THE CONFERENCE BOARD
Trusted Insights for Business Worldwide

China and the Financial Crisis

The Future of China's Economy and Business Environment

A Special Conference Board Workshop for the China CEO Council

Workshop Document for Discussion Purposes

May 18 2009 – Beijing

Contents

Objective of Workshop

The objective of this workshop is to envision and assess the post-recovery environment for foreign MNCs in China.

- The stimulus program and associated measures have seen a slew of new regulations, initiatives, and preferences.
- Some provisions appear to be favorable to foreign MNCs in China and some do not.
- How will these contradictions play out for MNCs and how will they play out for China's future?

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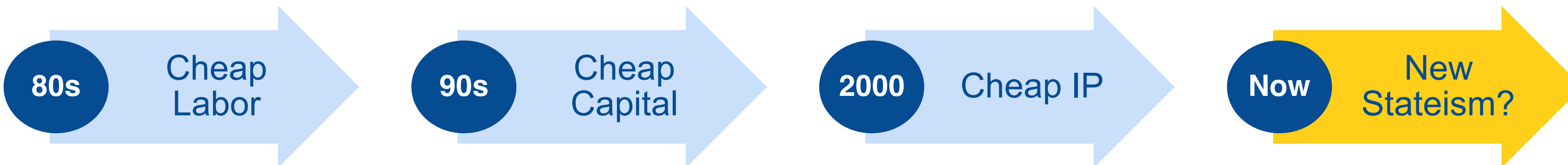
- This workshop sets out to dimension the factors shaping China's recovery across:
  1. The explicit components of China's recovery strategy thus far observed;
  2. A set of economic rebalancing imperatives that remain as of yet unaddressed;
  3. A set of exogenous factors – beyond China's control – that may impact China's recovery and economic future.
- We then evaluate how these factors may evolve and interact going forward to impact the post-recovery operating environment for MNCs in China.
- The polling exercise found in Section 4, together with various inputs gathered through the Council session discussion, will be incorporated into a more comprehensive China Center member report scheduled for delivery in the coming several weeks.

Contents

China – the "transitioning" economy

Is the Socialist market model heading toward more marketization, stopping for breath, or doing an about face?



- Stimulus activity and associated efforts to address the slowdown are re-empowering the center
- Surge of lending and liquidity is focused in the State-owned sector and may be directing credit in the near term away from SMEs/private sector
- SOEs under SASAC Central, Provincial, and Local dominate core of almost every industrial sector and key commercial sectors
- Are the large privates really private: Huawei, Geely, Sanyi, Chery?
  - Most often based on public sources of capital
  - Supported with subsidies, export credit lines, tax benefits
  - Given privileged access to government procurement
  - Domestic market supported with subsidies and tax benefits
  - Given privileged access to aid-facilitated opportunities abroad

Regulatory changes – appraising the next "transition"

A key determinant will be the regulatory direction and intensity of central government intervention.

Tightening

- Labor Contract Law
- Anti-Monopoly Law
- Foreign investment catalog expansion
- Environmental compliance laws
- Parcel / document delivery laws
- Most tax compliance processes
- Government procurement favoritism

Loosening

- Outbound investment approval
- RMB trade settlement rules
- Local project approval levels
- US$ / RMB fund activities
- Off-shore ownership structures

Directions→

1. Consolidation of rules and regulations inconsistently applied
2. Intensification of enforcement toward well-established objectives
3. Tightening of operating regulations and taxation; but loosening of investment regulations
4. No significant leveling of playing field

A closer look at the AML (I)

Perhaps the clearest indication of regulatory goals and directions has emerged from the recent 8 months of AML implementation.

Project	Outcome	Apparent Objective
Prior to the AML		
Carlyle acquisition of 85% of Xugong Engineered Equip	Death by 1000 cuts in administrative review	▶ Protect Chinese brand ▶ Keep publicly funded assets out of foreign hands
Post the AML		
InBev acquisition of 100% of Anheuser-Busch (outside)	Approved on condition of no Tsingdao control	▶ Protect Chinese brand ▶ Impede growing market share
Coca-Cola acquisition of 100% of Huiyuan juice	Blocked as restrictive of trade	▶ Protect Chinese brand ▶ Impede further growth of already dominant foreign brand
Mitsubishi Rayon 100% acquisition of Lucite (outside)	Approved with condition of yielding 50% of production capacity	▶ Prevent dominant control over key inputs for Chinese industry ▶ Preserve chance for Chinese producers to gain global share
Post but not AML reviews		
Fast organic growth of foreign express delivery companies (non transactional)	New postal law severely restricts all FIE express services	▶ Protect a non-competitive domestic service agent
“Private” suit brought against Microsoft (non transactional)	Pending	▶ Force concessions on IP and market pricing

A closer look at the AML (II)

Key Learnings –

- The AML converts an opaque and ad hoc regulatory process that invited complaints of unfair protectionism to a law-based process, derived from best international practice but still somewhat vague and administered in an opaque manner
- The AML establishes the authority and intent of Chinese regulators to intervene in restructuring anywhere in the world where they perceive interests at stake
- The law appears to be more for the benefit of State-owned and then privately owned national champion companies than for Chinese consumers, as is typical of anti-trust and pro-competition regulations
- The law exempts state-owned entities. We foresee a possibility that foreign regulators could fire back at Chinese expansion globally with a “mutuality of interest” argument based on common SOE ownership

State-owned enterprises – an unfinished project

When China joined the WTO in 2001, it had negotiated up to five years to meet commitments related to the most vulnerable industries. How well did they do in the game of catch-up?

☑	**Enterprise Scale**	China boasts the world's largest companies in several sectors, by market cap, user base, or turnover
☒	**Enterprise Footprint**	Aside from resource acquirers, very few Chinese enterprises operate at scale outside China, including the massive banks, insurers, and light manufacturers
☒	**Enterprise Value Chain**	No Chinese enterprises are amongst the top 20% that control 80% of the value chain in key global sectors (e.g. Big Silicon, Software, Oil, Automotive, Banking)
☒	**Enterprise Competitiveness**	Domestic market protection has sustained poor efficiency and lack of global competitiveness in many major sectors (e.g. PetroChina and SinoPec cost of production)
☑	**Enterprise Expandability**	Diverse forms of State support with commitment to globalize will enable non-organic expansion (Lenovo-Think Pad, Chinalco-Rio Tinto) some select players' organic expansion

China abroad – setting the stage for the future

Although we question that SOEs have achieved global levels of competitiveness, China has refined a process of global expansion, with Chinese characteristics, positioned them well, especially in markets generally ignored by the enterprises and governments of developed countries.

China has created "tradable" relationship assets already through this strategy –

- On a platform of "friendly," bilateral, leader-to-leader political "guanxi", China organizes integrated plans for small, medium, and large business activities in emerging economies
- These programs are multivalent, often including –
  - Chinese stakes in mineral or energy resources or valuable nascent operating companies (IT, power, transport)
  - Correlated planning and development of sectors with required infrastructure
  - Negotiated and privileged positioning in trade, retail, and distribution channels supporting demand for Chinese manufactured goods
  - Development of education, healthcare, and other social infrastructure
- Facilitation is achieved by –
  - A blend of integrated capital injections, through loans, currency swaps, export credits, direct investment against equity, often in complex combinations
  - Technical and security support for governments, many in states of sustained rebellion
  - Expansion of PLA tactical and naval projection capability to protect expanding interests

Which direction will China's next transition take (if any)?

Contents

Assessing the key factors influencing recovery and China's post-crisis business environment

8

Explicit Components of China's Recovery Strategy

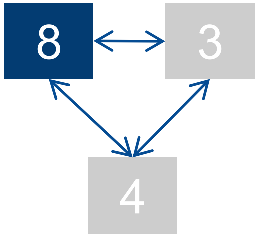
3

Economic Rebalancing Imperatives that Largely Remain Unaddressed

4

(Potentially) Influential Exogenous Factors Outside of China's Control

The 8 components of China's recovery and growth strategy



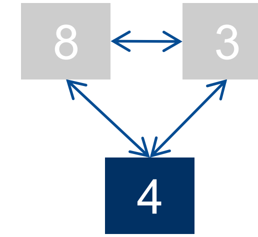
Based on public statements from leaders and observed developments, we see China undertaking a recovery and growth "strategy" comprising 8 main components…

1. **Stimulate domestic consumption** via direct spending incentives
2. **Protect and diversify exports** into Non-Traditional Major Export Markets
3. **Clarify focus of state funded infrastructure investment** into low-income housing and efficiency-enabling transport and energy infrastructure
4. **Deepen domestic sources of commercial finance** and broaden financial service suppliers and offerings
5. **Project the RMB** to support exports and effect favorable Asia economic integration
6. **Secure supply and price control of key commodities**
7. **Support existing industrial over capacity** (or even capacity expansion) unless environmentally destructive or energy inefficient
8. **Address business environment inefficiencies** to accrue cost advantages and enhance competiveness on a cost-per-GDP-growth basis in energy, transport, logistics and resource production

China's approach to recovery is neither strategic nor principled, but appears to be a collection of practical, ad hoc, and sometimes contradictory responses – that may or may not involve any basic reforms.

The 4 (potentially) influential exogenous factors

That are outside of China's ability to control; but are important drivers of China's recovery and growth measures…



1. **Weak US and EU Import Demand for Chinese Imports** – US and EU savings rates increase and consumer credit remains constricted – consumption (import demand) remains low, and far from peak levels indefinitely

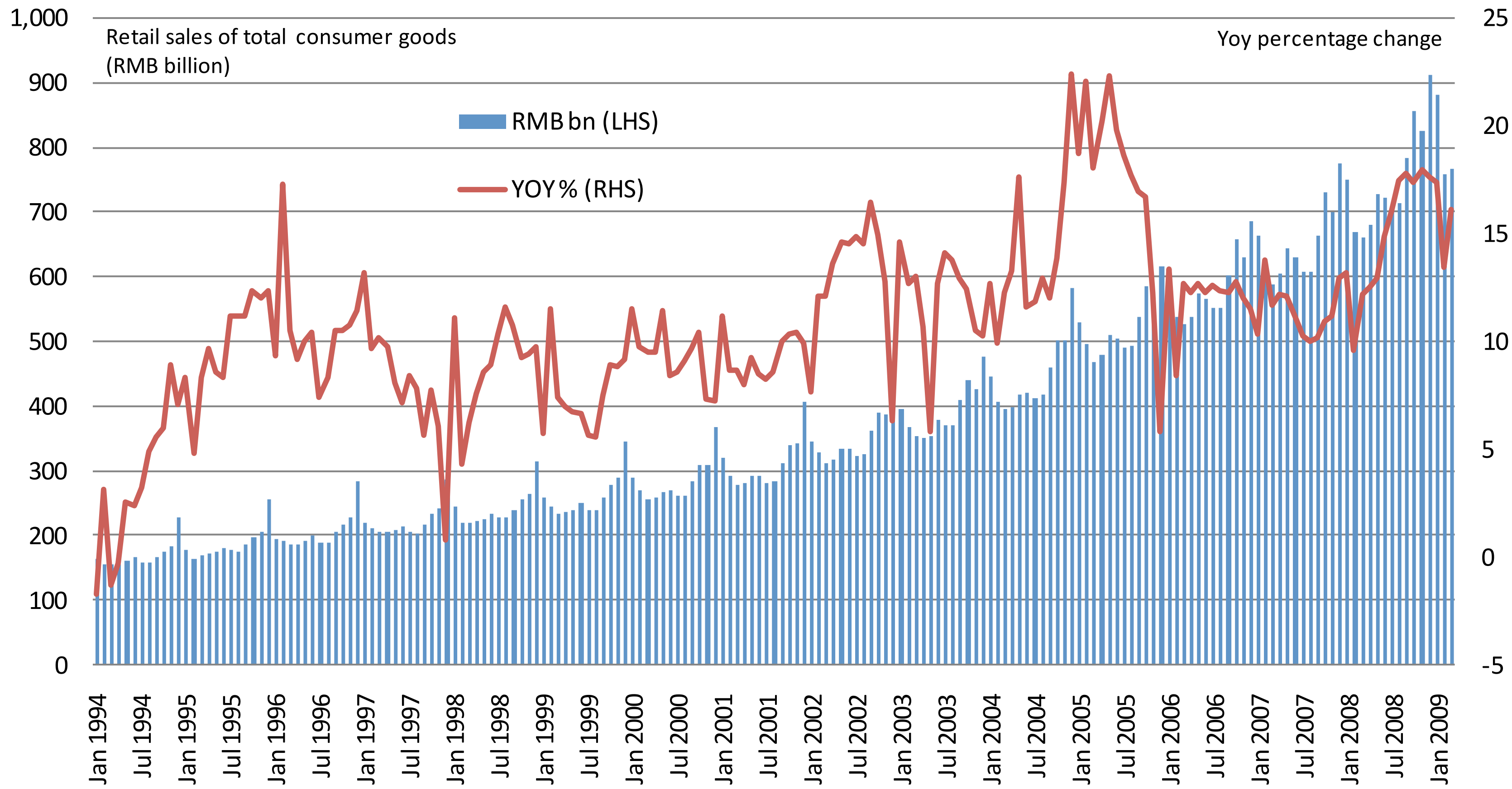
2. **Continued High Liquidity and Over Pricing of Assets –** Excess global wealth and savings remain, yielding high levels of "return-seeking" liquidity that drives continued over-pricing of all assets

3. **Continued US Dollar Devaluation** – US dollar continuously declines under pressure of deficit burden fueling increasing pressure for internationalization of the RMB

4. **Increased Protectionism –** National priorities and policies dominate global agreements – protectionist features become the norm in cross-boarder transactions and multinational operations

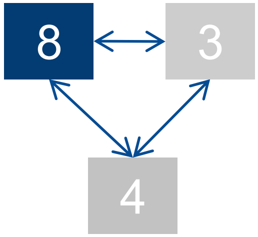
1. Stimulate domestic consumption via direct spending incentives

Consumption growth will remain steady, but the stimulus program's direct spending incentives will have little impact on long-term trends and structural imbalances.

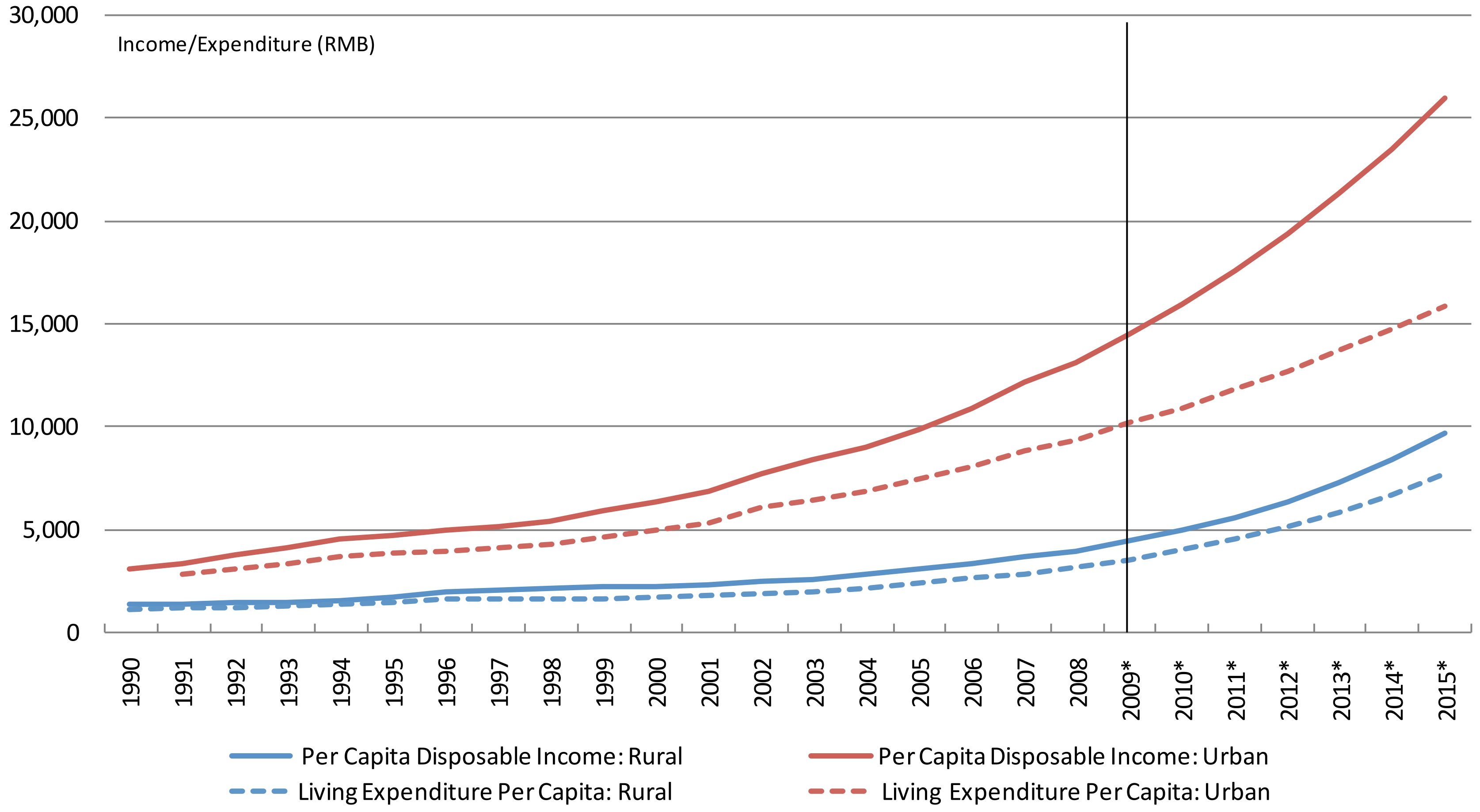


Note: Retail sales exclude auto and house sales
Source: CIEC, The Conference Board

1. Stimulate domestic consumption via direct spending incentives

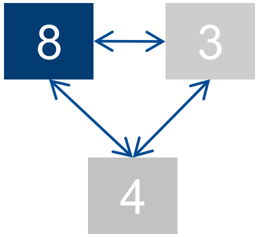


Consumer spending lags income in urban areas and the gap appears to be widening.

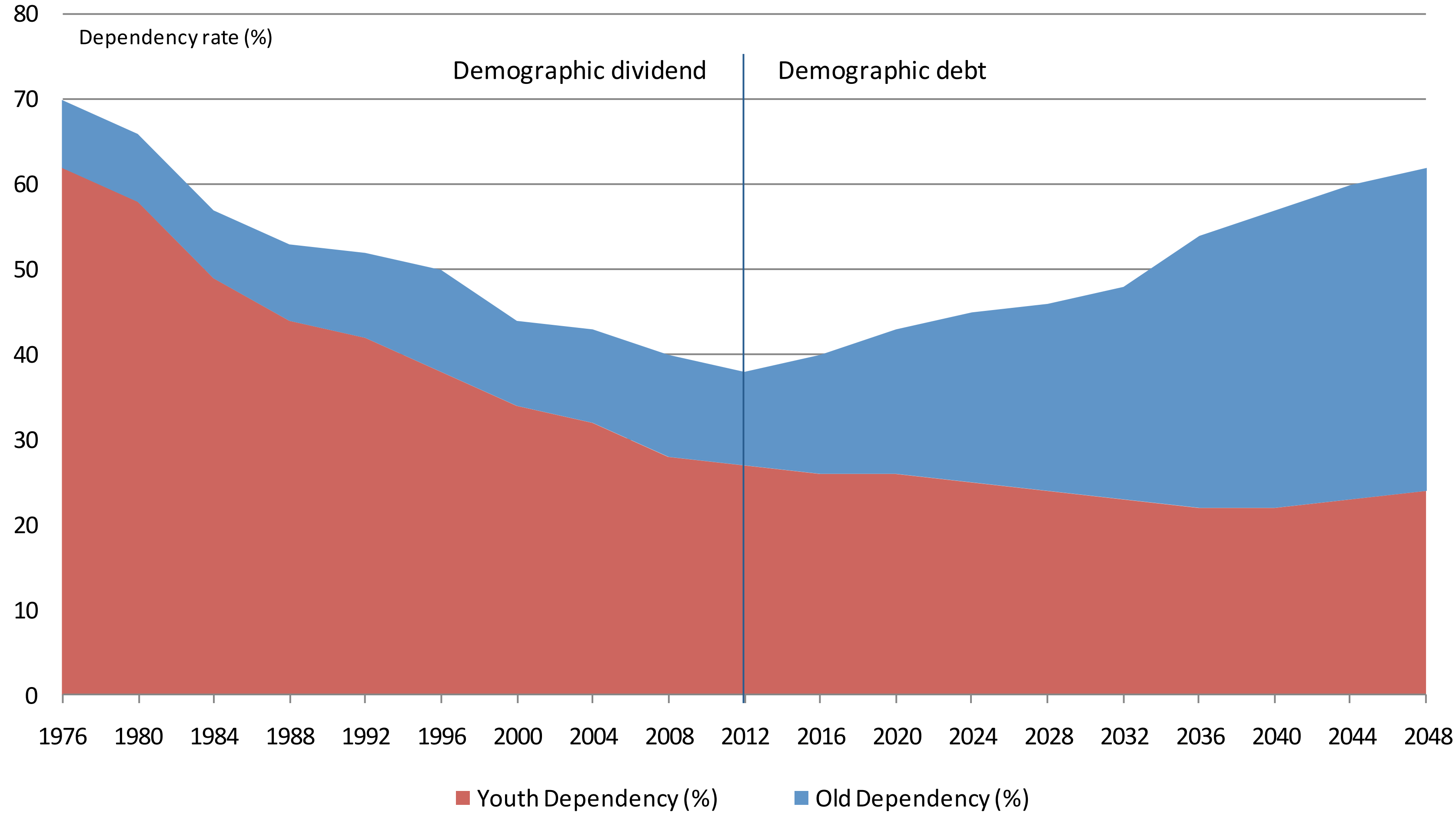


Source: Haver, CEIC and The Conference Board

1. Stimulate domestic consumption via direct spending incentives



Disposable income may grow ,but discretionary spending may be constrained by the increasing dependence on income earners.

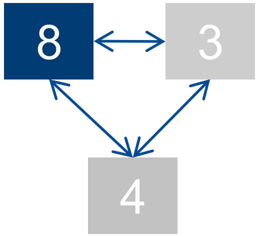


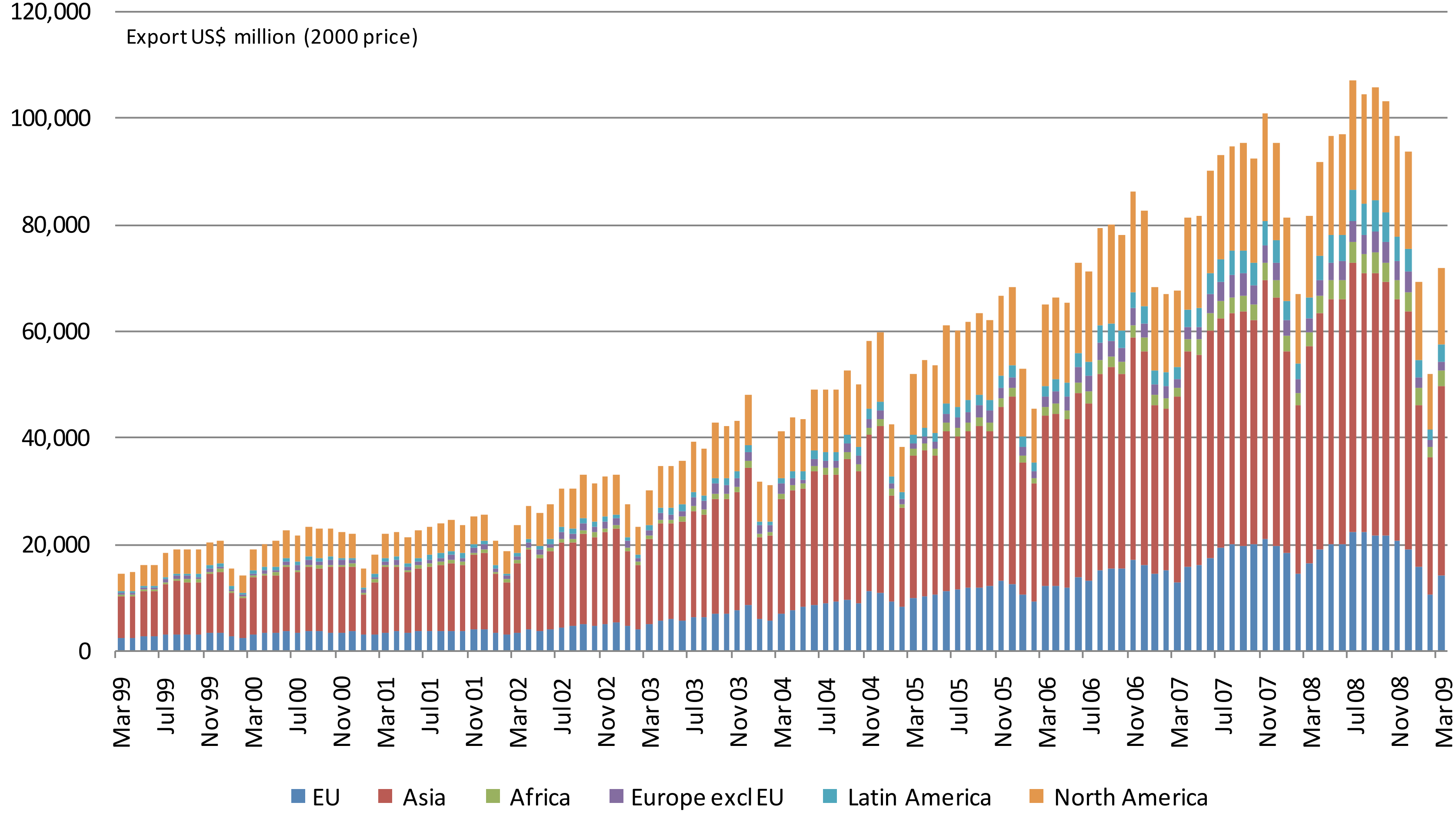
Source: NBS(data before 2002), CCPDS (data after 2002, predicted)

China's historical and forecasted population dependency rate (1976 – 2048); Dependency Ratio: (under 15)+(over 65) / (between 15 and 65).

2. Protect and diversify exports

Exports will remain an important focus – but the target export markets will change.

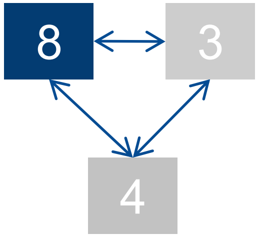


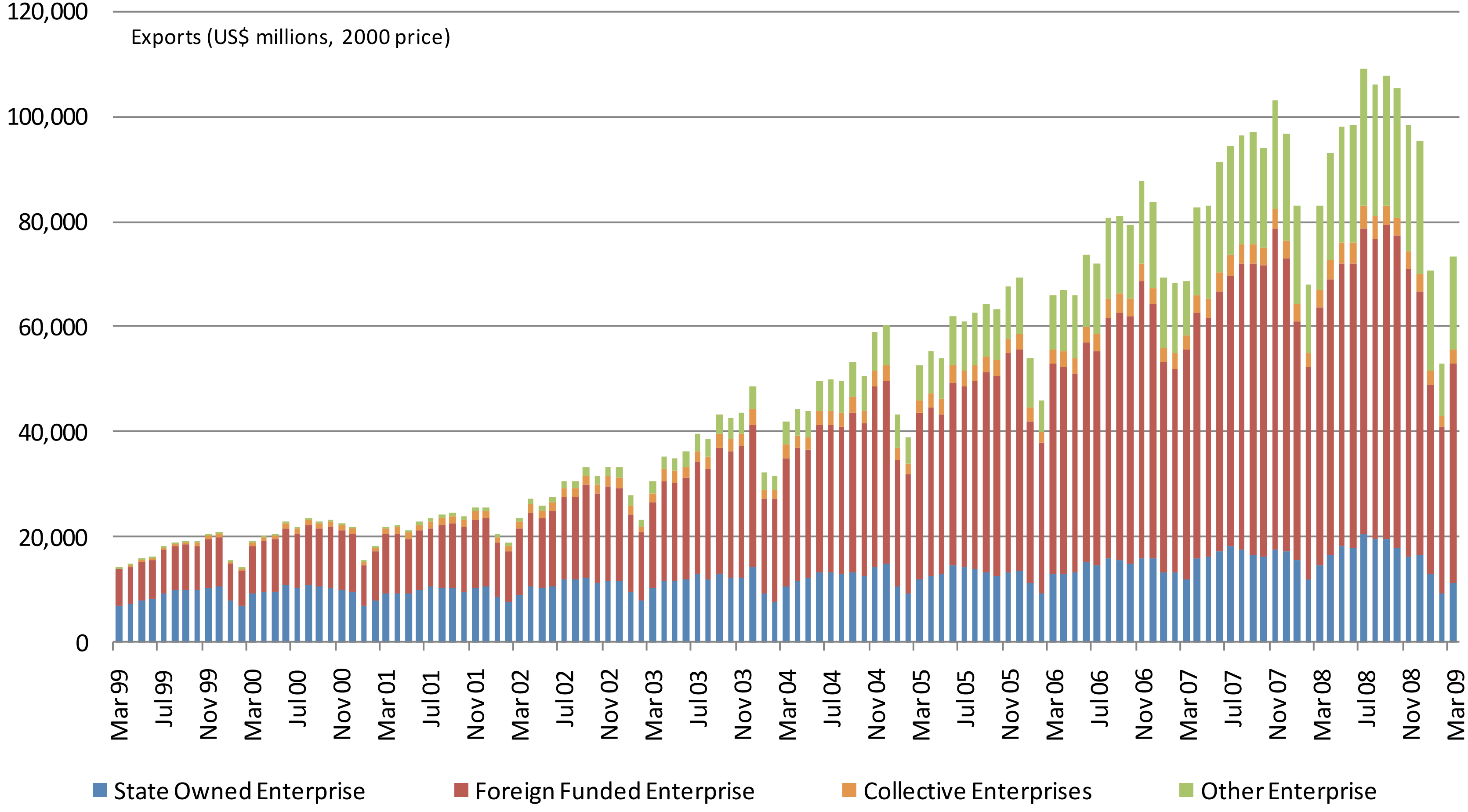


Source: CEIC, The Conference Board

2. Protect and diversify exports

China export share by ownership type

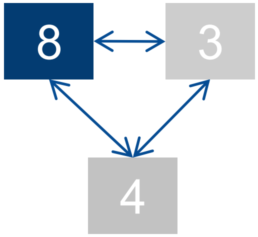


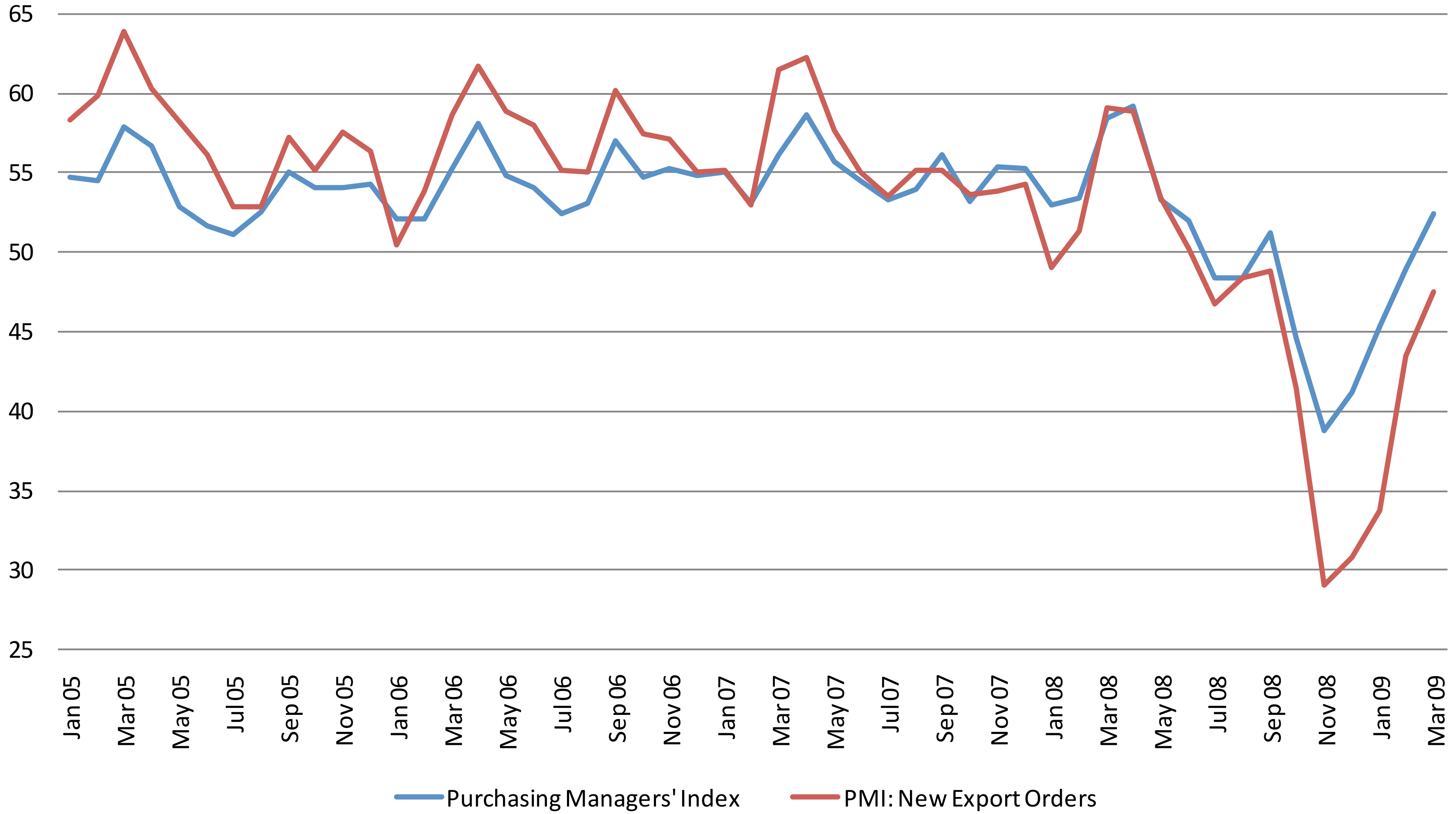


Source: CEIC, The Conference Board

2. Protect and diversify exports

China's purchasing Manager's Index and its components appear to be picking up.

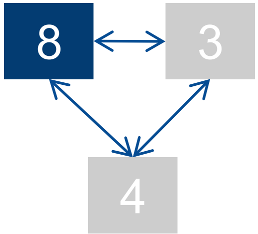




Source: CEIC, The Conference Board

3. Clarify focus of state funded infrastructure investment

Low-income housing, improved energy efficiency and transport linkage efficiencies are the intended areas of investment focus.



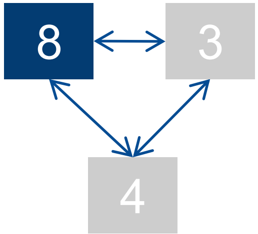
Category		Total Planned Spending Q408 - 2010 (RMB billion)				Central Government Spending (RMB billion)								
		Total (old)	Total (new)	Central/Local Govn't Split		Planned Spending			Actual Spending				Outstanding Spending		
				Central	Local *	2008 Q4	2009	2010	Total to date	Batch 1 Q408	Batch 2 2009	Batch 3 2009	Total to date	2009	2010
1	Transport & infrastructure	1,800	1,500	n/a	n/a	n/a	n/a	n/a	53	25	27.5	n/a	n/a	n/a	n/a
2	Post-earthquake reconstruction	1,000	1,000	n/a	n/a	n/a	n/a	n/a	….	….	….	n/a	n/a	n/a	n/a
3	Affordable housing	280	400	n/a	n/a	n/a	n/a	n/a	38	10	28	n/a	n/a	n/a	n/a
4	Rural living standards & infrastructure	370	370	n/a	n/a	n/a	n/a	n/a	66	34	31.5	n/a	n/a	n/a	n/a
5	Technological innovation & industry restructuring	160	370	n/a	n/a	n/a	n/a	n/a	21	6	15	n/a	n/a	n/a	n/a
6	Environmental protection	350	210	n/a	n/a	n/a	n/a	n/a	23	12	11	n/a	n/a	n/a	n/a
7	Health & education	40	150	n/a	n/a	n/a	n/a	n/a	30	13	17	n/a	n/a	n/a	n/a
	Total	**4,000**	**4,000**	**1,180**	**2,820**	**100.0**	**487.5**	**588.5**	**300.0**	**100.0**	**130.0**	**70.0**	**876.0**	**287.50**	**588.5**

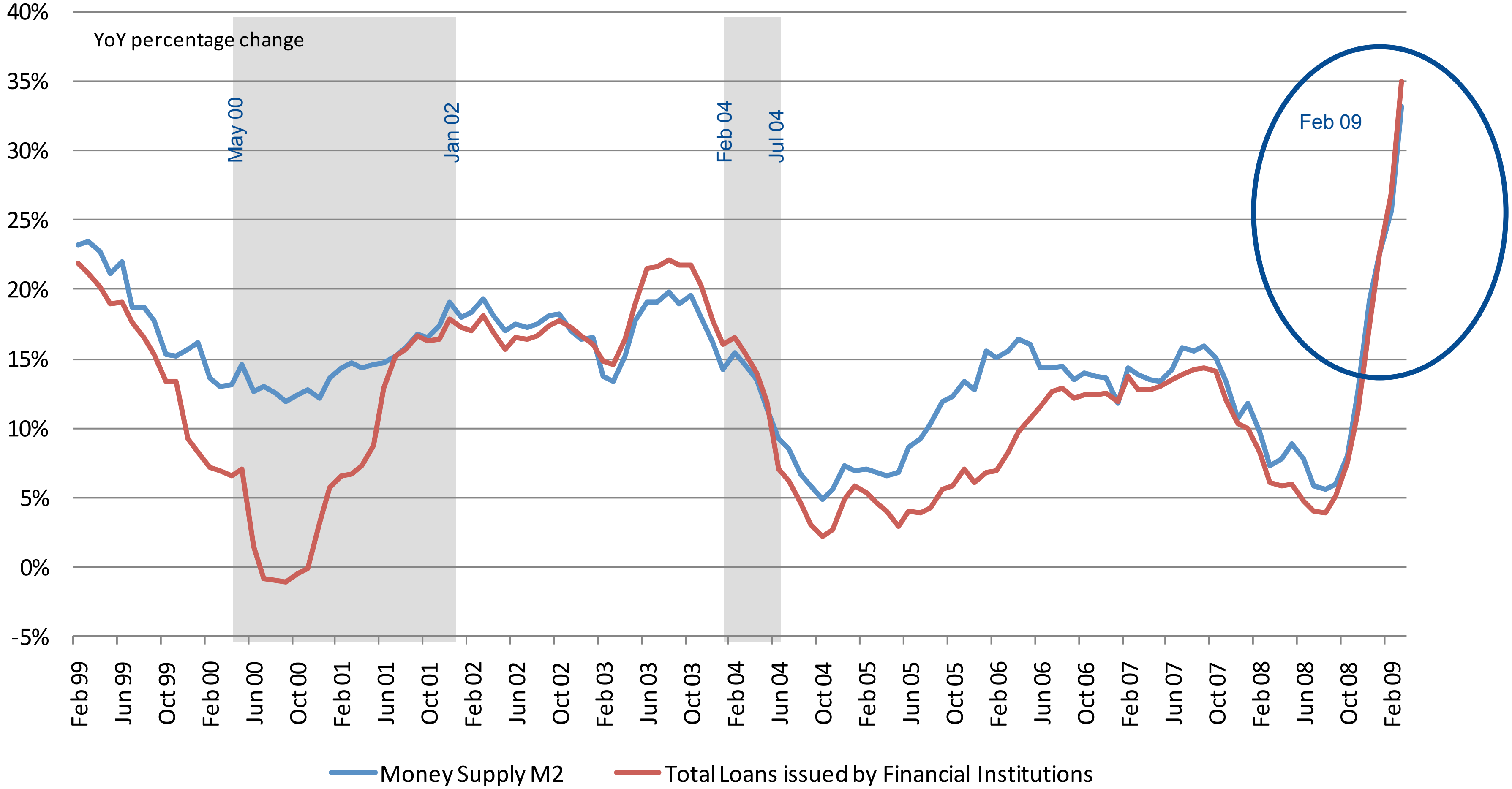
•Local governments + private sector

Source: Compiled by author from public domain

4. Deepen domestic sources of commercial finance and financial service offerings

Domestic capital markets will increase in scale and product diversity to allocate more domestic savings internally.



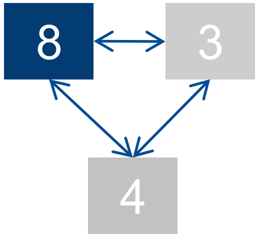


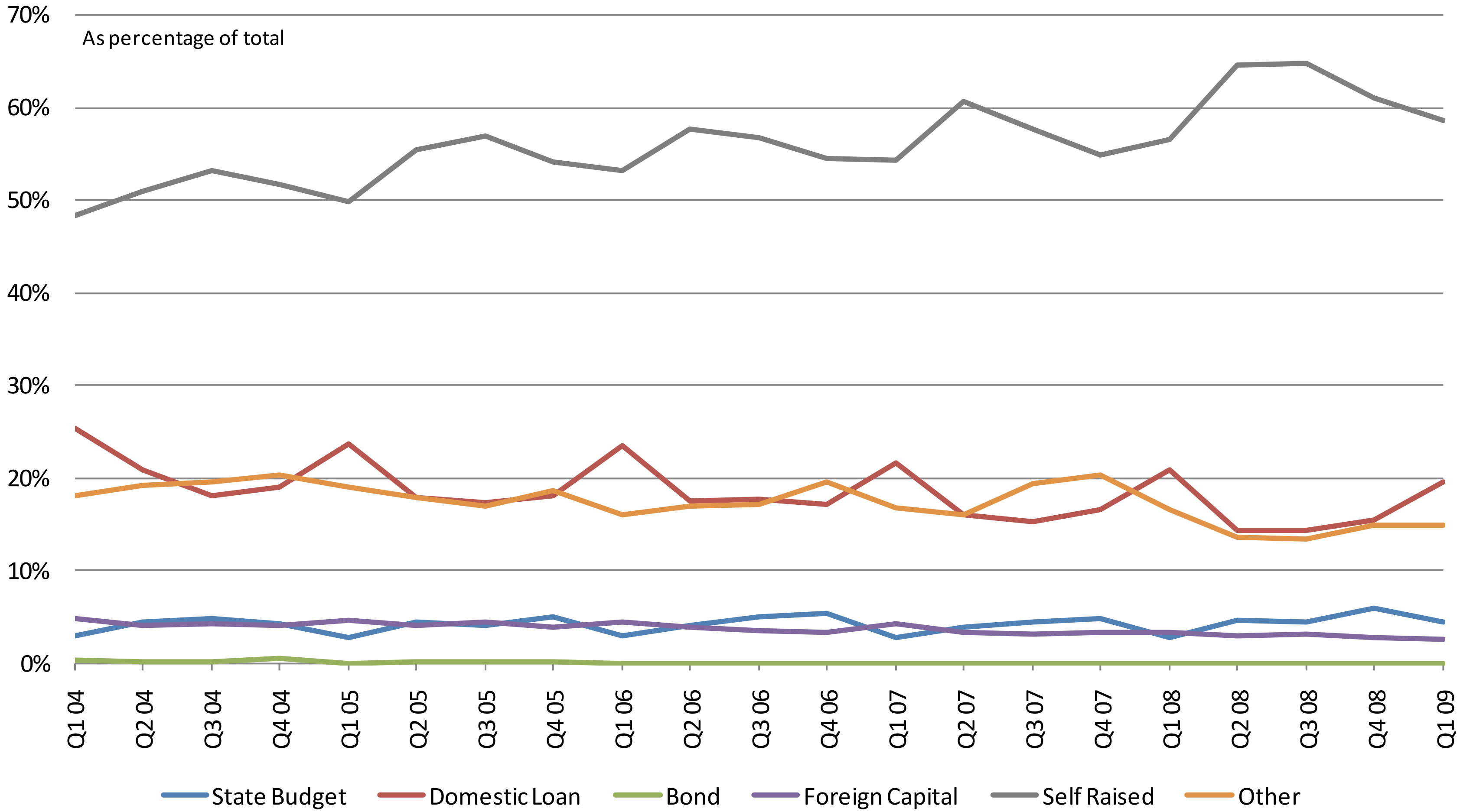
Note: Shaded area represents growth cycles of China's CEI, as determined by The Conference Board

Source: PBOC, The Conference Board

4. Deepen domestic sources of commercial finance and financial service offerings

Most FAI in China is financed from “self-raised” enterprise funds.

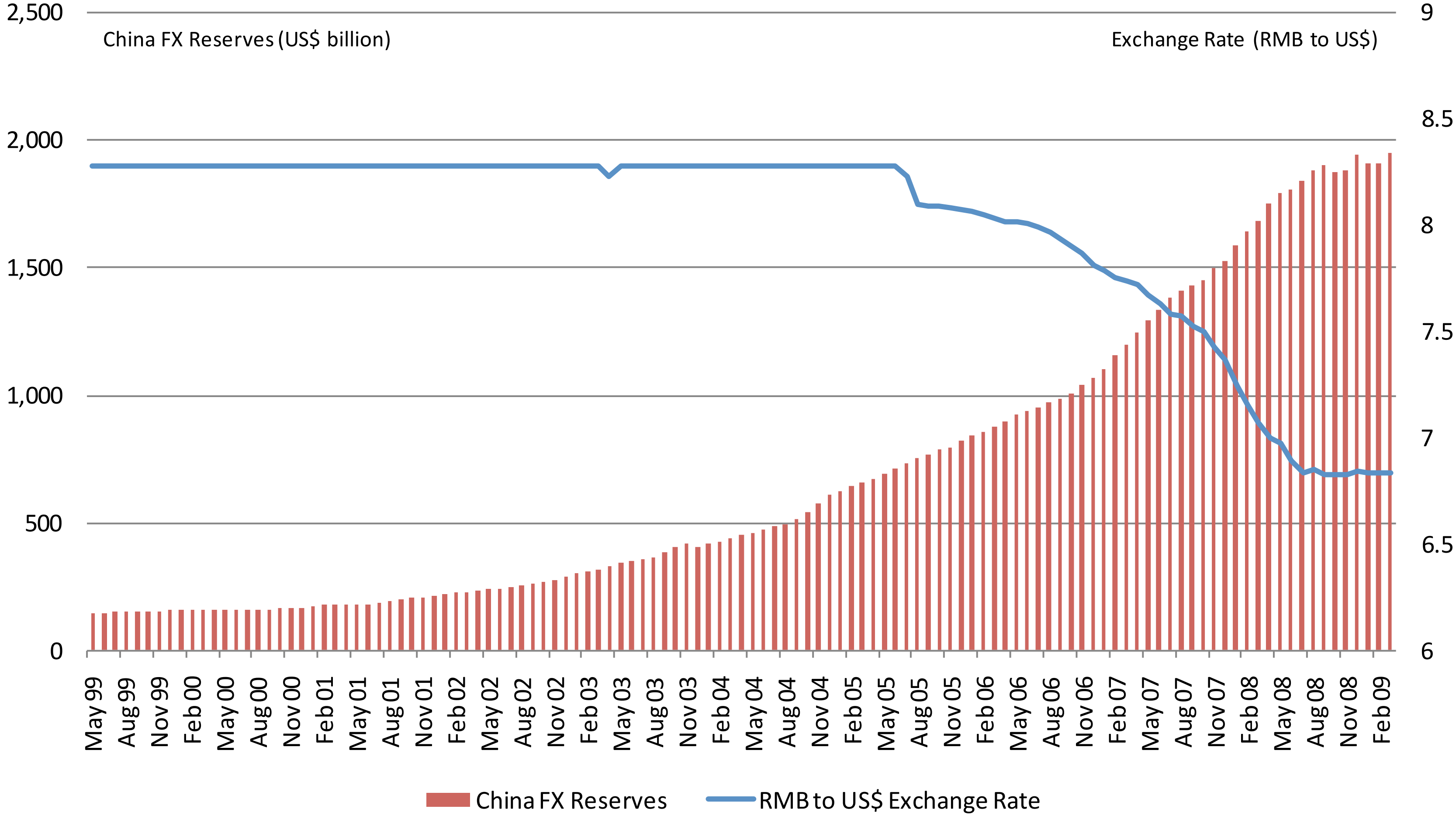




Source: CEIC, The Conference Board

5. Project the RMB to effect favorable Asia economic integration

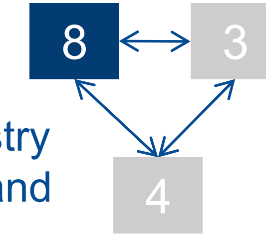
The RMB increase in use as a trade and settlement currency serving to link more tightly export markets and the Asian regional supply chain into a single system.



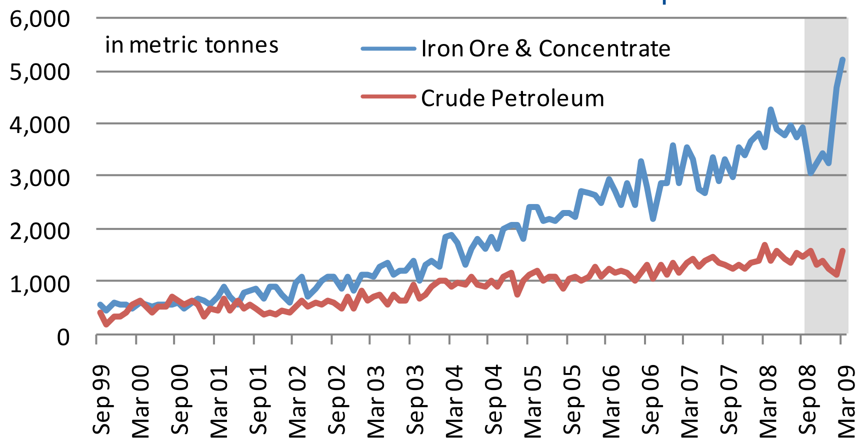
Source: DataStream, The Conference Board

6. Secure supply and price control of key commodities

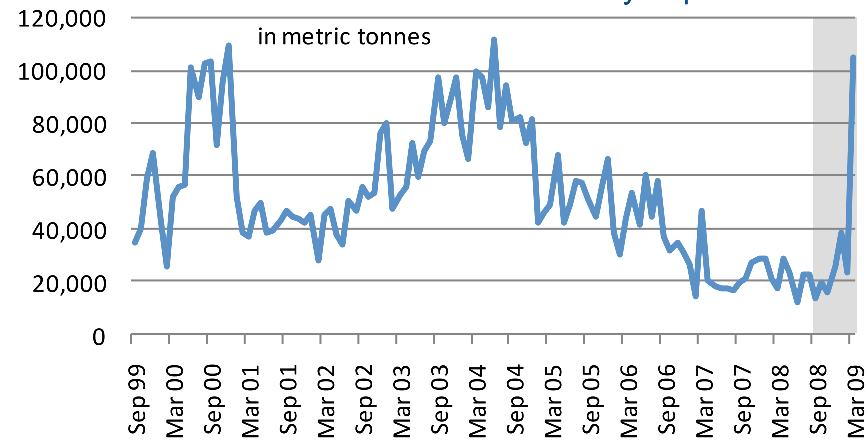
China will continue to be a major market for global commodities and its industry czars will increasingly seek methods through acquisition, trade agreements and customs unions to guaranty supply and price.



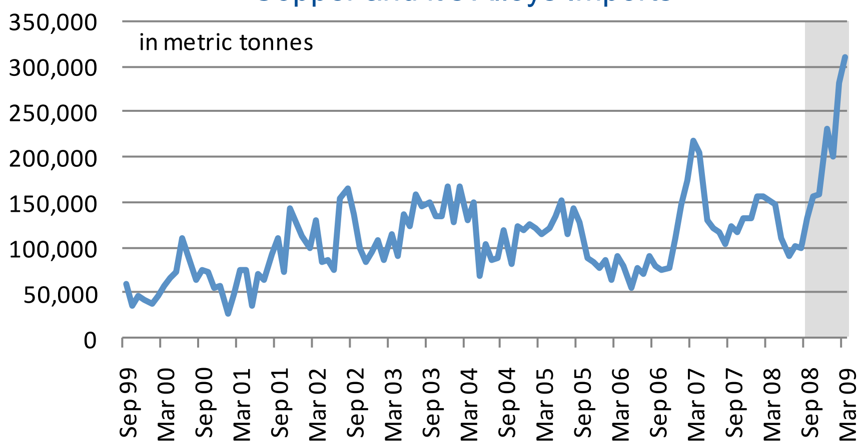
Iron Ore and Crude Petroleum Imports



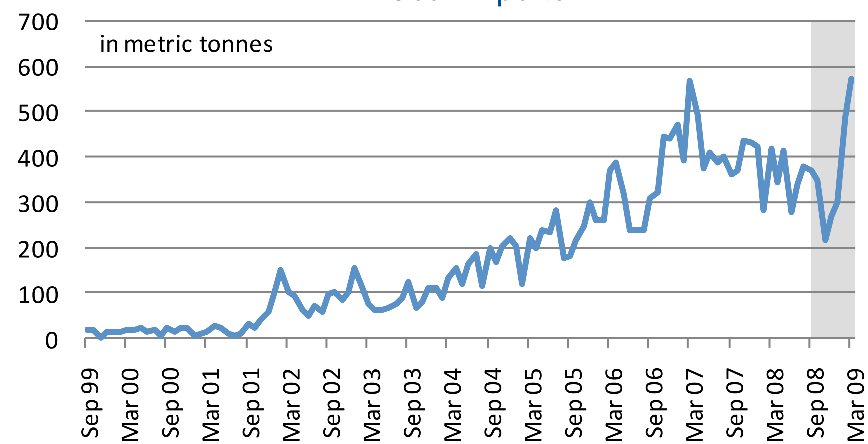
Aluminum and Aluminum Alloy Imports



Copper and it's Alloys Imports



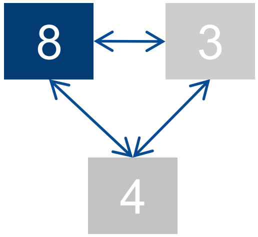
Coal Imports

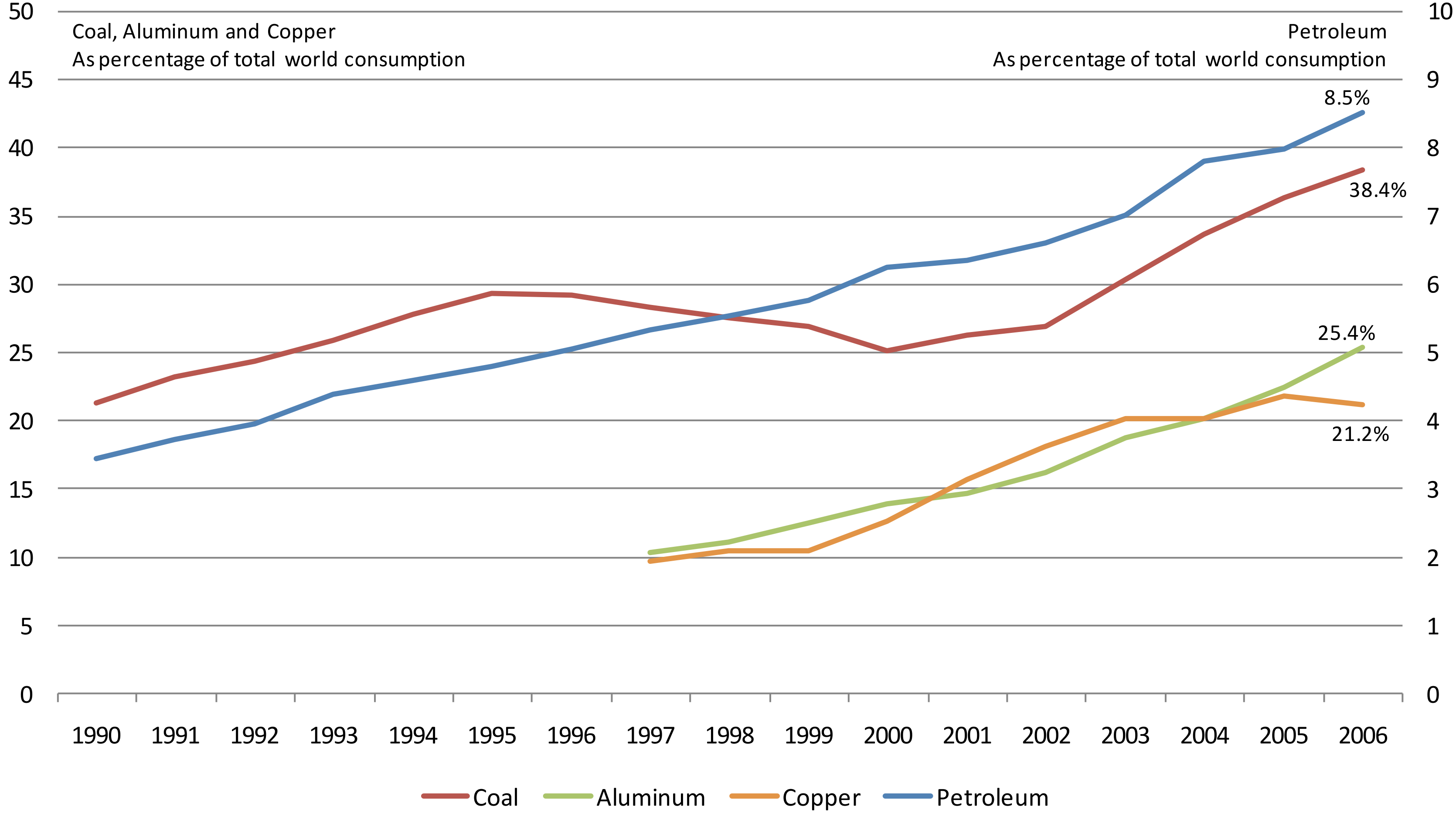


 Source: The Conference Board

6. Secure supply and price control of key commodities

China's growing share of global commodity consumption

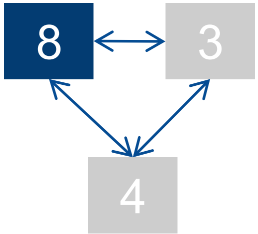


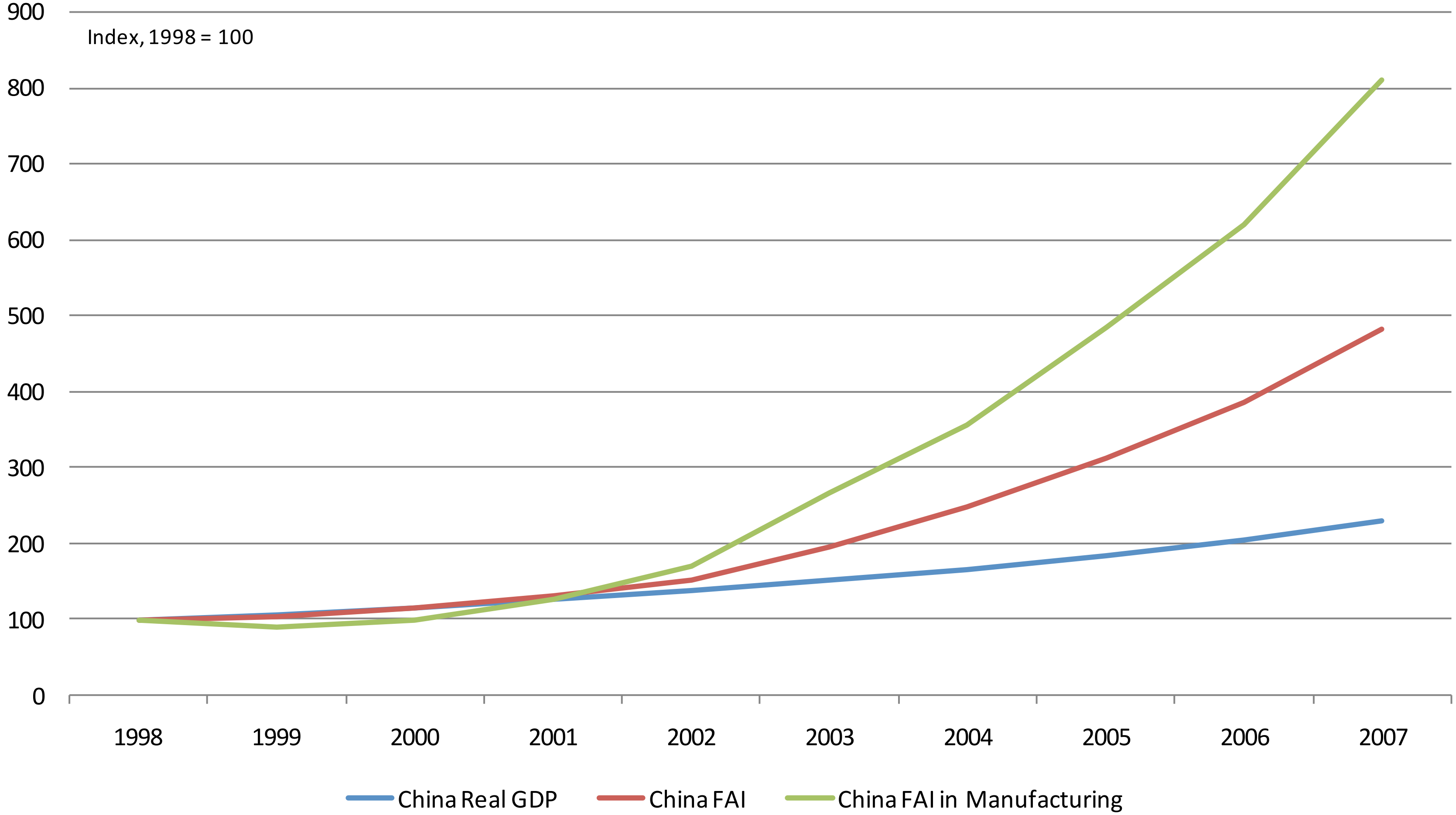


Source: Energy Information Administration, Metal Statistics Yearbook, The Conference Board

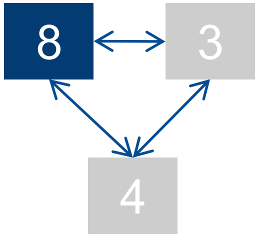
7. Support existing industrial over capacity

China will sustain significant investment in heavy capacity in order to sustain domestic and global price advantage.





Source: NBS, The Conference Board (The sum of manufacturing in total capital construction and innovation used as proxy of FAI in manufacturing until 2002)



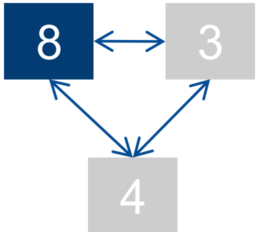
8. Address business environment inefficiencies to gain cost advantage

The 10 industry plans focus "in theory" on enhancing cost competiveness over the long term on a cost per GDP growth basis.

Target Industry		Key Development Objectives	Date
1.	Auto	• Lower purchase tax on cars with engines under 1.6 liters, from 10% to 5% for the period of Jan 20 to Dec 31 • Allocate RMB 5 billion to provide one-off allowances to farmers to upgrade their three-wheeled vehicles and low-speed trucks to mini-trucks or purchase new mini-vans under 1.3 liters for the period of March 1 to Dec 31 • Increase subsidies for people who scrap their old cars and lift regulations that restrict car purchase • Urge improvements to the credit system for car loans • In the next three years, earmark RMB 10 billion to support auto companies to upgrade technologies and develop new engines that use alternative energies	Jan 14, 2009
2.	Steel	• Special funds to be allocated from the central government's budget to promote technological advancement of the sector • Adopting flexible tax policy on steel exports • Readjustment of products mix, and improvement in product quality • Eliminate overcapacity	Jan 14, 2009
3.	Textile	• To increase the rate of tax rebates from 14% to 15% for exporting firms of textile and garment • To set up a special fund to help in upgrading technology • To encourage old factories to relocate to inland provinces and to the western regions • To encourage financial institutions to support the growth and consolidation of local textile firms	Feb 5, 2009
4.	Heavy Machinery	• To reduce reliance on imported parts • To promote integration of research institutions • To encourage machinery exports and imports of key technologies and machinery parts by implementing tax incentives	Feb 5, 2009

Sources: East Asian Institute: Background Brief No. 438; and various public sources

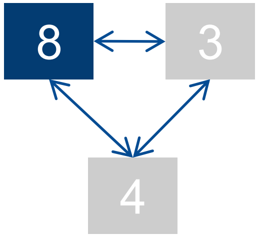
8. Address business environment inefficiencies (cont'd)



Target Industry		Key Development Objectives	Date
5.	Shipbuilding	• To increase credit support by an unspecified amount for ship builders (especially for export) • To extend the existing financial support policies for ocean-going vessels until 2012 • To provide tax rebates on key imported components for domestically owned oceangoing ships • To encourage the replacement of outdated ships • To suspend new shipyard construction • To support technological and industrial updates	Feb 11, 2009
6.	Electronics & IT	• To modify criteria for high-tech enterprises • To adjust tax rebates for exporters of electronics and information products • To promote third-generation mobile communication services and digital TV over the next three years. • To promote development of national science and technology projects, improve public technological service platforms	Feb 18, 2009
7.	Petrochemical	• To provide better tax policies and more credit access • To promote technological innovation and the construction of major petrochemical projects: provide RMB 100 billon to upgrade quality of oil products, and RMB 400 billion for new petrochemical projects and overseas acquisitions • To accelerate the building of reserves for oil products • To guarantee the supply of input materials for farming, such as fertilizers	Feb 19, 2009
8.	Light Industry	• To lift restrictions on processing trade • To raise export tax rebates • To extend fiscal and credit support to SMEs • To add microwave ovens and cookers to the list of appliance purchase • subsidy program • To speed up technology upgrades in certain sectors and to improve energy efficiency and environmental protection	February 19, 2009

Sources: East Asian Institute: Background Brief No. 438; and various public sources

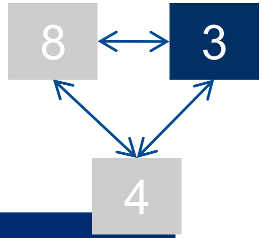
8. Address business environment inefficiencies (cont'd)



Target Industry		Key Development Objectives	Date
9.	Nonferrous Metals	• To provide subsidized loans for technical innovations of the sector • To adjust the rate of export rebate for the exporters of nonferrous products • To eliminate technically undeveloped producers • To promote company restructuring and avoid excessive output capacity	Feb 25, 2009
10.	Logistics	• To increase supply of necessary equipment • To promote an industry standard and establish an information platform • To build a special region for logistics development • To boost urban delivery, wholesale and rural logistics • To encourage mergers and restructuring of companies to support the emergence of internationally competitive large and modern logistics companies • To encourage the development of logistics for energy, mining, automobile, and medical industries as well as for agricultural products • To allocate RMB 100 billion (by central and local governments) within two years to support promotion and application of innovative products	Feb 25, 2009

Sources: East Asian Institute: Background Brief No. 438; and various public sources

The 3 unaddressed economic rebalancing imperatives



1
Healthcare, Pension and Other Social Welfare Funding

- Official rhetoric implies a stimulus spending emphasis on social welfare improvements; however allocations appear to be quite small
- Today only one-third of formally employed workers have pension rights.
- China's Urban Social Security Fund – with upwards of USD 70bn in revenues– is not sufficient to provide even USD 100 per capita lifetime retirement income for the aging urban Chinese workforce*.
- This deficient social safety net is considered one main reason why Chinese citizens have such a high propensity to save their money.

2
Real Estate Market Reform

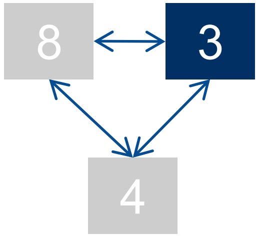
- Generally, real estate land banks are controlled by city governments who sell at high prices and unreasonable terms developers in order to augment budget shortfalls.
- This results in rapidly built, low quality (but superficially nice looking) high-end apartments that may not sustain value.
- The volume segment of the market is largely ignored.
- Title transference in notoriously opaque and inefficient significantly constraining the rise of secondary markets.

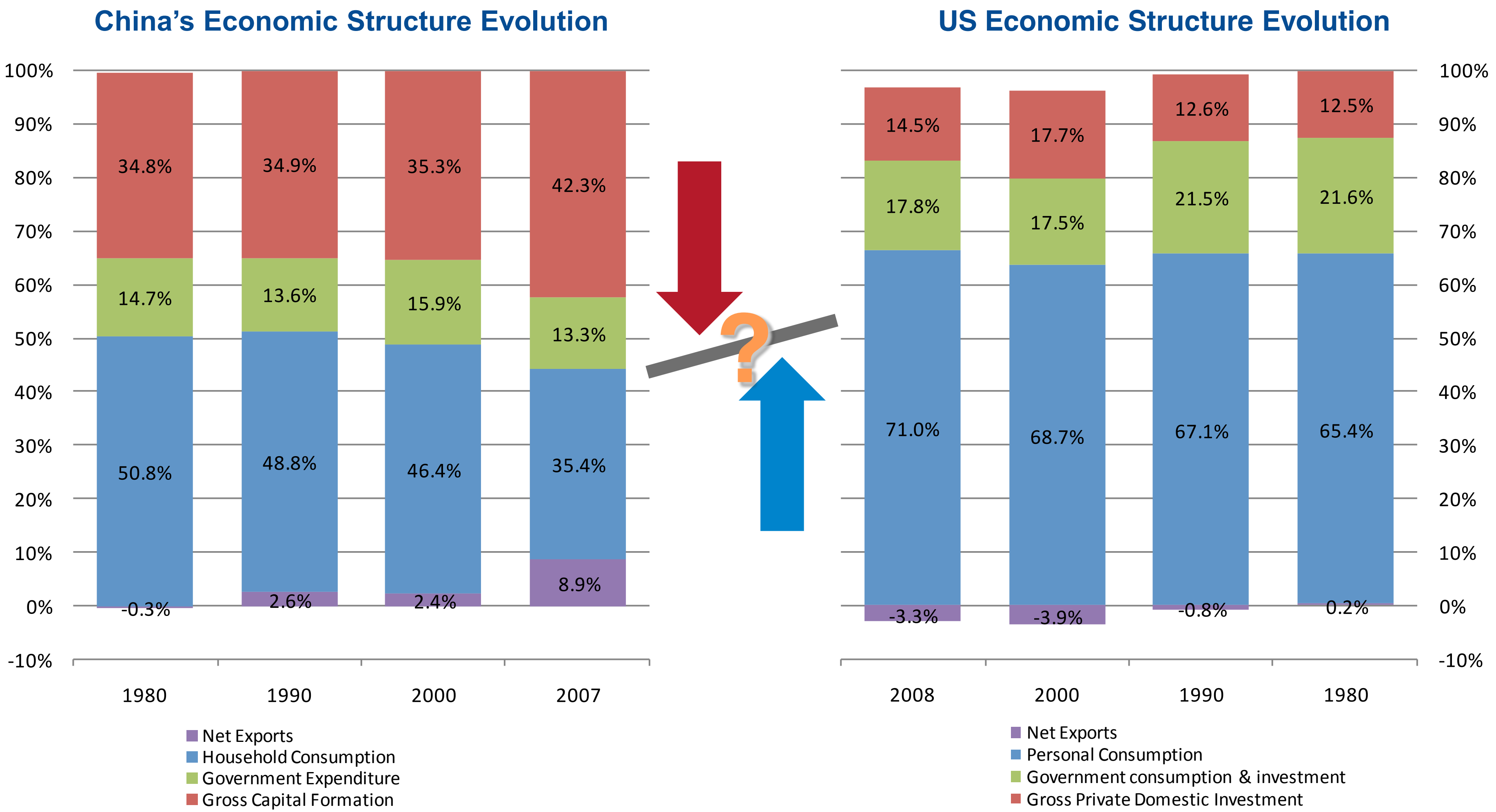
3
Service Sector Liberalization and Deregulation

- Most major service industries in China see market control consolidated amongst a small set of state owned incumbents, e.g.:
  - Telecoms and information services
  - Media
  - Transportation
  - Travel
  - Construction
  - Logistics
  - Financial Services
- Value added service areas are generally prohibitively restrictive; and foreign participation is very limited

* Source: Stephen Roach, Morgan Stanley at CDF May 21-23 2009

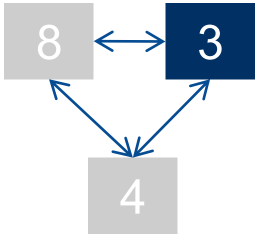
The rebalancing question – the US and China as analogs





The rebalancing question

As China's economy has grown rapidly to become the world's third largest, China's imbalances and investment shortfalls have likewise expanded to a very large size.



Key Imbalances –

1. Components of growth heavily weighted toward FAI and net exports
2. Huge deferral of maintenance in areas of environment, social infrastructure
3. Grossly inadequate provisions for predictable demographic changes
4. Many aspects of commercial and industrial enterprise growth fast at expense of sustainable, wide at expense of deep
5. Increasing levels of value redistribution on *ad hoc* basis, through quick response policy and tax change, subsidies, price controls and adjustments, market manipulations, warehousing, etc.

Rebalancing Means –

1. Raising labor/GDP elasticity (e.g. through economic pricing of all inputs)
2. Sharply reducing China's current account surplus, partially through increased imports and currency value flexibility
3. Assuring consumption growth in excess of GDP growth until balance has been achieved
4. Dramatically upscale environmental protection and support of social infrastructure
5. Reducing regional and inter-personal inequality
6. Promote underdeveloped service sectors on a commercially sound basis
7. Improve efficiency across the economy by exposing State-dominated sectors to domestic and international competition

Summary

With China's sustained success via the old model, how much reform is needed and practical?

- In many respects, the 8 components of China's stimulus and recovery strategy look to be "more of the same" – *a lot more of the same* – i.e. government-led investment in infrastructure and fixed assets – with the exception of:

    1. Redirecting state infrastructure spending towards grid access and efficiency and next-generation rail transportation – if the initiative remains on course. Of note, much of the spending proposed at the local levels appears to be for traditional infrastructure projects, e.g.: bridges, roads, airports, etc.

    2. Opening of the domestic financial services industry; although at this point, activity remains largely at the discussion level. Implementation timing is uncertain

- Major measures to stimulate and sustain domestic consumption – e.g. social security funding, healthcare reform, real estate reform and low-cost housing development, etc. – have not yet been articulated, much less taken.

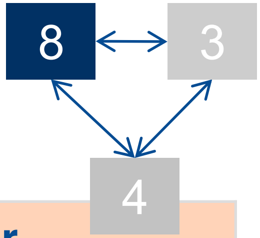
- Social security, environmental sustainability, healthcare, education, and other "social construction" programs appear largely rhetorical. Allocated funding in these areas is comparatively very small, and projects and intents remain undefined.

- Despite official rhetoric, support appears to remain strong for maintaining low value exports and production overcapacity.

- The RMB extension and aggressive expansion of FTAs effectively serves as a form of export finance supporting Chinese exporters, with some features boarding on protectionism and check-book diplomacy.

- **Key Question: Will "same old same old" work this time around?**

Contents



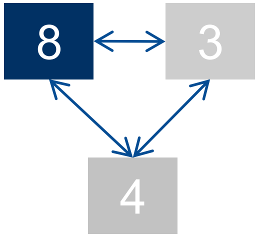
The 8 Recovery and Growth Strategy Components

Polling Exercise #1

Recovery and Growth Strategy Components	**Importance to Your Business** (1=low; 5=high)	**Impact on Your Business** (1=strongly negative; 2 = negative; 3 = neutral; 4 = positive; 5 = strongly positive)
1. **Stimulate Domestic Consumption** via direct spending incentives	1 – 5	1 – 5
2. **Protect and Diversify Exports** into non-traditional major export markets	1 – 5	1 – 5
3. **Clarify Focus of State Infrastructure Investment** away from industrial capacity and commercial real estate toward energy, next-gen transport and low income housing	1 – 5	1 – 5
4. **Deepen Domestic Sources of Commercial Finance**	1 – 5	1 – 5

The 8 Recovery and Growth Strategy Components (cont'd)

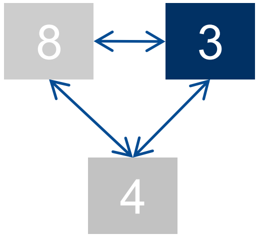
Polling Exercise #1



Recovery and Growth Strategy Components	**Importance to Your Business** (1=low; 5=high)	**Impact on Your Business** (1=strongly negative; 2 = negative; 3 = neutral; 4 = positive; 5 = strongly positive)
5. **Project the RMB** to protect exports and effect favorable Asian economic integration	1 – 5	1 – 5
6. **Secure the Supply and Price of Key Commodities**	1 – 5	1 – 5
7. **Support Existing Industrial Over Capacity**	1 – 5	1 – 5
8. **Address Business Environment Inefficiencies** to gain competitive cost advantage	1 – 5	1 – 5

The 3 Unaddressed Rebalancing Imperatives

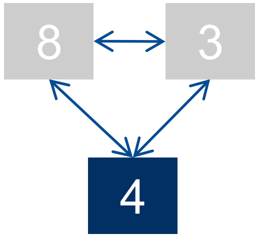
Polling Exercise #2



Unaddressed Rebalancing Imperatives	**Importance to Your Business** (1=low; 5=high)	**Impact on Your Business** (1=strongly negative; 2 = negative; 3 = neutral; 4 = positive; 5 = strongly positive)
1. **Significant Funding of Healthcare, Pension and other Social Welfare Programs** to encourage domestic consumption	1 – 5	1 – 5
2. **Real Estate Reform** to create a more efficient market	1 – 5	1 – 5
3. **Service Sector Liberalization and Deregulation**	1 – 5	1 – 5

The 4 Exogenous Factors

Polling Exercise #3



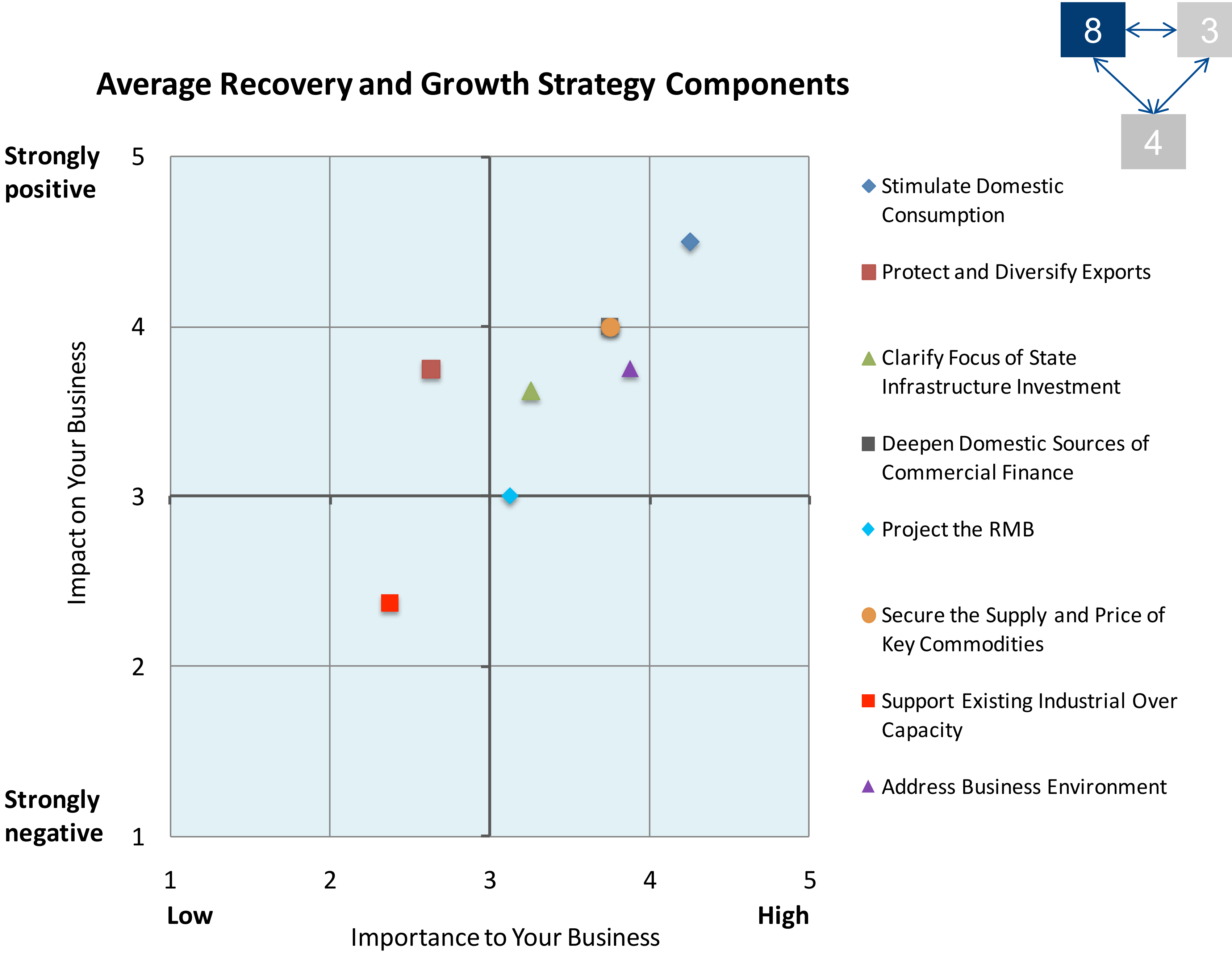
Unaddressed Rebalancing Imperatives	**Importance to Your Business** (1=low; 5=high)	**Impact on Your Business** (1=strongly negative; 2 = negative; 3 = neutral; 4 = positive; 5 = strongly positive)
1. **Weak US and EU Import Demand for Chinese Imports**	1 – 5	1 – 5
2. **Continued High Liquidity and Over Pricing of Assets**	1 – 5	1 – 5
3. **Continued US Dollar Devaluation**	1 – 5	1 – 5
4. **Increased Protectionism**	1 – 5	1 – 5

Preliminary Workshop Results

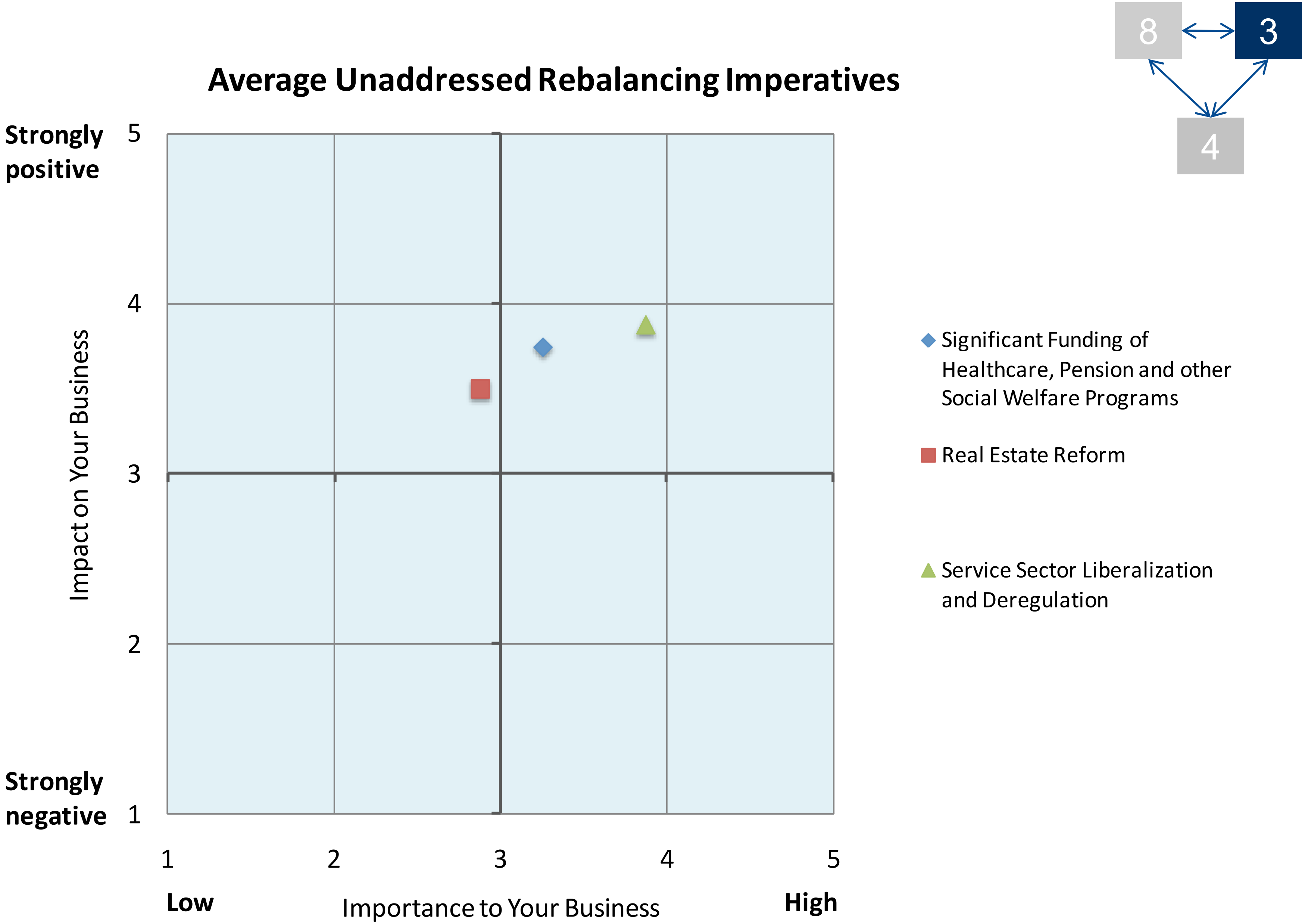
Summary of polling exercise results –

- **Factors seen as being the <u>most important</u> generally:**
  1. Stimulate domestic consumption (average rating of 4.3)
  2. Service sector liberalization and deregulation (average rating of 3.9)
  3. Address business environment inefficiencies (average rating of 3.9)
- **Factors seen as being <u>important</u> and <u>positive</u> for business:**
  1. Stimulate domestic consumption (average rating of 4.3 importance and 4.5 impact)
  2. Secure the supply and price of key commodities (average rating of 3.8 importance and 4 impact)
  3. Deepen domestic sources of commercial finance (average rating of 3.8 importance and 4 impact)
  4. Service sector liberalization and deregulation (average rating of 3.9 importance and 3.9 impact)
- **Factors seen as being <u>important</u> and <u>negative</u> for business:**
  1. Increased protectionism (average rating of 3.6 importance and 2.0 impact)
  2. Weak US and EU import demand for Chinese imports (average rating of 3.5 importance and 2.4 impact)
  3. In general, the exogenous factors were all seen as being more potentially negative for business than any of the China-specific factors.

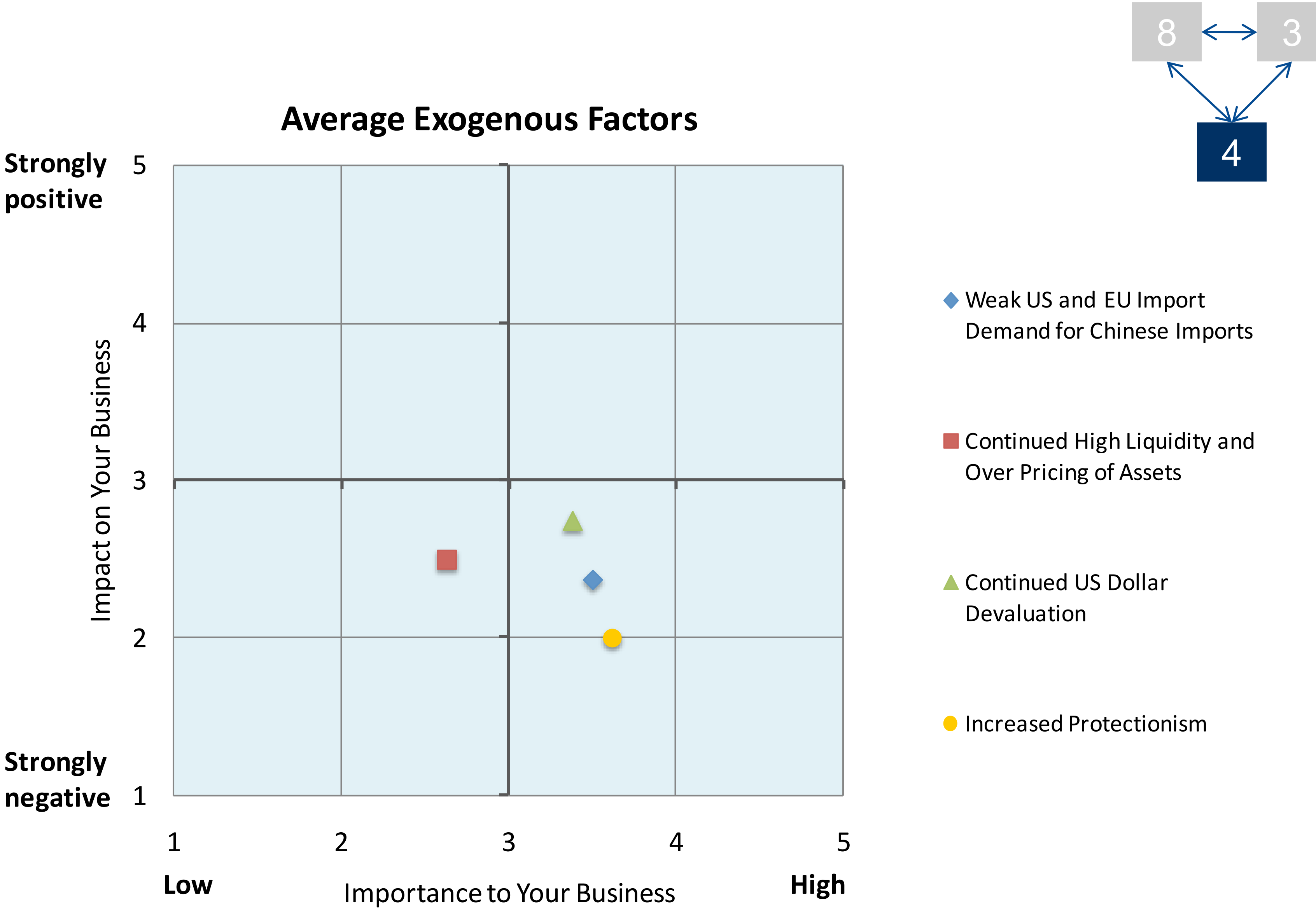
Average Recovery and Growth Strategy Components



Average Unaddressed Rebalancing Imperatives



Average Exogenous Factors



Contents

Historic Perspective – a Simplistic Chronology of China's Development Path

China's development path as seen along the 10 previous 5 year plans and their key focus areas.

Labor					Capital		Productivity		Indigenous Innovation
1953-1957	1958-1962	1966-1970	1971-1975	1976-1980	1981-1985	1986-1990	1991-1995	1996-2000	2001-2005
1st Plan	2nd Plan	3rd Plan	4th Plan	5th Plan	6th Plan	7th Plan	8th Plan	9th Plan	10th Plan

1958: The Great Leap Forward

1965: Start of the Cultural Revolution

1978/79: Reforms lead by Deng Xiaoping

1989: Tiananmen incident

1997: Begin of the Asian Crisis

2001: China's WTO ascension

Labor (1st–5th Plan)

- Industrial reconstruction and agricultural collectivization
- Focus on rapid industrial development and accumulation of industry output, especially heavy industry
- Socialist reform focusing on socialist collective ownership and public ownership

Capital (6th–7th Plan)

- Opening up and reform initiatives – "new socialist economic system with Chinese characteristics"
- Open door policy to introduce international trade and FDI
- From an administration driven command economy to price driven economic market system
- Capital intensive growth pattern

Productivity (8th–9th Plan)

- Structural changes in industry focus to secondary and tertiary industries
- Acceleration of opening up reforms and increased support of FDI
- Focus on increased productivity in the manufacturing industry

Indigenous Innovation (10th Plan)

- Upgrade and optimize industrial structure to strengthen long-term competitiveness
- Support indigenous innovation and China based IP
- Reduce growing imbalances between regions and income segments

Sources: NDRC, and various public sources

Assessing the 11th 5 Year Plan

Overview and key objectives of China's 11th 5 year plan.

- The 11th 5 year plan reflects Chinese policy makers increased focus on correcting growing economic and social imbalances emerging as a result of China's rapid economic growth.
- The 11th 5 year plan is not meant to provide concrete details on policies or implementation tools, but rather constitutes a set of guiding principles and major objectives for policy makers for the period of 2006 to 2010.
- These guiding principles and major objectives are supported by a set of policy orientations and main tasks/strategic priorities to help meet the objectives set.
- In addition, 22 overall quantitative benchmarks have been set to support monitoring the progress of key objectives. These quantitative benchmarks are divided into 4 categories reflecting the 11th 5 year plan's key objectives, all of which have clear target indicators set for 2010. While some of the key objectives and strategic priorities included in the plan are difficult to measure in a quantitative way, the 22 benchmarks clearly reflect the underlying focus on rebalancing economic and social imbalances.
- In several other key areas, for example in the areas of social insurance and social assistance as well as sustainable development, additional quantitative indicators and targets have been set in the plan.

Assessing the 11th 5 Year Plan

Based on guiding principles, policy orientations and objectives from the 11th 5 year plan, 5 key development areas can be summarized.

Key Development Areas	Main Objectives	Key Imbalances		
Macro economic development	• Stable macro economic environment • Improved living standards • Expansion of domestic demand	Investments and exports	◀▶	Domestic demand
Industry structure optimization	• Rationalization and optimization of the industrial structure and organization • Increased share of service sector output • Increased R&D to GDP ratio and focus on indigenous innovation • Emergence of key players with strong IP, brand recognition and international competitiveness	Industry sector	◀▶	Services sector
Resource efficiency and sustainable development	• Increased energy efficiency - energy intensity reduction of 20% (plus provincial targets) • Increased water resource efficiency • Reduction in air, water and solid waste pollution • Forest and eco-system protection	Increase in energy demand	◀▶	Sustainable development
Regional development	• "New socialist countryside" focus – Increase rural living standards and conditions; develop modern agricultural industry • Increased urbanization • Balanced urban-rural development, as well as regional disparities in living standards and development	Rural; Low-income regions	◀▶	Urban; High-income regions
Public services development	• Social protection (e.g. improvements in urban and rural social security and social assistance systems as well as labor market development • Health care services (insurance and medical assistance) • Education system development	Economic development	◀▶	Adequate public service offerings

Sources: The World Bank , NDRC, and other public sources

Assessing the 11th 5 Year Plan

Progress towards achieving the overall goals of the 11th 5 year plan has been good, however challenges in key areas such as industrial restructuring and environmental protection remain.

- While economic growth is well on track or has exceeded targets and significant progress can be seen in the areas of basic public and social services, progress towards sustainable development and energy efficiency have been mixed, and little progress has been made towards rebalancing China's overall growth pattern, industrial restructuring and reduction of widening social and regional gaps.
- To help monitor progress of key objectives, The 11th 5 year plan outlines 22 quantitative benchmarks, amongst which, the majority however are anticipated rather then obligatory targets.
- According to a report issued by the chairman of the NDRC in December 2008, progress in implementing 6 out of the 22 targets has been slow, all of which fall into the areas of economic restructuring and sustainable development (see indicators highlighted in red on next slide), which further indicates China's challenges ahead in these key areas.
- In conjuncture with China's current massive stimulus geared towards investment in heavy industry and infrastructure, it remains uncertain as to whether these targets are still within reach for 2010.

Sources: The World Bank , NDRC, and other public sources

Assessing the 11th 5 Year Plan

The 11th 5 year plan 22 key quantitative benchmarks.

Category	Indicator	2005 actual	2007 actual	2010 target	Target*	Problem Areas
Economic Growth	GDP (RMB trillion)	18.4	25.0	26.1	A	
	GDP per capital (RMB)	14,103	18,885	19,270	A	
Economic Structure	Share of services in GDP (%)	39.9	40.1	43.3	A	X
	Share of services in total employment (%)	31.4	33.2	35.3	A	X
	Ratio of R&D expenditures to GDP (%)	1.2	1.4	2.0	A	X
	Urbanization Rate (%)	43.0	44.9	47.0	A	
Population, Resources and Environment	Total population (100 million)	13.1	13.2	13.6	O	
	Reduction of energy use per unit GDP (%)	0.0	4.6[2]	20[3]	O	
	Reduction of water use per unit of VA (%)	0.0	n/a	30[3]	O	
	Efficiency coefficient of irrigation water	0.45	0.46[1]	0.50	A	
	Comprehensive utilization rate of industrial solid waste (%)	56.1	61.2	60.0	A	
	Total cultivated land (million ha)	122.1	121.7[1]	120.0	O	
	Reduction of total major pollutants emission (%)					
	COD	n/a	2.1[2]	10[3]	O	X
	SO2	n/a	3.2[2]	10[3]	O	X
	Forest coverage (%)	18.2	n/a	20.0	O	X
Public Services and Quality of Life	Average number of years of schooling (years)	8.5	n/a	9.0	A	
	Population covered by basic urban pension (100 million)	1.7	2.0	2.2	O	
	Coverage new rural cooperation health system (%)	75.7	85.7	80.0	O	
	New urban employment in five years (million)			45.0	A	
	Rural labor force transferred in five years (million)			45.0	A	
	Registered urban unemployment rate (%)	4.2	n/a	5.0	A	
	Per capita disposable income urban households (RMB)	10,493	13,790	13,390	A	
	Per capita net income rural households (RMB)	3,255	4,140	4,150	A	

Sources: The World Bank, NDRC

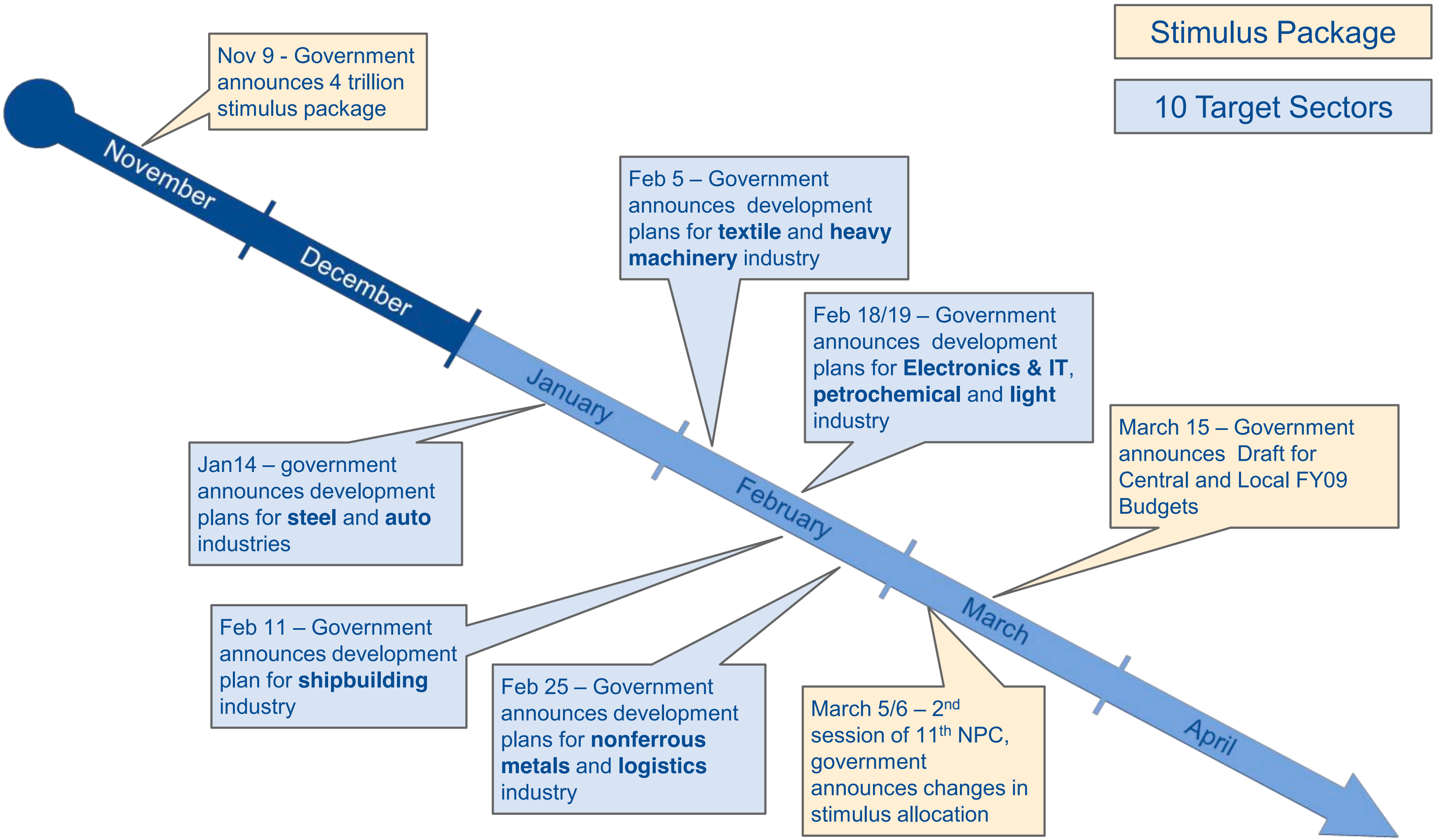
* O=Obligatory targets, A=Anticipated targets; [1] 2006 data; [2] Accumulated reduction in 2006-07; [3] Targeted accumulated reduction in 2005-10

Evaluating the Stimulus Program

China's stimulus program should be evaluated across three interconnected dimensions…

Evaluating the Stimulus Program

Timeline of events November 2008 – April 2009.



The Stimulus Package

Description of the stimulus package – general overview.

- In November 2008 the Chinese government announced an RMB 4 trillion stimulus plan, to be spend from 4Q 2008 until the end of 2010. The stimulus plan outlines 10 key priority areas – (1) transportation, (2) construction of rural infrastructure, (3) environmental protection, (4) innovation- and high-tech-oriented restructuring, (5) earthquake area reconstruction, (6) value-added tax reforms, (7) finance sector, (8) public housing development, (9) healthcare and education, (10) low-income initiatives – of which the majority are geared towards investment as opposed to stimulating consumption.
- Based on these 10 key priority areas, the government has allocated funding to the following categories: (1) transport & infrastructure including railroads, airports, roads and power grid; (2) post-earthquake reconstruction; (3) affordable housing, (4) rural living standards & infrastructure; (5) technological innovation & industry restructuring, (6) environmental protection, (7) healthcare & education. A significant portion of stimulus plan funding will go into infrastructure, which is potentially included in several of the spending categories (e.g. transport & infrastructure, post-earthquake reconstruction, and rural living standards & infrastructure).
- After an initial spending allocation was announced in November 2008, the government announced a revised version of funding allocation in March 2009, addressing public concerns that the stimulus plan was heavily skewed towards investment and capital intensive industries at the expense of consumption drivers and social welfare. However, spending categories related to social welfare and social rebalancing such as healthcare & education, rural living standards & infrastructure and affordable housing remain relatively low at 4%, 9% and 10% of total allocated spending respectively.
- China's Leadership clearly states the intent for the stimulus package is to dampen near-term economic distress, as well as to catalyze the required rebalancing and establish the foundation for sustainable growth. To this end, the stimulus package tries to incorporate a traditional approach of stimulating largely investment-oriented projects as well as social initiatives in the areas of employment, people's livelihood and social imbalances.

The Stimulus Package

Description of the stimulus package – funding split.

- The central government will come up with roughly RMB 1.18 trillion of the 4 trillion in total funding, while local governments , SOEs and private enterprises as well as policy and commercial bank loans will provide the rest. The central government has already spent a first batch of RMB 100 billion in Q4 2008, as well as a second and third batch in 2009, bringing total government funding to date to RMB 300 billion. Across the stimulus plan time horizon, the central government has allocated funding to be spend as follows:

4Q 2008:	RMB 100 billion
2009:	RMB 487.5 billion
2010:	RMB 588.5 billion
Total 4Q 2008 - 2010:	RMB 1.18 trillion

- In numerous speeches, premier Wen Jiabao and other government officials have stressed that the RMB 1.18 trillion in government funding will be newly added investment, however, admitted that some projects already included in the 11th 5 year plan would be included.

- Under the plan, local governments and the private sector are expected to raise RMB 2.82 trillion or roughly 70% of the stimulus funding. According to the NDRC, local government funding can be raised through the following main methods:
  - The RMB 200 billion bond program, undertaken by the Ministry of Finance (MOF) on behalf of local government s, which allows local governments to issue bonds in 2009.
  - Policy loans
  - Local corporate bonds

The Stimulus Package

Description of the stimulus package – funding split (cont'd).

- Most of the burden for funding lies with local governments, which, with eroding property deals (one of the main sources of income for local governments) and decreases in fiscal revenue, struggle to come up with the necessary funding. By law local governments are required to balance their accounts, and are not allowed to run deficits or borrow. However, the RMB 200 billion bond scheme, where the central governments borrows on behalf of local governments, will only provide for a small fraction of local government funding.
- Many local governments use local government-backed corporate bonds to obtain funding, a regulatory grey area which makes it difficult to assess the scale of local government debt (and where the money is flowing) as well as poses potential regulatory risk. According to a report from Xinhua, in March alone, Beijing, Shanghai and Guangdong raised RMB 25 billion by issuing medium-term bills on the inter bank market, through similar grey area corporate bonds.
- The majority of stimulus projects need approval from the NDRC but are executed and implemented by local governments. Reportedly, projects with funding exceeding RMB 30 million need NDRC approval, while projects with funding exceeding RMB 200 million need NDRC and State Council approval. However, other sources report that projects under RMB 100 million will only need provincial government approval. So far, approval processes and qualification details remain vague, and although it is reported that FIE participation is possible, little further details are currently available.
- It appears that local governments have proactively started to stimulate local economic activities. Shortly after the announcement of the stimulus package in November 2008, numerous sources stated that fixed assets investment plans for local governments soared to RMB 18 trillion. These numbers however, should be treated with caution, as it remains questionable how local governments will raise these huge amounts of funding.

The Stimulus Package

The stimulus package breakdown by category and anticipated government spending.

	Category	Total Planned Spending Q408 - 2010 (RMB billion)				Central Government Spending (RMB billion)									
		Total (old)	Total (new)	Central/Local Govn't Split		Planned Spending			Actual Spending				Outstanding Spending		
				Central	Local *	2008 Q4	2009	2010	Total to date	Batch 1 Q408	Batch 2 2009	Batch 3 2009	Total to date	2009	2010
1	Transport & infrastructure	1,800	1,500	n/a	n/a	n/a	n/a	n/a	53	25	27.5	n/a	n/a	n/a	n/a
2	Post-earthquake reconstruction	1,000	1,000	n/a	n/a	n/a	n/a	n/a	….	….	….	n/a	n/a	n/a	n/a
3	Affordable housing	280	400	n/a	n/a	n/a	n/a	n/a	38	10	28	n/a	n/a	n/a	n/a
4	Rural living standards & infrastructure	370	370	n/a	n/a	n/a	n/a	n/a	66	34	31.5	n/a	n/a	n/a	n/a
5	Technological innovation & industry restructuring	160	370	n/a	n/a	n/a	n/a	n/a	21	6	15	n/a	n/a	n/a	n/a
6	Environmental protection	350	210	n/a	n/a	n/a	n/a	n/a	23	12	11	n/a	n/a	n/a	n/a
7	Health & education	40	150	n/a	n/a	n/a	n/a	n/a	30	13	17	n/a	n/a	n/a	n/a
	Total	**4,000**	**4,000**	**1,180**	**2,820**	**100.0**	**487.5**	**588.5**	**300.0**	**100.0**	**130.0**	**70.0**	**876.0**	**287.50**	**588.5**

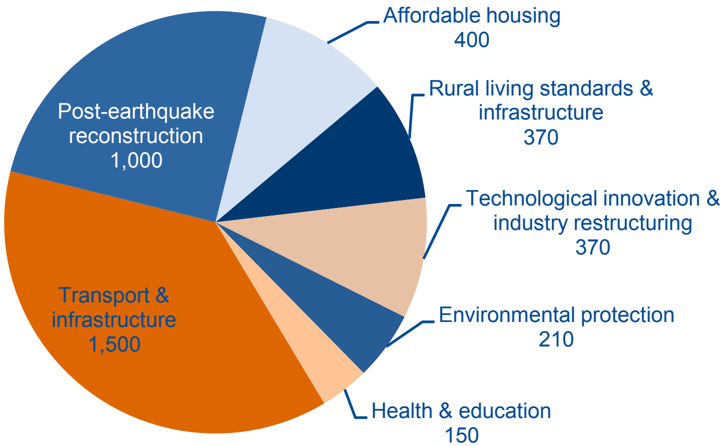
•Local governments + private sector

Source: Compiled by author from public domain

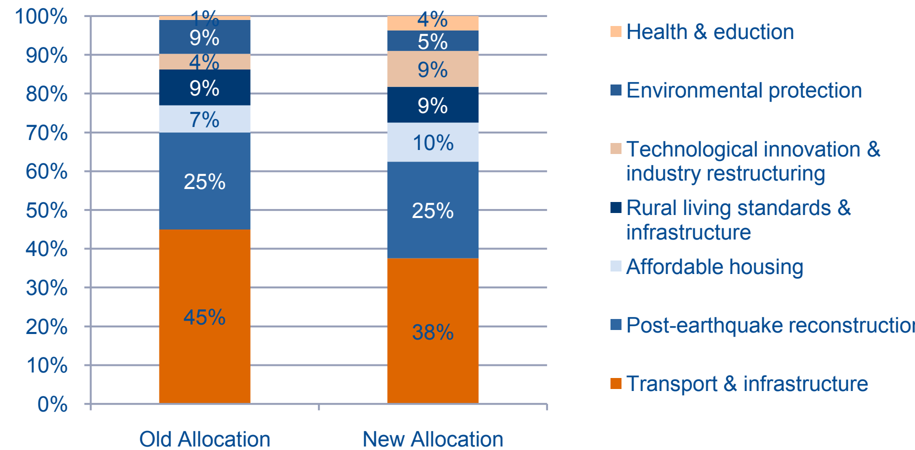
The Stimulus Package

The stimulus package breakdown by category and central government spending.

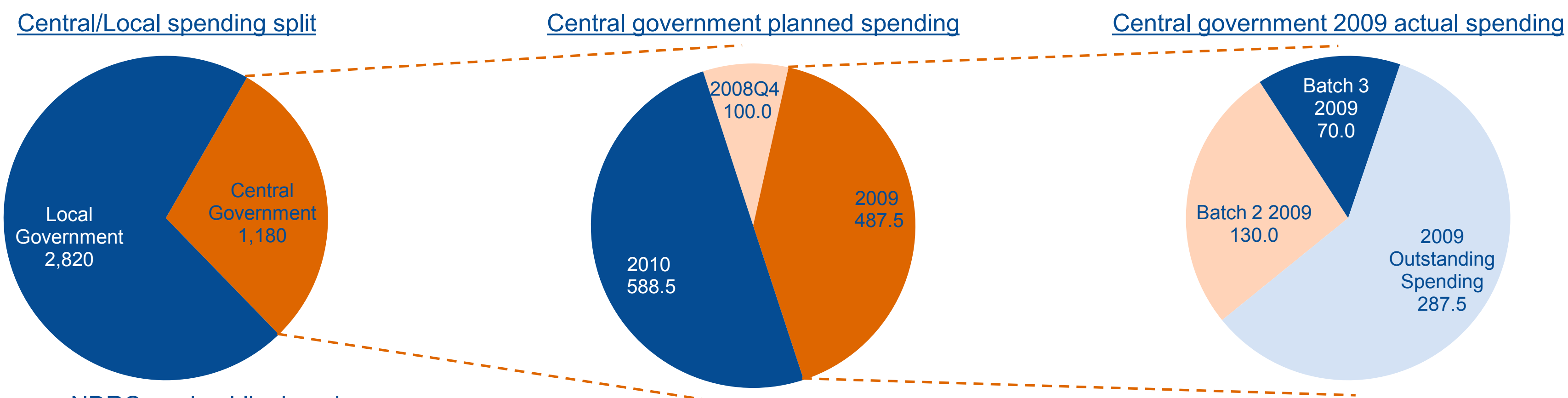
Stimulus package breakdown by category (RMB billion)



Stimulus package breakdown by old and new allocation (%)



Central government's spending on the stimulus package (RMB billion)

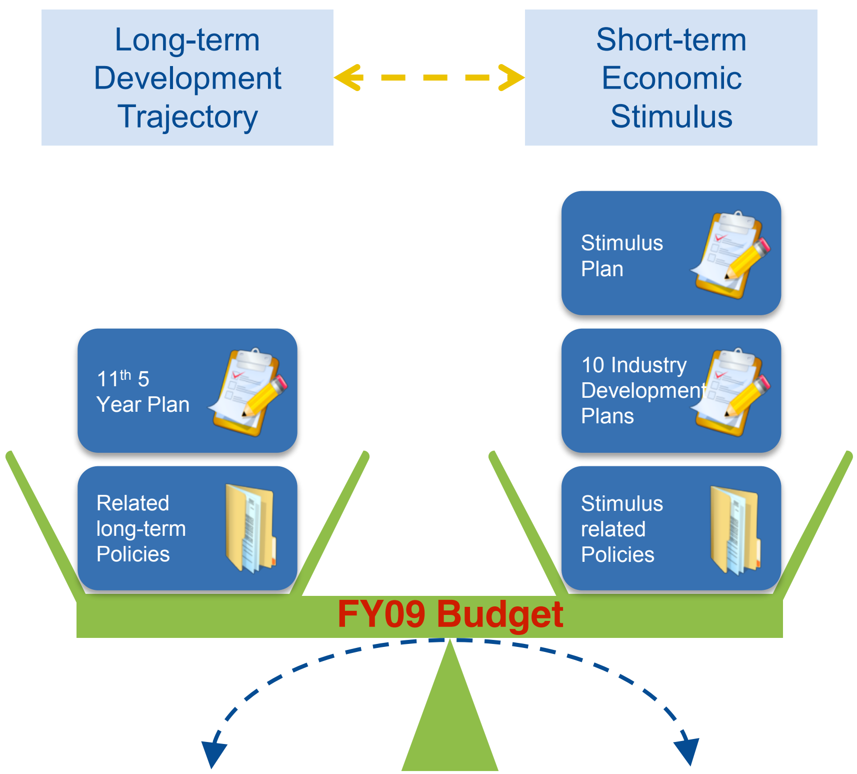


Sources: NDRC, and public domain

The Stimulus Package

The FY 09 budget (cont'd).

- On March 15 2009 the government announced their Draft for the FY09 Central and Local Budget. The budget can be seen as an attempt to balance short-term economic stimulus policies heavily geared towards infrastructure spending and capital intensive industries and more balanced development in the long-term.
- Total expenditures in the central budget will total RMB 4.3865 trillion, of which RMB 2.8889 trillion are paid out as tax rebates and transfer payments to local governments. This represents an increase of RMB 848.4 billion or 24% over 2008, of which 12% increase will be incurred at the central level, while 31% increase will be incurred at the local government level.
- Total deficit for 2009 is planned to stand at RMB 950 billion, including RMB 200 billion in bonds issued on behalf of local governments. With 3% of GDP, China's total deficit for 2009 should be well within the margin of safety.



The Stimulus Package

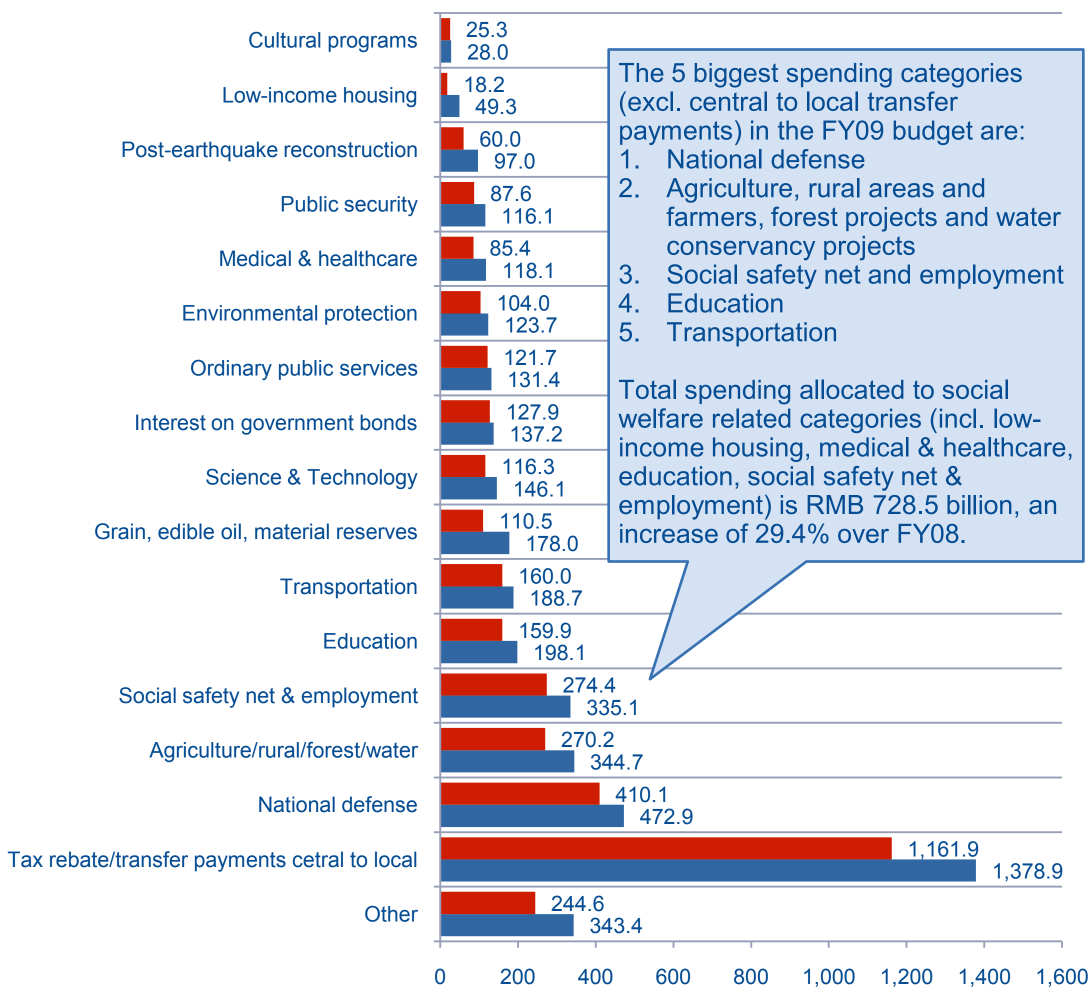
The FY 09 budget (cont'd).

Major Spending Categories (RMB billion)	2008	2009	Change (%)	2009 % of Total	2008 % of Total
Tax rebate and general transfer payments from central to local governments	1161.9	1378.9	18.7%	31.4%	32.8%
National defense	410.1	472.9	15.3%	10.8%	11.6%
Agriculture, rural areas and farmers, forest projects & water conservancy projects	270.2	344.7	27.5%	7.9%	7.6%
social safety net & employment	274.4	335.1	22.1%	7.6%	7.8%
Education	159.9	198.1	23.9%	4.5%	4.5%
Transportation	160.0	188.7	17.9%	4.3%	4.5%
Grain, edible oil, material reserves	110.5	178.0	61.1%	4.1%	3.1%
Science & technology	116.3	146.1	25.6%	3.3%	3.3%
Interest on government bonds	127.9	137.2	7.3%	3.1%	3.6%
Ordinary public services	121.7	131.4	8.0%	3.0%	3.4%
Environmental Protection	104.0	123.7	18.9%	2.8%	2.9%
Medical & healthcare	85.45	118.06	38.2%	2.7%	2.4%
Public security	87.6	116.1	32.6%	2.6%	2.5%
Post-earthquake reconstruction	60.0	97.0	61.7%	2.2%	1.7%
Low-income housing	18.2	49.3	171.0%	1.1%	0.5%
Cultural programs	25.3	28.0	10.7%	0.6%	0.7%
Other	244.6	343.4	40.4%	7.8%	6.9%
Total	**3538.0**	**4386.5**	**24.0%**	**100.0%**	**100.0%**

Sources: Central government website, and calculations by authors

The Stimulus Package

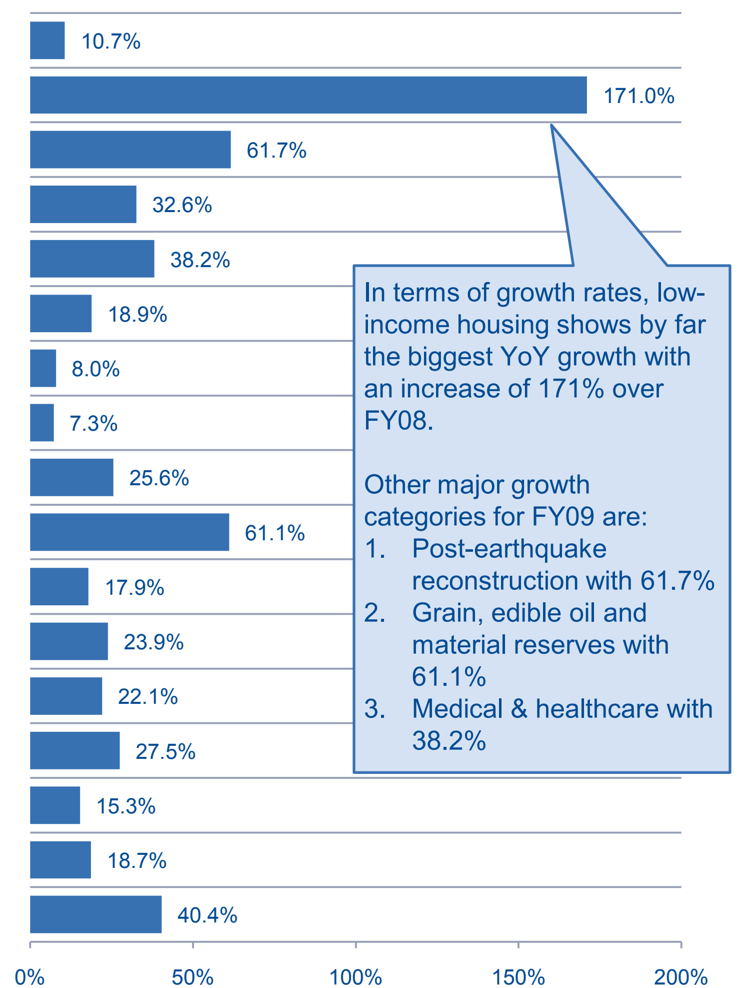
The FY 09 budget (cont'd).



The 5 biggest spending categories (excl. central to local transfer payments) in the FY09 budget are:

1. National defense
2. Agriculture, rural areas and farmers, forest projects and water conservancy projects
3. Social safety net and employment
4. Education
5. Transportation

Total spending allocated to social welfare related categories (incl. low-income housing, medical & healthcare, income housing, medical & healthcare, education, social safety net & employment) is RMB 728.5 billion, an increase of 29.4% over FY08.



In terms of growth rates, low-income housing shows by far the biggest YoY growth with an increase of 171% over FY08.

Other major growth categories for FY09 are:

1. Post-earthquake reconstruction with 61.7%
2. Grain, edible oil and material reserves with 61.1%
3. Medical & healthcare with 38.2%

Sources: Central government website, and calculations by authors

The Stimulus Package

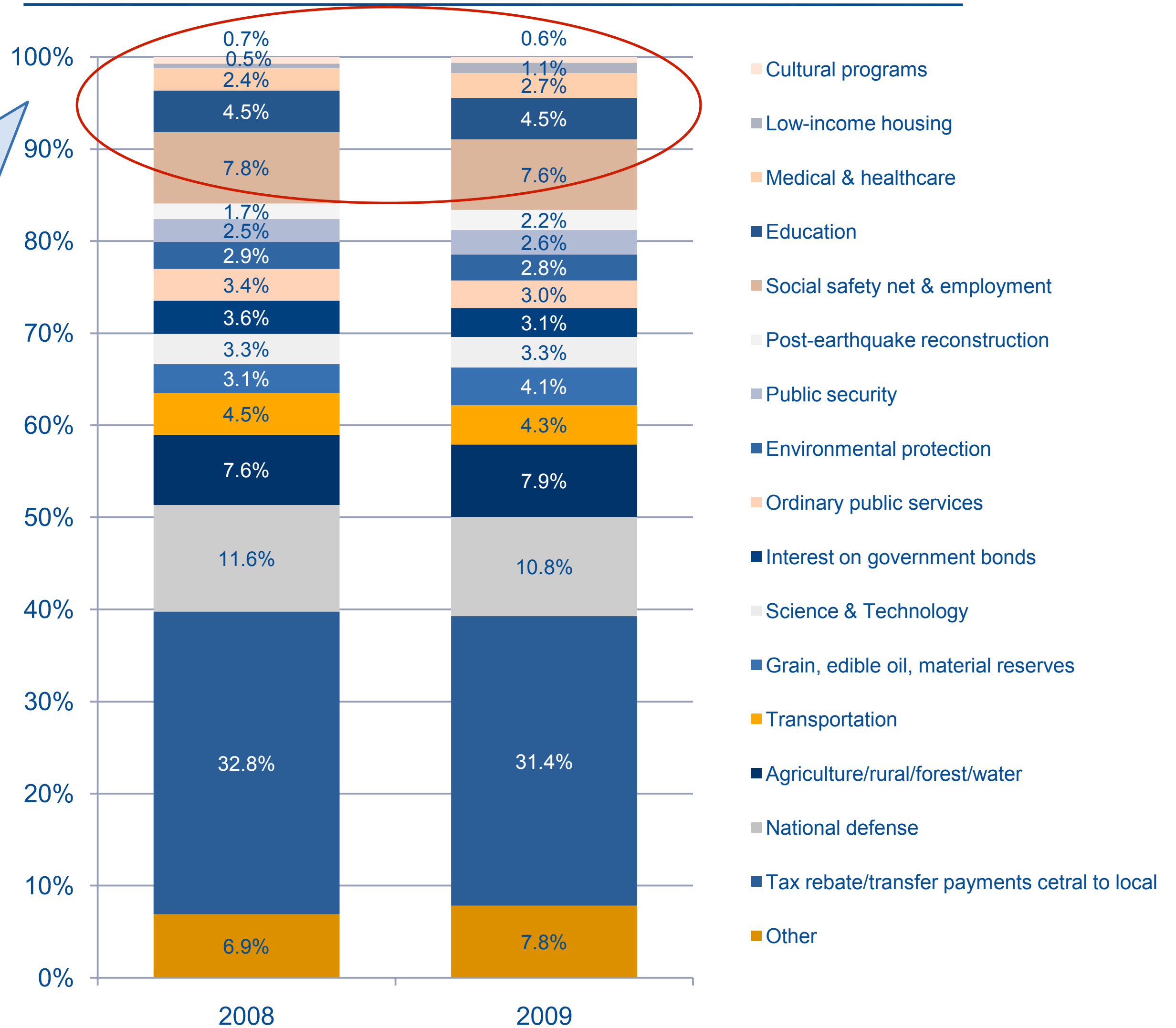
The FY 09 budget (cont'd).

No major changes in terms of proportional growth can be seen between FY08 and FY09 allocation.

Spending allocated to social welfare related categories (incl. low-income housing, medical & healthcare, education, social safety net & employment) as proportion of total allocated spending will only increase marginally from 15.9% in FY08 to 16.6% in FY09.

The only category with welfare related spending showing significant increase is low-income housing, where spending allocation as percentage of total allocated spending is planned to ncrease from 0.5% in FY08 to 1.1% in FY09.

Proportional spending by category for FY08 and FY09 budgets (as % of total budget)



Sources: Central government website, and calculations by authors

The 10 Target Industry Development Plans

Along with the 4 trillion stimulus package, the government has designated 10 industry target sectors to help revitalize strategic industries.

- Within 6 weeks of announcing the first industry development plan in mid-January, 10 target industry development plans have been announced to revitalize strategic industry sectors.
- Similar to the stimulus package, the industry plans mostly focus on supporting capital intensive industries such as automobile, steel, heavy machinery, shipbuilding, petrochemical and nonferrous metals. However, a number of other key industries, namely textile, electronics & IT, light industries and logistics are also part of the 10 industry plans.
- While the 10 development plans vary widely in terms of depth and detail and present a mixture of tangible measures and more vague “desirable outcomes”, they do include various anticipated policy changes such tax rebates and reductions, various subsidies, bank loans and other funds allocation. The plans aim to include both short term financial relieve for struggling industry sectors as well as more long term industry restructuring and efficiency initiatives (e.g. through market consolidation and reduction in overcapacity).
- Recent news reports state that China’s National Energy Administration (NEA) has completed a first draft for a new energy stimulus plan, which is currently under review by the NDRC. It is reported that under the new plan, the Chinese government is expected to invest more than RMB 2 trillion in renewable energies. Stimulus plans for other industries, for example building-integrated solar applications, have also been announced. It remains unclear, however, if and how this spending is part of the 4 trillion stimulus package.

The 10 Target Industry Development Plans

Description about what is known about each plan.

	Target Industry	Key Development Objectives	Date
1.	Auto	• Lower purchase tax on cars with engines under 1.6 liters, from 10% to 5% for the period of Jan 20 to Dec 31 • Allocate RMB 5 billion to provide one-off allowances to farmers to upgrade their three-wheeled vehicles and low-speed trucks to mini-trucks or purchase new mini-vans under 1.3 liters for the period of March 1 to Dec 31 • Increase subsidies for people who scrap their old cars and lift regulations that restrict car purchase • Urge improvements to the credit system for car loans • In the next three years, earmark RMB 10 billion to support auto companies to upgrade technologies and develop new engines that use alternative energies	Jan 14, 2009
2.	Steel	• Special funds to be allocated from the central government's budget to promote technological advancement of the sector • Adopting flexible tax policy on steel exports • Readjustment of products mix, and improvement in product quality • Eliminate overcapacity	Jan 14, 2009
3.	Textile	• To increase the rate of tax rebates from 14% to 15% for exporting firms of textile and garment • To set up a special fund to help in upgrading technology • To encourage old factories to relocate to inland provinces and to the western regions • To encourage financial institutions to support the growth and consolidation of local textile firms	Feb 5, 2009
4.	Heavy Machinery	• To reduce reliance on imported parts • To promote integration of research institutions • To encourage machinery exports and imports of key technologies and machinery parts by implementing tax incentives	Feb 5, 2009

Sources: East Asian Institute: Background Brief No. 438; and various public sources

The 10 Target Industry Development Plans

Description about what is known about each plan.

Target Industry		Key Development Objectives	Date
5.	Shipbuilding	• To increase credit support by an unspecified amount for ship builders (especially for export) • To extend the existing financial support policies for ocean-going vessels until 2012 • To provide tax rebates on key imported components for domestically owned oceangoing ships • To encourage the replacement of outdated ships • To suspend new shipyard construction • To support technological and industrial updates	Feb 11, 2009
6.	Electronics & IT	• To modify criteria for high-tech enterprises • To adjust tax rebates for exporters of electronics and information products • To promote third-generation mobile communication services and digital TV over the next three years. • To promote development of national science and technology projects, improve public technological service platforms	Feb 18, 2009
7.	Petrochemical	• To provide better tax policies and more credit access • To promote technological innovation and the construction of major petrochemical projects: provide RMB 100 billon to upgrade quality of oil products, and RMB 400 billion for new petrochemical projects and overseas acquisitions • To accelerate the building of reserves for oil products • To guarantee the supply of input materials for farming, such as fertilizers	Feb 19, 2009
8.	Light Industry	• To lift restrictions on processing trade • To raise export tax rebates • To extend fiscal and credit support to SMEs • To add microwave ovens and cookers to the list of appliance purchase • subsidy program • To speed up technology upgrades in certain sectors and to improve energy efficiency and environmental protection	February 19, 2009

Sources: East Asian Institute: Background Brief No. 438; and various public sources

The 10 Target Industry Development Plans

Description about what is known about each plan.

Target Industry		Key Development Objectives	Date
9.	Nonferrous Metals	• To provide subsidized loans for technical innovations of the sector • To adjust the rate of export rebate for the exporters of nonferrous products • To eliminate technically undeveloped producers • To promote company restructuring and avoid excessive output capacity	Feb 25, 2009
10.	Logistics	• To increase supply of necessary equipment • To promote an industry standard and establish an information platform • To build a special region for logistics development • To boost urban delivery, wholesale and rural logistics • To encourage mergers and restructuring of companies to support the emergence of internationally competitive large and modern logistics companies • To encourage the development of logistics for energy, mining, automobile, and medical industries as well as for agricultural products • To allocate RMB 100 billion (by central and local governments) within two years to support promotion and application of innovative products	Feb 25, 2009

Sources: East Asian Institute: Background Brief No. 438; and various public sources

Recent Policy Development and Changes

Ad Hoc and longer term policy changes.

Policy Changes	Ad Hoc	Longer term	Policy Details
VAT reform	✓	✓	In November 2008, China's government announced it would extend its value-added tax (VAT) reform to all industries nationwide , starting from January 1 2009. The reform aims to reduce the tax burden on companies by more than RMB 120 billion in 2009. Some of the key areas of the reform are as follows: (1) The reform aims to shift from the existing production-based to a consumption-based VAT regime, and will enable companies to deduct capital spending from the VAT; (2) Removed policies that exempted imported equipment from VAT; (3) Removed foreign-funded companies from eligibility for tax rebates on domestic equipment purchases; (4) VAT rate for small businesses and the self-employed who fall into the small-scale taxpayers category was reduced to a universal 3% from 6% for industrial companies and to 4 percent for commercial companies, (5) VAT rate for mineral products rose back to 17% from 13%.
Cut in bank lending and deposit rates	✓		In September 2008, the People's Bank of China (PBOC) has lowered interest rates for the first time in 6 years, cutting one-year lending rate by 27 bps to reach 7.2%. In total the PBOC has cut one-year lending rates five times by a cumulative 216 bps to reach 5.31% in March 2009. One-year deposit rates have also been cut by 189 bps from 4.14% to reach 2.25% by March 2009.
Reductions in reserve requirement ratio	✓		Since the second half of 2008, when the required reserve ratio stood at 17.5%, the PBOC has reduced the required reserve ratio several times. Since September 2008, different reserve ratios for smaller and larger financial institutions were applied. At the end 2008, the reserve ratios for small and medium sized banks and large banks stood at 13.5% and 15.5% respectively.

Recent Policy Development and Changes

Ad Hoc and longer term policy changes (cont'd).

Policy Changes	Ad Hoc	Longer term	Policy Details
Credit quotas	✓		At the end of 2008, China eliminated credit quotas applied by the central bank on commercial banks.
Export tax rebates	✓		By the end of March 2009, the State Administration of Taxation (SAT) had raised export tax rebates for the sixth time since August 2008. Increases were made for a total of 3,800 export items, accounting for roughly 1/3 of products covered by customs tariffs. Items include textile and garment exports, toys, high-tech products, iron and steel, nonferrous metals etc. Tax rebate increases vary across items.
Fuel tax increase for oil products	✓		In December 2008, the MOF and Ministry of Taxation announced increases in fuel consumption taxes, including the following main changes: (1) consumption tax on naphtha, solvents and lubricant oil to raise from RMB 0.2 to RMB 1 per liter and tax on jet kerosene and fuel oil to rise from RMB 0.1 to RMB 0.8 per liter; gasoline consumption tax to raise from RMB 0.2 to RMB 1 per liter and diesel consumption tax to raise from RMB 0.1 to RMB 0.8 per liter; (3) consumption tax on imported naphtha will be reinstalled, while tax on jet kerosene will be temporarily postponed; (4) consumption tax on naphtha produced domestically and used for production of ethylene and aromatic hydrocarbon products will be exempt until the end of 2010, while tax already paid on imported naphtha for the same usages will be returned.
Launch of Growth Enterprise Board (GEB)	✓	✓	The government has announced broad guidelines for the launch of China's Growth Enterprise Board on May 1. According to the China Securities Regulatory Commission (CSRC) companies that seek listing at the new second board should meet the following requirements: (1) Minimum net assets of RMB 20 million; (2) In business for more than three years; (3) Realize no less than RMB 100 million of net profits in the past two years, or net income and revenue in the previous year must be over RMB 5 million and RMB 50 million respectively; (4) YoY growth rate of 30% or more in recent two years.

Recent Policy Development and Changes

Ad Hoc and longer term policy changes (cont'd).

Policy Changes	Ad Hoc	Longer term		Policy Details
Support for SMEs	✓		▶	February 2009: In an attempt to ease options for small and medium sized enterprises (SMEs) to obtain bank loans, the MOF supplied RMB 1 billion to 330 qualified credit guarantee institutions, which insure loans.
FDI related policies	✓	?	▶	Changes in foreign direct investment (FDI) policies will reduce central MofCOM's role in decisions on transactions under US$ 100 million, FDI funded RMB funds, M&A deal structures and off-shore holding structures.
Stamp tax on stock purchase	✓		▶	In September 2008, China removed the stamp tax on stock purchases, while keeping the tax on sales at 0.1%.
Stimulate domestic distribution & consumption		✓	▶	In December 2008 the State Council released the document outlining measures to further stimulate the rural distribution network and domestic consumption. However, the document consists mainly of restatements made earlier by the government and remains vague in terms of tangible measures.
Rural subsidies for electronic products	✓	✓	▶	In February 2009, the government extended it's scheme for rural household purchasing subsidy for home appliances to all rural residents nationwide, which offers a 13% subsidy to a catalog of consumer electronic products. The program piloted in 2007 in the provinces of Shandong, Henan and Sichuan. The subsidy list currently includes microwaves, stoves, motorcycles, personal computers, water heaters, air conditioners TVs, refrigerators, washing machines and mobile phones. The subsidies are jointly funded by central and local governments with a 80/20 split, while the central government will cover 100% of subsidies in earthquake-affected areas. In some regions, the program is planned to continue until January 2013.

Recent Policy Development and Changes

Ad Hoc and longer term policy changes (cont'd).

Policy Changes	Ad Hoc	Longer term	Policy Details
Domestic consumption subsidies	✓		Local measures to increase consumption have been taken by issuing shopping coupons as well as travel vouchers which can be redeemed at local travel agencies. For example, both Zhenjiang and Nanjing in Jiangsu province have issued tourism coupons for local residents amounting to RMB 80 million and RMB 20 million respectively (as of February 2009). In addition, some provinces and municipalities are experimenting with cash coupons instead of bonus or salaries payments and coupons instead of cash subsidies for pensioners. Although the programs , which offer discounts to locally produced products, have shown success in increasing short term consumption, questions regarding long term effects and concerns regarding local protectionism remain.
Subsidies for car/motorcycle buyers	✓	✓	Starting from February/March 2009, the government will allocate a subsidy fund of RMB 5 billion for rural residents buying cars with an engine size of 1.3 liters smaller. • 10% discount (with a RMB 5000 ceiling) for purchasing light trucks and minivans from March 1 to December 31. • Subsidies of RMB 2000 and RMB 3000 respectively to replace used three-wheeled and four-wheeled vehicles. • 13% purchasing rebate (with ceiling of RMB 650) for farmers who purchase motorcycles from February 1 2008 to January 31 2013, with a cap at two motorcycles per rural household.
Increase employment	✓	✓	The government has allocated RMB 42.02 billion in their FY09 budget for employment initiatives and is aiming to provide 9 million new urban jobs in 2009, in order to keep the country's rural unemployment rate below 4.6%. (However ,this unemployment rate only applies to registered rural unemployment, which is potentially only a fraction of real unemployment).

Recent Policy Development and Changes

Ad Hoc and longer term policy changes (cont'd).

Policy Changes	Ad Hoc	Longer term	Policy Details
Graduate employment	✓	✓	In February 2009, the State Council issued guidelines announcing to increase placement of college and university graduates through provision of subsidy programs and social insurance, as well as launching a graduate training program within the next three years.
Support for lower-income real estate market	✓	?	In October 2008, the PBOC announced tax exemptions and down payment cuts for the real estate sector: (1) Minimum down payment for a first-time buyer of a residence smaller than 90 square meters was reduced to 20 percent from 30 percent; (2) Interest rates on mortgages for first-time buyers were cut by 0.27%; (3) The floor for interest rates was lowered to 70% of the central bank's benchmark rate. A document released by the government in December 2008 further stressed the government's support for the real estate sector: (1) Spend three years to build houses for 7.5 million low-income families in urban areas and 2.4 million households in shanty towns in forests, reclamation areas and coal mines; (2) Continue renovating aged buildings in rural areas, which will be financed by the central government; (3) Offer higher subsidies for the less developed central and western regions; (4) Carry out pilot projects in some area to test the feasibility of supporting construction with idle funds in local housing provident fund accounts; (5) To encourage transactions, second-home buyers, with per-capita room-at-home lower than the local average, will be allowed to enjoy favorable policies for first-time house buyers; (6) Tax on house transactions will be reduced in 2009; (7) Homeowners who had lived-in for more than two years will be exempted from a transaction tax, which had been levied on houses lived in for less than five years; (8) For those who had lived-in for less than two years, the base of tax will be transaction price minus the original price; (9) Banks should lend to developers of low-price apartments, especially those under construction, and offer services for mergers by credible developers.

Recent Policy Development and Changes

Ad Hoc and longer term policy changes (cont'd).

Policy Changes	Ad Hoc	Longer term	Policy Details
Healthcare reform		✓	In April 2009, the Chinese government unveiled a blueprint for China's long awaited healthcare reform. The core principles of the reform are to provide universal basic health care coverage as a "public service" to all Chinese citizens and to reform China's healthcare system by 2020. RMB 850 billion have been earmarked by the government for implementation over the next three years. However, specifics of the plan have yet to be released, especially regarding funding and implementation by local governments.
Land reforms		✓	In October 2008, the government announced major land reforms aimed at increasing the income of hundreds of millions of farmers by allowing them to lease or transfer their land-use rights.
Social insurance law		✓	A first draft of China's first social insurance law was issued in December 2008 for public comments. The law aims to consolidate previous regulations regarding various social insurance schemes and introduces new rules on the administration and distribution of social insurance funds. Under the new draft law, employers will be required to pay insurance premiums for 5 mandatory social insurances – old-age, medical, unemployment, work-related injuries and cmaternity insurances – and withhold the amount required to be contributed by employees from their remuneration based on the rate set out by local labor bureaus. The goal is to provide equal access to social insurance schemes and is an important step towards a nationwide social insurance system.