

<b>Exports</b>	<b>Value (USD billion)</b>	<b>yoy growth (%)</b>
January	86.6	33.0
February	82.1	51.7
March	83.4	6.9
April	97.5	26.8
<b>Imports</b>	<b>Value (USD billion)</b>	<b>yoy growth (%)</b>
January	70.7	27.5
February	58.4	13.1
March	76.6	14.5
April	80.6	21.3

Source: Chinese Custom

In the first quarter, exports under processing trade grew by 24.0% yoy to USD 133 billion, 1.5 pts faster than the yoy growth of 2006; imports increased by 10.9% yoy to USD 78.6 billion, 6.4 pts slower than the growth of last year. Under general trade<sup>1</sup>, export rose by 31.9% to USD 108.1 billion, 0.2 ppt lower than the 2006 yoy growth, while imports increased by 22.5% yoy to USD 91.6 billion, 3.4 pts higher than the 2006 yoy growth.

The accelerating growth of import under the general trade versus the decelerating import under the processing trade indicated the slowdown in importing raw materials and components for the purpose of re-exporting the finished-goods. Instead, import under general trade would still continue to grow and play a more important role in reducing the trade surplus, given the support of government policies.

The government aims to cut processing trade to narrow down the surplus. In addition to further reduction of export tax rebate on certain products highly involved in processing nature (for example, steel), the government tried to ban processing trade in more categories of chemical and resource products. A new policy took effect on 26 April, as the latest move to restrict the export of resource-intensive products and to balance trade. *The 2007 Prohibited List for Processing Trade*, which includes 186 new categories, bans processing trade enterprises from dealing in 990 products. On 12 April, the MOFCOM issued the *Circular on Issues concerning the Strengthening of Processing Trade Management*, calling on processing trade enterprises to optimize their structure, improve efficiency and make proprietary innovations. The circular is aimed at forbidding processing trade enterprises from engaging in the processing of high energy consumption, high pollution and low value-added products, thereby pushing forward the transformation and upgrading of the enterprises.

This growing trade surplus has led to frequent trade frictions and triggered protectionist measures from China's trading partners; while the large international payments surplus has been pressuring the Renminbi to appreciate. Surely the latest surge in trade surplus is giving more ammunition to the US politicians calling for a strong yuan.

<sup>1</sup> General trade refers to the import or export of goods by enterprises in China with import-export rights. According to the Chinese statistics, the scope of general trade covers: imports and exports using loans or aids; the imports of materials by foreign invested enterprises (FIEs) for processing of goods for sale in the domestic market; the export of goods purchased by FIEs or manufactured by processing domestically-produced materials; the imports of food and beverages by restaurants and hotels; the supply of domestically-produced fuel, materials, parts and components to foreign vessels or aircraft; the import of goods as payment in kind in lieu of wages in labour service cooperation projects with foreign countries; and the export of equipment and materials by enterprises in China for their investment abroad.

On 18 May, PBOC announced the widening of the managed floating exchange rate band. Effective as of 19 May, the floating band of RMB trading prices against the US dollar in the inter-bank spot foreign exchange market was enlarged from 0.3% to 0.5%. The Chinese currency will then be able to respond to market changes more flexibly. We don't see it as a very meaningful move as the previous band has never been tested. However, it is a political gesture as a preparation for the Sino-US Strategic Economic Dialogue later in the same month.

The surging trade surplus was also an important reason for the accelerating growth of money supply, despite the fact that the central bank had already raised the required reserve ratio four times (fifth time on 5 June, 07) since beginning–2007 to rein in liquidity.

Earlier in January this year, a spokesperson of the Ministry of Commerce pledged to correct the trade imbalance through increasing imports. It was the first time the Chinese government laid such a great stress on “import promotion”. The government would focus on imports in strategic areas by encouraging imports of key equipment, technology and resources by adjusting tariff rates; strengthening financial support for imports with targeted loans; opening domestic markets for regional economic cooperation; and encouraging imports from the least developed countries in Africa by scrapping tariffs on goods from those countries. The government is also trying to increase imports through some major trade fairs. As mentioned above, the country's largest trade fair, the Chinese Export Commodities Fair (also known as the Canton Fair), included import exhibitions for the first time at its April showing this year.

During the NPC, Bo Xilai, Minister of the Ministry of Commerce claimed that China was never in pursuit of huge trade surplus but trade balance with her trading partners. He reiterated that ‘trade surplus’ was not equivalent to ‘making profits’, and repeatedly argued that ‘trade surplus was on China's side, but profits were largely captured by the US and Europe’, and that the cheap and high quality Chinese exports had benefited the importers, retailers and consumers in the importing countries most. He further pointed out that the huge Sino-US trade surplus was largely a ‘structural’ issue against the background of globalization – part of the Sino-US trade surpluses were actually ‘transferred’ from the trade accounts of other Asian countries, Japan and Korea in particular, to the trade account of China.

During the second round of the US-China Strategic Economic Dialogue (SED) in May, China further suggested that the US should expand the range of exports of high-tech products and technologies to narrow the trade gap. At the same time, a China's purchasing delegation to the U.S. in May signed deals worth USD 32.6 billion, including the purchase of high-tech products such as aircraft engines and telecommunication equipments. The delegation also agreed to buy cellphones, cars and automotive spare parts, computer softwares, etc. from the US. Thus import of high-value added products is likely to rise steadily for the rest of 2007.

Despite the high trade and export figures in Jan-Apr 07, we maintain our earlier forecast that China's exports will see its momentum slowing down this year, due to the following factors: the slower economic growth in the US; the rise in protectionist sentiments and the increase in international trade frictions; RMB appreciations; slowdown in FDI; Government policies to discourage low value-added export processing activities; the shifting in growth strategy of the Chinese economy from “investment-led” and “export-led” to “consumption-led”.

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On the other hand, with the policy support of the government, import will continue to be strong this year, supported by factors such as RMB appreciation; the robust increase in household income; the emerging middle class; government policy to boost consumption; the influx of foreign consumer goods, especially branded products and luxury goods, due to their rising popularity in the markets. Therefore, we expect to see import growth gradually catching up or even surpassing the export growth this year – and thus trade surplus will grow slower or even narrow this year.

## Exhibit 7: Import and Export by Major Categories, Jan – Mar 2007

Item	Value (USD billion)	yoy growth (%)
<b>Total of Imports and Exports</b>	457.7	23.3
<b>Exports</b>	252.1	27.8
Of which:		
General Trade	108.1	31.9
Processing Trade	133.0	24.0
<b>Imports</b>	205.7	18.2
Of which:		
General Trade	91.6	22.5
Processing Trade	78.6	10.9

Source: National Bureau of Statistics, PRC.

## Exhibit 8: The Ten Largest Trading Partners of China in 2006

Country/Region	Trade value (USD billion)				year-on-year growth (%)		
	Total exports and Imports	Exports	Imports	Trade Surplus	Total exports and imports	Exports	Imports
Total	1760.7	969.1	791.6	177.5	23.8	27.2	20.0
EU	272.3	182.0	90.3	91.7	25.3	26.6	22.7
US	262.6	203.5	59.2	144.3	24.2	24.9	21.8
Japan	207.4	91.6	115.7	-24.1	12.5	9.1	15.2
Hong Kong	166.2	155.4	10.8	144.6	21.6	24.8	-11.8
ASEAN	160.8	71.3	89.5	-18.2	23.4	28.8	19.4
Korea	134.3	44.5	89.8	-45.3	20.0	26.8	16.9
Taiwan	107.8	20.7	87.1	-66.4	18.2	25.3	16.6
Russia	33.4	15.8	17.5	-1.7	14.7	19.8	10.5
Australia	32.9	13.6	19.3	-5.7	20.9	23.2	19.3
Canada	23.2	15.5	7.7	7.8	21.0	33.1	2.2

Source: National Bureau of Statistics, PRC.

## 9. Foreign direct investment

In the first quarter of 2007, China received USD 15.9 billion of utilized FDI, marking a growth of 11.6% yoy, after continuous monthly drops last year. The growth rate was 5.2 ppts higher than that of 1Q06. The number of newly established enterprises with FDI in the first three months was 9,497, up by 4.4% yoy. The upward trend was partly due to the more visible government policy direction towards FDI, especially after the passing of the law for unification of the tax rates for foreign and domestic enterprises, as well as the government's determination in boosting FDI in service and high value-added sectors. It is believed that some foreign investors had been holding their investment in China last year before the picture was clear. With a number of favourable factors such as the strong economic expansion, growing consumer market and the 2008 Beijing Olympics, the FDI growth is likely to reach 10% this year, compared with the 4.5% growth in 2006.

In 2006, China received USD 69.5 billion of utilized FDI, down by 4.1 % yoy over the amount of 2005 (USD 72.4 billion). The negative growth rate contrasts sharply with the high growth rate of 2005 (19.42% yoy).

If we look at the decomposition of the FDI by sector, the trend could be explained by the large amount of FDI in the sector of "banking, insurance and securities" in 2005, and then a significant decline in the sector in 2006. Excluding this sector would give us an utilized FDI figure of USD 63.0 billion in 2006, up by 4.5% yoy, compared with the -0.5% yoy growth of the previous year. The number of newly established enterprises with FDI also dropped to 41,485, 5.8% lower than in 2005.

By sector, in 2006, utilized FDI in the manufacturing sector accounted for 57.7% of the total utilized FDI; in real estate development, 11.8%; in financial intermediation, 9.7%; in leasing and business services, 6.1%; in transport, storage, post and telecommunication services, 2.9%.

Renminbi revaluation, the rising labor cost in China, competition from the BRICs, especially India and Russia, and increasing international trade protectionist sentiments towards China have reduced the relative attractiveness of China to foreign investors. Besides, government policies in 2006 such as strengthening regulations on processing trade and reducing export tax rebates in some categories were eroding the favorable policies for foreign investors since the reform in 1978.

During the National People's Congress in March, the government raised the corporate tax paid by foreign enterprises to 25% from 15% and lowered the rate from around 35% to 25% for domestic enterprises, in order to create a fair competition environment for both. However, the unification of corporate tax income was unlikely to have a great impact on FDI as China is such a big market with rapid urbanization and rising middle class that is accumulating wealth in an accelerating rate, not to mention there is 5-years transitional period for the foreign enterprises. It was also noteworthy that China was restructuring its economy through better utilizing the foreign investment. China was promoting FDI in high value-added manufacturing sectors while suspending approvals for foreign investments in high-pollution and low-efficiency ventures. It also encouraged FDI in service sectors such as railway, telecommunication, banking and finance that had previously excluded foreign investors. As government policy is paying more attention to the quality, rather than quantity, of the foreign investment, we expect to see FDI growing only steadily in the years to come, with the growth tilting towards the tertiary sector and the high-tech industries.

On the other hand, Chinese government has put more emphasis on the quality rather than quantity of FDI in order to achieve industrial upgrading and reduce environmental pollution through better utilization of foreign capital.

Favorable policies will increasingly be tilted towards foreign investment in new horizons such as R&D, hi-tech, sophisticated design and high value-added services, moving away from the traditional areas such as simple processing, assembly and low-valued manufacturing.

Moreover, government will optimize investment inflow to the country to offset any negative impact from policy adjustments. The government would accelerate plans to publish foreign investment guidelines in 2007. It will also encourage foreign investors to move from the nation's coastal to central and western regions.

And as disposable incomes are gaining at the pace of >10% a year, foreign enterprises are increasingly viewing China as a huge consumer markets rather than merely as a cheap production and sourcing base – another factor leading to the structural change in FDI in the years to come. There should also be the last wave of capital influx, hoping to capture the enormous economic development or market opportunities presented by the 2008 Beijing Olympic Games.

Overall, given that the Chinese government no longer crave for FDI as before, and is becoming picky about the nature, industry and environmental impact, etc. of the FDI, we expect to see, at most, a moderate growth in FDI this year.

## 10. Foreign exchange reserves and currency rate

Having attracted more foreign investment than any other developing country for 15 consecutive years, as well as recording huge trade surpluses for a number of years, China has been holding a foreign exchange reserves exceeding USD 1 trillion! At the end of 2006, China's foreign exchange reserves reached USD 1,066.3 billion, an increase of USD 247.5 billion as compared with that at the end of the previous year. China has overtaken Japan as the largest foreign reserves holder since February 2006. At end-March 2007, China's foreign exchange reserves topped US\$1.2 trillion. There were new additions of US\$135.7 billion in 1Q07, pushing its holdings of foreign exchange reserves up by 12.7% from the end of last year and 37.4% yoy than a year earlier. The boost was driven by continuous increases in foreign direct investment, which jumped 11.6% yoy to US\$15.9 billion in 1Q07.

The government has been eager to seek more channels to ease the pressures of its ever-rising foreign exchange reserves, which is estimated to continue growing after it quintupled in the past five years. Thus, contrary to its policies in the past, the government has implemented stricter regulations on incoming foreign exchange and loosened rigid controls on outgoing reserves. For example, it has allowed businesses to keep a larger share of their foreign exchange income. In 2006, the State Administration of Foreign Exchange granted 15 banks overseas investment quotas totaling US\$13.4 billion; 15 insurance companies were granted the quotas totaling US\$5.17 billion and one fund management company was given a quota of US\$500 million. Besides, it has encouraged financial investment abroad in the form of qualified domestic institutional investors (QDII). On 11 May, the China Banking Regulatory Commission announced on its website that commercial banks can invest as much as 50% of funds in the form of QDII in overseas stock markets. This was the first time China would let its banks buy shares overseas, diverting some of the country's 35 trillion yuan of savings from the domestic red-hot A-share market.

During the NPC, Premier Wen Jiabao pointed out in his government work report that the government would strengthen and improve foreign exchange administration, and actively explore and develop channels and means for appropriately using the foreign exchange reserves. The central government also announced the establishment of the State Foreign Exchange Investment Company, a ministry-level bureau directly under the State Council, in order to better make use of its massive foreign exchange reserve.

The new company will be transformed from Central Huijin Investment Co Ltd, an investment arm of the central bank. It will be comprised of several sections dealing with businesses in different segments of the financial sector, such as banking, insurance, securities, and forex investment. The new company would probably manage up to USD 200 billion of forex.

Once established, the company will draw from international successful experiences, in particular the Temasek Holdings of Singapore, in its management of foreign exchange investment. The Temasek Holdings of Singapore is a state-held financial company, which has been regarded as one of the best performing government-controlled enterprises.

Besides, the management of foreign exchange reserves and foreign exchange investment would be separated then. According to the Finance Minister Jin Renqing, the establishment of the new company is aimed at "making more profits by means of foreign exchange investment", while the regular management of foreign exchange reserves will continue to be done by the State Administration of Foreign Exchange.

On 21 May, China's new state investment agency has invested USD 3 billion in a renowned private equity firm, the Blackstone Group of the US, a sign of Beijing's eagerness to get a higher return on its hoard of currency reserves.

The yuan's exchange rate against the US dollar continued to rise last year. The yuan ended at 7.8051 against the dollar on the last trading day of 2006, appreciated by 5.7% since the fixed exchange rate of 8.28 to the greenback had been abandoned on 21 July 2005; and by 3.4% over the exchange rate at the end of 2005. This year, we expect to see the yuan appreciating further by about 5% against the US dollar.

While the US party leadership sees the demand for faster yuan appreciation as an act of economic warfare, China would take a firm stance in order not to repeat the historical mistake made by Japan in the 1980s. The Chinese government is reminded of the lesson that the yen's marked appreciation in the 1980s was the major factor leading to the burst of the bubble economy, and injuring the dynamics of the Japanese economy throughout the 1990s and the beginning of the 21<sup>st</sup> century. There are similarities in the two economies, both of which depend greatly on foreign trade and capital.

Furthermore, given the massive foreign exchange reserves held by China, China would incur huge losses in renminbi terms if the yuan appreciates significantly, especially for those US dollar-denominated assets.

Therefore, enhancing domestic consumption, encouraging imports and capital outflows through relaxing controls and QDII, finding better ways to 'spend' the foreign currencies, and being more picky about the incoming FDI are all fundamental ways to solve the structural problems caused by the ever-rising foreign exchange reserves and the "undervalued" RMB exchange rate.

## 11. Reforms of the Central Enterprises

In 2006, the central enterprises, referring to those SOEs directly under the management of the central government, have performed much better than before. According to the State Assets Supervision and Administration Commission (SASAC), the total profits of the central enterprises hit a record 754.69 billion yuan, up by 18.2% yoy; and posted sales totaling a record 8.14 trillion yuan, up by 20.1% yoy last year. By sector, central enterprises involving armaments, power, machinery, construction, commerce and trade reported growth of around 20%, while those in the sectors of telecommunications, metallurgy, mining, and petro-chemistry posted less impressive growth. Overall, Central enterprises exported 277.81 billion yuan of goods last year, 40% yoy higher than the previous year.

These figures show that government's unremitting efforts, especially since the setting up of the SASAC in 2003, in restructuring and optimizing the SOEs have been successful in raising the efficiency and improving the profitability of the SOEs. It should also be noted that a key factor behind the success of the SOE reforms was the reorienting of state capital away from non-critical areas towards strategically important sectors. At present, three-quarters of the total assets of the central enterprises concentrate in seven sectors — military industry, power grid and generation, oil and petrochemical, telecommunication, coal, civil aviation, shipment. Though less than 50 central enterprises are engaged in these industries, they contributed around 80% of the total profits of all central enterprises.

Although the central enterprises were making considerable profits during the past few years, most of them are still poor in corporate governance, management, innovation and efficiency. Whether or not they will continue to be profitable in the future is also questionable as 2007 is the first year of China's fully opening up, after the WTO transitional period came to an end in December 2006.

In the eyes of the central government, there are at least a number of reasons why the central enterprises should act fast to sharpen their competitiveness: First, the weak central enterprises would create the market expectation that they can only make money under the State protections and supports. Given that, private enterprises and foreign investors will be more prone to engage in businesses associated with the central enterprises, in an attempt to benefit from these assumed protections and supports. Surely this will undermine the government effort to establish a free, market economy in China. Second, the uncompetitive SOEs would harm the welfare of the general public, through providing uncompetitive products or services to the consumers, or else the government would have to use the taxpayers' money to subsidize the inefficient SOEs. Third, since most of the central enterprises are monopolizing the supply of products and services of strategic importance to the nation, their lack of efficiency, flexibility or creativity would pose substantial threats to national security.

The central government is fully aware of the problem, and we expect that the SOE reforms and restructuring will accelerate this year. Last December, the State-owned Assets Supervision and Administration Commission (SASAC) issued a guideline, urging high-quality SOEs to either go public directly or inject their high-quality assets or units into their existing, listed subsidiaries.

China is currently working on a scheme for the integrated listing of the central enterprises, which is expected to be worked out within this year. Under the scheme, the central enterprises will undergo shareholding transformation and then have their parent companies or main operations gone public mainly on the domestic A-share market. The integrated listing would lead to the decline of state-owned equities in the central enterprises, but the government claims that it would not

weaken the state control over them. The integrated listing would also help to improve the operation and efficiency of the central enterprise. At present, many subsidiaries of the central enterprises have been listed on domestic or overseas stock markets.

An alternative to the central enterprises, if they opt not to be listed directly, is to 'inject' their high-quality assets into their listed subsidiaries. In fact, 'asset injections' have become, and will continue to become one of the major triggers of investors' enthusiasm in the stock market – Shares prices of the listed subsidiaries are very likely to see marked gains once asset injections are announced, or even anticipated. We expect to see more and more asset injection activities in the near future.

In both cases, investor confidence in the listed central enterprises or subsidies would be based on the expectation that the government's continual efforts to restructure the SOEs will improve their competitiveness and boost their earnings. Besides, the earlier successful reform to convert non-tradable shares to tradable shares have laid a solid foundation for the SOEs to go public – since the reform have lined up the interests of the major shareholders with the small shareholders (and thus protecting the interests of the latter) and created more incentives for the former to enhance the earnings (and thus the share prices) of the listed companies.

Furthermore, both the state and the central enterprises will benefit a lot from either move, which will greatly enhance the profitability, market value and liquidity of their assets.

As restructuring, mergers and consolidations have progressed over the last three years, the number of central enterprises has dropped from 196 in 2003 to 159 in 2006. The SASAC aims to further reduce the number of central enterprises to 80-100 by the year 2010 and, of which, 30-50 would have become globally competitive by then.

## **Part Two: Development philosophy, guiding principles, and strategic thinkings of the Central Leadership**

### **1. President Hu Jintao's "Scientific Development Perspective" and "The Building of a Harmonious Society" were canonized as the leading ideology and guiding principle of the country's development, together with the "Three Representatives" & "Deng Xiaoping Theory", in the first time, by the CPPCC**

The 5<sup>th</sup> Session of the 10th National Committee of the Chinese People's Political Consultative Conference (CPPCC), China's top advisory body, concluded the annual meeting on 16 March 2007. During the closing session, a political resolution was adopted, addressing the theoretical significance of President Hu Jintao's "Scientific Development Perspective" and "The Building of a Harmonious Society".

The resolution raised the above strategic thinkings of President Hu to the same height as the "Three Representatives" and "Deng Xiaoping Theory", as the leading ideology and guiding principle of the country's development. It also suggested a political dimension to this concept – the strategic thinking was recognized as "the newest fruits of Chinese Marxism, having gathered the heartfelt support and consensus of people from all walks of

life throughout the nation. They have become the common base of thinking in uniting the Chinese people. Moreover, the momentum derived from these thinking weapons could advance the development of a socialist society with Chinese characteristics". The resolution put emphasis on the continuation of the implementation of these strategic thinking as the guarantee of the realization of the goal of an "all-round well-off" (*xiaokang*) society in the country.

Furthermore, the resolution pointed out that the year 2007 is of great importance to the country's drive of consolidating scientific development and building a harmonious socialist society, in order to address the problems encountered in the contemporary development and reform of the country and thus sustain the modernization and opening-up process of a socialist China.

This is the first time that the strategic thinking of President Hu was interpreted and signified in such a canonical and influential way by the CPC. The scientific development perspective is now viewed as defining the ideology of the fourth generation of government leadership managed by Hu Jintao and Wen Jiabao.

In fact, Hu and other state leaders have been promoting this new perspective or approach to economic development for several years. It aims to correct the presumed overemphasis in recent years on the pursuit of GDP growth, which neglects the ecology, regional gap, development of social welfare, people's lives in the rural area and the hinterland, and other structural problems arising in the course of the economic reform and opening up of China. In brief, the scientific development perspective looks for a stable, balanced, coordinated and sustainable growth model. "Being based on the people", "putting people first" and "serving the people" are at the core of the perspective.

## 2. The macro-view of China in the 'initial stage of socialism' by Premier Wen

Before the meeting of the NPC and CPPCC, on 26 February 2007, the Xinhua News Agency published an article based on a full speech by Premier Wen Jiabao without saying when or where the speech was made. It had been very rare for Premier Wen to comment on socialism and China in such an ideological way. The article, entitled "A number of issues regarding the historic tasks in the initial stage of socialism and the foreign policies of China", attracted massive attention at home and abroad. It is generally assumed that the article would not have been released without the full support of the current leadership.

In the address peppered with ideological phrases that harked back to the Deng Xiaoping era, the premier emphasized that China was still in the "primary stage of socialism" characterized by "underdeveloped productivity" and must therefore "unswervingly focus on economic construction". And since China was "still far away from advancing out of the primary stage of socialism", the country must "stick to the basic development guidelines of that stage for 100 years."

Premier Wen also said in his article that the current socialist system in China was imperfect and immature, leading to social injustice and corruption in the country. This appeared to be the first time that the state leaders gave such a description with socialist terms of the current status of China under their central leadership. In fact, on the last day of the NPC, Premier Wen replied to the press that "for our socialism to go from being immature to mature, imperfect to perfect, and undeveloped to developed, it will take a long time."

Obviously, the Central leadership have nurtured a sense of crisis to address the socio-economic problems encountered in China's development, which may plant the seeds of social unrest and further reduction of developmental sustainability in the future. In order to prevent and tackle these potential problems, the Central leadership nowadays is most concerned about changing the growth model of China structurally – from an open-ended unbalanced growth to a slower but better-balanced expansion, from fixed asset investment-dominated and industrial production-oriented to consumption-led and more environment-oriented. Correspondingly, the development philosophy has shifted from solely “growth-oriented” to “people-oriented” for the sake of the establishment of the “all-round well-off society”.

### 3. The written article of Zeng Qinghong:

On 16 March 2007, Zeng Qinghong, the Vice President of the People's Republic of China (PRC), published an article in QiuShi Magazine (Seek Truth), official party publication, trying to elaborate the relationship between the new vision of the Central leadership and “Deng Xiaoping theory” & “Three Representatives”.

The article is titled “Inheriting the past, creating the future, innovations of theories and practices to advance with time – On the development and inheritance of “Deng Xiaoping theory” & “Three Representatives” following the formation of major strategic thinkings in the Central Committee since the 16<sup>th</sup> CPC National Congress (2006)”.

In the article, Mr.Zeng illustrated the followings by shedding lights on President Wu's theorized strategic thinkings against the background of what Premier Wen described as “the primary stage of socialism”:

A. Since the 16<sup>th</sup> CPC National Congress, a series of important strategic thinkings has been raised. They include:

- (1) To be people-oriented
- (2) To realize scientific development
- (3) To build a harmonious socialist society
- (4) To construct a new socialist countryside
- (5) To develop a country of innovations
- (6) To establish a socialist concept of honor and disgrace
- (7) To push forward the building of a harmonious world
- (8) To facilitate the advanced construction of the Chinese Communist Party

B. “The formation of a series of important strategic thinkings since the 16<sup>th</sup> CPC National Congress” is built on the deep understandings of the characteristics of the transitional stage of social and economic development in contemporary China.

The transitional stage characteristics are the “4 deeps & 2 unprecedenteds”:

- (1) The deep transformation of economic system
- (2) The deep transformation of social structure
- (3) The deep adjustment of interest distribution
- (4) The deep change of ideas and thoughts

- (5) The unprecedented development opportunities
  - (6) The unprecedented challenges
- C. Without doubt, the intricacy and complexity of the reform and economic growth since the opening up in the late 1970s require the state leaders to develop actively the strategic thinkings to accommodate the problems arisen and deal with the challenges ahead. The relationship could be illustrated as below:
- (1) The scientific development perspective is to solve the uneven growth, and the serious structural problems and imbalances of the Chinese economy.
  - (2) The building of a harmonious society is to address the problems of lower-income people previously neglected by the government in its growth-oriented policy.
  - (3) The construction of a new socialist countryside is to reduce the gap between urban and rural development, and improve people's livelihood in the rural areas.
- D. In what sense "the formation of a series of important strategic thinkings since the 16<sup>th</sup> CPC National Congress" is the inheritance and continuation of "Deng Xiaoping theory" and "Three Representatives"?
- (1) Both "Deng Xiaoping theory" and "Three Representatives" put emphasis on science, technology and innovation as the prime driver of productivity.
  - (2) Both urge to make efforts to eliminate income disparity and polarisation of social classes in the society, giving full consideration to the fundamental interests of the majority.
  - (3) Both emphasize the progressiveness of China's culture and the spiritual side of the civilization, besides the material aspects of the development
  - (4) Finally, both pay attention to the social stability conducive to achieving prosperity and growth.

The above are the common goals of the scientific development perspective and the building of a harmonious society too. Therefore, in terms of "Why develop? How to develop? Develop for whom?", they all are consistent throughout the history and advance on the same path.

According to Zeng, since the 16<sup>th</sup> CPC National Congress, President Wu has continuously emphasized that the theory and work of the government should advance with time, be creative and with discipline. Finally, Zeng concluded that the formation of important strategic thinkings in the Central Committee since the 16<sup>th</sup> CPC National Congress" is the enrichment and development of "Deng Xiaoping theory" & "Three Representatives", through the following new additions:

- (1) To facilitate the construction of a new socialist countryside
- (2) To develop into an innovation-type country
- (3) To promote a resource-saving and environmental-friendly society

Overall, Zeng summarized the spirit of the strategic thinkings of the current leadership as "people-oriented" – to give the interests of people from all walks of life fundamental consideration in the government's policy-making. They serve as guidelines to achieve "for the people, based on the people, shared by the people".

## Part Three: Challenges and worries addressed by the central leadership

### 1. The press conference held by Premier Wen:

In addressing the press on 16 March 2007, Wen said that China was ready for maintaining the current momentum of steady and fast economic growth. However, he claimed that “it is not the time for complacency with respect to the economy”. Rather, his mind was full of worries. He bluntly admitted that the Chinese economy still face some major problems, the “four uns”, namely, unstable, unbalanced, uncoordinated and unsustainable.

- (1) *Unstable* : “Unstable since China has an excessively high investment growth rate, excessively large extension of credit, excessive liquidity of the currency, and improper foreign trade and international payment” – by Wen

He was referring to the overheated investment, excess liquidity that fuel the stock and property market, and the huge but still widening current account surplus.

- (2) *Unbalanced* : “China has unbalanced development between urban and rural areas, between different regions, and between economic expansion and social progress” – by Wen

He was voicing concerns over the urban-rural, east-west, and inner-coastal disparities, the regional fragmentation of the macro-economy, as well as persistent tensions in the income distribution.

- (3) *Uncoordinated* : “The primary, secondary, and tertiary industries are not coordinated, investment and consumption are not coordinated, and China’s economic growth relies too much on investment and export” – by Wen

He was drawing attention to the sharp contrasts between the heavily-developed manufacturing sector and the under-developed services sector, and to the divergence between excess investment and export and insufficient domestic consumption.

- (4) *Unsustainable* : “Unsustainable since China has failed to address well the issues related to energy saving, emission reduction, and enviromental protection” – by Wen

He was highlighting the twin perils of enviromental degradation and resource depletion.

Collectively the “four uns” made a compelling case for a change in growth-model. Premier Wen spoke with much greater conviction and confidence than he did several years ago in framing the China macro-development debate by the approach of “four uns”. It is not just the ways Premier Wen stated the problems that impressed the media but it also revealed a new sense of command over challenges and solutions in contemporary CCP leadership.

### 2. The four challenges mentioned by Premier Wen in the government report

Besides the “four uns” summarized by Wen, in his government report delivered on 5 March 2007, he had clearly reminded the public that there were still many difficulties and challenges facing China’s economic and social development.

Since 2004, Wen has urged that China needed to move from 'growth at any costs' to 'balanced growth'. Balanced growth means growth which is 'putting people first' and is balanced in five aspects: rural-urban; regional; economic-social; man-nature; and domestic-external sector. Elsewhere, Wen talked of the consumption and investment balance as well.

This year, Wen admitted there were shortcomings and inadequacies in the work of the government too, as in the past the government did not take strong measures to enforce the policy. The government also could not effectively communicate to local officials for the implementation and thus the policy effects were limited. The problem of unbalanced growth remained in the country's development.

To summarise, the challenges mentioned in the government report this year (2007) are:

A. There are serious structural problems in the economy.

- (1) There is a lack of proper balance among primary, secondary and tertiary industries, urban and rural development and development among different regions
- (2) Agriculture, the base of the economy, remains weak, and it is now more difficult than ever to steadily increase grain production and keep rural income growing.
- (3) The overall scale of investment is still too large, and the pattern of investment does not reflect consumer demand, the problem of excess liquidity in the banking system is serious, and the factors causing overheated investment and excess credit still remain.
- (4) The trade surplus has become large, and the imbalance in international payments has worsened.

B. The pattern of economic growth is inefficient.

- (1) This is mostly revealed in excessive energy consumption and serious environmental pollution.
- (2) The targets for saving energy and reducing pollutant emissions were set forth in the Eleventh Five-Year Plan. This is of vital importance in efforts to promote the change in the economic growth pattern and increase energy conservation and environmental protection.
- (3) However, they fell short of the targets set at the beginning of last year for cutting energy consumption per unit of GDP by about 4% and total discharge of major pollutants by 2%
- (4) The main reasons of failure are:
  - a. Industrial restructuring are proceeding slowly, while growth in heavy industry, especially in sectors that are highly energy consuming or generating large amounts of pollution, is still overheated.
  - b. Many backward production facilities that should have been closed down are still in operation.
  - c. Some local governments and enterprises have failed to comply with laws, regulations and standards for energy saving and environmental protection, and it would take time for relevant policies and measures to produce the desired results.

C. A number of serious problems affecting the people's interests have not been properly addressed.

- (1) Life remains difficult for many low-income people.
- (2) Problems in food and drug safety, medical services, education charges, public security and production safety remain a source of public concern.

- (3) Problems arising in land expropriation and requisition, housing demolition, shareholding transformation of enterprises, and environmental degradation that harm the interests of the people have not been fundamentally solved.
- D. The government's efforts to strengthen its administrative performance still have room for improvement.
  - (1) The root of the problems lies in institutional deficiencies and poor oversight.
  - (2) Moves to change the way the government functions have not made the expected progress, non-separation of government administration and enterprise management remains a problem, and the responsibilities of some government offices are not clear, leading to low productivity.
  - (3) Expenses related to carrying out official duties have not been standardized, and extravagance and waste are inflating administrative costs.
  - (4) In some local government offices, and among some of their employees, there are problems of bureaucratism, formalism, isolation from the people, neglect or dereliction of duty and even abuse of power and corruption.

Linking up part two and part three ...

It is an important strategic move by the central leadership to put "Scientific Development Perspective" and the "Building of a Harmonious Society" at the same level with "Deng Xiaoping Theory" and "Three Representatives". They give Chinese policy decisions a theoretical context in addressing the problems of "four uns". They also provide the current state leaders with a series of sound guiding principles and equip them with the necessary theoretical tools to implement actions to change the growth model of China.

To address the "four uns" problems and explore the right direction on its road of reform, China is believed to adopt a new model at this critical transitional point in its development journey. According to Wen, 2007 is "a year of strategic shift" under the guidance of "Scientific Development Perspective" and the "Building of a Harmonious Society". The series of central government policies announced in the NPC and CPPCC this year basically centered around these two themes, and the rationale behind those policies could only be fully understood in this context. Today, there is greater determination than ever for the Central leadership to proceed with the reform and the transition to the new growth model.

## Part Four: Themes and Focuses of the Central Government Policies

### 1. The shift in development philosophy: from "fast" to "sound" development

To adjust the problem of overemphasis on GDP growth, the government modifies its development philosophy from "a fast and sound economic development" to "a sound and fast economic development". "Sound" is placed before "fast" this time, recognizing the fact that the previous emphasis on "fast growth" as the number one issue has produced problems due to its unscientific approach.

The Chinese economy is exhibiting unstable characteristics: unbalanced growth in domestic consumption and investment; unbalanced development in the agriculture, manufacturing and service sectors; excessive liquidity; and

trade imbalance. Life is still difficult in the rural areas and in the under-developed regions, and basic living problems such as expensive education, unaffordable housing and medical care still exist. The government has also failed to address well the issues related to energy saving, resources conservation, emission reduction, proper land use and environmental protection.

Therefore, the new development philosophy places emphasis on “sound” economic development to ensure not only high quantity of growth, but also high quality of growth.

## 2. Goals in 2007:

During the NPC session, Premier Wen decided on the following six main goals as China’s economic and social development in 2007:

1. GDP to grow by about 8%.
2. A growth of 6% for both per capita disposable income of urban households and per capita net income of rural households; Total retail sales increases by 12%
3. Creating at least 9 million jobs in urban areas; and the rate of registered urban employment should be kept below 6%
4. The overall price level should remain basically stable; and the overall increase in consumer prices should stay below 3%
5. Improving in the imbalance in international payments
6. Development in technology, education and health.

## 3. Themes and Focuses of the Central Government Policies

### *Theme One: Improvement in people’s livelihood*

Policy focus 1: To promote more even distribution of wealth, improve social welfare (especially medical care and education) and strengthen the social security system.

Major policies to build a “harmonious society” include:

- i) To launch favorable policy towards “Go West” enterprises and promote government’s “Go West” strategy to support the development of the country’s western provinces.
- ii) To waive tuition and miscellaneous fees from all rural students receiving 9-years compulsory education, which will ease the financial burden of 150 million rural households with children attending primary and middle schools; in addition, the government will offer free education for students majoring in education in teacher colleges directly under the Ministry of Education.
- iii) To promote the new type of rural cooperative medical care system and the trial area will be expanded to cover over 80% of all counties; it will also accelerate the establishment of a new type of urban health care

service system based on community facilities. Moreover, in the coming periods it will launch the trial of basic medical insurance for urban residents that mainly cover major illness, with the government providing necessary assistance to the poverty-stricken population. The government further promises that the current medical public healthcare insurance will be extended to all urban residents.

- iv) To offer basic living allowance to low-income people and this social security system will be expanded to all rural area nationwide in 2007. Those with serious illness or disability are entitled to have more allowance.

Policy focus 2: To construct a new socialist countryside under the guidance of new strategic thinking

- Major policies to help the rural areas include: To develop the rural finance, to promote rural cooperatives, to reduce the access threshold for financial institutions into the rural market, to continue the shareholding reforms of the Agricultural Bank of China, the opening up of the China Postal Savings Bank, to conserve land use in rural area, to guarantee the steady development of grain production, to set up a sound grain security warning system, to expand the logistics network of agricultural product with the help of information system, to train rural people to match the local needs, and to strengthen agricultural science and technology to boost output.

Policy focus 3: To rein in runaway housing prices, and curb improper real estate development to ensure the supply of affordable houses for the public; to build more lower-priced small -and-medium-sized residential housing; to increase the accountability of local officials and enforce stricter administrative measures to combat illegal property construction.

## ***Theme Two: Energy consumption, environmental protection and economic restructuring***

Policy focus 1: To carry out the target responsibility system related to energy saving and environmental protection, with the focus on establishing a scientific, comprehensive and unified index of energy saving and discharge, as well as an inspection system and examination system; to intensify law enforcement, supervision and administration, with severe penalties imposed on offences against the laws and rules; To improve and tighten enforcement of energy consumption and environmental protection standards, including the closing down of enterprises that fail to meet environmental standards; potential new projects must be assessed for the impacts on energy consumption and the environment; to discard the backward productivity.

Policy focus 2: To step up upgrading of “Green” science and technology in order to save more energy and reduce pollution effectively and efficiently.

Policy focus 3: To emphasize the role of the market and make use of a full range of economic levers such as pricing, government finance, taxation and credit to promote energy saving and environmental protection.

Policy focus 4: To focus on energy conservation and pollution efforts in key industries such as steel, nonferrous metals, coal, chemicals, building materials and construction and in key enterprises that use more than 10,000 tons of standard coal annually.

Policy focus 5: To encourage the expansion of service sector in order to restructure the economy, such as invitation of foreign investment in the railway and telecommunication sector; at the same time, the government discourages low-end processing enterprises by reducing or eliminating export tax rebates and increasing export tariffs on low-value added product

### ***Theme Three: The set-up of a new state investment agency and other financial reforms***

Policy focus 1: To establish a new limited company to manage the huge foreign exchange reserve (1.2 trillion yuan as at 31<sup>st</sup> March, 2007), modeling after the Temasek of Singapore.

- On 21 May, China's new state investment agency has invested USD 3 billion in a renowned private equity firm of the US, a sign of Beijing's eagerness to get a higher return on its hoard of currency reserves.

Policy focus 2: To deepen reforms of state-owned banks, including China Development Bank and Agricultural Bank of China (ABC); to reform the rural banking system, especially the extension of rural credit channel and the opening-up of China Postal Savings Bank in March, 2007.

Policy focus 3: To develop the capital markets such as bond market and increase the proportion of direct financing vigorously, while continuing to open the financial market for foreign enterprises.

Policy focus 4: To improve financial regulatory organs; to study the viability of a risk warning system for banks.

- The China Banking Regulatory Commission (CBRC) issued a notice prohibiting the improper use of credit in early 2007. It is going to investigate the sudden rash of consumer loans and other bank credits in the first few months of 2007. It suspects that these loans and credits have been fuelling the country's red-hot stock market.

### ***Theme Four: The passing of two laws in March – Corporate Income Tax Law and Property Law***

Policy focus 1: The new Corporate Income Tax Law will standardizes the tax rate at 25% for both domestic and foreign enterprises, as of 1st January, 2008. It will unify the tax deductions and preferential treatment, which will be industry-specific, rather than regional-specific. New anti-avoidance provisions are introduced to strengthen tax collection and administration. On the other hand, to alleviate the impact on the existing Foreign-Invested Enterprises(FIEs), the Tax Law grants them a 5-years grace period to these enterprises.

Policy focus 2: In March 2007, the Property Law was passed to officially define and protect private property rights. For the first time, the protection of private ownership is explicitly stated in the nation's civil code. The law clearly defines the scope of state-owned, collective-owned and private property and gives them equal protection.

## Appendix: Government Policies

### 1. The Central Economic Working Conference

The 3-days annual Central Economic Conference was concluded on 7 December 2006. Eight major economic tasks for 2007 were announced and they are in many ways similar to those announced for 2006.

Eight major tasks:

- (1) To persistently strengthen and improve macro control to maintain and promote the sound economic development trend.
- (2) To focus on the economic development in the rural areas in order to promote the building of a “new socialist countryside”.
- (3) To actively promote the optimization and upgrading of industrial structure by strengthening energy conservation and ecological protection.
- (4) To improve the country’s capacity of innovation and to accelerate the development of an innovation-oriented country.
- (5) To implement an overall strategy of regional development and promote a sound development of urbanization.
- (6) To continue the reform of systems and accelerate the formation of the mechanism that helps to put into practice the scientific outlook on development.
- (7) To persist in the mutually beneficial and win-win strategy of opening up and open the country wider to the outside world.
- (8) To put people first and continuously promote social harmony.

### 2. The People’s Bank of China Working Conference

The working conference was held by the People’s Bank of China on 20-21 January, 2007. Main policies of the conference for 2007 are highlighted as follows:

- (1) Continuing to implement prudent monetary policy. The growth of M2 is targeted at 16%.
- (2) Deepening financial sector reform, with the focus being improving corporate governance and optimizing financial structure.
- (3) Enhancing and improving foreign exchange management. Efforts will be made to promote a balance in the balance of payments.
- (4) Strengthening risk prevention and dissolution to actively maintain financial system stability.

- (5) Facilitating financial product innovation to support the regulated development of financial market. Market rules supporting financial product innovation will be formulated and improved.
- (6) Promoting the construction of payment and settlement system steadily. The nationwide acceptance of cheques will be realized soon.
- (7) Intensifying anti-money laundering work according to law.
- (8) Moving forward financial service modernization drive in a faster pace.
- (9) Enhancing exchanges and cooperation with foreign central banks, regional and international institutions.
- (10) Restructuring internal management to improve services energetically. Budget management will be improved and strengthened. Efforts will be made to facilitate Shanghai's emergence as an international financial center.
- (11) Speeding up the building of Shanghai Head Office.

### 3. The Third Central Financial Working Conference

The third national financial work conference concluded on January 20 set out directions for improving China's financial sector. This high level meeting is held every 5 years starting from 1997. A wide range of financial reforms were discussed. Key points include:

- (1) Facilitating rural financial development by reducing the access threshold for financial institutions into the rural market; continuing the shareholding reform of the Agricultural Bank of China (ABC); promoting innovation of financial products and services, in the rural areas; and developing rural insurance and Rural Credit Cooperatives (ROC) actively.
- (2) Exploring ways to more actively manage the foreign exchange reserves; promoting the international balance of payments; improving the mechanism of the formulation of RMB exchange rate
- (3) Controlling the money supply and bank credits appropriately; optimizing the credit structure; facilitating the market reform of interest rate; and using financial tools to promote robust and stable economic growth.
- (4) Optimizing the structure of opening up of the financial sector; Opening the capital market to the world gradually; facilitating the financial cooperation between the Chinese Mainland, Hong Kong and Macau; and creating a fair environment conducive to open competition among domestic and foreign financial enterprises.
- (5) Expanding the size & weight of direct financing; raising the quality of listed companies; accelerating development of the bond market and reform of the insurance industry;
- (6) Monitoring closely short-term capital flows especially speculative activities; and strengthening the supervision of different financial industries.
- (7) Deepening the reforms of policy banks such as China Development Bank; establishing modern banking system and promoting commercial operation of the banks.

## 4. Key points of the annual Government Work Report

The annual report was presented by Premier Wen Jiabao during the 5<sup>th</sup> Session of the 10th National People's Congress.

### (1) *Review of the government work in 2006*

- a Adopted a series of timely macroeconomic regulatory measures to address major problems affecting economic performance, such as overheated investment, excessive money and credit supply and serious trade imbalance. The measures started to work, resulting in a drop in the growth rate in fixed asset investments and slower growth of the bank credit supply. The government thus prevented rapid economic growth from becoming overheated growth and avoided drastic fluctuations.
- b Work related to agriculture, rural areas and farmers was intensified. Steady progress was made in building a new socialist countryside.
- c Accelerated the adjustment of the economic structure. Formulated policies and measures to accelerate the development of the equipment manufacturing industry and promoted independent development of major technologies and domestic production of major equipment in key areas. Placed greater emphasis on saving energy and protecting the environment. Continued to follow the overall strategy for regional development.
- d Accelerated the process of reform and opening up. Reforms in various areas were deepened. Adjusted the trade mix by improving policies to control exports and encourage imports. The structure of foreign investment utilization was improved. Service industries were further opened up. Expanded economic exchanges and trade with other countries.
- e Developed social programs actively. The central government spent 157.1 billion yuan in 2006 on science and technology, education, health and culture, an increase of 34.5% over the previous year.
- f Strived to increase employment and improve social security work. Improved and implemented policies on employment and reemployment. Strengthened the social safety net. Carried out disaster relief work and rebuilt disaster-hit areas.
- g Strengthened democracy and the legal system.

### (2) *Five major tasks for economic development in 2007*

- a *Strengthening and improving macroeconomic regulation.* The government will continue to follow prudent fiscal and monetary policies; adjust the balance between investment and consumption; maintain an appropriate growth rate of fixed asset investment; and promote the sustained and sound growth of the real estate industry.
- b *Developing modern agriculture and promoting the building of a new socialist countryside.* The government will continue to ensure the steady development of grain production, raise the overall production capacity of agriculture, boost rural infrastructure development, increase rural incomes and develop rural human resources, through strengthening government policy, funding, application of science and technology, and reform.

- c *Taking strong measures to save energy, lower energy consumption, protect the environment and use land intensively.* The government will make them the breakthrough point and main fulcrum for changing the pattern of economic growth. It will improve and tighten enforcement of energy consumption and environmental protection standards; resolutely close down backward production facilities; concentrate these efforts on key industries such as steel, non-ferrous metals, coal, chemicals, building materials and construction and in key enterprises that use more than 10,000 tons of standard coal annually; accelerate the development of energy-saving and environmentally friendly technologies; and strengthen the protection of agricultural land and control the industrial use of land.
- d *Accelerating efforts to upgrade the industrial structure and make independent innovations.* The government will greatly develop the service industry, improve the level and technology of industry, and promote extensive IT application in the economy and in society; develop alternative and renewable energy sources and widely apply advanced technologies to upgrade traditional industries; use economic and legal tools to strengthen industrial planning and accelerate adjustments in industries with excess capacity; implement fiscal, tax and banking policies to encourage and support independent innovation, in order to increase basic research and research in cutting-edge technology; and formulate a national strategy for intellectual property rights for independent innovations and energetically develop corresponding venture capital investment.
- e *Continuing to promote balanced development among regions.* The government will continue to carry out the large-scale development of the western region; promote industrial restructuring and upgrading of old industrial bases such as Northeast China; Strengthen the production capacity of major grain-producing areas in the central region and increase the region's capacity to process agricultural products and support the development of advanced manufacturing and new high-technology industries in the area; continue to improve the industrial structure, strengthen the international competitiveness and increase the capacity for independent innovations in the eastern region; and step up state support for underdeveloped areas and promote accelerated economic and social development in old revolutionary areas, ethnic minority areas, border areas and poverty-stricken areas.

## **5. Key Points of the Report of the National Development and Reform Commission to the Fifth Session of the Tenth National People's Congress**

### **(1) Targets for national economic and social development in 2007**

- a 8 percent growth in GDP;
- b Creation of at least 9 million new jobs for urban residents, and registered unemployment rate of less than 4.6 percent;
- c Consumer price index below 3 percent;
- d An increase of 12% in retail sales of consumer goods.
- e Energy consumption per GDP reduced by 4%
- f An increase of 6% in both per capita disposable income of urban households and per capita net income of rural households;

- g Spending on research & development to reach 1.56% of GDP;
- h Undergraduate enrollment of 5.67 million and 424,000 postgraduate students; and
- i Less than 7.5% of natural population growth.

## (2) Eight Tasks for the economic and social development in 2007

In order to attain the 2007 economic and social development targets, the government will focus on the following 10 tasks:

- a Improving macroeconomic regulation and to maintain stable economic performance.
- b Constructing a “new socialist countryside”, promoting the development of modern agriculture and expanding channels for increasing rural incomes.
- c Reducing energy consumption and pollution emission, strengthening environmental protection and using land more intensively.
- d Enhancing the capacity for independent innovation and promoting improvement and upgrading of the industrial structure.
- e Implementing the overall strategy for regional development and promoting balanced economic development among regions.
- f Intensifying all reforms and raising the quality and level of opening up.
- g Developing education, health and culture vigorously and striking a balance between economic and social development.
- h Promoting the building of a harmonious society and solving problems that affect the vital interests of the people.

## 6. ‘No. 1 Document’ of the Central government in 2007

Chinese government for the fourth year in a row released its first government documents focusing on the rural development. Besides echoing the 2006 document aimed at creating ‘a new Socialist countryside’, it emphasized the development of modern agriculture as the key to achieve the goal. Key contents of the documents include:

- (1) Increasing investment in agriculture, countryside and farmers, and establishing an investment assurance mechanism to promote the development of modern agriculture.
- (2) Speeding up agricultural infrastructure construction and better equipping the modern agriculture
- (3) Fostering scientific technological innovation in agriculture and consolidating the scientific and technological support of modern agriculture development

- (4) Developing the multiple functions of agriculture and establishing a sound industrial system for modern agriculture
- (5) Building up rural market system and developing circulation industries of farm produce adaptable to modern agriculture.
- (6) Training new farmers and building a pool of talents for the development of modern agriculture.
- (7) Deepening comprehensive rural reform and innovating the system and mechanism driving development of modern agriculture.
- (8) Strengthening the leading role of the Communist Party of China in rural work to ensure the practical results of development of modern agriculture.