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ICBC—it's China's biggest chance

The imminent listing of the huge state-owned bank should mark the start of a new and improved era for the country's banking system

The planned initial public offering (IPO) of Industrial and Commercial Bank of China (ICBC) in late October is shaping up to be the most important event in recent Chinese banking history. It may be only the third of China's Big Four state-owned banks to list internationally, but as the largest—and until recently the worst in terms of the amount of bad loans it carried—its overseas debut marks the full emergence of China's banking system on the global stage.

Assuming its listing proceeds with no major hitches—and none are foreseen—the bank will command a market capitalisation of around US$120bn. This will not be quite enough to put ICBC in the same league as Citigroup, HSBC or Bank of America, but the sum will put it comfortably in the ranks of the world's top-ten banks (see table). The flotation, which will take place in both Hong Kong and Shanghai, will raise between US$19bn and US$21bn, making it the world's biggest IPO ever (the previous record was US$18.4bn set by Japan's NTT DoCoMo in 1998). Up for sale is 17% of ICBC's equity, three-quarters to be offered in Hong Kong and the remainder, in Shanghai.

More than about money

The money raised will certainly be useful for spending on technology, training and overseas acquisitions. But as Shang Fulin, head of the China Securities Regulatory Commission, said in late September, the IPOs of ICBC, China Construction Bank (CCB, which floated in October 2005, raising US$8bn) and Bank of China (BOC, which raised US$11.2bn when it listed in June) are about far more than money. Mr Shang suggested the listings have been driven principally by the government's goal of transforming the three banks into major global players. As if to emphasise this, ICBC announced at the end of September that it was lining up the purchase of an Indonesian bank, Bank Halim Indonesia. Tiny as it is—the family-owned bank had assets worth just over US$50m at the end of 2005—ICBC's successful acquisition would be the first purchase by a Chinese bank of an overseas bank outside Hong Kong.

Perhaps more significantly, the listings also mark the end of an era. Previously the Big Four Chinese banks—ICBC, CCB, BOC and Agricultural Bank of China—were used chiefly as funnels for government economic policy. But now they will essentially govern themselves, answer to international markets and be open to the scrutiny of investors, rather than follow the dictates of government planners or local officials.

For ICBC, what is surprising is the speed with which this switch in roles has occurred. Just seven years ago, in 1999, its non-performing loans (NPLs) stood at a whopping 47.5% of all loans. A huge chunk of these were shed that year, when ICBC and the other three state-owned commercial banks handed over Rmb1.3trn (US$165bn) worth of NPLs to four asset-management companies (AMCs) set up specifically to absorb the bad loans of the Big Four. Another wedge of bad loans disappeared from ICBC's books in June 2005 when it transferred Rmb246bn to one of the AMCs. This was shortly after it received in April 2005 a US$15bn capital injection from the government.

With the bank's balance sheet thus transformed, a couple of months later Goldman Sachs and American Express, both of the US, and Germany's Allianz announced they had reached agreement to buy 10% of ICBC for around US$3bn. This suggested a valuation of around US$30bn for the entire bank. In fact, the

Heavyweights
World's top-ten banks, July 2006

Market capitalisation	US$ bn
Citigroup	235
Bank of America	230
HSBC	200
JP Morgan Chase	150
Mitsubishi UFJ	145
Wells Fargo	120
ICBC*	**120**
UBS	110
Royal Bank of Scotland	100
China Construction Bank	100

*Forecast for end-Oct
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foreign investors handed over US$3.8bn for an 8.45% stake in January when the deal was concluded, valuing ICBC at around US$45bn. Some nine months later, though, that figure has almost tripled—an even more astonishing change in ICBC's fortune than its plunging NPL levels.

It is hard to gauge if ICBC's management has improved

All this shuffling of loans and injections of capital, however, will mean little if the bank's practices have not changed. Here, matters are harder to gauge. To be fair, most of the NPLs shed in 1999 and probably those removed in 2005 were the legacy of ICBC's being a tool of central planning in the 1980s and 1990s. Without having to set aside money against these bad debts which the state took back, ICBC's profits are rising nicely. It forecasts net profits of Rmb47.2bn in 2006, up from Rmb37.4bn in 2005.

The key issue, therefore, is how well the bank has been managed from 2000 onwards, particularly during the lending boom of 2001-03 when the value of new loans in China leapt by 40-50% annually. This remains an open question. For one, keeping track of what is happening in a bank which still has more than 18,000 branches and 360,000 staff must be a daunting task for ICBC's corporate leaders in its Beijing headquarters. In addition, with China facing a consolidation of thousands of companies due to the huge surplus of productive capacity in numerous industries, a big wave of bankruptcies seems inevitable at some point. In 2005 an official at the China Banking Regulatory Commission speculated that companies with outstanding debts of nearly Rmb180bn, almost all owed to the Big Four, would be declared bankrupt by 2008. Assuming ICBC takes its share of these according to its proportion of total loans, that would mean it could be sitting on Rmb60bn-80bn in future bad debts.

Sceptical note

It is tempting to strike a sceptical note. After all, the bank's ongoing lack of transparency and what might happen to its loan books if the Chinese economy enters a downturn make even its fans jittery in their less exuberant moments. In all likelihood, however, ICBC should prove more than big enough to handle even a severe drop in China's economic growth. The bank is a classic example of an institution which is "too big to fail". The government will continue to stand behind it, regulatory officials will continue to nudge it towards stronger governance and investors will continue to maintain faith in its future success—so long as they believe in China.

From a long-term investment point of view, ICBC is not the most interesting bank in China. Bank of Communications—which is already 19.9% held by the UK's HSBC—and the best of the other second-tier Chinese banks will not require the same huge amount of money for upgrading and restructuring their operations as ICBC will need. Neither do they have to worry about far-flung branches where anything can happen or face the same training requirements for their staffs, which are a fraction of the size of ICBC's. That said, none of these nimbler players will displace ICBC as the heavyweight of Chinese banking—and the barometer by which the rest of the world can measure the state of China's financial system.

Instant replay?

China's latest crackdown on DVD pirates looks familiar—and fake

In September when six major international studios joined forces to launch court proceedings against two Beijing retailers accused of selling pirated versions of their films, some observers said the move signified a forceful shift in Hollywood's intellectual-property-rights (IPR) campaign in China. But the legal action was not a first—the Motion Picture Association (MPA) says in 2002 and 2003 it initiated ten such civil cases in China, all of which were settled or ruled in favour of the plaintiffs. It was clearly, though, the studios' way of testing China's renewed pledge that improvements have been made to protect intellectual property. Earlier in September Wen Jiabao, the Chinese premier, was quoted as saying, "China's IPR protection efforts will carry the full force of steel, and it will definitely not be something that is soft as bean curd." However, Hollywood is not convinced and is "calling the Chinese government's bluff", says one analyst.

Hollywood has taken more legal action to combat piracy

Walt Disney, Paramount, Sony, 20th Century Fox, Universal and Warner Brothers are the studios involved in the two separate suits, which together include 37 allegedly pirated titles. The studios are asking Rmb500,000 (US$63,291) per title plus legal costs in damages. Copyright holders, though, have generally been reluctant to resort to court action because judicial penalties enforcing anti-piracy statutes in China are almost as uncommon as genuine DVDs of Hollywood blockbusters. Even when they are handed down, punishment is rarely severe. Thus, regardless of the outcome of the latest suit, no one expects film piracy in China to end any time soon. Some estimates say as many as 95% of the CDs, VCDs and DVDs in China are pirated. According to the MPA, its studios lost US$1.2bn in 2005 due to piracy in the Asia-Pacific region, with China the major offender.

Now one studio, Warner Brothers, is taking a different tack. As well as hiring expensive lawyers, it is trying to win over penny-pinching Chinese film buffs

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by aggressively promoting a market for legitimate films. In 2004 Warner became the first Hollywood studio to set up DVD operations in China, a joint venture with China Audio Video, known as CAV Warner Home Entertainment. In early 2005 CAV Warner began distributing DVDs in China, with an emphasis on getting new films to consumers as quickly as possible and keeping prices low. Selected Warner DVDs were released in China long before they hit store shelves in the US and, in the summer of 2005, the studio even tested a simultaneous release in cinemas in the US and on DVD in China of a little-known film, *The Sisterhood of the Traveling Pants*.

Cardboard packaging

Meanwhile, Tony Vaughan, CAV Warner's managing director, says his division has got pricing for China "about right". Most of its DVDs cost between Rmb22 and Rmb36, depending on the amount of special features included (prices for pirated discs start at around Rmb6 on the streets). He says Warner's market research has shown that China's white-collar consumers are increasingly willing to pay more for guaranteed quality. In April, however, Mr Vaughan put the pirates on notice, releasing some DVDs in simple cardboard packaging for Rmb12.

Still, only three Warner films have been released at Rmb12 so far. And the studio has only about 300 titles on sale in China. Thanks to Chinese laws limiting the number of foreign films allowed in the country, it is impossible to compete with the pirates, many of whom carry 300 titles in a single suitcase. Indeed, most observers doubt that Warner or anyone else can make real progress against piracy unless China opens its market wider to foreign films. "The maintenance of the theatrical exhibition quota, combined with the frequent imposition of 'blackouts' on the theatrical release of foreign films and the restrictions on home-video distributors compared with pirate retailers give movie pirates a tremendous market advantage," explains Mike Ellis, an MPA spokesman.

But with all the sound and fury from foreign studios, it is easy to overlook the fact that the biggest victims of China's pirates are the country's own film-makers. The MPA estimates that the film industry in China loses US$2.7bn per year in potential consumer spending. Because of piracy, Chinese film-makers cannot expect a long box-office run or favourable home-video distribution deals. The problem has got so bad that Chinese film-makers cannot even trust domestic television stations—some 1,500 pirated Chinese films are shown on local stations each year, the Chinese Movie Copyright Association said in August. A successful film-maker in China is someone who can sell films outside China but, given all the red tape, that does not happen often. "Film-making is not really a profitable business in China," reckons Philip Lee, a Hong Kong-based movie producer whose credits include *Fearless, Hero* and *Crouching Tiger, Hidden Dragon*.

Early release

Few domestic films are money-spinners

One domestic success story this year was *Crazy Stone*, a crime comedy, which happened to be the first release from Warner's new film-making joint venture in China. Warner released Rmb10 copies of the DVD for the critically acclaimed low-budget film just 12 days after its box-office opening. In cinemas, *Crazy Stone*, which was made for US$400,000, has grossed more than US$3m to date, the third highest take this year for a domestic film. Mr Vaughan would not provide sales figures for the *Crazy Stone* DVD, but says the early release was "absolutely a success". Mr Lee does not doubt that, but cautions that "such a successful case would not really help the independent producers from making profits", because no independent producers enjoy Warner's "favoured position" of being able to co-ordinate both the cinema release and video distribution on its own.

China began its latest "100-day intensive crackdown on piracy" in late July, one month after *Crazy Stone* hit the screens. Several government agencies are reportedly involved in the campaign, from the public security ministry to the culture ministry. The vice director of the State Press and Publication Administration has promised a "stern lesson" and "strict penalties" for those dealing in the illegal audio-video trade. Headlines in the state-controlled press dutifully trumpeted millions of pirated DVDs seized, dozens of underground factories destroyed, tens of thousands of shops and street vendors raided, and thousands more fined or shut down. Even a 24-hour "anti-piracy hotline" was set up so citizens can snitch on street vendors selling counterfeit DVDs.

Some analysts see such campaigns (this is not the first 100-day crackdown) and the media hype surrounding them as nothing more than blustering propaganda. Says David Scott, an analyst with London-based *Screen Digest*: "China's anti-piracy activities and seizures of counterfeit goods are frequently given high profile in the state-run media, but as yet the problem of piracy continues pretty much unabated." Clearly, the problem is too massive to be handled in short, isolated bursts—even if China's anti-piracy authorities are earnest in their efforts.

Piracy in China may be too massive for Chinese authorities to handle

Curious gap

Consider the curious gap between the combined production capacity of China's 774 registered DVD/VCD manufacturers and actual sales of legitimate discs in the country. Sales of legal discs accounted for less than 18% of those manufactured by licensed companies, according to a recent Chinese Academy of Social Sciences study on the impact of film piracy on the Chinese economy. In August

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Zhang Xinjian, a culture ministry official, admitted, "we are not optimistic about the overall situation on fighting piracy."

Most industry observers say unless sweeping policy changes are made, the pirates will continue to flourish. In addition to opening the domestic film market, Chinese authorities should implement stricter laws, issue clear sentencing guidelines and shift from meting out administrative to judicial penalties. According to Michael Yeung, a brand protection specialist at Hill & Associates, a Hong Kong-based risk-management firm, special laws and penalties have been put in place this time. For example, those caught selling more than 5,000 illegal discs are to be sentenced to three to seven years in prison, and vendors with 100 pirated discs are to be fined Rmb10,000-50,000 and have their licences taken away. After the campaign ends, however, it will be back to the original vague and ill-defined rules, Mr Yeung predicts. Indeed, in recent days there was nothing to suggest that it was not business as usual at your correspondent's neighbourhood DVD shop, which was still stacked with pirated films.

Counting beans

As imports soar and domestic producers abandon the crop in droves, China's centuries-old soybean industry is in crisis

Tofu is the most famous dish made from soybeans

Tofu may be one of China's most famous culinary inventions, but increasingly it is not made of Chinese stuff—thanks to surging imports of soybeans, tofu's basic ingredient. The country's US$3bn soybean market is dominated by imports from the US, Brazil and other countries, while Chinese farmers of the crop are reeling from their higher production costs. As a result, many are giving up cultivation, igniting concern that the country's own soybean industry is heading towards collapse.

For the past few years China's soybean market has brought nothing but smiles to foreign producers, who are reporting record sales to the mainland. Chinese purchases of imported beans have grown at a 15% annual clip and are expected to reach 30m tonnes by the end of 2006. According to the China Customs Administration, total soybean imports in the first eight months of the year have already hit 19.46m tonnes, a 10.3% increase from a year ago. Leading the charge is the US, which in 2005 sold over 11m tonnes of beans worth US$2.3bn, 80% more than in 2001. (Over 42% of all US soybean exports are destined for China.) Not far behind the US is Brazil, which sold a record 4.29m tonnes in the first five months of 2006, a 96% year-on-year jump, according to the Brazilian trade ministry.

Growing appetite

Demand for soybeans as animal feed has surged

This growing appetite for foreign beans has been ignited by the country's meat, poultry and fishery industries which use soybeans as feed, as well as by Chinese consumers' rising wealth and taste for such products. In the past decade Chinese soybean consumption has doubled and is expected to break the 40m-tonne mark this year.

With so such demand, there would seem plenty of wealth to share between domestic and foreign growers. But instead of profiting, Chinese farmers are unable to sell their crops and being squeezed out of their own market. More than 20% of the domestic crop from 2005 had failed to find buyers as of the end of July, according to Chinese media reports. The reason for this glut of home-grown beans is the simple fact that they are about one-third more expensive than imported ones. Unlike their foreign competitors who grow their beans in huge fields and employ mechanised planting and harvesting technology (all with government subsidies), Chinese farmers must cultivate their crops in small plots and rely on labour-intensive techniques. Costs of land and water have also been rising, thanks to China's rapid urbanisation. To make matters worse, Chinese farmers have limited access to adequate transportation, inexpensive storage facilities and an effective financial network. Unsurprisingly, Chinese experts say it costs US$20 per tonne more to bring harvested Chinese soybeans to the market than foreign ones.

The inefficiencies of China's soybean industry have been further exacerbated by foreign importers' aggressive acquisition and marketing strategy. In recent years international agri-business giants, such as Cargill, Bunge, Louis Dreyfus and Archer Daniels Midland, have snapped up China's excess soybean crushing facilities. Of course, these crushing companies then purchased imported beans. According to media reports, Cargill plans to raises its share of China's bean-crushing market to 15% from 10% in the next few years. Meanwhile, foreign importers have convinced many Chinese meat, poultry and fish producers to use more nourishing high-oil foreign soybeans as feed rather than low-oil Chinese ones.

Another contributing factor in the decline of China's soybean industry was the country's accession to the World Trade Organisation in 2001. Ahead of its membership, China lowered its soybean tariffs to 3% from 10-40%. Then there was the 2004 SARS scare, which caused China's bean stocks to pile up and prices to drop by more than 30%, following a

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plunge in demand from poultry farmers. In fact, Chinese soybean prices have yet to recover, currently hovering around the US$300 per tonne level.

With market prices barely above or sometimes below cost, Chinese soybean farmers are now starting to leave the industry. China's largest soybean producing region, Heilongjiang province in the north-east which accounts for around a half of the total national output, has experienced a 25% drop in the total acreage for soybean farming this year alone. In 2005 the entire Chinese soybean industry produced only 16m tonnes, a 2m-tonne decrease from 2004. Chinese soybean executives argue that for each additional tonne over the 20m tonnes of beans that need to be imported to meet domestic demand, 1m Chinese farmers stop growing the crop.

National food security

The trend is raising alarm bells both in the Chinese agricultural industry and the central government. In recent months the China's domestic press have been filled with passionate editorials calling on the government to save the industry from foreigners for the sake of national food security. Many within the Chinese bean industry urge the government to exercise stricter safety controls on foreign beans, which often have been genetically modified. To directly influence prices, other experts propose the establishment of national soybean purchasing co-operatives, as well as setting up a national reserve.

Foreign importers seem unfazed by the brewing backlash. Phillip Laney, China country director of the American Soybean Association, calls the situation a "tempest in a teapot". "There is no crisis," he says. "This is just an overreaction from people set in the old ways of controlling everything in the Chinese economy." Mr Laney notes similarities between the woes of the Chinese soybean industry and those of the US textiles industry, which is reeling from cheap Chinese imports. Indeed, Chinese and foreign observers both believe that China is unlikely to take direct action because of its contentious trade surplus with the US, and because it considers Brazil its key strategic partner in Latin America.

In July the Chinese government reduced railway transport fees to make life a little easier for soybean farmers. And in August the Chinese media reported that the country's top leaders issued a directive to the National Development and Reform Commission, agriculture ministry and other agencies to undertake joint research on possible ways to support the sector. But Li Xiande, an economist at the Chinese Academy of Agricultural Science, says the key for the Chinese soybean industry's survival is to step up its exports to markets, such as Japan and South Korea. Because Chinese beans are not genetically modified and have higher protein content, consumers in those countries may be willing to pay a premium price. "The old methods won't work," Mr Li says. "The best way is to stimulate demand." For the first eight months of this year, China exported only 250,000 tonnes of soybeans, according to the China Customs Administration.

Chinese leaders are examining ways to help soybean farmers

Alas, Chinese experts concede that no measures taken today will immediately boost the domestic industry. It appears Chinese soybean farmers, for now, have no choice but to hungrily watch their countrymen consume more tofu and other dishes made from imported beans.

Renminbi diplomacy

Despite the dropping of a punitive tariff bill, the US criticism of China's currency policy will persist

A US Senate bill that threatened to impose 27.5% tariffs on all Chinese goods entering the US has been scrapped. For the time being, the move has defused further confrontation between Beijing and Washington over China's alleged currency manipulation. But in truth, the last-minute decision on September 28th by senators Charles Schumer and Lindsey Graham not to put the bill to a Senate vote is of more symbolic than practical significance. Even if it had passed, the bill would almost certainly have failed to become law—due to the opposition of the Bush administration and a likely presidential veto. But the climb-down is a welcome step that will take some of the heat out of the increasingly fraught Sino-US trade relations of recent months, and may give the more "softly-softly" approach to China's currency regime that is now gaining momentum in the US more time to work.

Senators Schumer and Graham appear to have been persuaded to abandon their bill after the US treasury secretary, Hank Paulson, and the president, George W Bush, urged restraint. The crux of the position of those in the US who, like Messrs Schumer and Graham, are demanding rapid exchange-rate reform by China is the argument that the country's currency, the renminbi, is kept artificially undervalued by around 15-40% against the US dollar. This, they say, helps Chinese exporters to flood international markets with cheap goods. But Mr Paulson, appointed to his post in July, has recently paid a high-profile visit to China and upon his return home, argued to his Washington audience that threats were

Some US politicians say China keeps its currency artificially undervalued

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not the best means to get China to more substantially appreciate its currency.

US officials recognise that they cannot force China to revalue the renminbi

However, the abandonment of the bill is not necessarily a sign of moderating protectionist sentiment in the US. Rather it is recognition of what is realistically achievable. China will only reform its exchange-rate regime on its own terms, and it will not be pressured into action that does not suit its domestic situation. Messrs Schumer and Graham have admitted as much, saying that they only wanted to use the bill to bring attention to their concerns over the exchange rate. Their decision has, curiously enough, broadly coincided with the renminbi's recent rise to successive highs against the US dollar. The Chinese currency's central parity rate breached Rmb7.9:US$1 on September 28th to hit Rmb7.8998. This means that the renminbi has now appreciated by around 4.6% since July 2005, if the 2.1% one-off revaluation on July 21st 2005 is included.

Closed-doors agreement?

Some may credit the rise to the pressure on China from the proposed bill. But it is more likely that other factors have been at work. These include China's massive trade surplus with the US, as well as inflows of speculative money betting on further renminbi revaluation (and perhaps reflecting the consensus among most economists that it is in China's best interests to allow the currency to appreciate). Further factors may have included speculation that China might widen slightly the narrow daily band in which the renminbi is allowed to trade and rumours that Mr Paulson's trip to China may have produced a behind-closed-doors agreement with China on gradual currency reform.

There has been some speculation in the media that the latest rises in the renminbi are China's reward to the US for the more moderate and co-operative approach apparently exemplified by Mr Paulson. One of the key results of Mr Paulson's trip to Beijing was the announcement of a new framework for high-level economic dialogue between the two countries, which may allow them to express their differences on sensitive issues such as the renminbi in a less tetchy manner.

Advocates of exchange-rate reform in China are not confined to the US. Even China's central bank, the People's Bank of China (PBC), is reported to be in favour of a faster rate of appreciation. In early August Fan Gang, an economist who had previously argued for a slightly more rapid pace of appreciation, was appointed to the PBC's monetary policy committee. However, other forces in government—in particular the commerce ministry—are concerned that such a move could have a negative impact on the crucial export sector, as well as increasing financial pressures on China's farmers by making agricultural imports cheaper.

There is no doubt that US pressure for a larger revaluation will continue. Despite their decision to abandon their current bill, senators Schumer and Graham intend to have another try early in 2007 through a joint bill with two other senators, Charles Grassley and Max Baucus. Senators Grassley and Baucus have been promoting a less draconian alternative to the Schumer-Graham bill. But unlike the Schumer-Graham bill, next year's bill is unlikely to be China-specific but to apply to any country with an allegedly misaligned currency. After months of being singled out for criticism, China is likely to consider that good news.

Emperor's wrath

Hu Jintao moves to exert the central government's authority by shaking up the local power centre in Shanghai —and consolidates his own position ahead of a key Communist Party congress next year

China's intra-party power struggle is intensifying

The sacking of Shanghai's Communist Party secretary, Chen Liangyu, for his alleged role in a municipal pension-fund scandal appears set to weaken further the influence of the so-called "Shanghai faction", thereby strengthening the position of President Hu Jintao and his allies ahead of a crucial party congress a year from now. The move also strongly suggests that intra-party jostling for power, to which a recent string of unusually high-profile corruption cases is probably linked, is intensifying.

As party secretary in Shanghai for the Chinese Communist Party (CCP) and a member of the 24-member politburo, Mr Chen was one of the most senior politicians in more than a decade to be purged. His sacking—over allegations that the US$1.2bn Shanghai social-security fund was misused to finance construction, and that he protected corrupt staff and improperly exploited his position to benefit family members—is reminiscent of the purge in 1995 of Beijing's party chief, Chen Xitong. At the time, Chen Xitong's sacking and subsequent imprisonment were widely regarded as a sign that Mr Hu's predecessor as national president, Jiang Zemin, had consolidated his position and that of his factional supporters in Shanghai through the removal of a powerful Beijing-based politician. This time around, the tables have been turned, with Mr Hu confirming his growing authority through the dismissal of one of the most influential remaining members of the Shanghai clique close to Mr Jiang.

The move appears to have been driven by a combination of factors that reflect both the leadership's

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genuine concern over corruption within the party and the realpolitik of intra-party conflicts as senior officials manoeuvre for position. As far as the former is concerned, the party leadership has long recognised that corruption is one of the biggest threats to the country's political stability and to the CCP's long-term survival. Public discontent with ad-hoc taxes imposed by officials, illegal land seizures by local governments and rising income disparities has stoked social tensions in many parts of China. This has resulted in a sharp increase in public protests in recent years—a trend the authoritarian CCP is understandably eager to reverse. In this context, it is encouraging from one perspective that the CCP top leadership has been prepared to make an example of Mr Chen. In recent months there have been a number of other big corruption cases, including the dismissal and arrest in June of Liu Zhihua, a Beijing vice-mayor in charge of the US$40bn construction budget for the 2008 Olympics.

Convenient opportunity

The CCP's attempts to prove the sincerity of its anti-corruption drive, however, cannot be taken entirely at face value. Mr Chen's sacking does not suddenly prove that Chinese governance has improved—indeed, it may suggest the opposite. Given China's weak legal system and lack of political transparency, it can be argued that Mr Chen's downfall is as much a result of prevailing political influence aligning against him, and that the corruption probe merely provided a convenient opportunity for his rivals to engineer his downfall. Mr Chen is believed to have clashed with Mr Hu over the need to slow investment growth, and there have been rumours of personality differences between the two. In this context, Mr Chen's sacking can be seen as a reflection of a conflict between the old regime's support for rapid economic reform and the more conservative, pro-poor stance of the Hu administration.

Whatever the true extent of friction between Mr Hu and Mr Chen, the increase in high-profile corruption cases certainly suggests an increase in political ferment as officials, their patrons and protégés all seek to advance their prospects in the wide-ranging realignments that have already begun ahead of the 17th CCP Congress in October 2007. That meeting will be a crucial event in Chinese politics, because it will usher in a younger generation of officials to be groomed as eventual replacements for Mr Hu and his politburo colleagues.

At the very top, Mr Hu has begun to look increasingly dominant. When he came to power in late 2002, Mr Hu faced the considerable challenge of presiding over a CCP politburo packed with allies of his predecessor, Mr Jiang. (Mr Hu owes his rise to the late Deng Xiaoping, not Mr Jiang) That is still the case, but Mr Hu's ability to assert his authority over the Shanghai faction appears to have increased. In particular, the president, who is also the CCP general secretary, has had considerable success manoeuvring his own appointees into key provincial positions. Before Mr Chen's disgrace, of the 62 positions occupied by the CCP party secretaries and governors of China's 31 provinces, some 38 had changed hands since the beginning of 2003. Presumably, that number now rises to 39, with Mr Hu having the opportunity to install one of his own supporters as Shanghai party chief.

Mr Hu has the opportunity to name a supporter to lead Shanghai

Power shift

For the time being the city's mayor, Han Zheng, has taken over as acting party secretary in Shanghai. Mr Han has links to the Shanghai clique but interestingly he is also, like many of those in Mr Hu's coterie, a former member of the Communist Youth League (CYL), which Mr Hu headed in the 1980s. Although the importance of CYL membership should not be overstated—it is a standard promotion path in the party these days—Mr Hu has nonetheless appeared keen to promote former CYL members. Following a spate of reshuffles in the past few months, some 17 leaders with a CYL background are in charge of various provinces. This compares with just three identifiable members of the Shanghai clique (down from four before Mr Chen's sacking).

These realignments will also affect the lower levels of the CCP in the run-up to its congress. Some 170,000 officials from the provincial level all the way down to township governments are set to be reshuffled during the next year. The process began in July. How it plays out is likely to be as important in some ways as the outcome of manoeuvring at the very top. This is particularly pertinent in the current climate, because the strong response to the pension scandal in Shanghai may in part reflect the central leadership's frustration at sometimes being unable to control provincial outposts. This dynamic, in which Beijing's agenda is often at odds with the priorities of local-level officials, affects many of the key issues facing the government—most notably its attempts to curb overinvestment and to prevent indiscriminate and environmentally damaging development.

Conflicting agendas

The goals of central and local government officials increasingly clash

Local officials throughout China often prioritise rapid economic growth, but this goal is increasingly incompatible with the central government's long-term agenda of promoting more balanced growth. In recent years, the unbridled development that has taken place in many parts of China has doubtless proven to the central authorities in Beijing the truth of the maxim: "heaven is high and the emperor is far away". But as Chen Liangyu and others are discovering, perhaps not as far away as they would like.

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What's new in your industry

Agriculture

After nearly 13 years of negotiations China's State Administration of Quality Supervision, Inspection and Quarantine (SAQSIQ) has agreed to terms with the US Department of Agriculture (USDA) to begin exports to the US of fragrant pears from the Xinjiang Uygur Autonomous Region. China's first application to export the region's pears in 1993 was denied by the USDA, and not until 2005 the two sides came to agree on quarantine procedures to guard against invasive pests. USDA inspectors approved health and safety standards at export-processing facilities in the Xinjiang city of Korla, where nearly 120,000 tonnes of the pears are produced annually.

Officials at the National Development and Reform Commission (NDRC) warned that China's cotton supply is entering a prolonged period of undersupply due to liberalisation of the textiles industry following China's accession to the World Trade Organisation in 2001. Cotton imports rose from 870,000 tonnes in 2002 to 3.03m tonnes in just the first eight months of 2006. Measures have been taken to enhance the domestic production of cotton, which reached 5.2bn tonnes (roughly two-thirds of total demand) in 2005, but demand continues to outstrip production. China exported approximately US$115bn worth of textiles in 2005, an increase of 20.6% year on year from 2004.

State-owned **China Guangxi State Farms Sugar Group** will invest US$18.9m in the Zhuang Autonomous Region of Guangxi province to construct a sugar-processing facility capable of refining 300,000 tonnes of sugar annually. Construction on the new facility will begin on October 29th with completion scheduled for the end of 2008.

Aviation

AMECO Beijing, an aircraft-maintenance joint venture between **Air China** and **Lufthansa** of Germany, announced plans in late September for the construction of a 70,437-sq-metre Airbus-A380 maintenance hangar outside Beijing's Capital Airport. Upon completion, the US$87.5m hangar will be the largest such facility in Asia. The hangar can accommodate six wide-body aircraft and four narrow-body aircraft at one time. AMECO projects the facility will handle maintenance on 11,500 planes annually. The AMECO board of directors also approved the construction of a second maintenance facility of the same size alongside the first, citing statistics that the aircraft-maintenance market in China will grow at an 11% pace per year.

Settlement has finally been reached between **China Eastern Airlines** and Nanhai Park of the Inner Mongolia Autonomous Region for a plane crash that killed 55 people in November 2004. While experts from the China Research Academy of Environmental Sciences estimate that damage done to the park exceeds Rmb105m (US$13.3m), China Eastern agreed to pay US$2.7m in compensation to restore the lake's contaminated ecosystem.

China's three largest airlines—China Eastern, **China Southern Airlines** and **Air China**—raised jet-fuel surcharges on October 1st for the third time in 2006. The previous two surcharge increases were government mandated and affected only domestic flights. But the latest price increases affect international flights—in some cases, surcharges have been raised by as much as US$50 per ticket. The airlines hope the increases will offset soaring jet fuel costs, which have led to a majority of China's domestic carriers to post losses in the first half of 2006.

Consumer goods & retailing

US-based **Office Depot** announced its first foray into the mainland market with its proposed acquisition of **AsiaEC**, a Beijing-based retailer. While AsiaEC boasts a presence in the large-market cities of Shanghai, Guangzhou and Shenzhen in addition to Beijing, its services are limited to contract sales, direct mail and Internet-based retail sales, as AsiaEC has no store network. Financial terms of the agreement were not disclosed.

Gome Electrical Appliances, a Chinese electronics retailer, is approaching the domestic market from a different angle with the opening of its high-end retail electronics subsidiary, **Eagle Electrical Appliances**, at two locations in Shenyang and Beijing. The outlets measure 20,000 sq metres and 10,000 sq metres respectively and aim to provide a more comfortable and better-serviced shopping experience to win greater high-end market share. Unlike Gome, which is now extending outlets into cities across China, Eagle will focus only on cities with more than 2m citizens and the presence of a consumer population with enough disposable income to pay premium prices for high-end electronics. By 2010 Eagle hopes to open 30 new outlets in major Chinese cities, including Shanghai, Guangzhou, Shenzhen and Chengdu.

Energy & power

China's third largest hydro-electric power plant, dubbed the Longtan hydropower project, began storing water for its reservoir on September 30th. Water levels are expected to rise from 215 metres to 290.5 metres by October 15th, slowly building up to a level of 375 metres by August 2009, when the project will be completed. The Longtan project, a Rmb30bn (US$3.8bn) investment by **China Datang Corp**, will have an annual capacity of 16.7bn kw/hours, half of which will be directed to the Pearl River Delta region to meet growing energy demand.

Keppel Seghers, a division of **Keppel Integrated Engineering** of Singapore, secured a contract with Jiangsu provincial officials to provide waste-to-energy technologies for a US$13.3m plant. To be completed in the third quarter of 2008, the plant will be capable of treating 800 tonnes of waste per day, resulting in the production of 12 mw of green energy. The plant, for which Keppel Seghers will also provide technical support and training services, is a model that other Chinese cities such as Shenzhen and Tianjin hope to replicate in the future.

Food, beverages & tobacco

GRUMA SA de CV, a Mexican corn-flour and tortilla producer, opened doors to its new plant in Shanghai's Fengxian district on September 30th. The plant has an annual capacity of 15,000 tonnes of wheat tortillas, 7,000 tonnes of corn tortillas and 6,000 tonnes of snacks. The Shanghai facility is GRUMA's 89th worldwide, but its first in Asia. The plant will initially limit its supply to the east Asia region with plans to expand into central Asia and the Middle East in 2007 to meet projected demand.

Health & pharmaceuticals

China's first case of bird flu in over a month was reported in the Inner Mongolia Autonomous Region on September 29th.

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The outbreak in Xincheng village marks the ninth in 2006—in this case, 985 chickens were killed by the H5N1 virus and another 8,990 were culled to contain further spreading. Quarantine on the region in Hunan province affected by the next most recent outbreak was lifted on September 6th, three weeks after the H5N1 strain killed 1,805 ducks and required the culling of an additional 217,000 ducks.

Petroleum & petrochemicals

China National Petroleum Corp (CNPC) announced on September 29th its willingness to resume a now defunct oil-development contract negotiated with the former Iraqi government covering the Ahdab oilfield, a mid-size field capable of producing 90,000 barrels per day. While promises were made by the Iraqi oil ministry to visit China shortly in order to discuss the resumption of contracts signed under the former government of Saddam Hussein, CNPC officials maintain no illusions that large oil and gas contracts will most likely be reserved for US-based oil companies by the generally pro-American Iraqi government. That same day CNPC began trial operations on a refined oil pipeline between the Xinjiang Uygur Autonomous Region and Gansu province, a 1,849-km line expected to transport 10m tonnes of refined oil products annually.

Telecoms & technology

China's second largest personal-computer (PC) maker, **Founder Electronics**, announced plans for a series of desktop PCs based on processors made by **Advanced Micro Devices (AMD)** to be released in late October. Following the launch of desktop PCs, Founder will develop a series of notebooks and servers based on the AMD64 processor. The collaboration marks the second time AMD and Founder have co-developed a series of desktops—in 2003 Founder released a series of home media-centre computers based on AMD processors. Founder sold 2.5m desktops in 2005, making the company the seventh largest manufacturer of desktops in the world.

Transport & logistics

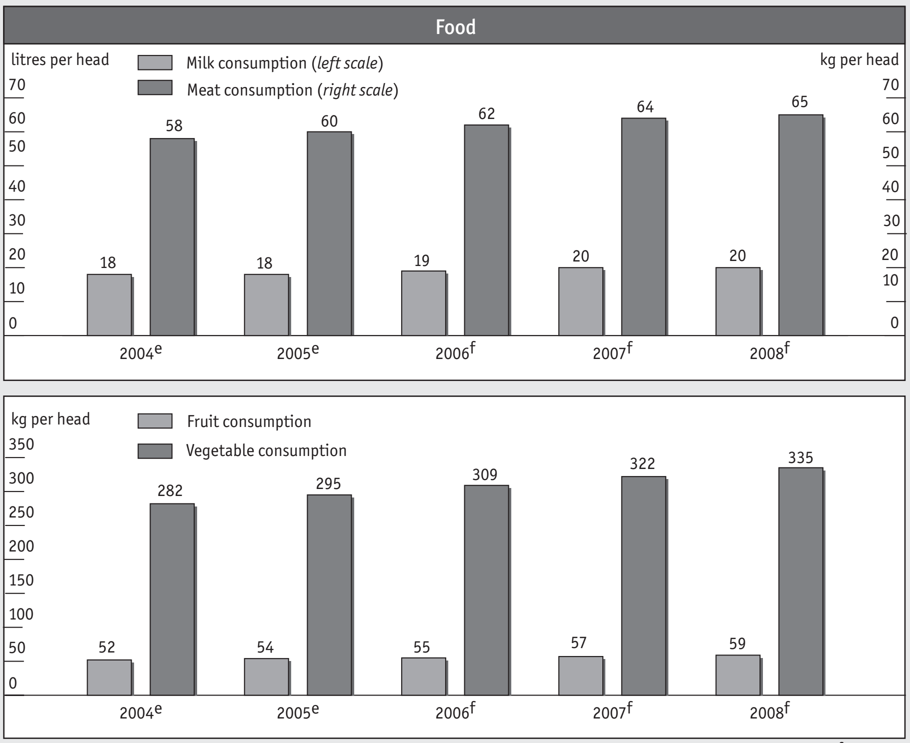
Construction began on September 29th in the central Chinese city of Wuhan on a new national railway hub that, upon completion, will cut travel times from Wuhan to Beijing and Wuhan to Guangzhou. The new Rmb4.1bn (US$519m), 370,000-sq-metre station will be completed in 2008 and will be expected to handle over 30m passengers per year. The new railway hub, with 20 tracks and 11 platforms, will be on a par with major stations in Beijing, Shanghai and Guangzhou. The Chinese railways ministry has pledged a further Rmb35bn over the course of the 11th Five-Year Plan for the further development of railway infrastructure.

China's largest container manufacturer, **China International Marine Containers**, announced plans on October 2nd to set up a joint venture with **China Railway Container Transport** to build 18 large pivotal railway container stations in China's biggest cities. The venture, to be named **China Railway United International Container**, will involve a total investment of Rmb12bn and the development of stations in the cities of Shenyang, Dalian, Harbin, Beijing, Tianjin, Qingdao, Zhengzhou, Xi'an, Chengdu, Chongqing, Kunming, Wuhan, Lanzhou, Urumqi, Guangzhou, Shenzhen, Ningbo, and Shanghai. Efficiency will be buoyed by China's decision to increase train speeds on national railways for the sixth time in nine years from January 1st to 200 km/hr. Test runs under the new speed limit between the Hebei provincial cities of Ji'nan and Qingdao, showed that a 342-km distance required 1 hour 53 minutes to traverse, resulting in an average speed of 181.6 km/hr.

In an effort to cut down on counterfeiting of its bar-code-based paper ticketing system, **Guangshen Railway** will begin utilising disposable electronic tickets produced by **Confidex**, a Finland-based ticket vendor. Guangshen Railway will order 25m tickets per year over the next five years for less than US$0.19 per ticket. The tickets will employ embedded chips from Netherlands-based **Philips Semiconductors**, whose Mifrare Ultralight chips were also employed in tickets for the football World Cup in Germany earlier this year.

Golden Ocean, a Bermuda-based dry-bulk transportation company, placed an order with **Jiangsu Rong Sheng Heavy Industries** on October 2nd for two 75,000 dwt ice-class paramax vessels to be delivered in 2008. Golden Ocean will pay US$34.5m per vessel, raising the number of panamax vessels Golden Ocean expects to deliver in 2008 to six.

Selected economic indicators



Source: Economist Intelligence Unit

e Estimates f Forecasts

Deal watch

Joint ventures, contracts, MoUs and other agreements, Sep 25th to Oct 9th 2006

Agreement (date reported)	Participants (equity stake)	Value	Additional details
Automotive			
Agreement signed (Sep 29th)	By **Dongfeng Chaoyang Diesel** of China and **Navistar Corp** of the US	—	Pending government approval, Dongfeng will produce light-duty and mid-range truck and bus diesel engines for Navistar, with production scheduled to begin in 2008
Agreement signed (Sep 28th)	By **Volvo (China) Investment** and **Shandong Lingong Construction Machinery**, both of China	—	Volvo (China) will purchase a 70% stake in Lingong Construction Machinery, whose annual sales revenue reached Rmb2bn (US$253m) in 2005
Aviation			
Contracts awarded (Sep 29th)	To **Rolls-Royce** of the UK by **Air China** and **Hainan Airlines**, both of China	US$1.3bn	Air China will purchase Trent 1,000 engines for its new fleet of 15 Boeing 787 Dreamliners for delivery in 2008, while Hainan Air will order 100 AE3007 engines to outfit its 50 new Embraer ERJ145 aircraft expected in 2007
Consumer goods & retailing			
Agreement signed (Sep 29th)	By **Warburg Pincus** of the US and **Wangfujing Department Stores** of China	—	Pending government approval, Warburg Pincus will purchase a 49% stake in Wangfujing Department Stores, whose flagship is on Wangfujing Street in downtown Beijing
Energy & power			
Contract awarded (Oct 3rd)	To **Atomic Energy of Canada** by **Third Qinshan Nuclear Power** of China	US$10.6m	Atomic Energy of Canada will provide engineering services and equipment for the construction of a spent-fuel dry-storage facility at Qinshan Nuclear's CANDU nuclear power plant
Agreement signed (Sep 28th)	By **Gamesa Energy China** of China and the Shandong provincial government	US$356m	Gamesa Energy China will construct and bring onstream wind farms with an annual total installed capacity of 250 mw in eastern China's Shandong province
Financial services			
Agreement signed (Oct 3rd)	By **Morgan Stanley** of the US and **Nan Tung Bank** of China	—	By acquiring the city commercial bank, Morgan Stanley gains access to a commercial-banking licence to offer services on the mainland.
Agreement signed (Sep 29th)	By **Allianz China Life** and **Agricultural Bank of China**, both of China	—	Allianz China Life will co-operate with Agricultural Bank of China to provide bancassurance services, which contributed 60% of Allianz China Life's total income in 2005
Agreement signed (Sep 29th)	By **China Merchants Bank** of China and **AirPlus International** of Germany	—	China Merchants Bank will enlist AirPlus International to issue a new travel-oriented corporate credit card that offers dual-currency renminbi and US-dollar services, to be released by the end of October
Media & entertainment			
JV established (Oct 2nd)	**Greater China Media & Entertainment** (51) and **Beijing New-Element Corp** (49), both of China	—	The JV will conduct marketing and branding business services for enterprises looking to develop connections within China's film and television industries
MoU signed (Sep 28th)	By **Channel NewsAsia** of Singapore and **Suzhou Broadcasting System** of China	—	The two television stations have pledged to exchange talent, co-develop content and assist each other in news coverage. SBS will include Channel NewsAsia as one of the few foreign channels broadcast in Suzhou
Metals & mining			
JV established (Sep 28th)	**Compania Vale de Rio Doce** (25) of Brazil, **Zhuhai Yueyufeng Iron and Steel** (40) of China and **Pioneer Iron & Steel** (35) of India	—	The JV Zhuhai YPM will construct and operate a steel-pellet plant in the Guangdong provincial city of Zhuhai, with annual production capacity of 1.2m tonnes expected to come online in 2008
Telecoms & technology			
Agreement signed (Oct 1st)	By **China Unicom Newspace** of China and **Global Music International** of the US	—	The agreement calls for the joint development of wireless music services and the broadcast of Global Music's video content for China Unicom's mobile-phone network
Agreement signed (Sep 28th)	By **China Jinshilin Techno** and **Shanghai Forests Information Technology**, both of China	US$200m	China Jinshilin, a subsidiary of US-based fab-less semi conductor manufacturer TechnoConcepts, will co-operate with SFIT to provide set-top boxes for Internet-protocol TV in Henan province in the next three years
Transport & logistics			
Agreement signed (Oct 2nd)	By **Hyundai Heavy Industries** of South Korea and **China Qinhuangdao Shuoqin Metal Materials** of China	US$51.9m	Hyundai will acquire a 20% stake in Shuoqin Metals in order to secure a steady supply of steel for its shipbuilding ventures, estimated at 300,000 tonnes to 500,000 tonnes of steel for 2007

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Culture

Chinese scholars object to standardised image of Confucius. A new bronze statue representing the official image of Confucius as sanctioned by the statue's commissioner, the China Confucius Foundation (CCF), was unveiled in late September in the Shandong provincial city of Qufu. Commemorating the 2,557th anniversary of Confucius' birth, the 2.26-metre bronze is the product of eight months of deliberation by Chinese scholars whose goal was to both commemorate the philosopher as well as to promote an image appropriate to his cultural standing. But the new statue has left many historians baffled, as they contend that it bears little resemblance to the historically accurate image of Confucius. The CCF maintains that historical accuracy matters little—the real importance lies in standardising a recognisable image to promote Confucian thought worldwide.

Education

Education ministry plans textbook switch to promote gender equality. The education ministry has endorsed UNICEF's "child-friendly-school" system for implementation in nearly 1,000 schools in western China in the next five years. "Child-friendly school" is a learning-system philosophy that promotes equality in the classroom and between the sexes. Images depicting gender-normative content—such as mom washing the dishes while dad reads the paper—will be replaced with images that portray men and women equally. The education ministry and UNICEF have tested the programme in over 100 schools in China's western provinces in accordance with new compulsory education regulations. The education ministry promulgated on September 1st nine-year compulsory-education programmes in rural areas and has pledged US$27.3bn in funding for the next five years.

Environment

Scenic spots to enjoy new legal protections from harmful activity. Regulations on Scenic Spots Protection came into effect on October 1st, giving legal protection to China's thousands of designated scenic areas. The new rules target individuals or entities that operate without approval on government-protected land. Companies found guilty of mining, quarrying or constructing on designated lands face fines between Rmb500,000 (US$63,291) and Rmb1m. Those who erect advertisements or stage events that damage the environment or contaminate the water supply will pay for restoration costs as well as face fines between Rmb50,000 and Rmb200,000, depending on the severity of damage incurred. Individuals found littering or writing graffiti in these areas face Rmb50 fines.

Financial services

Regulator introduces tighter supervision of foreign-exchange trading. The State Administration of Foreign Exchange (SAFE) announced measures to more tightly monitor and control China's fledgling forex trading system, including a new system of classification for institutions which handle forex transactions. Beginning November 1st enterprises will be classified into various categories determined by their history of transparency and compliance with SAFE regulations in order to better monitor discrepancies between companies' reported and actual forex earnings. SAFE also announced the extension of forex trading hours in order to match the hours when direct financial dealings take place between authorised financial institutions.

Tax authority announces favourable policies for foreign investors in China's central provinces. The State Administration of Taxation (SAT) announced new tax policies on September 27th for foreign enterprises investing in China's central provinces, where fixed-asset investment remains low. Foreign entities that choose to reinvest the profits generated by their ventures in China into designated provinces in central China—Shanxi, Henan, Anhui, Jiangxi, Hunan and Hubei—can enjoy a 40% rebate on taxes paid on capital invested. SAT officials elaborated further that should the reinvestment be directed towards the export-oriented or high-tech companies, taxes could be fully rebated.

Healthcare & pharmaceuticals

Province enacts law to prevent gender imbalance. Henan, China's most populous province, passed legislation in late September to curb practices resulting in the nationwide gender imbalance. The 24-item bill prohibits foetal gender identification for all non-medical reasons beginning on January 1st 2007 and imposes penalties of up to Rmb30,000 (US$3,798) on families who request such services. Hospitals and medical facilities which skirt the new laws could have licences revoked and equipment confiscated. In order for foetal gender identification to be performed legally, three doctors must approve the procedure—abortion will require the approval of at least county-level population-and-family-planning department officials.

Organs from executed prisoners for transplant declared legal. On September 28th a foreign affairs ministry official confirmed that organs from executed prisoners could be lawfully used for transplant in Chinese hospitals in response to a *BBC* report that such organs were being sold to transplant patients. The foreign ministry official denied that such organs were traded or that prisoners were executed to meet demand for transplant. In order for organs to be lawfully transplanted in China, donors must provide written consent, and transplants must receive regulatory approval from either the provincial health department or a local provincial high court. While the Chinese government refuses to release statistics for executions on grounds that they are a state secret, Amnesty International, an international human rights group, placed the number of executed prisoners at more than 1,500 for 2005, which made China the world's No. 1 executor of prisoners.

Needle-exchange centres open to curb spread of HIV among addicts. Before the end of 2006 the health ministry will open 300 new health centres across China to combat the spread of HIV among China's growing population of intravenous (IV) drug users. The health ministry operated 91 such centres at the end of 2005, and cited dramatic declines in the number of addicts who shared needles in areas where clinics operate as the impetus for the wider implementation of the programme. Statistics released by the health ministry for 2005 reveal that 288,000 of Chinese citizens living with HIV/AIDS contracted the virus via IV drug use, accounting for 44.3% of China's total HIV/AIDS population. In addition to needle-exchange centres, the ministry plans to open more methadone clinics to assist addicts in fighting their addiction.

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Get ready for more work

China's proposed changes to its labour law will not be as draconian as foreign companies fear, but they will make running a business tougher

By Steven Sitao Xu

Recently, during a broad discussion on labour-cost issues with several executives from multinational companies (MNCs) in Beijing, the topic of China's amended labour law came up. I must admit the intensity of concern expressed by some of them surprised me, as no domestic company I know has paid much attention to it. In fact, some very shrewd Chinese businessmen I know were not even aware that the government was planning changes to the country's labour law (the National People's Congress is currently working on a draft of the Labour Contract Law, as it is officially known). But are the MNC executives' concern warranted? If so, how should they prepare for any changes that could fundamentally alter the bargaining positions between employers and employees in China?

Based on comments by major chambers of commerce in China and the US-China Business Council, foreign employers' concerns centre on two areas: stricter contractual obligations to employees and the role of trade unions. In my view, there will still be a lot of flexibility in defining employee contracts, but trade unions look like they will become a fact of life of doing business in China.

With regards to employee contracts, MNCs are worried about proposed rules which could increase employers' administration costs, such as shorter probationary periods and a cap on damages payable for violating a non-compete clause. These possible changes, however, need not drive MNCs into the overpriced arms of corporate lawyers because they do not read like absolute state diktats. More importantly, the massive slack in China's labour market means the government is unlikely to implement vigorously any policies which will have an adverse effect on the employment rate.

In contrast, draft rules on trade unions should not be ignored so quickly. There have been a number of reports of many factory workers returning home from booming Guangdong province due to harsh working conditions and some fresh university graduates accepting unpaid jobs in violation of the minimum wage law. This suggests that workers in China are prone to exploitation because of their inability to speak with one voice through powerful organisations that represent their interests. An enhanced role for labour unions goes with the current Chinese leadership's motto of "putting people first" and redressing the ever-growing gap in wealth among the country's population.

The government has other motives in shifting favourable treatment from foreign investors to its own citizens. With the economy beset by major imbalances, Chinese policymakers no longer view attracting foreign direct investment at all costs as a priority. As China is becoming a large exporter of capital, the bar for foreign investors who want to do business in China is being raised. In addition, recent setbacks in the globalisation drive of some Chinese companies have fanned resentment against MNCs' dominance in many areas of China's domestic economy. And last but not least, continued economic liberalisation has heightened the government's fears of losing political control. That is why it now wants to raise the profile of state-controlled labour unions—which have long been viewed as nothing more than "vases", or a decoration of the Communist Party—to help maintain social stability.

The worst-case scenario

Given labour unions' higher profile in the future, MNCs may as well embrace them and work proactively with the Chinese government. The worse-case scenario for MNCs would be to put up a resistance and have the government force the issue, as apparently happened at Wal-Mart. And dealing with a surly government agency may not be half as upsetting as trying to reverse the damage done to one's corporate reputation by certain accusations of exploiting Chinese workers. Of course, at the same time, MNCs should engage in ongoing dialogue with the government to ensure that enhanced protection for workers' rights does not compromise labour-market flexibility.

Why do most Chinese executives take such a cavalier attitude towards labour unions? It seems most domestic companies feel that so long as job creation is one of the government's key concerns, its unionisation drive will remain mere rhetoric—as is its efforts to build a "harmonious society". But while they are usually very good at interpreting officials' true intentions, overconfidence in their ability to do so sometimes leads local firms to underestimate the government's will to enforce its stated policy. Stronger labour unions may just be such a case.

The bottom line for MNCs is this: They must understand that China's rewriting of the labour law is not simply about improving Chinese workers' rights; nonetheless, the Chinese government's unionisation drive is for real.

Steven Sitao Xu, an economist by training, is the Economist Intelligence Unit Corporate Network's director of advisory services in China

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