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# China News Alert Issue 332

## Capital Markets

### Reduce reliance on US T-bills, says Cheng

China should be cautious in buying or selling huge amounts of US Treasury bonds due to the inherent risks they pose, Cheng Siwei, an influential economist, has said, suggesting that the suitable ceiling for the nation's foreign exchange reserves is US$800 billion.

"The country should diversify its currency portfolio for foreign exchange reserves and reduce the share of US dollar-dominated assets for risk control purposes," said Cheng, the former vice-chairman of the Standing Committee of the National People's Congress, in a speech at Fudan University.

The nation's foreign exchange reserves, the world's largest, climbed US$453 billion in 2009 to US$2.4 trillion. China is also the largest owner of US Treasury securities and held US$889 billion of the securities by the end of January this year after scaling it down from US$894.8 billion in December 2009.

Yi Gang, head of the State Administration of Foreign Exchange, said in March that the country's diversified allocation for foreign exchange reserves mainly include the US dollar, the euro, and the Japanese yen, without providing the currency composition of the holdings. However, analysts maintain that over 70 percent of the forex reserves are in US dollar-denominated securities.

"We could maintain the scale of forex reserves by increasing the overseas purchasing volumes to slash the trade surplus, and also spur more direct investment abroad," Cheng said.

Talking about the mounting pressure from countries like the United States on yuan appreciation, Cheng said China should keep the yuan exchange rate "basically stable at reasonable levels" but with more flexibility.

"Don't make the valuation of the Chinese currency too political ... the rate fluctuation will directly impact the global trade framework and impede the progress of the global economic recovery," he said.

Cheng said China should tune its foreign exchange policy to market demand without interference from the central bank if the floating exchange rate fluctuates within 3 percent.

"The 3 percent fluctuation is acceptable at the current stage. We can expand the movement range and types of currency gradually when the government's management level improves, and finally make Chinese yuan a fully convertible currency," Cheng said, without providing any time frame, but adding that the final goal will be achieved "sometime soon".

China ended its currency peg to the US dollar by linking the value of the yuan to a basket of currencies in July 2005, but re-pegged it to the US currency in July 2008 after the global financial crisis.

With regard to China's mounting inflation concerns, Cheng said it would be difficult for the government to achieve the consumer price index (CPI) target of 3 percent this year, as more liquidity would enter the real economy. "5 percent CPI growth in 2010 looks more achievable," he said.

The country posted a higher-than-expected 2.7 percent CPI in February.

China should discuss exit strategies with the US and Europe, and act in accordance with these nations to avoid the excessive hot money inflow that may fuel domestic inflation, he said.

[Source: China Daily](http://www.chinadaily.com.cn/bizchina/2010-04/01/content_9673532.htm) ([see archive](Reduce_reliance_on_US_T-bills_says_Cheng.pdf))

### Ministries unveil budgets for 2010

Four ministries have made public their annual budgets for 2010 after the central government pledged to tell taxpayers how their money is spent.

The Ministry of Finance (MOF), the Ministry of Housing and Urban-Rural Development (MOHURD) and the Ministry of Science and Technology (MOST) posted their 2010 annual budgets on their websites, a day after the Ministry of Land and Resources (MLR) made its budget public.

According to the statistics, the total spending budget of the MOF is 2.45 billion yuan (US$359 million), while the MOHURD has 843 million yuan, the MOST 21.2 billion yuan and the MLR 3.5 billion yuan.

All four budgets highlight the areas of revenue and expenditure, though without detailing items, such as the amount to be allocated for receptions and car purchases.

"This is the first time ministries have made public their budgets and it is usual that it is not exactly what the public expected. We will make more detailed budgets to the public step by step," said Lai Wensheng, director of the MLR's finance department.

"Information on the budget each department makes public will become more detailed," said Liu Shangxi, vice-director of the research institute for fiscal science under the MOF. "We will make it an ongoing process to add more items to the budget. Yet, I cannot say when items like expenditure on buying vehicles will be made public."

Ye Qing, vice-director of the Hubei Bureau of Statistics, concurred, saying: "Although every ministry included expenditure on housing in its budget, there is no further explanation on how the money is to be spent."

According to the MOF, expenditure on housing refers to three kinds of housing subsidies that administrative departments pay to their employees. The four ministries' budgets all give a figure for their total expenditure, without stipulating the percentage of the three housing subsidies and how the money will be spent.

The expenditure on housing by the MOF is 60 million yuan, while that of the MLR is 136 million yuan, the MOHURD is 26 million yuan and the MOST is 24 million yuan.

Ye admitted the expenditure on housing is too high. "With housing prices in Beijing so high, taxpayers won't be happy that they pay for government employees' housing," he said.

Experts still consider it a step forward in pushing for transparent budgets and promoting public supervision of the government.

Bai Jingming, vice-director of the research institute for fiscal science under the MOF, said this is another step towards enhancing budget transparency from central to local governments.

"It will help the public to know how government money is allocated to solve social problems and to further understand the policies of our country," said Bai, "It also lets the public supervise the government more directly."

[Source: China Daily](http://www.chinadaily.com.cn/china/2010-04/02/content_9678413.htm) ([see archive](Ministries_unveil_budgets_for_2010.pdf))

## Corporate & Commercial

### Domestic firms more cautious over foreign buyouts

Chinese companies are planning to take a more cautious approach to foreign acquisitions, avoiding outright buyouts and seeking more partnerships and alliances, a report by the Economist Intelligence Unit has said.

According to the report, among survey respondents who say they are definitely or likely to make an overseas investment, 47 percent would prefer to strike either joint ventures (29 percent) or alliances (18 percent) while only 27 percent say they will do so through acquisitions.

"Our analysis of transactions worth more than US$50 million between 2004 and 2009 shows that half the deals involved the buyer taking at least 50 percent ownership of the target. But Chinese executives are beginning to sense that this may not be the best approach, not least because it can set off alarm bells among the public and regulators," said Xu Sitao, China chief representative of the Economist Group.

Chinese companies made 298 cross-border acquisitions in 2009, with much of those investments welcomed by cash-strapped Western companies that would be hard-pressed to survive without it. But China's buying spree has raised a number of concerns, particularly where it has involved State-owned enterprises (SOEs).

And Chinese companies are discovering just how difficult it can be to get mergers and acquisitions (M&A) right, especially when they are cross-border deals. These factors have encouraged companies to lower their ambitions.

"Multiple investments of minority stakes in different companies in different countries can give a Chinese company many valuable 'windows' to learn about management and technology in different markets without triggering a foreign investment review or the political pressure associated with 'control' issues," said Stephen Harder, managing partner of law firm Clifford Chance LLP (China).

Meanwhile, the report showed that outbound M&As remains dominated by SOEs. According to analysis of deals worth more than US$50 million between 2004 and 2009, an overwhelming majority of China's outbound M&A transactions―81 percent―were made by State-owned entities.

"This will remain a cause for concern abroad, not only because many deals involve control of natural resources but also because State ownership seems to confer unfair advantages on the acquired companies," said Alison Kennedy, managing partner of strategy with consulting firm Accenture in China.

In the survey conducted for the report, 82 percent of respondents cited a lack of management expertise in handling M&As as the biggest challenge for Chinese companies making purchases abroad. Only 39 percent feel they know what is required to integrate a foreign acquisition. And only 39 percent of survey respondents say they had identified attractive targets within their chosen geographic markets―increasing the risk that Chinese buyers will succumb to the temptation to buy assets that have become available as a result of the global financial crisis, rather than focusing on carefully researched targets.

The report is based on in-depth interviews with large Chinese companies with extensive investment experience abroad, an online survey of 110 Chinese executives and interviews with several foreign participants and advisers to Chinese deals overseas.

In addition, the report analyses available data on Chinese companies' cross-border transactions over the past five years, focusing on deals worth more than US$50 million.

[Source: China Daily](http://www.chinadaily.com.cn/bizchina/2010-03/31/content_9667616.htm) ([see archive](Domestic_firms_more_cautious_on_foreign_buyouts.pdf))

### PMI surge indicates strength of continued economic rebound

China's manufacturing picked up in March indicating the strength of the continued economic rebound, boosting hopes for possible interest rate hikes and yuan appreciation, said analysts.

The Purchasing Managers' Index (PMI), released by the China Federation of Logistics and Purchasing and the National Bureau of Statistics on Thursday, rose to 55.1 in March from 52 in February.

The HSBC China Manufacturing PMI, released the same day, rose to 57 in March after falling to 55.8 in February, when the indicator was affected by the lunar New Year holidays and winter weather conditions.

PMI is a measure of manufacturing activity and readings above 50 indicate expansion.

The rise in PMI fueled optimistic market sentiment as Chinese equities rose to a two-month high. The benchmark Shanghai Composite Index rose 38.31, or 1.2 percent, to 3147.42 at the close.

The rising momentum of manufacturing activity could continue, analysts said. "While some slowing is expected in sectors sensitive to government tightening, industrial activity is likely to be supported by the recovery in external demand and strengthening domestic consumption," said Jing Ulrich, managing director and chairman of China Equities and Commodities at JP Morgan.

Analysts said the rising index indicates that the Chinese economy is likely to maintain the high growth rate it achieved in the fourth quarter of last year, when it expanded 10.7 percent year-on-year, the fastest since 2007.

"The PMI figure implies that annualised industrial output growth in March could exceed 20 percent while the gross domestic products (GDP) growth in the first quarter of this year could be up to 12 percent," said a report by Nomura Securities.

The report forecast that China's GDP growth could be 10.5 percent for the whole of 2010 and may even be higher.

But uncertainties remain for the manufacturing sector, said Ulrich. "Chinese manufacturers are facing margin pressure on a number of fronts, including higher wage costs and rising raw material prices."

With the economic expansion continuing steadily, analysts said it also provides a basis for the nation to hike interest rates amid growing risks of asset bubbles and rising inflation.

The upward trend in manufacturing could also make policymakers think in terms of making the yuan more flexible, analysts said.

China's home prices soared last year thanks to the ample liquidity in the financial system as a result of the country's massive stimulus package. Economists such as Tang Min, deputy general secretary of the China Development Research Foundation, have warned against the unaffordable effect of bursting bubbles on the national economy.

Meanwhile, the consumer price index (CPI), a major measure of inflation, rose to 2.7 percent in February from 1.5 percent in January.

Although the rise is partly attributable to the consumption boom during the lunar New Year holidays, some economists have cautioned that the country's record new yuan lending of 9.59 trillion yuan (US$1.4 trillion) last year could stoke inflation.

"Although March CPI inflation should be lower than February, which is usual for the month following the lunar New Year, the Producer Price Index (a measure of factory-gate prices) is expected to continue rising on higher commodity and raw material prices," said Wang Tao, head of China economic research at UBS Securities.

"Underlying inflationary pressure from the recent credit expansion and property price rises is not abating," she said.

Wang said the strong growth in the first quarter could set the stage for the start of interest rate hikes and yuan appreciation.

"We expect the central bank to start raising interest rates in the second quarter, possibly in April, in order to anchor inflation expectations. This would also be a good time to move on the yuan," he said.

[Source: China Daily](http://www.chinadaily.com.cn/bizchina/2010-04/02/content_9679704.htm) ([see archive](PMI_surge_indicates_strength_of_continued_economic_rebound.pdf))

### Geely could find Volvo a tough nut to crack

When Li Shufu, chairman of Zhejiang Geely Group Holding Co Ltd, celebrated the company's agreement to take over Swedish luxury brand Volvo, nobody could foresee the challenges and risks ahead for the Chinese automaker.

Yes, the deal gives the Hangzhou-based company access to new technologies, control of the Volvo brand name and, perhaps, a shortcut for Geely into the global automobile industry. But conversely, the huge purchase could also be the privately owned automaker's fast track to financial ruin.

And while Geely proved it could muster enough capital to conclude the transaction, whether it has the financial muscle to take over and develop Volvo over the long haul remains to be seen.

Addressing the money issue, Yin Daqing, Geely's chief finance officer, said in Beijing that Geely has obtained "enough" financing to foot Ford's US$1.8 billion bill and still have US$0.9 billion left over for future operational costs.

However, according to a Bloomberg report last week citing a Volvo board member, in reality the Chinese automaker will need at least US$1.4 billion to revive the troubled Swedish brand, a sum that Geely may be hard pressed to come up with.

Domestic auto analysts agree that forecasting Geely will need between US$1.6 billion to US$2 billion to keep the Swedish firm operational.

Volvo reported losses of US$1.69 billion (almost 10.5 billion yuan) in 2008. That compares with a 1 billion yuan profit for Geely in 2009.

Last year Li admitted that the company had about 10 billion yuan in debt, a sum he later declined to explain in detail.

Based on those numbers, it appears near impossible for Geely to garner the financial support required to revive the Volvo brand.

Moreover, "it will be very hard for Geely to allow Volvo to recover from its poor performance within two years because of the high operational costs associated with Volvo," said Frank Xu, head of mergers and acquisitions at China International Capital Corp Ltd.

Xu has helped several interested companies evaluate Volvo since Ford first put the Swedish automaker on the market at the end of 2008.

The dealmaker also cast serious doubt on Li's promise to move Volvo out of the red in two years, indicating Volvo's profitability may come to the detriment of Geely.

In 1999, Ford spent US$6.4 billion to acquire Volvo, and 10 years later will only receive US$1.8 billion back. Even Ford, the century-old US auto giant, could not manage Volvo profitably.

[Source: People's Daily](http://english.people.com.cn/90001/90778/90861/6935722.html) ([see archive](Geely_could_find_Volvo_a_tough_nut_to_crack.pdf))

### Google's exit is not exactly a windfall for Baidu

In the week since Google began rerouting mainland traffic to its Hong Kong site, Google's Chinese users did not shift en masse to rival Baidu Inc. However, many of the company's domestic partners and advertisers were scared away by fears that Google's sour relationship with the government might impact them.

According to Alexa Internet, a United States-based online Web traffic tracker, traffic on Baidu only increased 1.3 percent in the past seven days since the world's largest search engine announced on 23 March it would stop censoring its Chinese search results.

That means most of Google's Chinese users are still using the US search engine although the accessibility of Google's uncensored Hong Kong website was interrupted.

Figures from Alexa show that most of the traffic from Google.cn has been picked up by Google.com.hk, of which user visits surged 2,056 percent over the past week.

It said an additional 3.2 percent of global Internet users have visited Google.com.hk in the past seven days, roughly equivalent to the total traffic of Google.cn before the company threatened to exit the mainland.

"For ordinary Chinese Internet users, visiting Google.com.hk has not been that much different from visiting Google.cn," said Edward Yu, president of Analysys International.

Conversely, Google's commercial partners in China have "panicked" over fears that Google's move may worsen their relationship with the Chinese government and thus affect their businesses.

Baidu did not respond to a request for comment on this report.

On 30th March, access to Google.com.hk was blocked for most of the day, but the service quickly resumed normal operations on 31st March.

Google's spokesperson first said the accessibility issue was due to a global technical upgrade of its search engine, but later blamed it on the Chinese government.

Compared with ordinary users, Google's business partners and advertisers seem to be more unsettled. China's major Web portal, Sina.com, said it was reevaluating cooperation with the US Internet-search giant Google, according to a report from Xinhua News Agency, citing an anonymous company official.

Google's other domestic partners such as Tom.com, Tianya and China Unicom have all announced plans to steer clear of the search engine after it rerouted its search services to Hong Kong.

Cheng Yu, general manager of Zoom Interactive, a Google advertising retailer in Beijing, said his business has dropped 20 to 30 percent after Google's announcement in January that it may pull out of the mainland.

He said many of his clients, especially big advertisers, have reduced their spending budgets on Google.

[Source: People's Daily](http://english.people.com.cn/90001/90778/90860/6938455.html) ([see archive](Googles_exit_is_not_exactly_a_windfall_for_Baidu.pdf))

## Others

### Boom time ahead for 3-D cinema industry

Makers of digital movie equipment are forecasting a surge in sales as Chinese and European cinemas upgrade to tap the popularity of 3-D movies such as Avatar.

Sales at Christie Digital Systems USA, the world's largest maker of digital projectors, may double to US$400 million this year if it can meet demand, said Jack Kline, president of the Cypress, California-based company, a unit of Japan's Ushio Inc. Kortrijk, Belgium-based Barco NV, the second largest, estimates revenue will climb 50 percent to US$200 million.

The upgrades in Asia and Europe are part of a worldwide trend in theatre spending. The three largest US chains are outfitting 14,000 screens for digital projection after raising US$660 million. Cinemas charge more for 3-D movies and will benefit from the 19 films scheduled for release this year, up from 14 in 2009, according to researcher Hollywood.com Box-Office. Digital systems also cut costs by eliminating film reels and projectionists.

"We didn't expect China to expand so fast," said Andrew Robinson, managing director at Harkness Screens International Ltd, the largest maker of screens for digital cinemas. Harkness, based in Dublin, sold 500 screens in China last year, Robinson said.

Harkness is running its US factory around the clock, seven days a week, Robinson said in an interview. A second plant in France is running 18 hours a day, he said. The wait for delivery is 10 weeks, up from the usual four, he said.

Like in the US, demand for 3-D theaters in China is increasing following the success of James Cameron's Avatar, the highest-grossing movie of all time, said Weng Li, a spokesman for China Film Group, the State-run company that controls most cinemas and film distribution in that nation.

There are about 2,000 digital screens in China, including 800 that are equipped to show movies in 3-D, Li said in an interview. Even small cities in China are installing 3-D equipment, he said.

Avatar has generated US$193.6 million in ticket sales in China since its release, the film's second-highest grossing nation behind the US, according to News Corp's Twentieth Century Fox.

China Film Group is seeking bids to add 500 digital projectors over the next four to six months, said John Wilmers, chief executive officer of Ballantyne Strong Inc, an Omaha, Nebraska-based seller of digital cinema equipment and services.

Time Antaeus Media Group, based in China, plans to add 500 to 700, Christie's Kline said.

Consumers may lose enthusiasm for 3-D as the format becomes more common, said Matthew Harrigan, an analyst with Wunderlich Securities in Denver.

[Source: People's Daily](http://english.people.com.cn/90001/90778/90860/6938424.html) ([see archive](Boom_time_ahead_for_3-D_cinema_industry.pdf))

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