THE CASE FOR CHINA

DECEMBER **2006**

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China's economic ascent since the Communist party introduced free-market reforms in 1978 ranks among the world's most important economic developments of recent times. In the past two decades or so, China has emerged from nowhere to become the world's fourth-largest economy[1] and the impact of this rise is being felt the world over.

This paper looks at how China's economy has emerged as a global force. It discusses why China's economic outlook is buoyant as well as what challenges the country faces to sustain its impressive economic performance.

KEY POINTS ABOUT CHINA

- China's government has embarked on economic reform that has unleashed an industrial revolution
- China's economic outlook appears robust because the future is bright for exports, fixed-asset investment and consumption
- China's impressive economic growth has created investment opportunities
- China is tackling many of its macro-economic, micro-economic and social challenges such as an overheating economy, an inefficient state sector and social tensions between haves and have-nots
- China's investment infrastructure is improving. The government is attempting to remove inefficiencies in the share market

DENG'S NANXUN

In 1992, Deng Xiaoping, recently retired as the official leader of China, defied his doctors' advice and toured the parts of China where the economic reforms he had unleashed 14 years earlier had most taken hold. The journey was the centrepiece of Deng's plan to ensure those now officially in charge of China pushed on with his two-pronged economic reform programme. These reforms had stalled after political upheavals in 1989.

The first strand called "reforms" was about relaxing direct state control over the economy in favour of "market socialism" – a term to describe the meshing of free-market and controlled economics. Farmers and businesses were given incentives to work harder and produce more. Communal farms were divided between families who could plant what they wanted and sell some of the produce themselves. Likewise, state-owned businesses were allowed to sell any output beyond their state quotas.

The second strand called "opening up" was about easing China back into the world economy. Deng wanted China to grow wealthy from exporting and to have the ability to absorb the latest technology available elsewhere. Special economic zones were created to attract foreign investment. Tax incentives were offered to motivate foreigners to build up-to-date factories staffed with locals that could produce export-quality goods.

The highlights of Deng's trip in 1992 were his visits to the special economic zones of Shenzhen and Zhuhai in southern Guandong province and then his stay in the bustling coastal city of Shanghai, China's traditional financial hub. On various stops along his travels, Deng spoke of "bolder reforms" and "more opening up". Somewhere he uttered the line that became his most famous: "to get rich is glorious".[2] The national media, at first reluctantly then furiously, began to air accounts of the patriarch's journey and speeches.

1 Source: Bloomberg 25 January 2006. Statement is based on output being measured in US dollars.
2 Source: Asiaweek 2001. Article "Man of the Century" by Thomas Hon Wing Polin and Tim Healy.

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For the rest of 1992, many reports on public affairs contained references to Deng's nanxun or "imperial tour of the south". Economic reform was revitalised to such an extent that China's growth rates have exceeded those of other major economies ever since. As the table shows, for the past two decades or so China's economy has expanded at an average annual rate of about 9% a year. No major economy has even approached this performance.[3]

Table 1: Real GDP growth in recent decades

	AVERAGE ANNUAL GDP GROWTH 1988-1997 (%)	AVERAGE ANNUAL GDP GROWTH 1998-2007 (%)
China	9.9	8.9
India	5.9	6.5
Developing Asia ex-China and India	6.3	4.1
Developing economies	4.1	5.8
Advanced economies	2.9	2.6
US	3.0	3.2
UK	2.2	2.7
Japan	2.9	1.3
Australia	3.3	3.4

Source: International Monetary Fund, World Economic Outlook, April 2006

CHINA'S ECONOMIC ACHIEVEMENTS

China's economy has been changed beyond recognition since the reforms commenced.

Many Chinese consumers boast the latest electronic gadgets and sport the latest fashions. Cranes and neon signs dot the skylines of rejuvenated cities such as Shanghai where development is concentrated. Private firms, foreign-invested joint ventures and foreign companies are now an important part of the economy, delivering 47.9% of gross industrial output in China in 2004.[4]

China's economic growth has been at such a fast pace for so long that everybody seems to know at least one stunning statistic about China that sums up what an economic giant it has become.

Some people like to quote China's appetite for raw materials. Others about how much of the world's resources would be consumed if China's population of 1.3 billion consumed as much per person as US citizens do. Some tell how China is already the world's largest consumer or producer of numerous goods.

In 2005, China was the world's biggest consumer of aluminium, traded iron ore, copper, nickel, steel and was the second biggest guzzler of oil.[5] At the same time, China is the world's biggest producer of toys (about 70% of the world's total), textiles (60%), home appliances, (60%) shoes (50%), mobile phones (35%) and computers (34%).[6]

These numbers explain why China's economy is so important to world growth and why it drives stock markets the world over.

China's economy grew 9.9% in 2005, to overtake the UK as the world's fourth-largest economy (in US-dollar terms), while inflation stayed tame. The increase in annual inflation has stayed under 2% every month since April 2005.[7]

So far in 2006 China's economy has surged, expanding at an annualised pace of 10.4% in the September quarter. After the economy grew at an annualised pace of 11.3% in the June quarter, the fastest pace in 12 years,[8] Chinese authorities raised lending rates and ordered banks to curb lending, in an attempt to prevent China's economy overheating. The World Bank in August warned that booming spending on factories may create overcapacity and drive prices and corporate profits lower and ultimately lead to more bad loans.[9]

But Chinese authorities are only acting to cool economic growth to a more sustainable pace of around 7% to 8% – a rate that will still keep China's economy as one of the fastest growing among the major nations.

3 Source: International Monetary Fund (IMF), World Economic Outlook, April 2006. www.imf.org
4 Source: Economist Intelligence Unit, Country Profile 2006, China. Page 44.
5 Sources: WBMS, Barlow Jonker and IEA.
6 Sources: CSFB, August 2005; Bloomberg, February 2006.
7 Source: Bloomberg.
8 Source: Bloomberg.
9 Source: Bloomberg.

CHINA SNAPSHOT

GDP:	9.9% (2005)
Inflation:	1.4% (12 months to October 2006)
Federal budget % GDP:	Minus 1.3% (2005)
Current account % GDP:	7% (2005)
Jobless rate (urban):	4.1% (September 2006)
Population:	1.3 billion
Government:	One-party state

Sources: Bloomberg

CHINA'S POLITICAL STRUCTURE

China is run by the Chinese Communist Party, which is arguably one of the country's long-term investment risks. Transparency is limited, the rule of law is eroded in a one-party state and information is controlled. All these factors heighten uncertainty for business.

The Communist Party was at its most powerful before 1978 when it oversaw the daily lives of the Chinese through state-owned enterprise "work units" and through so-called neighbourhood committees. The work units provided housing, education, healthcare and political instruction as well as wages to citizens while the neighbourhood committees provided social controls in cities, from enforcing family-planning policies to providing law and order.

The rise of the private sector automatically diminished the Communist Party's control over the day-to-day lives of the Chinese. And as the Chinese have got wealthier, they have shown more reluctance to submit to high levels of control or surveillance. At the same time, the party's popularity has waned due to corruption, widening income gaps and unrest over state-owned enterprises laying off large numbers of workers.

The Communist Party has not yielded any political power even as it introduced free-market reforms and stepped back from tight day-to-day control over the population. While the Chinese have more personal freedom in their lives, organised dissent is discouraged.

China's rulers appear determined to press on with economic reform, a willingness shown by its decision to enter the World Trade Organisation in 2001. The WTO agreement opened up a large number of sectors such as banking and agriculture to foreign competition and limited the government's capacity to backtrack on many reforms. There are no signs of any political unrest that could destablise the country. The Chinese have never had a democratic form of government and appear uninclined to risk greater prosperity for more political freedom.

Limits to power

But for all their enshrined power, central authorities have less command of the economy than outsiders might expect because local governments control development and so are the direct beneficiaries of the foreign investment that has poured into China. This has provided some advantages and disadvantages for China's economic development.

The advantage is that many local authorities have interpreted some edicts from Beijing in the most pro-growth manner possible. This has spurred growth development more than would otherwise have been the case.

The downside to the dispersion of control over development are that local authorities are exposed to corruption and have sometimes been reluctant to heed central instructions to slow project approvals whenever Beijing authorities have attempted to cool an overheated economy.

CHINA'S ROSY ECONOMIC OUTLOOK

Fidelity sees that, notwithstanding periodic slowdowns, the outlook for China's economy is bright because investment in roads, infrastructure and other fixed assets, exports and consumption are poised to propel the economy for some time to come.

Robust investment

Fixed-asset investment is one of the key drivers of growth in China. Investment in real estate, factories and other fixed assets in towns and cities jumped 30.5% in the first seven months of 2006 compared with a year earlier.[10]

The frantic investment activity springs from China's desire to industrialise as quickly as possible. Many local authorities are approving plans of local and foreign businesses to invest in real estate and factories, especially those destined to make export goods.

10 Source: China's National Bureau of Statistics as reported by Bloomberg on 16 August 2006.

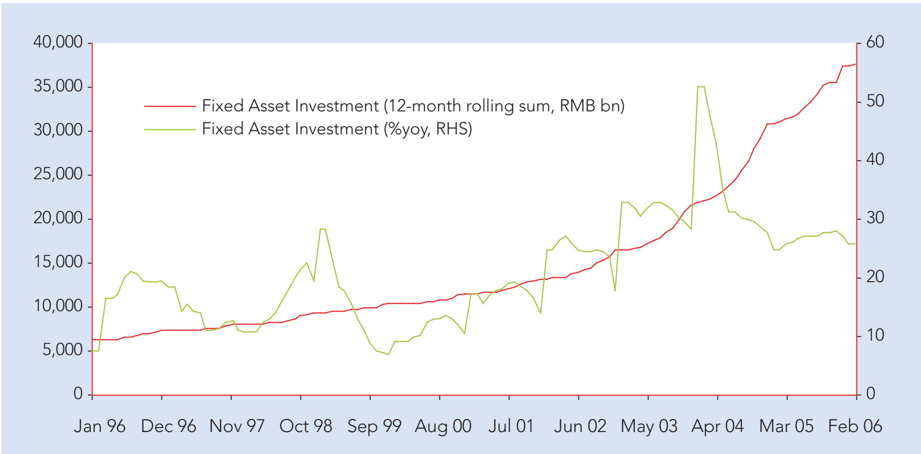
Investment in real estate has soared since the late 1990s when people were allowed to buy their own homes (whereas previously, at best they were allotted homes at low rent by the government or by state-owned enterprises). Real estate investment has jumped more than 20% a year since 2000, with growth topping 30% in 2003.[11]

Much of the government-sanctioned investment headed for infrastructure is designed to make up for the years of neglect given to transport and power facilities. Those who forecast that fixed-asset investment is expected to stay strong in China point out that the country's industrialisation has years to go until it reaches the maturity of other countries such as Korea.

One spur to investment is the fast pace of urbanisation which is occurring at an unheralded pace because peasants are heading to the cities to try to snare some of the riches of the country's industrialisation.[12] In the past 20 or so years as authorities gradually eased restrictions on movements, the population of China's cities has soared from about 200 million to about 500 million.[13] Authorities will have to invest in infrastructure and housing to accommodate the shift while companies will have to invest in plants and equipment to meet changed consumption and service demands.

Fixed-asset investment growth is so rampant it is considered a risk to the economic outlook because it could leave China with idle factories, falling profits and rising non-performing loans. The World Bank in August spoke of how Chinese "policymakers are worried that high investment could cause overcapacity in specific sectors, and may affect the banks because loans may turn bad".[14]

Chart 1: Fixed-asset investment since 1996



Source: CEIC, Citigroup, March 2006

Strong exports

China is a classic export success story. Export growth has averaged nearly 20% a year over the past 20 years, an average bolstered by China achieving export growth rates above 35% in the past three calendar years.[15] China's 40% jump in exports helped the country achieve a current-account surplus of 6.1% of output in 2005.[16]

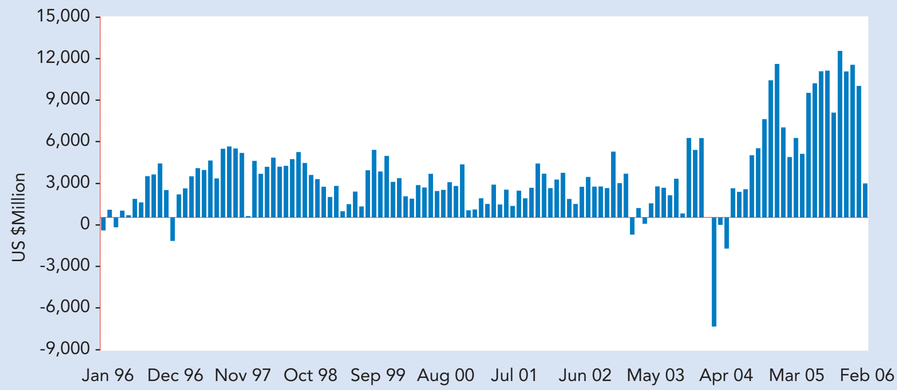
Chinese goods keep gaining market share because of the low cost and improving quality of production in China. More than 12% of US imports come from China now, compared with only 3% in 1990. The type of goods exported from China has changed over time. In 1985, raw materials accounted for more than 50% of exports. In 2004, this ratio stood at 7% because factories making manufactured goods had migrated to China, largely from Hong Kong. Nowadays, more of China's exports are sophisticated goods. Exports of machinery and electrical equipment rose to 41.8% of all exports in 2004, from 20.6% eight years earlier.[17]

China's capacity to export has expanded in recent years because even more foreign companies have set up factories in the country. China has attracted more than US$220 billion in foreign investment since it gained entry into the World Trade Organisation in December 2001. In 2005, factories built with foreign money account for more than half of China's exports which reached a record US$762 billion.[18]

China's export performance has led to it becoming the world's biggest holder of foreign-exchange reserves after Japan, having more than US$818 billion in reserves as at the end of 2005.[19]

11 Source: EIU, ibid. Page 45.
12 Source: World Population Prospects, United Nations Secretariat, CLSA, June 2005.
13 Source: World Population Prospects, United Nations Secretariat, CLSA, June 2005.
14 Source: World Bank press release No. 2006/47/EAP "China: With the macro outlook remaining favourable, more focus can be put on rebalancing the economy, says World Bank report".www.worldbank.org
15 Source: EIU, ibid. Page 49. 16 Source: CEIC. 17 Source: EIU, ibid. Page 50. 18 Source: Bloomberg. 19 Source: Bloomberg.

Chart 2: China's trade balance since 1992



Source: Bloomberg, CEIC, March 2006

Rising consumption

Consumption is set to become a bigger driver of China's economy. China's rising incomes per capita and the emergence of a middle class point to stronger consumption. Per-capita disposable income in Chinese towns and cities jumped 10.2% in the first six months of 2006 compared with a year earlier, while rural incomes gained 11.9%.[20]

Retail sales jumped 13.7%[21] in July, the fifth straight month that sales growth exceeded 13%. Rising incomes spurred spending on clothes, furniture and mobile phones.

China is hoping consumption makes a larger contribution to economic growth, at the expense of fixed-asset investment and exports, to make economic growth more sustainable. To do this, authorities have raised some minimum salaries and welfare payments and spent more on health, education and housing to encourage people to consume more and save less.[22]

SOME OF CHINA'S COMPANY SUCCESS STORIES

China Shenhua Energy – No. 1 in coal in China

China Shenhua Energy Co. is the largest integrated coal-based company in China with a 6% market share and is the world's second largest coal producer by coal reserves.

The Beijing-based and Hong Kong-listed company is principally a coal miner however has a complementary and vertically integrated rail transport infrastructure and electric power generation business. Its primary customers include power plants and metallurgical producers based in China.

The company is well placed because the outlook for coal prices remains strong due to higher demand, resource depletion and railway bottlenecks disrupting supply and weak environmental and safety standards supporting high coal prices. Furthermore, strong consumption growth fuelled by rising demand from Chinese utilities is outstripping the ability for domestic suppliers to deliver.

Shenhua, however, is expected to boost production. Its Shendong mine, which accounts for 80% of the company's total coal production, is likely to maintain high double-digit growth in the medium term. In addition, its extensive transportation network should ensure the company will not be significantly affected by transport bottlenecks. The company's sales rose 20% in volume terms to 81.5 million metric tons in the first six months of 2006, compared with the same period a year earlier.

The company is likely to benefit from industry consolidation given its strong finances and leading position in a fragmented market. On the downside, given that a significant portion of net profit is derived from the coal segment, the business and operating results are highly dependent on average realised product prices as well as domestic and international coal demand.

In general the coal market is cyclical and has in the past exhibited significant fluctuations in supply, demand and price from year to year.

Sources: Fidelity, Bloomberg 14 July 2006, HSBC Report 2 June 2006.
Reference to individual companies is for illustration purposes only and does not constitute a recommendation or reflect a stock-holding status of any kind.

20 Source: Bloomberg.
21 Source: China's National Bureau of Statistics as reported by Bloomberg on 14 August 2006.
22 Source: Bloomberg.

ZTE – Helping connect the Chinese

ZTE Corp. is a leading full-range telecom-equipment provider and is one of the largest telecom equipment vendors in China. Its offerings include wireless communications, wireline access and switch, optical and data communications, handsets and telecom software and services.

In addition, ZTE, which is based and listed in Shenzhen, is one of the few companies worldwide that is capable of providing all three types of 3G technology (WCDMA, CDMA2000 and TD-SCDMA).

The company's strength lies in its CDMA and TD-SCDMA series of products. Its CDMA products are used in 60 countries and by 100 operators worldwide. Furthermore, ZTE is positioned well to benefit from its low-price strategy and maturing technologies in developing countries. More recently, the company has started to increase research and development investment in WCDMA to build capacity to accommodate the increasing popularity of the European 3G technology around the world.

The company's comprehensive range of products is a strong competitive advantage in the telecom market. It is expected that the overseas market should continue to drive revenue growth, in particular from growth in handsets, telecom software and services segments.

Furthermore, increasing brand recognition in overseas markets and continued government support should maintain stable margins in overseas sales. Recent weakness in domestic sales and margins have been reflected in weaker financial year 2005 and first quarter 2006 results. Since 2005, domestic telecom players have been holding back investment in preparation for large future 3G investment plans. Despite this, promising overseas sales and effective cost controls are positives for the company.

Sources: Fidelity, DBS Group Research Report 16 August 2006.
Reference to individual companies is for illustration purposes only and does not constitute a recommendation or reflect a stock-holding status of any kind.

Sina Corp. – China online

Sina Corp. is one of the largest providers of online media and value-added information services (VAS) in China and for Chinese communities abroad.

The Shanghai-based and US-listed Sina provides services through five major business lines including SINA.com (online news and content), SINA Mobile (mobile value-added services), SINA Online (community-based services and games), SINA.net (search and enterprise services) and SINA E-Commerce (online shopping).

The company's portal network is comprised of web sites that enable users to access an array of regionally focused content through interest-based and community-based channels. The potential for online usage in China is significant, with about 123 million internet users out of its 1.3 billion population. Given the potential, this should provide the company significant avenues for growth.

Furthermore Sina is one of the stronger brands among Chinese internet companies. It is expected to be viewed as a premium channel due to its attractive brand and professional, highly educated user base. Sina recently announced plans to broaden its exclusive content in areas such as sports and entertainment.

These areas have proved to be profitable and are also seen as important to maintain and extend the company's leadership position. On the negative side Sina's mobile phone-related business has underperformed recently largely due to the Chinese government's regulation on the promotion of fortune-telling mobile related services and China Mobile's billing system.

However the growth potential for Sina's core business in China remains vast given the large number of mobile-phone users and customers who still do not have wireless service.

Sources: Fidelity, Deutsche Bank Report 3 August 2006, Zacks Investment Research Report 8 August 2006.
Reference to individual companies is for illustration purposes only and does not constitute a recommendation or reflect a stock-holding status of any kind.

China Life –

China Life Insurance Co. is the largest life insurance company in China and by market capitalisation one of the largest insurance companies in the world.

The Beijing-based and Hong Kong-listed company is a leading provider of individual life insurance, annuity products and accident insurance and has a 45% market share in China. It is also one of the largest asset managers and institutional investors in China. The company is majority owned by the government and conducts business in every province and major city in China.

The company is well positioned in the life insurance market in China, which is still underdeveloped relative to global standards. China had just a 1.9% share of global premium volumes in 2004 with insurance premiums per capita of US$27.3 and a premium to GDP ratio of 2.1%. The respective global averages are US$292.2 and 4.53%. This suggests that the life insurance industry in China looks set for favourable growth.

The strategy of the group is based on positioning the group to benefit from the macro and socio-economic trends and the development of enterprise pensions which are expected to drive the company's growth strongly over the next few years. Furthermore the company should benefit from the rising interest rate environment ahead from higher yields.

Over the first half of 2006, China Life has recorded strong premium growth of 22% year-on-year, however growth of lower margin products has slowed as the company continues to look for new business opportunities. The group is targeting market share expansion by growing its regular premium business over the second half of 2006.

Over the longer term, favoured regulatory reforms are expected to open new investment channels that will provide insurers access to investments in infrastructure and qualified domestic investor status, which gives them power to invest in foreign share markets. In addition, given that its earnings are predominantly in yuan, the company should benefit from any appreciation in China's currency.

Sources: Fidelity, HSBC Report 26 July 2006, Merrill Lynch Report 18 July 2006.
Reference to individual companies is for illustration purposes only and does not constitute a recommendation or reflect a stock-holding status of any kind.

CHINA'S ECONOMIC CHALLENGES

As with any country, China faces challenges to sustain its economic ascent.

Macro-economic challenges

China faces several macro-economic challenges.

The economy threatens to overheat

Among the biggest short-term risks to China's economy is the possibility that it may be overheating. The economy grew at an annualised rate of 11.3% in the second quarter of 2006,[23] a rate that appears even excessively fast for China.

China is hosting one of the biggest building booms in history and one that is financed by debt. Cities around China have authorised the building of luxury hotels, shopping malls, multi-lane highways, universities, bridges, dams, schools, public housing and airports while companies are putting up plants and factories. These are some of the key ingredients behind the Asia crisis of 1997-98.

Central authorities have recently acted twice to cool economic growth and may do so again. In April and in August 2006, the People's Bank of China, the country's central bank, raised its one-year lending rate by 0.27% each time, to take the rate to 6.12% and asked the nation's banks to curb lending.

China's economic drivers are narrow

China's economic growth is too reliant on public spending and foreign investment. There is little about China's growth that appears self-sustaining. That is to say consumer spending and business investment need to become more important components in China's economic growth for that growth to be considered balanced.

Authorities have taken steps to boost consumption but it could take time to change the saving mentality among the Chinese. The lack of comprehensive health or social systems and the jump in the cost of education explain why many Chinese to hoard, rather than spend, their new wealth.

Weak central controls over the economy

Beijing authorities have little control over the pace at which the economy can expand. The lack of central control over the economy is among the reasons why China's economy has experienced spurts of overheating due to excessive investment in factories and other real estate.

As we have spoken about, the decentralised approval process for development means local authorities can defy Beijing when ordered to slow the speed of development.

Another limit on the country's ability to control the speed of economic growth is the lack of a western-style monetary policy where interest rates control credit expansion. One problem in China is that bank lending is managed through the state-owned banking system, where managers are rewarded by the political system for directing money to state firms and then largely excused for losses in the state sector.

23 Source: Bloomberg.

The other issue is that under a controlled exchange-rate system authorities lose control of the money supply because they inject liquidity into the banking system when they purchase foreign exchange in order to preserve the exchange rate.

Export backlash

The biggest threat to China's export success stems from that very success. Political opposition against Chinese goods has taken hold in many countries such as the US because their popularity has driven the current accounts of many of its trading partners, especially the US', into deficit and threatens the viability of local manufacturers making competing goods. In reaction, countries such as the US constantly threaten to impose trade restrictions on Chinese goods.

Some of the opposition to China's export success has taken the form of calling on China to revalue its currency, in a bid to boost the price of Chinese exports. On 21 July 2005, when the yuan was pegged at 8.28 to the US dollar, China introduced a "crawling peg" system, under which the yuan was realigned daily but only allowed to move 0.3% against the US dollar. This limit was raised to 3% in September 2006. In practice though Chinese authorities have let the currency fluctuate far less than the limit.[24] On 15 November 2006, the yuan was trading at 7.87 to the US dollar, a rise of only 3% since the end of the peg.[25]

Micro-economic challenges

China faces several micro-economic challenges.

Large inefficient state sector

China is burdened with an inefficient state sector where state-owned companies operated with outmoded equipment and underskilled workforces.

These enterprises were originally established to help the Communist government achieve wider social and economic goals, rather than achieve a financial profit. When the reform process began many were burdened with providing expensive welfare services to bloated labour forces (the so-called iron rice bowl) and bureaucratic management structures. In one sense, their existence was threatened by the free-market reforms and many struggled when the prices of most goods and services were liberalised in the early 1990s.

The government has taken steps to make state-owned companies more efficient. It has closed some, merged others, reduced government ownership by selling shares and allowed others to layoff workers. According to the Economist Intelligence Unit, state-owned enterprises laid off about 30 million workers between 1998 and 2004.[26] It says the number of industrial state-owned enterprises has been slashed to 31,750 in 2004 from 118,000 in 1995[27] while the count of total state-owned enterprises stood at about 150,000 in 2003.[28]

There are however many political impediments to reforming state-owned enterprises. Officials at all levels are reluctant to lose control over these companies and there is the danger of social unrest tied to letting go even more workers.

Wobbly banking system

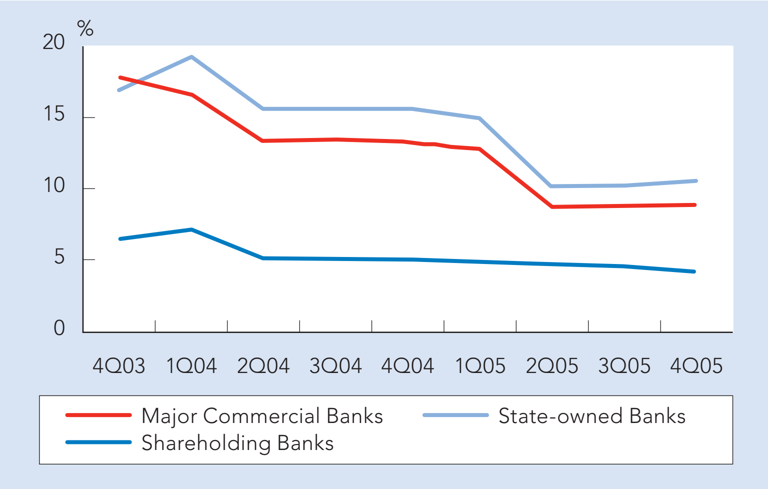
Banking is a troubled industry in China. Bad loans are rife due to unchecked lending to state companies and poor internal controls in the past. Repeated fraud investigations have undermined confidence. Most bank internal systems are antiquated and banking practices are often at odds with what many would consider sound practice (borrowing rates, for example, are generally not layered to account for risk.)

Chinese authorities are motivated to reform the banking system because they are aware that the Asian financial crisis of 1997-98 highlighted how weak banking systems can destabilise economies. They also know that local banks will face stiff competition from foreign banks which can enter China from the end of 2006 – a concession China agreed to when it signed onto the World Trade Organisation.

Beijing's banking reforms incorporate five broad themes. Firstly, the government has tried to reduce the level of non-performing loans on the balance sheets of the Big Four banks which had the closest affiliations with state-owned enterprises.[29] Notably, the state has spent vast amounts over the past two years propping up several banks by injecting foreign-exchange assets and selling bad loans to asset-management companies. Since then, many of the struggling banks have made significant gains in reducing their non-performing loan ratios, as shown in Chart 3.

24 Source: EIU, ibid. Page 54.
25 Source: Bloomberg.
26 Source: EIU, ibid. Page 32.
27 Source: EIU, ibid. Page 44.
28 Source: EIU, ibid. Page 31.
29 The Big Four banks are the Bank of China, the Construction Bank of China, the Industrial and Commercial Bank of China and the Agricultural Bank of China.

Chart 3: Non-performing loan trend in China's banking sector (4th Quarter 2003 – 4th Quarter 2005)



Source: Merrill Lynch

Secondly, authorities created new regulatory bodies to improve supervision. The China Banking Regulatory Commission, for instance, has taken over bank supervision from the central People's Bank of China, to ensure that banks upgrade management and meet capital-adequacy requirements. Moreover, China has adopted international standards for loan classifications and has set up internal credit-rating systems in order to meet the updated international requirements. It has also implemented more auditing inspections to ensure risk controls are carried out regularly.

Thirdly, the government is encouraging banks to list on the stock exchange in the belief that the demands placed on publicly traded companies makes them more efficient. The Bank of China, the third-largest state-owned lender, listed on the Hong Kong and Shanghai stock markets in mid-2006, the third state bank to do so.[30] The Industrial & Commercial Bank of China, the country's biggest lender, plans an initial public offer later this year, as does the China Merchants Bank.

Fourthly, the government has moved to improve internal bank management and external supervision. It has tried to achieve this by tackling fraud, implementing a performance-assessment-and-incentives system to improve the quality of staff and by closing loss-making branches. Statistics show that the number of branches fell to 85,000 in 2003 from 142,000 in 1995 while the number of employees declined to 1.3 million in 2003 from almost 1.7 million in 1995.[31]

Finally, the government has pushed for banks to adopt a fee-based approach to business and to upgrade technology, particularly for small and medium-sized banks. A fee-based approach is seen as making banks less vulnerable to cyclical economic downturns.

Social challenges

Rising unrest

Social tensions are rising in China. Large income disparities have emerged between urban and rural citizens. Many people are not properly covered by the health system. There are little to no social security benefits to help those gaining least, if anything, from China's economic rise. It must be remembered that China is still a poor country on many measures.

While China is the fourth-largest economy in terms of total output, in 2003 the World Bank rated the country 134th in terms of gross national product per capita when measured in US dollars.[32] The World Bank, in the same survey, rated China 119th when gross national income per capital is measured on a purchasing-power parity basis.[33]

Chinese authorities acknowledge that social unrest is rising in China and have recently taken steps to boost social stability. At the annual meeting earlier this year of China's National People's Congress, which decides the direction of government policy, there was a shift in focus away from economic policies towards those that are likely to improve the lives of rural Chinese and narrow the income disparity between rural and urban citizens.

On social programmes, the government announced plans to implement a free nine-year compulsory educational system for all rural children, build a nationwide rural healthcare system and increase pension coverage for urban poor. Authorities also announced plans to boost investment in rural China to improve roads, power and water supplies and irrigation systems.

30 Bank of Communications Ltd., China's fifth biggest lender, and China Construction Bank, the country's third-largest lender, listed in 2005.
31 Source: Merrill Lynch 2005.
32 Source: World Bank. 2005 World Development indicators page 22. www.worldbank.org
33 Where an allowance is made for the cost of living in countries when making comparisons about living standards.

Pollution

Damage to the environment is mounting in China, especially to its rivers and arable land. Aside from the effect on the quality of people's lives, there are concerns that the rise in pollution could threaten future economic growth and cause political unrest.

At China's National People's Congress, the government said it will aim to reduce unit-energy consumption by 20% and pollution by 10% via technology upgrades, to curb the harm the country's industrialisation is doing to the environment. It intends, for example, to build wind-power projects, impose stringent environmental protection policies and stricter regulation on high-waste industries and introduce energy-saving programmes for those enterprises with high energy use.

CHINA'S NUMEROUS SHARES

Investors in Chinese companies need to be abreast of the various types of shares Chinese companies can issue.

A-shares are those of Chinese companies listed and traded on the Shanghai and Shenzhen Stock Exchanges, denominated in yuan and originally designated for domestic investors only. Since 2003 qualified foreign institutional investors have been able to purchase these securities up to a maximum value of US$10 billion.

B-shares are those traded on the Shanghai and Shenzhen Stock Exchanges that were originally designated for foreign investors. The underlying securities are denominated in yuan but paid out in US or Hong Kong dollars.

H-shares are those of Mainland Chinese state-owned enterprises that are listed on the Hong Kong Stock Exchange and available only to foreign investors. These securities are denominated in Hong Kong dollars. The companies are incorporated in Mainland China.

Red Chips are those of overseas-incorporated Mainland Chinese companies that are listed in Hong Kong and available only to foreign investors. These companies have substantial mainland interests and are controlled by affiliates or bureaus of the Chinese government. These securities are denominated in Hong Kong dollars.

Other Hong Kong-listed Chinese companies are those listed in Hong Kong that have substantial Mainland interests but are not controlled by affiliates or bureaus of the Chinese government.

G-shares are the name given to China companies listed in Shanghai and Shenzhen that have reduced their non-tradeable government-owned stakes to minority holdings. The letter G comes from "gugai", the Mandarin word for share reform. G-shares are not considered an official class of shares although G-share indices have been created to track the performance of companies that have undergone these reforms. See section for a fuller description of this reform.

INVESTING IN CHINA

China's economy has been the best performing major economy in the world for close to two decades yet its share markets have fared poorly in comparison.

But this appears to have changed – since 2000 earnings growth has risen as economic growth has increased. There are key reasons Fidelity thinks economic growth better translates into earnings growth these days.

First, the government has introduced many market-friendly policies in recent years. Among these, restrictions on foreigners dealing or owning A-shares have been modified, the government has taken steps to restructure and dispose of the two-thirds of the A-share market that is non-tradable and domestic investors are being allowed to buy B-shares. There is some discussion on merging A- and B-share classes.

Second, the A-share reform has allowed management to become shareholders, a factor that better aligns the overall interests of management and shareholders.

Third, many company management teams are more focused on generating profit. They have begun to understand that return on capital is the key determinant on how investors will judge them.

Fourth, there are many more industries represented on the stock exchange now. In September 1997, the China stock market was only represented by a few sectors, namely materials (26%), utilities (15%) and industrials (40%). But now, because many more companies have listed, there is a far broader array of sectors. These include energy, telecoms, industrial consumers and technology. This change is helping China's stock market to provide more investment opportunities and better reflect the performance of the country's economy.

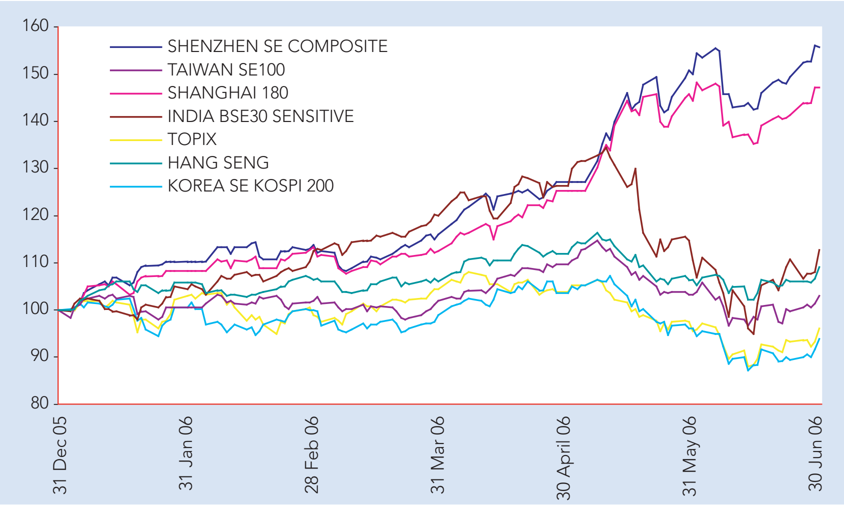
Fifth, (and related to the previous point), the initial public offerings have helped the market because many sound companies have listed.

Sixth, transparency and disclosure in China is improving. Many of the longer-listed companies have learnt what investors are looking for and so their disclosure has improved. Many A-share companies and some H-share companies report quarterly.

Last, China's acceptance into the World Trade Organisation in 2001 has given companies more incentive to be market orientated.

These reasons go a long way to explain the improving sentiment surrounding China's share market. As the chart shows, the Chinese share markets have been the best performing of the major Asian markets in 2006.

Chart 4: Asia's stock markets in 2006



Source: Fidelity and Thomson Financial DataStream. All indices are in local-currency terms.

CHINA'S A- AND B-SHARE MARKET UNDERPERFORMANCE

China has been a perfect example in recent years of how even a booming economy can do little for a country's stock market, as shown by how China's A- and B-share markets have struggled in recent years. From 1 January 2002 to 28 April 2006, the Shanghai Composite Index fell 12.5% in local-currency terms whereas the MSCI China Index gained 150.0% in absolute terms, for an annual rate of increase 23.6%.[34] (Add on the six months to 31 October 2006 and the Shanghai Composite's fall of 12% becomes a rise of 12% and the MSCI China Index's gain becomes 159%.)

The reason for the difference between the indices is that A- and B-share stocks only comprise a tiny portion of the stocks found in the MSCI China Index – often just around 1% of the index.[35] Most of the stocks found in this MSCI China Index are Hong Kong-listed Chinese companies; so-called H-shares, Red Chips and other Hong Kong-listed stocks. These are typically the larger more liquid Chinese stocks that have performed strongly in recent years.

The major reason China-listed stocks have struggled even though the Chinese economy has thrived is tied to the fact that the majority of companies listed in Shanghai and Shenzhen are minority-tradable holdings, are poorly managed and don't focus on shareholder returns. These companies are yet to convince investors they have robust corporate governance and they are under-researched. Therefore they are yet to gain the confidence of investors. In addition, the fact that some have reported poor earnings and have low dividend yields has undermined performance.

The performance of the MSCI China Index in recent years highlights how China's largest and most well-researched stocks have posted higher earnings and gained investor confidence during a period when China's economy has been one of the world's best performers.

The more interesting question regarding the A- and B-share markets may well be why these shares have surged over the past 10 or so months. Firstly, the reforms the government has introduced have been well accepted. Secondly, investors have gained more confidence in the sustainability of the earnings growth of Chinese companies. This has given investors more confidence to invest in smaller and Chinese-listed stocks. Lastly, China's economy is powering and shows no signs of slowing to any marked degree. The economy grew 11.3% in the second quarter of 2006, its fastest expansion in 12 years.[36] The economic outlook is upbeat because the prospects for investment, consumption and exports are strong.

34 Source: DataStream.
35 The only B-share companies in the MSCI China Index on 30 April 2006 were China Intl. Marine B (0.45% of the index) Guangdong Elect. Pwr. Dev. B (0.2%) and Zhijiang Se Elec. Pwr. B (0.17%). There were no A-shares in the index on that date.
36 Source: Bloomberg.

REDUCING NON-TRADEABLE SHARES ON CHINA'S SHARE MARKETS

China authorities have acted to reduce a big inefficiency on China's two share markets, the high level of non-tradable shares. These were effectively government-owned holdings similar to the ownership structure of Telstra Ltd.

In mid-2005, when Chinese authorities announced steps to solve a problem that arose because the central government was reluctant to lose control of state companies about 65% of domestic Chinese shares were non-tradable.

While tradable and non-tradable shares were identical in terms of face-value and shareholder rights, the dual structure created inefficiencies.

Corporate governance was hampered because the board, shareholder and auditor committees were often controlled by the holders of non-tradable shares. Non-tradable shareholders did not benefit from a rise in the stock price, so they were often indifferent about creating shareholder value. Non-tradable majority stock holdings prevented the consolidation that was needed in some industries. The price of tradable shares was seen as suppressed because of a concern that a future sale of non-tradable shares would flood the market with supply.

To address these inefficiencies, China's government announced plans in 2005 to sell its holdings in domestic companies through a new share class – G-shares – which can be traded alongside A- and B-shares. All listed companies on the Mainland stock exchanges were encouraged to change the status of their large holdings of non-tradable shares so that they could be bought and sold. The process involved compensating minority shareholders, whose holdings would be automatically diluted, for example, by giving them an additional three shares for every 10 they own and segregating minority voting rights to ensure an independent voice. Timetables were arranged to avoid a sudden flood of equity to the market and initial public offers were suspended for the better part of 12 months.

The government started selling its non-tradable holdings on 30 December 2005 and indices were created for G-shares on the Shenzhen and Shanghai Stock Exchanges. Since then, about 20 companies a week have issued G-shares. At this pace, all companies should complete their reform of non-tradable shares by the end of 2006.

This transfer of shares from government to private ownership is expected to better align management with shareholder needs, making access to capital easier and Chinese markets more attractive to investors. It explains in part the improving sentiment surrounding China's share market. As Chart 4 shows, the Chinese share markets have been the best performing of the major Asian markets in 2006.

SUMMARY

China's economy has been unleashed from stifling controls and its rise has been one of the most important events of modern times. There is talk that within three or four decades – depending on the growth assumptions – it will be the world's largest economy.

The economy faces many challenges to reach its potential but the reform process seems set in place. The government and people appear to have a "Corporate China" mentality. Their mission is to improve the per capita wealth in China over the next three or four decades, rather than just achieve a top ranking in absolute terms.

Whatever the achievements of China's economy, they will stand as testimony to the economic and political astuteness of Deng. For not only did he set China on its economic rise, he thought up a strategy to ensure the rise would last long after he would.

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