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# China and the new global financial order.

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# Preface

We examine China's role in the emergence of a new global financial order from the current financial crisis, and the opportunities and challenges for both multinational and Chinese investors.

# Contents

# Executive summary

Just as the world's financial system faces the most severe crisis in memory, China's economy is reaching a level of maturity and strength that will give it an unique and central role in the new financial order to emerge from the crisis. There is little doubt that many of the changes the world faces are deeply structural, not part of a normal business cycle. This paper explores China's role in the emerging order.

### Potential to gain

Our analysis argues that China, with its huge, consuming population, strong infrastructure investment, high savings rates, soaring productivity, and strong domestic balance sheet will potentially be a stabilising force in the coming years, much as China was during the Asian financial crisis a decade ago. It is our view that the direct impact on China's financial services sector is not severely threatening, and in fact China's strong liquidity situation and strong external debt situation position it well, not only to withstand the impact of the global crisis but potentially to gain advantage from it, especially in outbound investment opportunities.

### Balancing the opportunities and challenges

At the same time, our analysis also demonstrates that China faces a number of challenges from the indirect impact of the global crisis on China's real economy. The decline in exports depresses one of the most significant contributors to China's high GDP growth, while domestic consumption is softening and at risk as a result of declining property values and domestic equity markets that are well below their peaks in 2007. Economic indicators tell us that China's depressed equity markets, declining exports, and somewhat negative consumer sentiment measures are balanced against sustained fixed asset investment, increased lending by financial institutions, and generally positive business conditions. All these predict a slight downturn but not as serious a recession as that which much of the rest of the world faces.

China's public position is that increased domestic consumption will offset export declines. Most recently, huge government-sponsored infrastructure, environmental, and social programme spending has been approved for the next two years, for an amount equal to nearly half of China's 2007 exports. If these proposed spending levels are reached, they will not only drive growth but will provide large opportunities for Chinese and MNC companies to capture new revenue. On the other hand, such spending levels will challenge the government to prevent adverse tax, inflation, and monetary impacts.

### China's growing role in global financial markets

When we look at the broader context of global trends and China's emerging role, we find that in the last seven years, basically from accession to the WTO, China has had a steadily growing impact on world economic organisations, standards organisations, and other agents of economic diplomacy. More recently, China's emergence as a major global creditor has made it a much sought-after investor and lender in everything from banks to mines to manufacturers. While this fast-paced, large-scale activity has had ups and downs for lenders and borrowers, buyers and sellers, it has also definitely shaped a high level of engagement on China's part in global financial activities, perhaps higher than is evident at this point.

### China's future relationship with the rest of the world

Overall, the combined impact of China in global diplomatic, regulatory, and policy organisations, together with its US$2 trillion foreign exchange reserves and recently declared RMB4 trillion infrastructure expenditures, and domestic consumption potential, assure that China will have an increasingly bigger role globally in the coming years. Among other things, it means the world has a large stake in China's stable growth, since only a stable and steadily growing Chinese economy will enable China to provide liquidity, consuming markets, and supply-side efficiency and reliability to make it a stabilising agent in global financial activity.

# 1. The global crisis and direct impact on China

Key point:

- The financial crisis will bring deep structural change to the global financial order.
- The global crisis has shown that China is not decoupled from the rest of the world.
- China, an under-leveraged economy, does not have the same financial services problems of the US and EU.
- The crisis may represent more of an opportunity than a threat for China.
- Private equity, venture capital and sovereign wealth funds will have an increasing role in the management of the world's largest enterprises, which has major implications for the future financial order.
- China is better equipped to deal with volatility and capital insufficiency in its banking and financial services than other countries that have under-regulated for a decade.
- The rescue models for financial services companies being adopted by governments around the world are very similar to China's model of State intervention from the beginning of reforms.

China's long-appreciating currency reached a peak in value against the US dollar in July 2008, from which it has subsequently retreated. The retreat is not significant in percentage terms, but it is very significant in what it says about China's development and the world financial situation.

That peak represents an important turning point in several respects. Government leaders returned to their long-practiced agenda of driving high growth levels, after a brief but intense focus on the evils of inflation. The once-popular debate over whether China's economic development was coupled or not to the financial health of Europe and North America died quietly, as the intensity and breadth of the global financial crisis began staring leaders and experts in the face. Major media, business leaders, political leaders, and academic experts began asking how severely China would be impacted by the crisis and how it should respond. Since September terms like "meltdown," "depression," and "global recession," became commonplace, indicating that the financial sector crisis was spreading to real economies around the world. The heady growth of global consumption and trade that had fueled China's dramatic rise since the late 1990s was coming to an end.

We believe that the crisis represents more of an opportunity for China than a threat. Of course, urgent and smart policy moves and investment decisions are critical at this moment in time. China is by no means without threat. However, the aggregate conditions in China are very favourable, compared to those economies where the crisis was engendered. For those economies, the risks loom large, and the challenges remain severe. Systemic leverage in the US reached 350 percent of GDP on the eve of the crisis, compared to 270 percent in the Great Depression. In comparison, China overall remains an under-leveraged economy. Consumer debt is almost non-existent and both the public and private sector fund all manner of fixed asset investment and consumption from real-time revenue surpluses. At least since China's accession to the WTO, bank debt has been a shrinking component in domestic fixed asset investment, declining to 20 percent in recent years, with China's high rate of fixed investment in property and industrial capacity funded increasingly by the retained earnings of profitable enterprises.

We should also take into consideration the additional insulation provided by China's exchange rate management and its capital firewalls, which served China so well during the Asian financial crisis. From an overall financial management viewpoint, one cannot imagine a better situation to be in facing this crisis than low leverage, high savings, and current account surpluses. There is good reason to believe China can navigate clear of serious damage during the crisis and emerge in a position of strength.

## 1.1 Dimensioning the problem

There is no handy measure of the amount of wealth destroyed in the deleveraging of the world's financial institutions or the ultimate aggregate impact on world consumption. Both are driven by a combination of hard economic factors and fickle sentiment, most notably investor and consumer confidence that determine how much and where money actually flows. But the numbers in every corner of the complex global financial architecture are staggering. Fannie Mae and Freddie Mac alone had exposure to US$4.7 trillion in mortgages, a number that surged since 2004, when the Government sponsored enterprises (GSEs) began guaranteeing obligations far beyond their traditional, direct mortgage activities. Among the surprises of the third quarter of 2008 was not only the size of the numbers involved, but the extent to which the world's mature and developing economies were linked together. As the world turned and the sun rose and set, giddy shifts in investor sentiment drove equity markets up and down like spectator waves in a large sports stadium.

It is easier to take measure of the first wave of government responses, beginning with the US$700 billion made available in the bailout legislation in the US, several additional US$100 billion in Federal short-term funds and guarantees, as well as unpredictable investment requirements in nationalised financial services entities. By mid-October, Britain had injected £37 billion and nationalised banking assets. Germany put on the table €500 billion in loan guarantees and capital injections and France €360 billion. Adding the EU bailout aggregate of approximately US$2.6 trillion to that of the US, the total amount approaches US$4 trillion, a number everyone concedes is a short-term emergency measure aimed to quiet markets, not to solve the longer term challenges of the global financial system. Even as these monies flowed, global equity markets convulsed in a fierce search for direction, posting daily gains or losses that sometimes exceeded 10 percent of their total value. The meeting of the G20 in Washington in November 2008 produced pledges of closer cooperation but no significant clarity in new policy directions.

## 1.2 What does "recovery" mean?

Facing a crisis of this intensity, much of the current discussion is focused on recovery. But what does "recovery" mean? We should be clear that what is within reach of recovery is some measure of stability in global financial markets, not a recovery of the systems and relative wealth distribution that existed before the crisis.

As a consequence, ultimately, key insights about China and the future of foreign investors and Chinese investors are less about how China will manage near-term adjustments to the acute, global crisis. Ultimately, they are more about China's role in an emerging new global financial order.

## 1.3 A shift in geographical and structural wealth

We are in the midst of a sequence of events that are not fundamentally cyclic in nature but deeply secular. The massive shift in wealth and investment capacity is one critical part of the story. After all, China's forex reserves stand at US$2 trillion, over half of the total bailout commitments of the European and US government combined. Global forex reserves as of 2006 stood at US$5 trillion. The world's top five sovereign wealth funds, newly bloated with oil dollars, foreign direct investment (FDI), and/or export surpluses, control US$1.8 trillion. The Abu Dhabi Investment Authority (ADIA) alone controls US$875 billion. A shift in wealth of this magnitude anticipates a shift in ownership and control of major financial, industrial, and commercial enterprises.

But the shift in investable capital is not only a geographic shift; it is structural as well. As equity markets retrench, enterprises seeking growth capital have sharply reduced IPO initiatives and increasingly look to venture capital, private equity investments, and other well-funded private or sovereign investors for capital. While there is a robust proliferation of such wallets and channels, it implies a sharp contraction of ownership away from the broad shareholder populations that have shaped current practices of minority shareholder rights, governance, transparency, and accountability. Managing directors of private equity funds, sovereign wealth funds, and venture capital groups, wherever they are located, will have an increasing role in the management of the world's largest enterprises, at the expense of traditional boards of directors.

## 1.4 Global banks and the China model

A final and important secular shift is in the relationships between governments and their major financial institutions, even in the countries most committed to free markets. Though it hardly needed to be confirmed, the crisis has indeed shown beyond doubt the core utility of major banking and insuring institutions to national economies and the unwillingness of governments to let them fail. This could not have been clearer in the decision of the US Treasury to let Lehman Brothers fall into bankruptcy, a decision that taught the US Treasury an immediate and painful lesson about how the world's investors viewed that act of omission. That single piece of legislation from the US Congress pumped the national debt up about 10 percent and underscored the commitment to government intervention in the wake of global events entrained by Lehman Brothers.

We are witnessing critical changes in the triangular relationship that links the US and European governments, their large financial sector players, and their real economies and consumers who use credit. These shifts have two dimensions. Regulations will certainly be profoundly revised, with at least a decade ahead of intensification and refinement. The second dimension, direct governmental intervention and ownership of financial services institutions in avowedly free market economies, is a more marked contrast from the past. The crisis and responses have made the relationship between the US, UK, and Swiss governments and their major banks more akin to the Chinese model which historically has been consistently criticised by outside free-marketers. The US Secretary of the Treasury adamantly opposed taking equity in banks, even as the US$700 billion bail-out bill was being passed under an urgent timetable. However, Congress insisted on empowering him to do so, and it turned out the failure of his initial plan to calm markets made the equity option attractive. Whether in the end the US Treasury takes ownership stakes in banks remains to be seen. British Prime Minister Gordon Brown was quicker to move to nationalise the most troubled banks, and he has won acclaim for doing so. This sharp change from the non-interventionist direction firmly espoused in the 1980s by former US President Ronald Reagan and former British Prime Minister Margaret Thatcher has been succinctly called by the *Financial Times* "The Return of the State." For China, the State never left.

While the current wave of direct intervention in financial services by governments is often compared to that of Sweden during its financial crisis of the early 1990s, there is some doubt that, facing a new global financial order, even the US, Britain, Japan, Korea, and other major developed and new developed economies will be able to unwind the high touch, government ownership model they are quickly building now.

Since the early 1990s, the Chinese government, faced repeatedly with banks accumulating bulging portfolios of non-performing loans (rather like sub-prime mortgages as a form of radically underpriced risk), has quickly and efficiently ported money into the banks to recapitalise them. After late 2003, with the founding of Central Huijin, a state-owned limited company, large sums were ported into the Bank of China, China Construction Bank (CCB) and the Industrial and Commercial Bank of China (ICBC) in exchange for equity. Central Huijin also bought stakes in troubled securities companies through China Jianyin Investment Limited. Some of these were controlling stakes. Central Huijin has historically functioned as an investor in the banks and acts as a stabilising agent, reacting to potential liquidity issues on behalf of reforming financial enterprises.

Representing China's first true sovereign wealth fund, the China Investment Corporation (CIC) was founded in September 2007. The goal was to demarcate a hard currency fund that was ready and able to take advantage of attractive overseas investments that would diversify the State's holdings and improve returns. The Ministry of Finance issued RMB1.55 trillion of special government bonds with which it bought US$200 billion of foreign exchange from the People's Bank of China (PBOC) to establish CIC. Immediately upon inception, CIC bought Central Huijin from PBOC for US$67 billion, a full one-third of CIC's first capital tranche. Central Huijin continued to function as a holder of equity in state-owned financial institutions, not overseas targets, and an investment platform. Central Huijin continues to be an important guarantor of liquidity in China's major banks and its mission is clearly divergent from CIC's, which has led to speculation that the two may be separated soon. Whatever the fate of Central Huijin, it is an excellent example of the many tools the State has to fine-tune the liquidity situation in the major banks, as well as support their market capitalisation when listed. Its roles goes beyond that though. It is also helping dress banks for successful IPOs or supporting the market capitalisation (and the acquisition muscle) of already listed banks pursuing overseas acquisitions.

In this aspect of crisis positioning as well, the Chinese government, building the socialist market economy, finds additional advantage that contributes to China's stability amidst the global financial turmoil. China is not only clearly more comfortable than the US or UK in buying bank equity and keeping a steady hand on the tiller of China's financial sector. Importantly, China has more pathways for intervention than the US government. Central Huijin, the national pension fund, and an undisclosed number of state-owned enterprises (SOEs) have recently been increasing their holdings of key banks on public markets and pre-IPO banks by making share acquisition agreements in advance.

The US government, on the other hand, had to create special legislation, and the Treasury itself may or may not take a direct equity interest in the nine banks targeted. The fact that the Treasury's position has gone back and forth on this issue of taking equity in banks is an indication of the uncertain direction of US policy. Nonetheless, the Treasury has been unable to avoid pumping liquidity into Citigroup and AIG, among others, although the exact terms and dimensions are not clear.

The Chinese direction is still *zhengqi fenkai*, separating government from business operation, putting layers of separation between pure policy and regulatory organisations and sector associations, and then between associations and operating enterprises in their sector. In stark contrast, the US direction is inevitably, albeit haltingly, toward more direct influence on the lending policies of the banks. The US Treasury intends to order the banks to maintain "minimum lending levels," according to recent media reports.

# 2. China's financial sector, real economy and regulatory response

Key point:

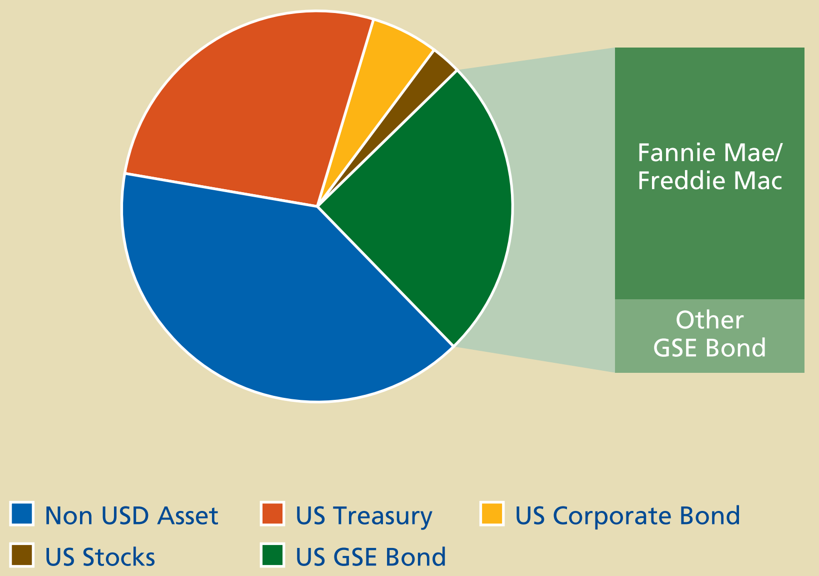
- China's export driven economy is challenged by the significant slowdown in export growth, which might cease to grow by the end of 2008 or early 2009. Increasingly strong warnings to this effect are now coming from China's top leaders.
- Near to medium term, China's mid-size commercial banks may be under stress as a result of the decline in export-driven manufacturing in certain regions of China.
- Slowdown in China's real estate and steel sectors may have serious knock-on effects for China's economy.
- China's leadership response has been swift and significant, with a huge fund announced for infrastructure and social welfare, to be expended by 2010.
- Leading economic indicators suggest China is heading into a slowdown, but the signals are mixed and the indications are of a moderate slowdown. China may play a role in the global crisis similar to its role ten years ago in the Asian financial crisis.
- The global financial crisis shows early signs of unblocking Chinese outbound investment into overseas financial enterprises.

## 2.1 Direct impact of the crisis on China's financial institutions

To analyse the impact of the crisis on China in the short and mid-term, we will look at both the direct impact on China's financial sector, the indirect impact on China's real economy, the regulatory response, as well as the global trends in capital flows in and out of China as the new global order takes shape.

With China's huge forex reserves largely held in US dollars, the direct impact is potentially huge depending on how specific issues are resolved by foreign governments. China is the top foreign holder of Fannie Mae/ Freddie Mac bonds, with total value around US$ 300-400 billion, representing about 20 percent of total China foreign reserves, according to CICC. Still, with the guarantee of Freddie and Fannie corporate debt by the US government, China has dodged major potential losses.

**Chart 1: China's Foreign Reserve Portfolio (as of June 2008, total = US$1.8 trillion)**




Source: CICC[1]

In general, China's exposure to the worldwide financial crisis has been limited, but the rising concern about the ripple effect of the deepening financial crisis plus the uncertain outlook for China's banking sector has pushed down the share prices of Chinese commercial banks. Total announced exposure of Chinese banks to Lehman Brothers has reached US$380 million, with ICBC topping the list. The government's sovereign wealth fund CIC. held a 9.9 percent stake in Morgan Stanley, while Ping An has reported a US$2.3 billion loss on its investment in Dutch-Belgian financial services group Fortis.

**Table 1: Holdings of Chinese banking institutions in troubled overseas assets (Unit: US$100 million)**

| | Forex net position (as of 30 June 2008) | Investments denominated in US$* (as of 30 June 2008) | Subordinated face debt value (as of 31 December 2007) | Fannie Mae/ Freddie Mac exposure (as of 30 June 2008) | Lehman Brothers exposure (as of 18 September 2008) |
|---|---|---|---|---|---|
| ICBC | 27.65 | 242.27 | 12.26 | 27.16 | 1.52 |
| BOC | 17.96 | 601.28 | 62.86# | 172.86 | 1.28 |
| CCB | 53.31 | 252.50 | 10.00 | 32.50 | 1.91 |
| CITIC | 6.76 | - | 13.09 | 15.84 | 0.76 |
| CMB | 18.44 | - | 0.00 | 2.55 | 0.70 |
| Total | 124.12 | - | 98.21 | 250.91 | 6.17 |

Source: Xinhua Finance website (Financial Crisis on Wall Street Will Have Minimal Direct Impact on China's Banking Industry, But Policy Adjustments and Economic Transformation Will Affect Profitability and Future Business Models, published on Friday, 19 September 2008)

Note: Exchange rate of 7.3046 on 28 December 2007 and 6.8591 on 30 June 2008

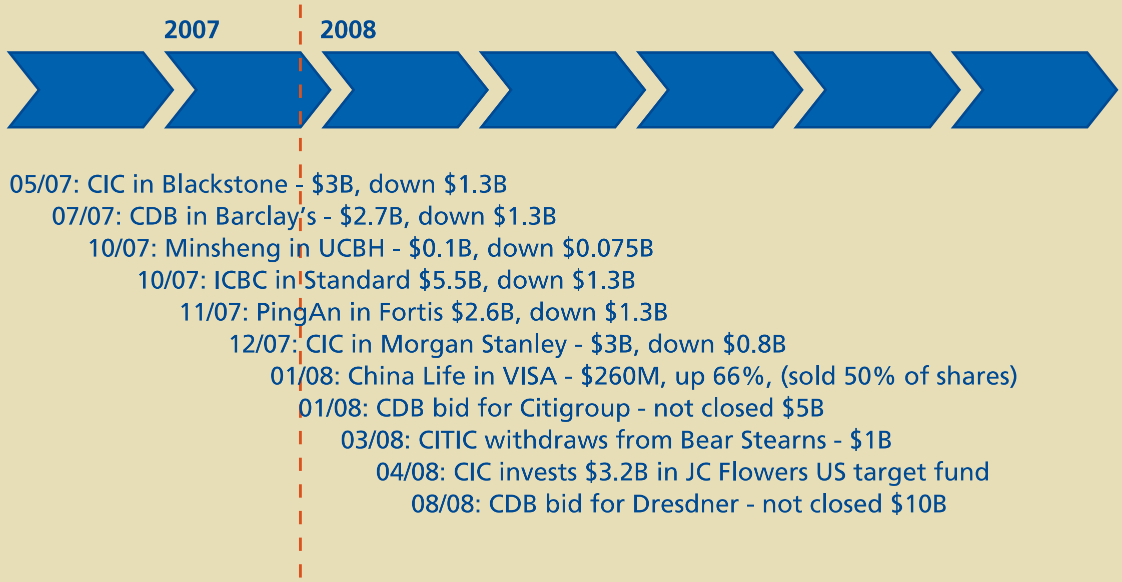
* Mainly trading assets, available for sale and held to maturity assets;

# Face value of RMB36.454 billion plus provision of RMB9.461 billion

1 http://money.163.com/08/0910/09/4LFJEENJ00251LJU.html

Before the global crisis reached full stride, China's official policy promoting outbound investment, coupled with seemingly attractive prices of leading financial global service companies and seemingly irreversible slippage in the value of the US dollar, prompted a number of exploratory investments by Chinese funds, banks, and insurers in several overseas targets. These included private equity funds, investment banks, commercial banks, and diversified financial service providers. By early 2008, the results were disappointing, and many rounds of soul-searching and review led to a very cautious wait-and-see approach to any new outbound financial investments in 2008. In fact, with very few exceptions, outbound investments into global financial players were not closed in 2008, for various reasons, representing a very cautious approach to outbound investment into financial services during the initial months of the global crisis.

**Chart 2: Chinese enterprise outbound investment into financial services (US$ billions)**




The period of extreme caution has now drawn to a close, stimulated in part by the consolidation, M&A activity globally in the sector, and the very attractive pricing of assets. More and more voices globally, as well as opinions voiced by some of the world's most savvy private equity investors, are making the case that financial service shares are now very attractively priced. This is especially so for long-term investors, like China's CIC and its State banks. This is the door-opening minute to get significant equity in some of the world's great financial institutions, an achievement that would help China not only get a better return on its forex capital but participate in and learn from a range of global financial players. In this way, the crisis has reached a point that could well accelerate Chinese outbound investment into the financial sector and position China for more than a full recovery of the losses suffered through the 2007 investment campaign.

## 2.2 The sector and enterprise level response

At the sector and enterprise level, China's central government has responded to converging forces of domestic economic factors and the global crisis with a series of regulatory adjustments, some small adjustments, some dramatic and potentially very significant for investors. To manage credit available in the system, careful tweaks have been made continually to lending rates and reserve requirement increases. Rates and reserve requirements had been steadily raised for several years, as leaders were concerned about the economy overheating. These changes historically have not had the direct impact expected, in part because 50 percent or more of fixed asset investment was from consumer spending of income and savings as well as enterprise spending from retained earnings in an era of soaring profits.

Nonetheless, PBOC has used interest rate adjustments - independently managed on RMB and foreign exchange, deposits and lending - to send signals to the economy broadly of its perspective on overall economic trends and currency issues. In 2003, as pressure mounted to let the RMB appreciate, interest rates on foreign exchange were reduced to slow inbound deposits. Now, in response to the government's reading of major economic indicators, late November saw China's central bank order cuts in commercial banks' benchmark lending and deposit rates on the RMB by 1.08 percentage point, the fourth cut since mid-September. The cost of one-year bank loans will fall to 5.58 percent from 6.66 percent, while the benchmark one-year deposit rate falls to 2.52 percent from 3.60 percent, not only easing credit but effectively increasing the bank's spread as a percentage of their cost of funds. These changes, accompanied by a number of official media commentaries and quotation about the gathering economic and employment problems, do suggest that the government will continue to be quick to move to minimise China's slowdown.

Fast money supply growth coupled with global commodity inflation pushed through very large Producer Price Index (PPI) rises and moderate Consumer Price Index (CPI) rises through the first half of 2008 that confirmed general policy directions toward tightening credit and cooling investment growth. However, as the second half of 2008 unfolded, the government reversed course, concerned about slowing growth, stubborn depressed equity markets, and strong downward pressure on real estate values.

Real estate values are perceived to be a key factor in China maintaining financial stability. In China's immature investment landscape, real estate remains a key store of wealth for enterprises and individuals alike. Since the fourth quarter of 2007, pressure has grown to reverse regulatory practices intended to cool the property development markets and recognise the risks of a downturn. The global crisis, rooted in a different kind of real estate problem in the US, has amplified concern in China and brought a broad range of changes. Property prices are down over 25 percent in China's worst hit markets, developers are running out of money, while public complaints about affordable housing are reaching deafening levels. Anecdotally, a number of domestic investors are reporting a rising number of distressed development projects, where developers have run out of capital and progress has stalled. This adds to other warning signs, including reported downturns in start-ups by developer giants like Vanke, SOHO, and Country Garden.

A sharp downturn in real estate asset values and construction can potentially trigger a number of problems in addition to a reduction in affordable housing. The domestic cement and steel industries have been recipients of huge fixed asset investment over the last half decade, and they are already reporting declines in production levels and demands. To press forward consolidation of the steel sector and improve international competitiveness, Chinese steel industry leaders have invested in four major port-based integrated steel-making facilities. However, now threatened with softness in construction, automotive, and durable goods markets, 2008 steel production is expected to rise a modest 2 percent over 2007 to 500 million tonnes, considerably below the 530-550 million tonnes projected at the beginning of the year. Construction employment is the major source of income for most male migrant workers, who not only represent an important demographic in terms of reform-driving urbanisation but also pose a threat to stability if unemployed in large numbers. Finally, overseas investors in PRC real estate may conclude that the era of sustained capital gains is over and begin to carry their capital out of the economy to other destinations.

Understanding the government's new approach to the property sector is of utmost importance for domestic and foreign investors in Chinese property assets. The changes are far-reaching and profound. The headline change is the devolution of more responsibility to the local level for real estate policy formulation, a change that has prompted 18 cities immediately to announce policies to boost local property markets. For China observers with many years of experience, this is reminiscent of Deng Xiaoping's first reform moves, when the central government released control over some key economic policy decisions to local leaders. The move reflects a change in the general trend of the current administration to centralise important economic controls.

The policy changes include reducing taxes on gains and transfers, providing more loans and subsidies for developers and buyers, relaxing restrictions on investment buying, and extending the time limit for development of land use rights. Other changes in the real estate market include easing of restrictions on second house mortgages and stimulation of lending to real estate developers. Enthusiasm is tempered, according to China internet monitors, by consumers who do not want to see already high-priced housing supported unreasonably by government policy. However, putting key decisions in the hands of local decision-makers inevitably will reduce the role of ideology and increase the role of basic market and commercial factors in real estate policy, and that should help rationalise and stabilise the sector. Localisation of this kind has throughout China's 30 years of reform resulted in a kind of deregulation. It is not without its own risks and excesses, but overall it is responsible for much of China's reform momentum and has been a major factor for attracting Chinese private sector investors and foreign investors to invest in the real estate sector.

Steel is a good example of enterprise and regulator response to the crisis in a key sector. First is pressure to consolidate. Steel has been a laggard in this regard, particularly as compared to sectors like aluminum, which was essentially consolidated into a monopoly before China joined WTO. China has a very fragmented steel industry. Its top 10 steel companies produced less than 50 percent of total production in China, while the top five Japanese steel mills contributed 74 percent production in Japan in 2007. Overall, the domestic economic downturn will speed the reform process and solve three problems. It will force out of business inefficient mills that cannot survive in a real market, force more consolidation, and permit the government to position the industry to support a wide range of hyper-competitive exports, from automobiles to durable appliances. In addition to consolidation for steel, as details of the stimulus package emerge, it is clear steel will be strongly supported. Estimates are that the stimulus spending will increase steel consumption by 50 million tones in 2009, almost the exact level of under-utilised production capacity in 2008.

Consolidation of the steel sector is consistent with overall large sector, capital intensive industrial policy. The government has previously stated it intends to reduce the number of large SOEs under the national level State-owned Assets Supervision and Administration Commission (SASAC) from 150 down to as few as 80. The results will not be achieved through privatisation but through consolidation. China continues the push for more restructuring of SOEs by merging large conglomerates even as it accelerates the sale of non-strategic assets across a wide range of sectors. This is "grasping the large and letting go the small."

As for the steel industry, part and parcel of the global crisis impact is the plummeting price of steel, weakened demand and growing over capacity, and highly volatile iron ore and energy costs - all of which will lead to further consolidation and should lead to a slowdown in investment. China really launched its huge investment in increased capacity during the steel shortage and sharp price increases of 2005. Now the situation is radically different, and the recovery timing and trajectory highly uncertain. Outside China, giant Mittal Arcelor has already announced it is reviewing its ambitious acquisition and expansion plans, reconfiguring its estimates of global demand of the future.

The general plan in China is for regulators to shape five giants in the steel industry, under the leadership of Baosteel, Capital, Anshan, Wuhan, and Hebei. For some steel mills already operating at losses, the harder economic times may make for more opportunities for both domestic and foreign investment in those smaller steel companies. But to shore up the strength of the giants and to position the industry overall to be an intensely competitive global sector, significant support has been poured into the sector for technology upgrades and to construct four new, state-of-the-art, highly integrated port-based steel cities. At the same time, Baosteel has acquired 80 percent of Guangdong Steel and lifted its steel capacity to around 37 million tonnes. And a new steelmaker - Hebei Iron & Steel - was formed in the north of China by uniting Tangshan Steel and Handan Steel to create a company with capacity of around 31 million tonnes.

## 2.3 China's growth model and the impact of the crisis

China has viewed itself since reforms began as an economy in transition, going through several stages of socialist and capitalist development toward realisation of a hybrid socialist market economy. Strong growth has been a feature of the Chinese economy since reforms gained traction in the early 1980s, and after a brief hiatus, Deng Xiaoping made a famous visit in March 1992 to Shenzhen that triggered a sustained return to deep commercial and institutional reform, soaring FDI, and steady growth across the board. Although the central government has repeatedly explored new ways to govern its major assets, restructure certain sectors, engineer a steady stream of campaigns for improved investment, governance, and strategy, fundamentally, the Chinese development model had crystallised by 1998 into an economy driven by four forces: 1) dynamic export growth; 2) high levels of fixed asset investment; 3) high household savings rates; and 4) double-digit increases in household spending.

China's export growth has clearly registered the decline in consumption capacity of the mature economies to which it historically has exported. From its peak of 40 percent year-on-year growth registered in April 2007, China's export growth has moderated to 10 percent in recent months and very likely will sink even lower. It is estimated that every 1 percent decline in the US GDP growth will cause an almost 5 percent drop in China's export growth. With US now registering negative 0.3 percent GDP growth rate, not to mention a predicted negative GDP growth rate of -1.4 percent for 2009, and Europe facing similarly bleak prospects, China cannot depend on the traditional contribution of exports to growth.

Facing a sharp downturn in consumer demand from the US and Europe, what Chinese leaders and analysts most commonly cite as the solution is to increase household consumption and infrastructure investment. How feasible is this?

**Table 2: The components of China's current growth model**

| Economic structure (Percentage of GDP at current market prices) | 2004 Actual | 2005 Actual | 2006 Actual | 2007 Estimate | 2008 Estimate |
|---|---|---|---|---|---|
| Private consumption | 39.80 | 37.70 | 36.40 | 37.50 | 37.40 |
| Government consumption | 14.50 | 14.10 | 13.60 | 14.50 | 14.60 |
| Gross fixed investment | 40.60 | 41.00 | 40.80 | 42.70 | 40.00 |
| Stockbuilding | 2.50 | 1.80 | 1.90 | 2.00 | 1.00 |
| Exports of goods & services | 33.90 | 36.30 | 38.30 | 41.30 | 39.10 |
| Imports of goods & services | 31.30 | 30.90 | 30.70 | 31.90 | 32.00 |

Source: EIU report in October 2008

As Table 2 indicates, private consumption has grown aggressively but actually declined as a contributor for GDP for the last half decade, while fixed assets have remained steady and export growth has increased. The ability of China to sustain growth rates at or close to double digits will depend on changing the course of these trends. Accordingly, it is worth looking a bit deeper into issues surrounding private consumption. Consumer demand in rural areas also has been stagnant or even in decline since 1997, a dire trend related to the growing wage inequality between urban and rural populations. The mid-2008 surge in food prices was a boon to China's rural population, but whether or not it will make a sustained contribution to rural consumption remains to be seen. Agricultural productivity increases have sharply lagged those for industrial and commercial sectors and, according to current policy, rural economic development will become an increasingly important focus.

There were indications that the global financial turmoil and China's relatively minor response up until recently would not be enough to lift depressed consumer spending at a measurable level. Early indications have been a decline in automobile sales and consumer durables, and of course residential property as noted earlier. Overall, the rapid increase in wages over the last three years would support the potential for accelerated consumption. The PBOC's recent downward adjustment of interest rate by 108 basis points also could discourage more bank savings, where depositor interest rates are already negative in real terms.

However, there are strong counter-forces. China's new consumers, (almost all the single child of two aging parents and four grandparents), are also acutely aware of the growing burden of supporting their elders in the face of a social system that has still not seen adequate investment by the State. In Asia, some research indicates that, as interest rates decline in banks, people may be motivated to save even more because they are earning less on their existing savings and generally are worried about health care, retirement, and education costs. So they do not feel like consuming if avoidable. The view is supported by independent measures of consumer confidence by NBS and others, which has consistently been negative for most of 2008, arguably in response to depressed stock prices, growing inflation, and the drumbeat of bad news from the global financial crisis. Negative consumer confidence is not a good sign for those expecting increased household spending to offset a decline in exports.

As the sense of urgency has increased in China, the response of the leadership has been dramatic. Over the last months, meetings in Beijing have produced a number of plans to increase infrastructure, and investment of some RMB1.8 billion has been discussed for improvements in freight and high-speed passenger rail links all around the country. Most recently, the official website of the State Council announced a huge stimulus package of nearly RMB4 trillion (US$586 billion) approved by the State Council for investment into infrastructure and social welfare by 2010. The statement said the spending would focus on 10 areas. They included picking up the pace of spending on low-cost housing as well as increased spending on rural infrastructure. Money will also be directed into new railways, roads and airports, as well as health and education, environmental protection, and high technology. Overall, in a series of announcements of major stimulation spending over the entire course of the 11th Five Year Plan, adding in local government plans, the number is now totalling nearly RMB20 trillion, about half of China's 2008 GDP.

This recent package of nearly RMB4 trillion to be invested in a 24-month period represents a surge in domestic government spending equal to 49 percent of China's total exports to the world in 2007, and would more than offset any foreseeable decline in exports. There are two issues to watch as this pending unfolds. First, it is important to determine how much of this is genuinely an increase in what was already planned, since aggressive fixed asset investment has always been part of China's growth calculus, and much of it was sponsored or leveraged by government spending. Secondly, if in practice there is a substantial spending surge on the government's part, it will not be neutral with respect to taxation, inflation, and monetary policy. The actual impact of this level of investment plus the collateral impact on other aspects of the economy and government will have to be overseen with great care and caution.

## 2.4 Risk concentration and the mid-tier

If China's real economy continues to slide from the combined downward pressures of reduced export growth and earnings, reduced inbound formal FDI and hot money, and trends in consumer spending that do not support the required growth and buoyancy, where might we see signs of stress emerge?

The first cracks are appearing in the south and southeast, where export oriented manufacturers are folding in sizeable numbers. Along with the loss of many Pearl River Delta and Zhejiang SMEs dependent on the export trade, mid-size commercial banks face a certain level of risk from chain reactions that would seriously impact the regional economies.

One of the broader measures of China's health in the manufacturing sectors, the Purchasing Managers' Index, fell to a seasonally adjusted 44.6 in October from 51.2 in September, according to the China Federation of Logistics and Purchasing. (A reading below 50 reflects a contraction, and above 50 an expansion.) Manufacturing contracted in July 2008 for the first time since the survey began in 2005. It also shrank in August. The October index was a record low, falling to 44.3 from a positive 54.6 in September. During the same period, new orders dropped to 41.7 percent from 51.3. The index of export orders declined to 41.4 percent from 48.8. Inventories grew, with the index climbing to 51.4 from 50.5, according to the Federation.

Estimates of enterprise failure in the Pearl River Delta run as high as 30 percent. Many manufacturers in the delta area compete in export industries with razor thin margins, and over the last few years have faced volatility in commodity pricing and rising labour costs that have pushed them toward the edge prior to the global financial crisis. In Zhejiang, around 20 percent of small-and-mid-size enterprises (SMEs) lost money during the first half of 2008, and some flagships have either missed significant loan payments due or gone into bankruptcy. A major southern textile group, the Jianglong Group, collapsed in 2008, and giant, privately held steelmaker FerroChina has defaulted on large loans.

Holding the bag on these defaults are some of China's more fragile mid-tier banks that have seen considerably less media exposure than the top State-owned giants. China has 125 mid-tier city commercial banks and over 3,500 rural credit cooperatives. Among these lending organisations, there is generally less strength to deal with a wave of defaults and they are vulnerable to the possibility of depositors choosing to go to the larger major State banks. Although city commercial banks have become more competitive over the past five years in general, with most of them meeting basic capital sufficiency requirements, some city commercial banks, suffering from their own irregular banking practices, have made little progress in consolidation.

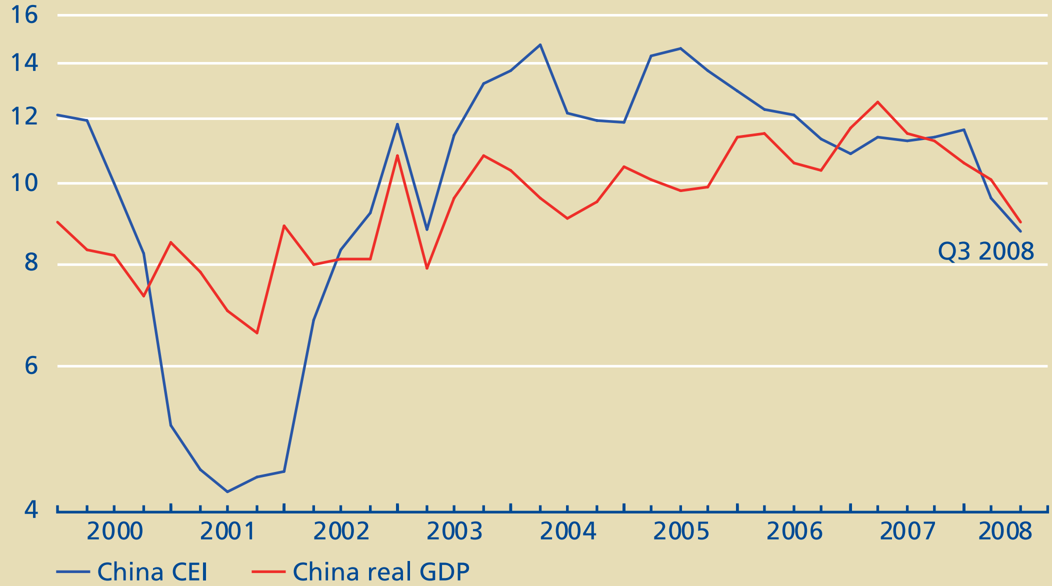
Certain mid-tier banks with a higher percentage of loan portfolio in property development, have seen increasing overdue loans in 2008. These banks rely almost entirely on loan interest for their earnings, (estimates are approximately 70 percent), and increased defaults, along with tightened margins and reserve requirements are taking their toll. Obviously, a departure of a significant number of depositors could quickly worsen their situation. There is some concern about latent credit risk in banks at this level, as well as systemic credit insufficiency throughout the banks and mid-tier enterprises, with a consequent ratcheting up of default risk in any particular sector or location. The central bank has monitored this situation carefully. For example Yi Gang, a vice-governor of the People's Bank of China mentioned the risk of a possible lack of liquidity in a recent official article, and within days PBOC announced the injection of RMB50 billion into commercial lenders. SASAC research head Li Baomin suggested that more such injections would be forthcoming.

It is difficult to assess the level of risk posed to mid-tier banks by pressure in the real economy for two reasons. First, in the larger cities like Shanghai, Nanjing, and Hangzhou, municipal resources could be available to support them if levels of stress merit it. Secondly, the quality of their credit risk management and current loan portfolios is difficult to assess, even though there are in theory consistent accounting requirements for all financial lending institutions in China that constrain some of the historic sources of reporting errors. Mid-tier banks remain to a certain extent committed to supporting important local projects and, in official media, concern has been expressed that the RMB4 trillion stimulus package that is a central component in the central government's emerging policy might also direct important credit sources away from SMEs when they are most at risk.

## 2.5 The macro view - China and China in Asia

A systematic look at the overall prospects in the economy can be gleaned from an macroeconomic survey that plot coincident economic indicators (CEI) against GDP. In this representation of one such analysis reaching back nearly a decade, the CEI have consistently tracked GDP, and in some recent months led GDP, marking the turning points in China's cyclic economic trends. It is interesting that in recent months the downside risks are very apparent in both GDP measures and the broader set of coincident indicators.

**Chart 3: Year-over-year changes in China's CEI and GDP (Year-on-year percent change)**




Source: National Bureau of Statistics and The Conference Board: China Center for Business and Economics

Among the internal components of leading and coincident indicators are equity market, property trends, and several confidence measures, consumers, entrepreneurs, and industrialists. While the equity markets have been a consistent drag on the indicators, confidence numbers have been up and down, the least steady among commonly measured forward looking data series. The confidence series may be among the most important in predicting the potential success of a campaign to accelerate growth in private consumption.

**Table 3: Confidence components of China's leading economic indicator survey**

| | Entrepreneur confidence index | | | Enterprises prosperity index | Consumer confidence index |
|---|---|---|---|---|---|
| | General | Manufacturing | Real estate | | |
| **1QT** | 140.60 | N/A | 131.10 | 136.20 | 94.80 |
| **2QT** | 134.80 | 132.90 | 118.40 | 137.40 | 94.10 |
| **3QT** | 123.80 | 119.30 | 96.40 | 128.60 | 93.80 |

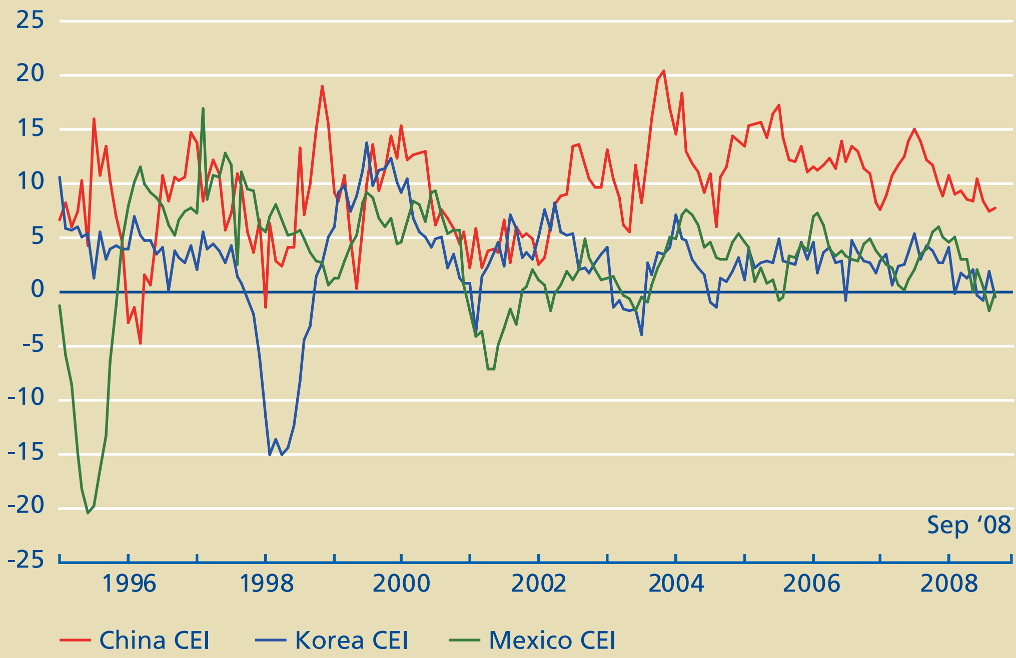
Source: National Bureau of Statistics

The entrepreneur confidence index decreased in the third quarter in all sectors except mining, especially in the manufacturing and real estate industry. The entrepreneur confidence index experienced the sharpest decrease in most developed eastern coastal areas of China, an indication of stress in manufacturing and property development, both harbingers of a further slowdown of China's economy.

These leading indictors are being realised in sharply negative industrial output figures appearing in the monthly data of the final quarter of the year. The China Electricity Council, which reports officially on power generation, power consumption, and light and heavy industry output, recently reported in its January to October 2008 reports that industrial output growth slowed to 14.4 percent year-on-year in the first ten months of 2008, with light industry growing by only 12.8 percent. These figures witness steep drops in September and October from previous months. January to September showed growth of 15.2 percent over the previous year, and January to August showed 15.7 percent.

China's macro economy survived the Asian financial crisis of 1997-98 as a result of a strong external debt position and the controls China maintained over capital accounts and exchange rates. A comparison of China and the rest of Asia over the last decade makes some interesting points.

**Chart 4: China's CEI vs. Mexico and Korea**
**(6-month percent change - annual rate)**

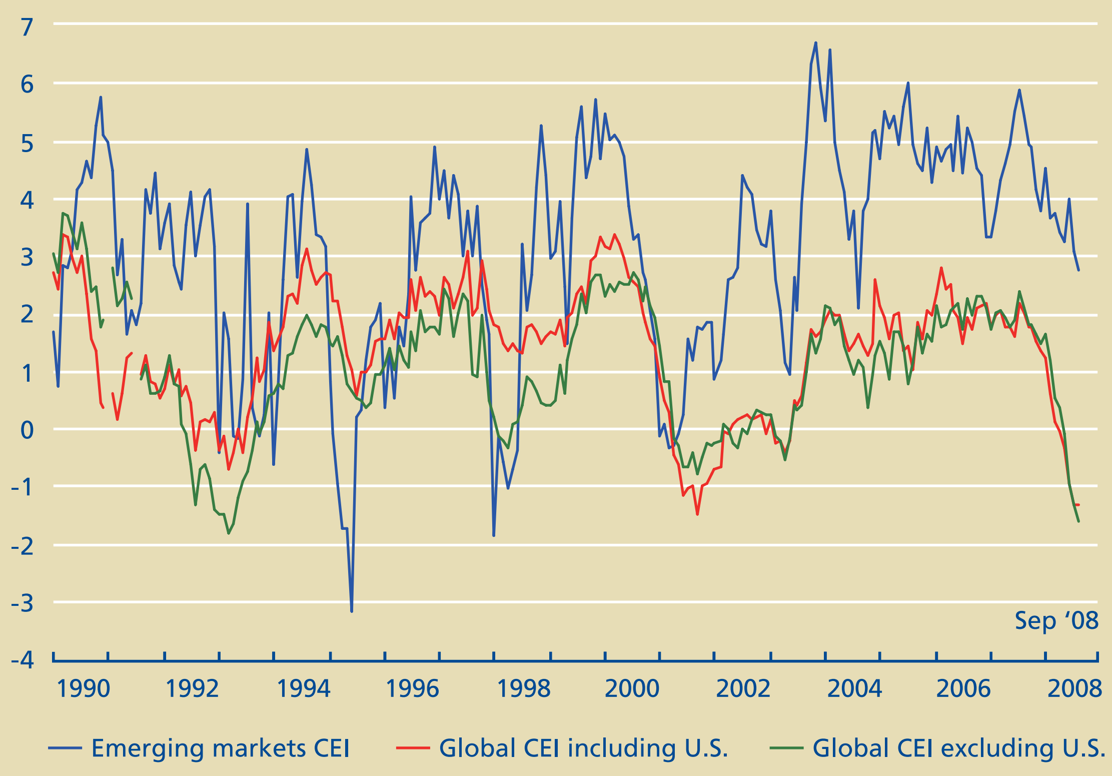



Source: The Conference Board, China Centre

After the sag in China's growth when the Asian financial crisis unfolded, China's CEI have either moved in a direction counter to the rest of Asia or lagged Asia. During the crisis, China suffered a small dip in the early months, but quickly recovered as the remainder of Asia, including Korea went into considerable decline, reaching negative 15 percent on the chart. Then something quite interesting happened. As Asia emerged from the crisis in 1999, Asia's indicators began to move increasingly in synchronisation with China's, albeit with exaggerated volatility, until softness began to batter other Asian economies from the end of 2007 into 2008. China consistently outperformed the rest of Asia and Mexico during this post-crisis period. The implications here, supported by a rapid growth in intra-Asian trade and investment, is that China has indeed become established as the engine of growth as well as a pillar of stability for Asia over all.

There is now also an emerging appreciation that China and much of Asia are not likely to be impacted as seriously as the developed nations, especially the US and Western Europe. This is a combination of limited direct impact in financial institutions as well as the fundamental financial strength. Macroeconomic indicators of this show that emerging market CEI generally are continuing to outperform the aggregate global numbers, both including and excluding the US.

**Chart 5: Emerging market CEI vs. global CEI (6-month percent change - annual rate)**




Source: The Conference Board

# 3. Investors react

Key point:

- China will remain among the world's most attractive investment destinations, but some adjustments will be required of investors.
- These include a focus on growth capital as opposed to take-overs, a longer period of three to five years before exits can be effected, and more attention required to a robust value proposition to meet the needs of sellers.
- We can expect continued refinement of regulations restricting access to key sectors, like banks, but pressure to enhance performance and maintain liquidity will create good in-bound opportunities.
- At the same time, China's strong liquidity position and ability to take advantage of bargains overseas will move more Chinese capital outward.
- China, by virtue of its stage of development and urgent development needs, is ideally positioned to be one of the world's leading producers and consumers of cleantech technologies and products.
- We believe on balance the trend in China is toward more significant cooperation with MNCs and more market openness, as a result of increasing confidence and capability but also increasing recognition of the benefits of greater global integration on fair and level terms.

While inbound and outbound investments continue their long term trends upward, it is remarkable how the sharp peak in inbound investment experienced in 2007 is being replaced by a sharp peak in outbound investment in 2008, reducing substantially net investment surplus for China. These figures do not significantly reflect the pressures of the global financial crisis, which we expect to accentuate the trend even more, as China's strong liquidity position and ability to take advantage of bargains overseas move more Chinese capital outward.

**Table 4: Aggregate cross-border investment flows**

| Foreign direct investment (US$ billion) | 2004 Actual | 2005 Actual | 2006 Actual | 2007 Estimate | 2008 Estimate |
|---|---|---|---|---|---|
| Inward direct investment | 54.90 | 79.10 | 78.10 | 138.40 | 95.40 |
| Outward direct investment | 1.80 | 11.30 | 21.20 | 17.00 | 49.00 |
| Net foreign direct investment | 53.10 | 67.80 | 56.90 | 121.40 | 46.40 |
| Stock of foreign direct investment | 245.50 | 272.10 | 292.60 | 431.00 | 526.40 |

Source: EIU report in October 2008

# 3.1 Domestic and inbound trends

In the first three quarters of 2008, total inward FDI grew 39.9 percent year on year to US$74.4 billion. The growth was 29 percent higher than for the same period of last year. At the same time, IPOs by Chinese enterprises in overseas markets slowed down sharply throughout the year, with money raised in the third quarter of 2008 shrinking 86.1 percent and the number of IPOs dropping 62.2 percent as compared to a year ago. There is a general consensus that IPO activity is entering a prolonged slowdown, and capital seeking, high potential entrepreneurs are turning increasingly to private equity sources, both domestic and international. That was evident before the global financial crisis hammered markets outside China to levels comparable to where Shanghai and Shenzhen had already been driven.

We have already discussed the formation of new investors in China, a response to high levels of liquidity that have accumulated especially over the last five years. This trend may also be turning, but it is less clear. Venture capital fundraising in Chinese Mainland during the third quarter of 2008 (by foreign and domestic institutions) was US$492 million, down 84 percent in value on the previous quarter, according to Zero-2-IPO. Private investors from Europe, the US and other major countries, after a period of excitement about China's growth rates in the face of rapid de-leveraging in their own economies, may now have weaker motivation to invest in the Chinese market. The financial crisis affecting them in their home countries has brought the appearance of some attractive valuations back home.

This homeland attraction coincides with some frustration felt by foreign investors at changes over the last few years. These are changes that have made investing at scale in China very difficult, partly from push-back by regulators and partly from very high valuations. From mid-2006, new regulations and administrative hurdles have emerged, which have three kinds of impact on cross-border acquisitions. Simply put, new regulations have restricted commonly used structures for raising money offshore based on assets within the PRC's borders. In addition, an increasing number of trigger events have been established that require review by the Ministry of Commerce, some related to categories of enterprises and some related to the newly implemented Anti-Monopoly Law. Finally, a tightening of policy impacting some sensitive, restricted sectors, like the Internet, heavy machinery, and mining, has made it more difficult to put together the kind of work-arounds that were commonly used to establish commercially attractive investment targets even in these restricted categories.

Commercially from the sell side, China is only gradually adjusting from the period of heady valuations that were common prior to the market turndown in October 2007. Venture capital and private equity firms are waiting to readjust their profit estimates to a more rational level when the dust has settled and the post-crisis economic order is clearer. During the peak days of the A-share markets, some legal requirements for indexing acquisition valuations to traded share prices were customarily employed to establish valuations linked to A-share multiples that were very high. Flexibility in valuation - some might say realism - is slowly returning to the marketplace.

Turmoil in the financial markets and the resultant lack of leverage has had an impact on the ability to finance larger transactions. We have seen some interesting potential deals in sectors such as mobile phones, struggle to close as multiple bidders work to raise the equity and debt required by their investment models. Exits are also impacted. Trade sales as an option to the stalled IPO market are experiencing a lack of buyers, since strategic buyers are similarly strained by the lack of leverage.

A fair summary, then, of inbound foreign investment by financial players, confirmed by recent Deloitte surveys of private equity investors, is that China will remain among the world's most attractive investment destinations. However, some adjustments are forthcoming. In the short run, there is a slowing of all inbound FDI. September FDI was only US$6.64 billion, significantly below the monthly average to date in 2008 of US$8.3 billion.

As investment picks up, we can expect several changes. First, 100 percent acquisitions and control deals will not be common; rather growth capital deals will be the focus in the coming years. Secondly, facing challenges in exit, quick turn-around opportunities will be rare, and financial investors can expect to hold assets for three to five years before exit. Finally, more attention will have to be paid to fashioning a value proposition that reflects insight into the development interests of both Chinese regulators and officials, at the appropriate government level, as well as the interests of the founders and managers of the target companies. Making capital available in and of itself will not drive the best deals.

As the Chinese economy matures and domestic funding grows, cross-border investors will need to broaden their view of acquisition strategy to be viable. First and foremost is to be cognisant of the long-standing principles of reform in China: commercialisation (somewhat akin to privatisation), consolidation, and globalisation. Just as these are the goal posts of government strategy and practice, they are the footings of foreign investor value propositions to business and government leaders. The good news is that there remains much to be done in the reform agenda, and there is tremendous value to be extracted by those making a positive contribution.

The importance of a compelling value proposition has been made clear by recent changes in the approach to inbound investment into China's banks by strategic bank investors. The China Banking Regulatory Commission (CBRC) issued guidelines in 2006 to clarify the criteria for strategic investment into State-owned banks ("Guidance on Corporate Governance and Related Supervision of State-owned Commercial Banks"). The guidelines present five basic rules for strategic investors.

These include a stipulation that such investors must hold no less than 5 percent of shares and the holding period should be more than three years. Such investments are accompanied by a technical assistance provision that binds the foreign investors to a certain level of technical assistance, often stipulated in terms of number of professionals to be seconded to the operation of the invested bank. However, at the same time that such assistance is encouraged along with the introduction of world-class banking products, the government also showed considerable sensitivity to the risk of losing control to foreign investors.

Major bank investments by foreign banks involved a three-year lockup period. Some of these lockups will begin to lapse this year. There is growing speculation that some Western institutions battered by the global crisis will be either interested in or perhaps even compelled to sell some of their holdings to shore up their finances. However, some market watchers say foreign banks would only exit their hard-won China stakes as a last resort, given the high barriers to entry to the mainland banking sector and the country's strong growth prospects. Even though Chinese bank shares have been under pressure, along with other Chinese enterprises, the government has been quick to support the shares in ways discussed above, which would discourage exits by foreign banks.

Inbound investment by MNC strategic investors outside of banking will slow, most directly as a function of the stress these companies are suffering globally, the lack of leverage, and the depressed ability of the world's consumers to take up production from existing capacity. Over the last few years, foreign investment in China from strategic investors has tilted heavily toward greenfield developments, but that is likely to change in the direction of consolidation of existing capacity. An important exception will be cleantech, where China is destined to be a prime development and investment geography, for a number of sustainable reasons. China is positioned to be one of the world's leading producers and consumers of cleantech technologies and products, in the areas of renewable energy, recyclable materials, overall high efficiency growth and lifestyle.

## 3.2 Domestic enterprises and funds and their outbound activity

In the first six months of 2008, Chinese outbound M&A reached US$32 billion, accumulated from a total of 102 deals. This amount alone has already eclipsed the entire year of 2007 (US$26 billion from 166 transactions) and dwarfs preceding years by significant orders of magnitude, according to ChinaVest. Despite the deepening of the financial crisis, there continues to be strong interest by Chinese companies investing overseas, even since the continuing and potentially deepening crisis in the US and EU financial sectors.

Outbound investment by Chinese enterprises has been strongly encouraged by the government for at least a decade. Resource investment was, of course, the origins of this policy, and China continues to seek higher levels of resource security, not only by securing ownership in everything, (oil, gas,minerals and pulp farms and, recently, food farms), but also increasingly working to control the shipping and pipeline transport links that support the movement of these resources to China. China has had a major impact on the way the world purchases resources by focusing on equity ownership instead of long-term contracts burdened with all manner of currency and price-indexing.

It is important to understand the drivers of China's expanded outbound investment. First and foremost, there is pressure to put China foreign exchange reserves to work, diversify China's holdings across geographies and currencies, and find better returns. Beyond that, in simplest terms, is an extremely important context. Outbound investment is the unavoidable next step in China's reforms. Many of the areas in which SOEs and SMEs of all ownership types have been unable to achieve global levels of performance organically, they now seek to achieve through acquisitions.

Outbound investment is the path for Chinese enterprises to grow beyond the value added processing trade and contract manufacturing that has been the key driver of growth up to this point. From the early 1990s, China's leaders have been concerned about the small piece of the value chain that Chinese companies render for Chinese made goods. By some estimates, of every dollar of retail value for Chinese made goods, the value accrued to the Chinese-maker might be as low as 3¢ to 5¢. Outbound investment into strategic, value-chain stretching acquisitions addresses that concern. Outbound investors are looking for management resources, know-how, best practices, technology, innovation processes, brands, channels to markets, and global customer bases.

Chinese financial services companies are part of this trend, making more global acquisitions with a strategic rationale in mind, hoping to learn from their global peers and gain access to best practices in areas spanning from IT to risk management. In addition, owning regional banks and insurers, such as Standard Bank in South Africa, complements broader overseas expansion strategies. The Standard Bank investment is an excellent example. It provides access to a strategic client base that China needs - in this case African mining, energy and natural resource companies. It provides a comfortable network of support organisations for Chinese interests moving into Africa, serving as a provider of merchant services, a channel for investment funds, and a facilitator for many aspects of transactions undertaken by Chinese interests. Typically Chinese acquirers of mineral or energy resources will seek collateral projects in IT, logistics, benefaction, and the like, all facilitated by establishing a foundation of Chinese owned financial services.

For manufacturing enterprises, Lenovo is a good example of the emerging model. Lenovo was, of course, not the first Chinese manufacturer and brand owner to acquire a foreign enterprise but there are two points worth noting from this acquisition. First, it was a massive deal, enabled by the fact that the Think Pad division was accumulating losses for IBM, and the survival of laptop makers was increasingly dependent on ultra-lean, cost-managed manufacturing. Secondly, post-deal, Lenovo decided not to dismantle the US-based operations but rather move its own headquarters there, truly globalising the company and its image, a clear step in line with the name change from Legend to Lenovo some time before. By keeping the management and headquarters intact, Lenovo preserved the significant value of the intangible assets it had acquired, avoiding the synergy trap that had resulted in losses for many outbound acquisitions made by firms in consumer electronics, outdoor power tools, and the like.

How are Lenovo and other Chinese strategic investors responding to the crisis? On 13 October 2008, Lenovo announced that it is open for acquisitions that complement the strategy of the company. As Think Pad is more fully digested, bargains available in the US and EU will support Lenovo's further expansion as a genuine global brand. German newspaper *Euro am Sonntag* reported that a potential target is Fujitsu Siemens Computers, which is jointly owned by German technologies group Siemens and Japanese consumer electronics manufacturer Fujitsu according to Mergermarket. Somewhat under the radar screen, a number of Chinese buyers are acquiring directly and indirectly assets in technology sectors in particular, in IT and in cleantech subsectors.

In the midst of the crisis, resource companies are also remaining active. On 16 October 2008, China Petrochemical Corporation (Sinopec) announced it will acquire Canada-based Tanganyika Oil Co. Ltd., for a consideration of US$2 billion, through its wholly-owned subsidiary Sinopec International Petroleum Exploration and Production Corporation On 20 October, PetroChina was reported to be interested in acquiring oil and gas fields in Indonesia for roughly US$2 billion. High level diplomatic exchanges between Chinese Premier Wen Jiabao and Russian Prime Minister Vladimir Putin featured agreements on Chinese loans to Russia's energy sector in exchange for resource and pipeline purchase and investment opportunities.

Chinese steel companies are seeking to diversify their iron ore sources to win more bargaining power in negotiating yearly contracts with the world's three biggest producers. Steelmakers like Jiangsu Shagang Group Co. and Sinosteel Corp. have increased their investments in Australia. A Chinese consortium led by Jiangsu Shagang recently abandoned its attempt to buy Brazilian iron ore miner Nacional Minerios. However, these types of deals are likely to continue because Chinese steel companies need iron ore by foreign companies. In pursuing equity in ore resources, Chinese steelmakers are going vertical in ways that are not typical of the steel enterprises of other countries. As ore prices fluctuate wildly, plunging in recent months to a fraction of their peak, it will only become clear over time whether this is an adaptive strategy or not.

Finally, Chinese financial players are becoming active again. On 8 September 2008, the Bank of China took a 20 percent stake in La Compagnie Financiere Edmond de Rothschild for US$341 million. CIC is said to be increasing its stakes in existing fund investments abroad, with its announcement on 20 October that it will raise its stake in Blackstone from 10 percent to 12.5 percent. As of that date, a share of Blackstone was priced at roughly US$9 on the New York Stock Exchange, in contrast to US$30 when CIC first bought in. In addition, some new funds are being invested, also into private equity players. CIC, through its bank holding company Central Huijin, is investing in H-Shares of China's major banks, along with other Chinese financial investors, in part to support the share prices and overseas buying power of these banks.

In spite of the challenges many export-oriented companies in China are facing, China's liquidity situation appears to be strong, and outbound investment interest and capacity are robust. This is all the more significant because China, the other BRICS, and the Middle East are in positions to play the major role in stabilising global financial markets. For China, this opportunity can fuel a surge forward in its internationalisation agenda, moving financial and manufacturing enterprises into the ranks of the world's great corporations, not only in terms of market capitalisation, but also in terms of operational scope, footprint, and capability. Greatly expanded outbound investment is entirely consistent with China's strategy, and it is well within its financial means. The only constraint is concern about the risk of substantial capital losses in the current environment. Even if the world remains in a slow growth or no growth situation for one or two years to come, if valuations and markets begin to stabilise, we can expect a surge in Chinese outbound activity.

## 3.3 A new era of growth, a new era of cooperation

There remains a sharp divide in the perception and treatment of foreign interests and Chinese interests within the Chinese economy by the stewards of China's economic development. Statistical reporting, for example, continues to classify foreign-owned entities as a class of ownership, something that does not happen in the mature economies of North America and Europe. This is likely to remain the case as China continues to refine the separation of regulation from ownership, and the economic model includes State ownership of major enterprises in key sectors.

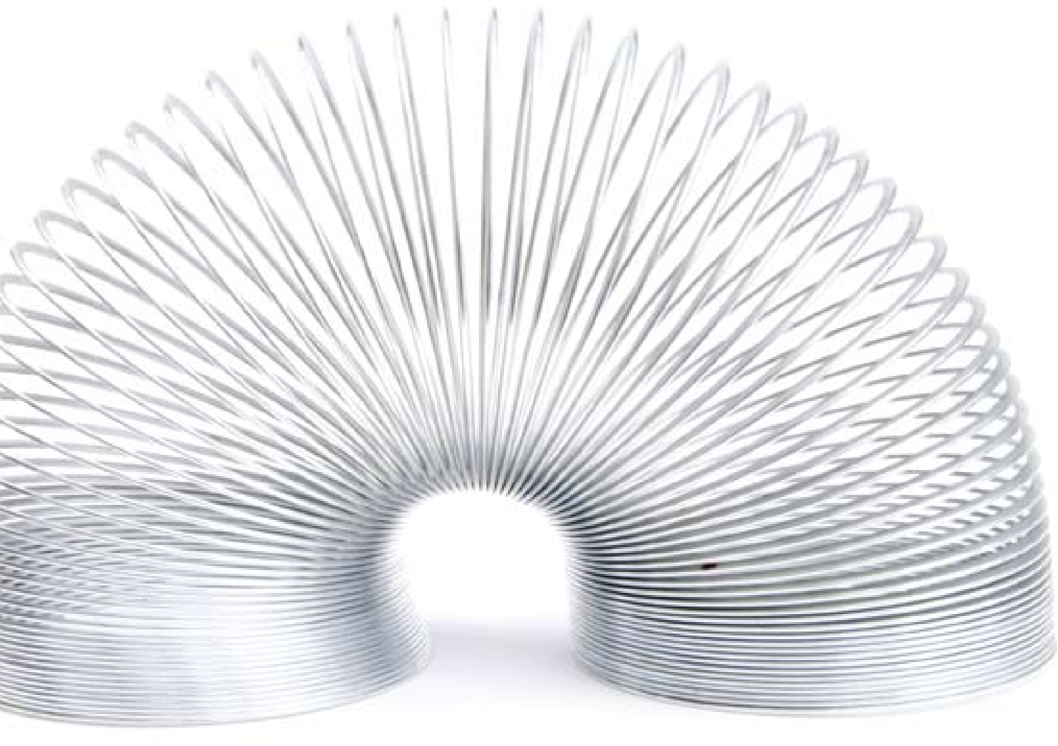
If there is one over-riding issue that will shape the future of Chinese enterprises and MNC investors in China, it is the pace and nature of the emergence of genuine openness and cooperation across this historic divide. It is relevant here, because we believe that the global financial crisis holds the promise that it will speed significantly the reduction of barriers for investment and cooperation in both directions across China's borders.

However, we believe the stage is set for the global financial crisis to move China toward more openness and cooperation with the outside world, a direction we believe will be enormously productive for industry and commerce globally and for China's reform agenda. Much of this discussion has raised examples of a high level of complementarities between the needs and assets of Chinese and non-Chinese, financial and real-economy enterprises.

Financial sector cooperation and integration can already be seen in some important emerging examples. Blackstone, after CIC's initial investment in it, made an important investment by taking 20 percent of one of China's leading chemical groups, Blue Star. Together, Blackstone and Blue Star began to cooperate in seeking appropriate acquisition targets outside of China. Similarly, the acquisition of a 20 percent stake in Standard Bank - discussed earlier, by ICBC for US$5.5 billion was significantly assisted by Goldman Sachs, who along with Allianz Group and American Express, has an equity interest in ICBC. Up to this point, these triangular projects have primarily been spawned by foreign financial enterprises investing in Chinese banks, but that will change as the global financial crisis evolves and Chinese banks increase their shares in financial services players abroad.

There may be fewer examples of this kind of synergistic cooperation in non-financial entities, but in mega-deals like Chinalco's US$14.5 billion investment in Rio Tinto, we saw a similarly critical role played by co-investor Alcoa.

As cooperation and integration among real economy enterprises progresses it will raise new integration and operational needs. First and foremost will be a requirement to adjust organisations quickly and efficiently to the new global environment. Long periods of post-deal integration with missteps and unnecessary costs will be potentially lethal. World class cost management, internal and external communication, high levels of financial efficiency, effective financial controls, and strong human resource management will all be more critical than ever.



# 4. Looking forward - The new order and business opportunities

Key point:

- We are optimistic about both the ability of China to withstand the global financial crisis and the future opportunities for both Chinese and MNC investors.
- China may find benefit in its relatively strong external financial position and in turn provide a stabilising benefit to the rest of the world.
- Protectionism is a risk, but there is a better than even chance that the need to open global capital flows and control inflation will trump the political appeal of protecting markets around the world, for both trade in goods and cross-border investment.
- The proposed level of government expenditure on infrastructure and social needs could be a windfall for MNC and Chinese companies in many manufacturing and service sectors.
- China will likely emerge as a prominent player in restoring liquidity and economic vitality to the mature economies of the world, because it has the financial resources to do so and doing so is consistent with current reform and development needs.

Generally, our assessment of the situation for the Chinese economy as a whole and for Chinese enterprises, in their own market and globally, is optimistic. This is not to say that the situation is without extreme challenges, risks, and potential missteps. But examining the underlying causes of the global crisis emanating from the US and EU, and considering the areas of strength in the Chinese economy, we see the possibility that China may find benefit in its relatively strong external financial position and, in turn, provide a stabilising benefit to the rest of the world.

At this time of writing, experts are divided in where the global financial order is going. The weight of the majority seems to rest with those who believe real economies may not have reached bottom and will recover very slowly, perhaps showing recessionary behavior until deep into 2010 or early 2011. Spending in the US plunged by 3.1 percent in the third quarter of 2008, even before the full weight of the financial crisis was factored in. However, with the exception of situations where major PE firms made highly leveraged investments and restructuring, major corporations were not nearly as leveraged going into the crisis as financial investors, and so far they have survived with balance sheets intact. No one would argue, however, with the proposition that the financial sector and the real economies of the US and Europe are far from solid ground.

In the financial sector, consolidation and major ownership changes are unfolding on a daily basis, and the various government capital injections are either in position or already underway. Nonetheless, thawing of credit flows has been very slow, and most expect the deleveraging process to be sustained and irreversible. Most obvious is the fact that markets cannot return to the easy credit of the light collateral days, and going forward, financial investors and real economy businesses will have to adjust to tougher borrowing terms and rising interest rates. A recent CITI publication set forth ten rules for corporate borrowers, all focused on expectations that credit will be harder to get and its cost will be significantly higher.[2] Ultimately, that will slow growth, force a rationalisation of assets, and actually impede the level of industry consolidation that might speed recovery in many sectors.

2 "Navigating Troubled Waters: What the Credit Market Turmoil means for Corporations" (October 2008)

In late October, China's chief central banker, Zhou Xiaochuan was reported as saying: "Currently our overall economic situation is good. The competitiveness of our financial institutions has strengthened, with big improvements to profitability and the management of risk. We have relatively abundant market liquidity. In short, our financial system remains very solid, and should be able to withstand external impact.[3]"

The major risk identified in the official discussion is the downward pressure on exports, and there is widespread belief that the current crisis could trigger protectionist practices for both trade and cross-border investments, that would be harmful to China.

Political pressures around the world created by a financial and real economy crisis of this magnitude makes it difficult to say with certainty whether a pervasive wave of protectionism will sweep the globe. In our opinion, it will not, because of offsetting pressures in both the financial and real economies. With China alone controlling a wallet of US$2 trillion, another US$3 trillion in forex holdings in other economies, and sovereign wealth funds allocating US$1.8 trillion for investment, it seems highly likely that the pressures to invest on one side and the urgent need for investment on the other will permit these funds to flow somewhat freely. In fact the process is already underway. The financial inefficiency of not permitting this would simply be too high. Nonetheless, it is fair to say that the first wave of bailout funds made available in the US and Europe was justified by the urgent need to shore-up investor confidence, but did have the effect of putting some attractive banking assets out of reach of well-funded foreign buyers.

In the trade economy, we are accustomed to seeing political campaigns in the US wherein protection from cheap imports becomes something of a mantra addressed to workers whose jobs are lost or at risk. What we have not seen is real protectionist measures taken after the campaign ends. This is no guarantee it will not happen, but an offsetting and potentially decisive concern is the inflationary impact of curtailing imports. Even if protectionist steps did positively impact employment in the US and EU, a proposition that is by no means certain, the inflationary impact of broad protectionist measures is more certain and carries with it substantial political risk. Also, if China's huge stimulation package creates the momentum it could, it will bring in its wake attractive export opportunities for the US and EU. Rather than erect protectionist barriers, trade negotiators would be better directed to seek significant shares of the stimulation spending.

What are the implications for investors? First and foremost, the promised government stimulation should provide new revenue opportunities to Chinese and MNC companies who have capabilities in transportation infrastructure, environmental remediation, cleantech industries, and energy. There are already signs that more Chinese aggregators of capital (such as industrial investment funds and strategic investors, large SOEs with cash reserves, wealthy individuals, and large private groups) are looking for more cooperation with MNC funds. We can expect good returns for fund managers as well as strategic investors in China who are innovative in their approach to models of cooperation between Chinese and MNC investors. Cooperation provides enhanced prospects for both kinds of investors to benefit from the government's stimulus funding, and gain better access to the ongoing activities of consolidation and commercialisation of SOE assets, especially at the provincial level. Our research suggests that foreign investors in China will see new opportunities, many different from those that have existed, but potentially of greater magnitude. These will require new ways of thinking and smart investment in information, learning, and access.

3 China Daily, 29 October 2008

Central Bank Governor Zhou's remarks on the country's relative stability accurately describe not only China's strengths today but the strengths that had carried it through the Asian financial crisis of 1997-98 in very good shape. The liquidity in China's own financial markets, coupled with the controls on capital account convertibility and RMB exchange rates, not only helped China defend against serious impact from the crisis, but also set the stage for its emergence as the undisputed engine of growth for Asia. Leading economic indicators prior to the crisis showed China's ups and downs moving counter to the rest of Asia. After the crisis, China led the economic trends in the region.

Will something similar to what happened during the Asian financial crisis happen again in this global financial crisis? The global financial crisis and what is now increasingly recognised as a global recession will continue to evolve in the months ahead. While the recessionary impact on global growth is likely to take two years or more to abate, the extreme volatility that has characterised September to November 2008 may stabilise significantly much sooner. If that happens, China will likely emerge even more prominently as a player in restoring liquidity and economic vitality to the mature economies of the world, a development that would both enhance China's stature as a responsible financial force in global affairs and significantly stabilise and advance its movement toward its most important reform goals.

# About Deloitte China Research and Insight Center

The Deloitte China Research and Insight Center ("CRIC") was established by Deloitte China in 2008 to provide our clients in China and around the world with information on developments in China which may be relevant to their businesses.

The CRIC publications range from in-depth reports examining critical issues and trends to executive briefings which update on new developments and their impact. CRIC also contributes to the development of Deloitte global research publications in collaboration with research centres around the Deloitte global organisation.

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