

Welcome to the July 2007 edition of Pragma's China Newsletter, prepared by Jesa Consulting

➔ FOCUS ON: Newly enacted Chinese Bankruptcy Law



In line with the numerous legislative changes which have been taking place in China over the past few months, comes the implementation on June 1st of the new bankruptcy law, which introduces significant changes from its predecessor.

The Law of the People's Republic of China on Enterprise Bankruptcy (no. 54) was first enacted on December 2, 1986 as trial implementation and then formally came into operation in 1988. Since China was in the very initial stages of switching from a centrally-planned economy to a market-based one, the law was plagued with tribulation from the start. The two primary problems with this law were that: 1) it only applied to State-Owned Enterprises - private companies were not even mentioned; and 2) employees' interests were placed before those of creditors. The now 20 year-old law placed the government in charge of every stage of the bankruptcy process. As a result, politics became more important than profits and for fear of social unrest, more importance was placed on laid-off employees. Need-less-to-say this created an unfriendly investment environment for potential creditors. Not many bankruptcy cases led to successful reorganizations and for this reason the PRC issued a review of the law in 1994; the current law is the result of a 12-year period of drafting and deliberation following this review.

The new law creates a formal corporate-bankruptcy procedure with judge appointed administrators and with creditors having payment priority over employees. Since creditors will be supervising the process, it means that professional, and even foreign lawyers and accountants will be leading the process (rather than Communist Party officials with secondary concerns). It will allow bankrupt companies to continue to run their assets, with a plan to reorganize them into viable businesses instead of going into liquidation (as is done in other parts of the world including the U.S.).

An important article in the law will allow both voluntary bankruptcy filings by the debtor and involuntary bankruptcy filings against the debtor by its creditors. The debtor that voluntarily files may choose reorganization (which restructures the enterprise's debts), liquidation (which ends the enterprise's operations and sells all assets for the benefit of the creditors), or conciliation (which allows for a quick compromise of unsecured claims without protracted bankruptcy proceedings). Another important provision states that a third-party administrator can oversee the bankruptcy or reorganization process. But the law also adds that either the debtor or the administrator can take control of a debtor company and oversee its affairs (the creditors get to decide which path they believe is best).

Many experts agree that this law will strengthen protection for foreign investors in the country. This is because it provides a stable legal environment for dealing with problematic investments through insolvency or restructuring proceedings. *Prior to the law many foreigners were afraid to invest into China due to the lack of legal framework that can protect their interests if debtors default.* The new law will cure this since it is set to apply to all types of enterprises, including private firms, SOE's, financial institutions, and foreign-invested companies. It will bring China's bankruptcy system more in line with international standards by giving creditors more protection. But despite the good news, not all concerns will vanish as of yet. This is primarily because many experts are still sceptical about whether there are adequately trained judges and professionals in China to implement this complex piece of commercial legislation.

A positive result of the law is that while China's banks currently recover only about 20% to 30% of the face value of delinquent loans, the new law will allow the recovery rate to be closer to 70 cents on the dollar (i.e. much closer to the global average).

Most companies have been waiting for the new rules to be applied before filing for bankruptcy, therefore there is an expect surge of claims which will occur when the law will officially come into force on June 1st. The legislation will most likely not apply to SOE's until 2008 (although many say it will not apply to them even then). In either case, the new law comprises of 12 chapters with a total of 136 articles. Overall this is very simple when comparing it to other countries with mature bankruptcy legislation. For this reason we should expect to see improvements made to the law as companies file for bankruptcy; thus bringing China a step closer to matching international standards.

Contents

FOCUS ON:

Newly enacted Chinese Bankruptcy Law

What is Jesa?

U.S.'s Trade Deficit with China - implications for FDI?

China's Modifications in the Financial Sector to Slow Economic Growth

Highlights from Around China

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We speak: English, German, Italian, French, Spanish, Mandarin

What is Jesa?

Jesa is a service company headquartered in Shanghai specializing in facilitating start-up of new industrial productions while providing reliable management and control solutions.

We operate four main branches in China and a foreign office in Ulan Bator (Mongolia). Since 1998, Jesa has built a team of 70 specialized professionals in addition to 25 technicians following projects locally. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on each single commercial and technical issue.

Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients save financial resources. Jesa is currently expanding its services to provide support to those companies seeking to develop environmental projects in China, such as alternative energies and environmental management.

Jesa signed a Partnership Agreement with Pragma



On 28th April 2007, Saro Capozzoli (General Manager of Jesa) signed a partnership agreement with Pragma,

Europe-based association of law firms with members worldwide.

Through this partnership Jesa will be able to share its services with more than 350 lawyers and legal advisers around the world and at the same time gain access to an esteemed global network. Jesa will be able to provide Pragma with its full-range of services geared towards entry into the Chinese market and serve as the link between Europe and the Far East, including Chinese firms wanting to expand abroad. Jesa will greatly benefit from Pragma's extensive network and knowledge-base, allowing us to have friends ready to offer support throughout the globe. Furthermore, through Pragma, Jesa will have representative offices on no. 2 Via Cordusio in Milan.



Pragma's Board of Directors with Saro Capozzoli, Manager of Jesa, after signing the convention of development in China – Madrid, April 2007.

From left to right: Carlos Manubens, Cecilia Caria Mendes, Saro Capozzoli, Greg Wolton, Gilberto Gelosa, Michel Lacroix and Gustavo Cuevas.

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U.S.'s Trade Deficit with China: implications for Foreign Direct Investment?

China's trade deficit with the United States has been a hot issue for quite some time. Whilst China's trade in goods will continue to grow by 20% and surpass \$2.1 trillion in 2007, the United States and China will continue to have the most imbalanced bilateral trade relationship in the world. The United States imports more goods from China than it exports and the US's trade deficit with China reached a record high of \$232.5 billion USD last year. Overall, China alone accounted for 28.4% of the United States' \$818.1 billion trade deficit in 2006. The current trade imbalance is caused in large part by intrinsic features of China's labour market and consumer base. The vast majority of China's 1.3 billion people still live in rural areas. China has, by some estimates, a surplus rural labour force of 120 million people, many of whom migrate to industrial centres to look for factory work and thus drive down wages, at least in certain areas. As long as wages are low, the United States (and other world nations) will continue to gobble up products made in China, while Chinese consumers will prefer to buy cheaper, homespun alternatives to American products. While the trade deficit is most pronounced with the U.S., the European Union also holds a significant deficit with China. For this reason, China's actions to counteract the trade balance will in turn affect policies on the world arena.

Since the trade deficit poses great threats for both nations, Chinese Vice Premier Wu Yi travelled to the U.S. in May to meet the United States Treasury Secretary Henry Paulson for the second round of the Strategic Economic Dialogue, the highest platform of communication between the two countries. One of the major issues which were discussed was the relaxation of restrictions on exports of certain hi-tech products to China from the United States. Wu's argument was that,

as a global leader in science and technology, the U.S. should be able to exercise its full comparative advantage within this industry. The U.S. has placed strict export control policies of hi-tech products for security reasons, but opponents like Wu state that this would be an excellent way to diminish the trade deficit between the two countries.

From another perspective of this issue, the media has focused much of its efforts in following the fluctuations of the Yuan's exchange rate, especially compared to the U.S. Dollar. The focus of the Yuan's fluctuations to the USD is especially important with regards to the trade deficit because a relatively strong Dollar gives foreign businesses and consumers more purchasing power than before and makes Chinese goods even cheaper. At the same time a weak Yuan makes foreign goods more expensive for Chinese consumers. Therefore, if the Yuan rises (as it did when it peaked on May 15th at 7.68; before falling back to 7.6948) the Dollar will be weaker, leading to less importation *from* China by the U.S. and more exportation *to* China. Since July of 2005, the value of the Yuan has only risen 7.1% to the U.S. Dollar. Never-the-less, it should be noted that many experts oppose this as a solution to the trade deficit and claim that focusing on a rising Yuan will only lead to major negative side effects.

When looking at China's radical changes in the past months, it is possible to see a pattern which reflects the PRC's desire to reform and stabilize its economy. For example, the standardization of the personal income tax has placed Chinese and foreign employees on a similar playing field for tax filing. Changes in the labour law have made it possible for local workers to receive just and higher wages for their labour. The rising labour rates will play a strong influence in rising manufacturing costs and lowering exports. The newly introduced unified corporate tax law will abolish favourable tax treatments to foreign enterprises (while still stimulating certain sectors such as the hi-tech industry). Frequent tweaks to the domestic financial system (such as increasing interest rates and export taxes) are also aimed at reducing the trade deficit by altering the Yuan's world value; along with helping the overall slowdown of the economy. Another important change has been with regards to land property, since the system has been standardized to raise the overall price of land and introduce a bidding process for companies interested in purchasing. This was done to avoid excessive under-valuation of land in China. Changing this will also be a strong move towards increasing manufacturing expenses and in turn reducing exports. It should be noted that there still exist multiple exceptions to these laws and certain favourable treatments. For example, the central and north-eastern Chinese regions in dire need of development hold favourable tax rates and premium land prices to stimulate investment there, not to mention lower wages. Also certain "favourable" industries are targeted to obtain similar beneficial treatments.

In all, it will not be surprising to see further changes in the near future as China's system progressively modernizes. The only question to pose ourselves is how these changes will affect foreign companies in the country, or wanting to enter. While the answer may vary depending on the industry in which one operates or in which region one is seeking to invest, one thing is certain: the economic climate of China is geared towards a path of reform and stabilization which will help it grow.

China's modifications in the financial sector to slow economic growth

Warnings about China's stock market bubble have been flagged around the globe and debated heartedly. While the scenario is still purely speculative, the PRC has entered into a series of modifications to its financial system geared at slowing down the roaring economy and reducing the trade surplus with the United States and Europe. The basic changes are outlined here:

The one-year benchmark lending interest rate was raised 0.81 percentage point to 6.57% and the one-year deposit rate was raised 0.27 percentage point to 3.06% (the increases are the fourth since April). These increases are done in order to remove the disincentives to save, thus slowing down the overall economic trend in fear of a stock price bubble. Furthermore, the increases will be able to curb the influx of speculative capital (i.e. hot money) by shortening the interest rate gap between the Yuan and the USD. Another change that was implemented was that the daily band in which the Yuan is allowed to fluctuate will be widened from 0.3% to 0.5% in order to allow for a freer flow of market forces help boost the flexibility of the Yuan. The government has also imposed that commercial banks will have to increase their reserve ratios from 11% to 11.5% starting June 5; this is done in order to cut excessive lending.

Another drastic move by the PRC is expected to take affect June 1st and is related to raising export taxes by 5 to 10 percent on a range of 142, including steel products, pig iron, nickel, lead and zinc, and cut import tariffs on 209 types of goods, including home appliances, kitchenware, softwood, coal and fuel oil, to pare off record trade surpluses between China and other nations. The government plans to further reduce tax rebates including some basic materials and textiles. It would improve taxes on coal and reduce import taxes on other raw materials. These changes, with respect to the export taxes, are aimed at slowing down the country's export boom and ease the country's trade surplus.

The government has assured that these have all been macroeconomic changes aimed at stabilizing excessive liquidity which could lead to a bubble burst; they will not affect the equity market and the overall impact on stocks is not expected to be significant. The changes will congruently help to establish equilibrium to the various trade surpluses China has with other nations.

Highlights from Around China

Construction begins on massive power transmission line

Preliminary construction has begun on what is to be the world's longest power transmission cord. The line will run 2,000km from Sichuan Province, across seven provinces, and reach Shanghai city. The line is expected to supply one fifth of the city's electricity needs and about 20% of the city's peak demand. The new supply will help curb sulphur emissions since the source of the power is hydro-electric. Shanghai is having difficulties coping with the growing demand, especially since it can no longer build new generators due to pollution issues. The total cost of the project is expected to be 18 billion RMB (2.31 billion USD) and will be completed by 2011.

Pudong Bank to raise capital

The Shanghai-based Pudong Development Bank announced that it will aim to raise 8 billion RMB this year in order to boost capital and provide funds needed to support the bank's development; boosting its capital adequacy ratio from the current 9% to 10% by the end of the year. The banks plans to do this either by selling additional shares in the Yuan-dominated A-share market, selling more shares to its New York-based partner Citigroup (raising their stake from 3.78% to 19.9%; costing 10 billion RMB), or getting listed in overseas markets like Hong Kong.

Schaeffler Group to further tap Chinese market

The Germany-based leading bearing and automotive supplier, Schaeffler Group, opened a research and development center in Anting, Shanghai last month. The move was done as an attempt to further tap into the lucrative Chinese market. The 220 million RMB and 21,000 square meter center will hold about 100 engineers which will focus on adoption of know-how for products for the Asian markets. The centers opened at congruently with the unveiling of their new 110,000 square meters factory in Taicang, Jiangsu Province.

Hangzhou Bay Bridge nearing completion

Workers just recently placed the last connecting girder on the Hangzhou Bay Bridge which will connect Ningbo and Haiyan in Zhejiang Province. The 36-kilometer bridge will now be paved and serviced and is expected to officially open early next year. The bridge will also be an essential artery for the heavy traffic entering Shanghai from these areas.

Hong Kong will not use the Yuan as currency

Hong Kong has publicly announced that it has no intention of using the Chinese Yuan as an anchor currency for the Special Administrative Region. There has been a significant spilt between the two currencies since the Hong Kong's currency system was first introduced in 2005. The local HKD has fallen 0.6% against the U.S. Dollar while the Yuan has fallen an entire 2%.

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Please consider the environment before printing this newsletter.