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1 Summary

Key Messages

- *General Secretary of the CCP – Xi Jinping – replaced Hu Jintao as China's new President. At the same time, the new Chinese Government under Li Keqiang has taken office in March this year after the two annual conferences (liang hui) of CPPCC and NPC.*

- *Xi Jinping after taking over as Chairman of the Communist Party has been nurturing the notion of a "Chinese Dream", an inspirational rather than informative slogan with the ultimate goal of the "great revival of the Chinese nation". In the absence of clear substance, Xi's talk of a dream has sparked a lively debate and needs further clarification in the months to come.*

- *Maintaining economic growth, improving people's livelihoods and safeguarding social justice are the three top tasks of the newly-installed government. The new leadership has made it clear that the economic trajectory of China shall move away from mere quantitative figures and rather towards an integrated slow-growth model based on quality instead.*

- *The continued urbanization push by the new government remains a top priority and is intended to unleash enormous consumption and investment demand while creating urban job opportunities.*

- *According to newly published data, China's inequality is said to be on the decline. China in January for the first time since 12 years has published data on the country's Gini Coefficient, indicating a reduction of inequality from 0.491 in 2008 to 0.474 in 2012.*

- *On May 6th the State Council again highlighted the key priorities of macro policies being stabilizing growth, controlling inflation, and preventing and reducing risks. In light of rising corporate and local government leverage, little labor market pressure and existence of excess capacity in some sectors, the government seems to be less focused on cyclical growth boosters and more on structural reforms, eager to release more "reform dividends".*

- *The major opposition to reform is expected to come from the state sector, namely from the state-owned enterprises that have long enjoyed a privileged status. Those "vested interests" remain very powerful and reluctant to allow any erosion of the benefits they have accrued.*

- *The anticipated slow-down in China's economic growth has taken place in H1 2013. After a renewed credit expansion in H2 2012 and a resulting slight recovery of growth, GDP growth stood at 7.7% YoY in Q1 2013, indicating that much of the momentum that was built up in the economy in Q4 2012 (7.9%) has been lost.*

- *China's current account surplus dropped below 3%, exports suffered, the strong credit expansion have not exerted the expected increase in investment activities and the industry has seen a continuation of a downward trend.*

- *This widely anticipated first sign of rebalancing and the lackluster H1 have caused a number of economic institutions to adjust their forecasts for China, downgrading the previously set 8% growth target to a new 7.75% or even 7.5% for 2013.*

- *For H2 it is expected that investment and production activity will strengthen as the expansion in credits, the urbanization push and a recovered property market will unfold their effect, but in the long run growth will be harder to attain.*

- *The exponential expansion of credits and government debts remains a major risk threatening the soft landing.*

- *The market access remains restricted in many areas and the dominance of the state sector needs further opening in order to unfold the productivity potentials.*

2 Appreciation of the economic situation

2.1 New leadership

As was expected, after the path had been cleared during the 18th National Congress of the Communist Party, the **General Secretary of the CCP – Xi Jinping – replaced Hu Jintao as the new President of the People's Republic of China.** At the same time, **the new Chinese Government under Li Keqiang has taken office** in March this year after the two annual conferences (liang hui) of CPPCC and NPC.

In an attempt to create a dynamic phase and mark his inauguration, Xi Jinping after taking over as Chairman of the Communist Party has been nurturing the notion of a **"Chinese Dream"**, an inspirational rather than informative slogan with the ultimate goal of the "great revival of the Chinese nation". In a speech on the Chinese Dream in November 2012, Mr. Xi clarified that "our people love life and expect a better education system, more job stability, better income, more reliable social security, medical care of a higher standard, more comfortable living conditions and a more beautiful environment. They hope that their children can grow up better, work better and live better. The yearning for a good and beautiful life is a goal for us to strive for".[1] This goes in line with the party's long-term goals, namely the attainment of a "moderately well-off society" by 2021 (the party's 100th birthday) as well as the creation of a "rich, strong, democratic, civilized and harmonious socialist modern country" by 2049, the 100th anniversary of the PRC. In a struggle to win over the people's affection and as such government legitimacy, Mr. Xi has also instigated an **anti-graft and anti-extravagance campaign** in the public sector, vowing to crack down on both "tigers" and "flies" – powerful leaders and lowly bureaucrats. However, Mr. Xi has also spoken of a "strong-army dream", indicating the anxiety about internal support from the nationalist fraction. Therefore, in the absence of clear substance, Xi's talk of a dream has sparked a lively debate and needs further clarification in the months to come.

Maintaining economic growth, improving people's livelihoods and safeguarding social justice are the three top tasks of the newly-installed government. In order to achieve this, the government has acknowledged that reforms are more than necessary shall the goal of building a modern, harmonious and creative high-income society by 2030 be achieved. In order to strengthen market forces and reduce existing inequalities while at the same time keeping the goal of doubling national income by 2020 (from its base in 2010) in mind, Premier Li made it clear that reforms shall be the centerpiece of his new government. On this year's reform agenda are the reduction of administrative barriers in government (for controls and approvals), capital account convertibility (to be achieved in the next 3-10 years), fiscal reforms (to reduce the financial burden for local governments who now often retreat to land-grabbing practices in need for cash), reforms for China's railway investment and ownership structures, health care and insurance, food and drug safety, the *hukou* [2] system as well as rural land reform.[3] At the same time, the state sector is to share a larger part of the country's responsibility. The State Council ordered that the tax contributions by state-owned enterprises to the government be raised by about 5 percentage points by 2015.[4]

In direct connection with most above set goals, the **urbanization push** by the new government – also known as the biggest migration in human history – remains a top priority and is intended to unleash enormous consumption and investment demand while creating urban job opportunities. **With 20 million Chinese migrating to urban centers every year, the government intends to reach an urbanization ratio of 70 percent by 2020** (in 1978 it was still

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[1] CaixinOnline: "The Chinese Dream"; 31st January 2013

[2] ***Hukou system:*** *The hukou system is a system of household registration introduced in 1958 in order to control the movement of people between rural and urban areas. As developments with regards to access to welfare institutions as well as schooling have developed differently in rural and urban areas, the hukou system has contributed to a great extent to today's inequalities.*

[3] UBS Investment Research: "More Reforms, Not Stimulus"; 10th May 2013

[4] Reuters: "China OKs sweeping tax reforms to tackle inequality"; 5th February 2013

at a meager 18 percent).[5] It is a daunting task, yet a necessary one, looking at the simple fact that China needs to move up its value chain and on top is running out of farmland.[6] In this respect, several pilot projects are under way attempting to incentivize the rural population to move into local urban centers, enabling the country to push through agricultural modernization and achieve the much needed efficiency gains therein.

On May 6th the State Council again highlighted the **key priorities of macro policies being stabilizing growth, controlling inflation, and preventing and reducing risks**. Emphasis lies in the fact that by establishing "risk control" as a key priority, the government demonstrates its increasing concern about the looming risks in connection with local government debts that are on the rise and shadow banking credit expansion. Policy measures taken so far indicate that a shift is taking place towards curbing the credit binge and a more sustainable long-term growth, refraining from credit-induced short-term stimuli for the economy as has been the practice in the past. In light of rising corporate and local government leverage, little labor market pressure and existence of excess capacity in some sectors, the government seems to be less focused on cyclical growth boosters and more on structural reforms, eager to release more "reform dividends". This in turn will mean the Chinese government will have to accommodate with slower economic growth in the future.

As daunting the challenge may seem, **China's government seems determined to take the necessary measures** in order to rebalance its economy and achieve a 7.5% growth until 2020. Somewhat anxious in light of the formidable task, President Xi called for courage when he said the situation was like "wading through a dangerous shoal" to help deepen reforms in China's development.[7] Meanwhile, Premier Li stressed in his opening speech the sacrifice it takes along the reform path in order to strengthen market forces and strip power from the state. He was quoted saying: "It's about cutting power, it's a self-imposed revolution. It will be very painful and even feel like cutting one's wrist."[8] In acknowledging the need for reforms and their respective implementation, Premier Li stresses that **"talking the talk is not as good as walking the walk"**.[9]

The major opposition to reform is expected to come from the state sector, namely from the state-owned enterprises that have long enjoyed a privileged status. Those "**vested interests" remain very powerful and reluctant to allow any erosion of the benefits they have accrued**. Premier Li however leaves no doubt about his determination when he clarifies that: "Nowadays, stirring up vested interests is more difficult than stirring up one's soul, but no matter how deep the water is, we must wade through because we don't have other options – it's our nation's fate and future that are at stake".[10] Therefore, while it remains to be seen how strong the vested interests are in preventing too much reform (recent developments suggest it is unlikely we will see bold moves with regards to major reforms to SOEs, after the *People's Daily*[11] on April 15th started publishing a series of front-page articles praising the role of SOEs in China's economy), it is a clear sign that the current leadership has acknowledged the necessity for reforms, does it want to achieve a smooth rebalancing of the economy and make sure China does not get stuck in the so-called middle-income trap.

2.2 Economic performance: reforms versus growth

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5 Miller, Tom; "China's Urban Billion: The Story Behind the Biggest Migration in Human History"; 2012

6 *The Chinese government has identified a minimum threshold of 120 million hectares of farmland in order to ensure adequate food production of its citizens. Currently this threshold is being reached or already overstepped, depending on the source.*

7 Xinhuanet: "Xi orders courage to help deepen reforms", 5th March 2013

8 The Telegraph: "China's new premier Li Keqiang "to cut state control over economy", 17th March 2013

9 WSJ: "New Premier Exhorts China to "Walk the Walk""; 17th March 2013

10 The Telegraph: "China's new premier Li Keqiang "to cut state control over economy", 17th March 2013

11 ***People's Daily****: A government-owned newspaper and mouthpiece of the CCP, whose editorials provide an important indicator of the direction of government policy*

In a weak global economic environment, the first half year of 2013 has seen the **anticipated slow-down in China's economic growth. GDP growth stood at 7.7% YoY in Q1 2013, indicating that much of the momentum that was built up in the economy in Q4 2012 (7.9%) has been lost.** This widely anticipated first sign of rebalancing and the lackluster H1 have caused a number of economic institutions to adjust their forecasts for China, such as the IMF who downgraded the previously set 8% growth target to a new 7.75% for 2013.[12] UBS in June even went as far as the targeted 7.5% growth announced by Wen Jiabao in his last State of the Union speech in March, in light of the weak demand and the stronger yuan.

Economic indicators suggest that this rebalancing has started as economic activities have been relatively weak in H1. **Consumption was hampered by slower wage growth and the government's frugality campaign**. This trend seems to have weakened, however, in May with retail sales growing at 12.9% YoY and catering spending jumping from 7.9% YoY in April to 9.2% in May, indicating that the impact of the frugality campaign (that also hit hard the watch industry) is about to fade.

Exports continue their decline since early 2013 and have taken an especially hard hit in May 2013, growing at a meager 1%, down from 14.7% still in April. This collapse is however mostly attributable to the fact that the government has intercepted practices of overstating export figures in order to bypass currency controls, bring money into the country and bet on an appreciation of the yuan. While imports have also declined 0.3%, the trade surplus in May accounted for USD 20.4bn.[13] UBS expects that **net exports will not contribute anything to GDP this year.**[14]

China's **current account surplus has dropped below 3% of GDP in 2011 from the 2007 peak of 10% and is expected to dip to 2.3% in 2013** before recovering to a still weak 4% of GDP by 2017[15], demonstrating the economic transformation away from export to a more consumer-based economy. This also indicates that the yuan is now close to its fair value and has taken away pressure from the currency that has hitherto been considered artificially undervalued.

At the same time, strong **credit expansion have not exerted the expected increase in investment activities**, with fixed investment growth staying at around 20% YoY.

As a result of those developments, the **industry has seen a continuation of a downward trend, with a growth of industrial production edging down to 9.2% YoY in May**, reflecting the weak exports and equally lackluster domestic demand in particular for light industrial production.[16]

CPI inflation has been relatively moderate at 2.3% YoY in Q1 2013, which is mainly to be attributed to stable food and fuel prices. Loose monetary conditions and a modest recovery of aggregate demand are expected to push up CPI inflation to around 2.7% YoY in 2013.[17]

Although the **PMI has slightly recovered in May to 50.8[18]**, this cannot hide the fact that the industry is concerned. Similarly, after a short rebound in early 2013, **China's domestic A-share market has been depressed by the newly installed property tightening measures**,

[12] WSJ: "IMF Forecasts Lower China Growth, Warns on Debt", 29th May 2013

[13] NYT: "China's Export Growth Slows Amid Concern of Slowdown"; 8th June 2013

[14] UBS Investment Research: "China Focus – Weak Exports Blunt Recovery Hope"; 10th June 2013

[15] The Economist: "Fair play or foul?"; 21st April 2013

[16] Ibid.

[17] Ibid.

[18] WSJ: "China Manufacturing Index Rose in May"; 2nd June 2013

tightened regulation on shadow banking activity, and disappointing real economic activity in Q1, resulting in a year-to-date loss of 2.3% for Shanghai Composite Index.[19]

H1 2013 has shown that a rebalancing is taking place and the Chinese government appears committed to stick to their words about sacrificing short-term growth for structural market-reforms. **For H2 it is expected that investment and production activity will strengthen as the expansion in credits, the urbanization push and a recovered property market will unfold their effect.** The government's efforts to not let credit expansion get out of hand and push through reforms will however further adjust the economy towards a slow-growth model.

2.3 China's economic policy outlook for 2013: from quantity to quality

Even though the annually set target rather served as a minimum acceptable floor than an actual target range throughout the past decade, the 7.5% growth target contains a clear message since 8% growth was often named the necessary benchmark to reach in order to assure sufficient creation of jobs to absorb the new entrants on the labour market. The new leadership has made it clear that the **economic trajectory of China shall move away from mere quantitative figures and rather towards an integrated slow-growth model based on quality instead**. The current Chinese economy characterized by a strong imbalance originating from earlier policies focusing on export-led growth funded by cheap credits as well as heavy investments in fixed assets is no longer sustainable. The resulting inefficiencies and lower productivities in the public sector[20], overcapacities in certain sectors, regional and rural-urban inequalities, weak domestic consumption and weaknesses in the financial system render reforms inevitable. While this has been understood, the slower growth figures China has been experiencing since 2012 suggest that rebalancing is starting to unfold its effects on growth. The **question will no longer be whether growth gets slower, but whether this change will come abruptly or incrementally**.

This transition will be everything but straightforward. The Chinese government now faces the inconvenient **trade-off between accommodative policies allowing reforms to unfold and short-term fast economic growth**. While global demand did not meet expectations, the Chinese government has this time and despite a renewed earthquake in Sichuan refrained from providing financial stimuli and the PBOC kept an accommodative monetary policy, demonstrating the **government's commitment to pushing through reforms and allowing the economy to grow at a slower pace**. Similarly, a paper issued by the National Bureau of Statistics (NBS) in early June orders local government officials to "stop blindly pursuing investment growth at the expense of structural reforms" and put emphasis instead on "education, employment, income, housing, social welfare, health care, and the environment".[21] **Structural adjustments towards a rebalancing of the economy are taking shape**. A group of Chinese researchers from the Development Research Center of the State Council (DRC) presented their paper in March titled "Ten-year Outlook: Decline of Potential Growth Rate and Start of a New Phase of Growth". In it, they argue that China is going through its "natural landing" process on its way to catch up with advanced economies, envisaging a slower growth of 6.5% between 2018 and 2022. According to them, contracted infrastructure investments, lower returns on assets, overcapacities, shrinking labor supply, slower urbanization, and increasing risks in the financial and real estate sector indicate the natural transition to slower growth has begun. **2013 may be the year that China's service sector officially eclipses industry,** indicating that the government's policies towards an upgraded economic model are taking traction. The service sector climbed to 47.8% of GDP in Q1 2013, a growth of 1.6 percentage points from a year

[19] UBS Investment Research: "China By The Numbers"; 21st May 2013

[20] A World Bank report suggests TFP growth in the state sector was 1.5 percent a year, whereas the nonstate sector's TFP grew at a rate of 4.6 percent a year; World Bank; "China 2030 – Building a Modern, Harmonious, and Creative High-Income Society"; 2012

[21] Peterson Institute for International Economics: "Getting Used to Slower Growth in China: Quality over Quantity"; 6th June 2013

earlier.[22] This, however, still falls short of international comparison, and it is suggested that China by now should stand at a service sector contributing 55-60% to GDP.[23]

Wen Jiabao leaves no doubt that a structural adjustment is unavoidable. He acknowledged in his last State of the Union Speech the need for more domestic consumption and that there was **"growing conflict between downward pressure on economic growth and excess production capacity"**.[24] China's industrial sectors such as steel, cement, electrolytic aluminum, plate glass and coal coke sectors suffer from overcapacity in the range of a 70 to 75 percent utilization rate, while emerging industries such as PV and wind turbine manufacturing only reach an utilization rate of 60 to 70 percent, according to Zhang Ping, head of the National Development and Reform Commission (NDRC).[25] International benchmarks are between 80 to 85 percent, indicating that China is producing far more of everything than it can absorb or export, and so far has even kept investing in order to keep the economy on track.

While global and domestic demand certainly have harmed export revenues, the **slower growth is also partly self-induced**. The reason why the government has so far refrained from monetary stimuli are recent developments in the real estate and credit markets, the sectors identified as risk factors by the new government. In a long **campaign trying to curb the developments in the hot real estate market**, Beijing in 2012 raised mortgage down-payments, forbade the buying of second homes in key markets and introduced the objective to implement a nation-wide property tax into the 12th five year plan.[26] Considering the fact that property investments remain the best bet in an economic environment characterized by financial repression (capped interest rates on deposits) and an underdeveloped social welfare system, the housing market is expected to recover.

In H1, in particular **the credit situation has reached worryingly high levels**, experiencing a spike in so-called total social financing (TSF), a measure including all credit vehicles in China. Since 2008, China's credit to GDP ratio is estimated to have soared from 123% to 180% in 2012[27], while TSF has grown by another 59% in Q1 2013 compared to 2012[28]. This raises concerns about the quality of investments and the repayment capacity since most such credits are less-well supervised. Trust loans have been growing particularly fast, with 378% YoY in Q1. While the government in early 2012 already had managed to curb further growth in credits, the resulting slower economic growth might have caused the government to again relax its tightened policies, leading to more growth again, yet also to the spike in credits (and government debt) we are witnessing now. Regulatory tightening in H1 with regards to TSF has resulted in a slightly more moderate growth of RMB 1'190bn in May and are expected to reach RMB 17tn for the whole year.[29]

This expansion puts increasing pressure on debt. According to IMF estimates, **China's government debt totals nearly 50% of GDP, at a budget deficit of 10% of GDP**.[30] The budget deficit approach they were using, however, combines central government fiscal deficit as well as the borrowing activity of local government financing vehicles (LGFV). This suggests that government support made a substantial contribution to China's growth, and in particular LGFVs were in a vanguard role in stimulating China's economy after the financial crisis. Taking into account the relatively moderate central government deficit of 1.6% of GDP, it becomes evident

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[22] The China Perspective: "Inside China's Economy: Huge LGFV Debts Threaten Financial Soundness; Manufacturing Tipped to Slow"; 23rd April 2013

[23] The Economist: "The post-industrial future is nigh"; 19th February 2013

[24] The Telegraph: "China will struggle to hit growth target, says Wen Jiabao"; 5th March 2013

[25] Xinhuanet: "China needs to address industrial overcapacity: top economic planner"; 6th March 2013

[26] Chiang, Langi: "Politics push China's property tax toward Beijing", Reuters, 13th March 2013

[27] WSJ: "IMF Forecasts Lower China Growth, Warns on Debt", 29th May 2013

[28] Peterson Institute for International Economics: "The Role of Trust Companies in China's Recent Credit Growth"; 31st May 2013

[29] UBS Investment Research: "Weak Exports Blunt Recovery Hope"; 10th June 2013

[30] WSJ: "IMF Forecasts Lower China Growth, Warns on Debt", 29th May 2013

that **the 10% deficit provided an ongoing counter-cyclical stimulus for the economy**. Lax policies after the financial crisis in 2008 are the main reason for the surge in such local government financing vehicles (LGFV), a vehicle to issue bonds since local governments are not allowed to directly raise debt. The National Audit Office in 2011 found that local governments were indebted to the tune of RMB 10.7tn, equivalent to 26.5% of GDP.[31] New figures reveal that total new financing in January reached RMB 2.5tn, a surge of more than 50% from December and more than double the figure a year ago.[32] Within the next three years, LGFV debt to the tune of RMB 3.49tn will mature.[33]

While rating agencies, investment banks and the IMF have long raised concerns about the issue in particular with regards to local government debts, a stark warning has now also come from Zhang Ke, senior auditor and vice-chairman of China's accounting association. While for him it is not a question anymore whether the situation of local government debts is out of control, the remaining question is when it is going to explode, pointing at the maturity mismatch of investments and credits that are often rolled over. Provinces, cities, counties and villages are estimated to owe between RMB 10tn and RMB 20tn, making roughly 20-40 percent of the national economy.[34] The problem with such debt is that they are backed by a government guarantee, so they receive the best credit ratings from domestic agencies. Old debt, however, is often repaid by issuing new debt. Mr. Zhang warns that this could spark a bigger financial crisis than the US housing bubble. **In reaction to the worrying developments, Fitch in April downgraded China's long-term credit rating from AA- to A+**.[35] While China has the means to absorb this debt internally, the question is more whether they should continue to increase. In an economy that still restricts the inflow of foreign capital, growing public debt levels would reduce the amount of capital available for more efficient and productive projects.

While those developments suggest the authorities to keep an accommodative monetary policy, the labor market could be a possible reason for a change in the current leadership's short-term thinking. As domestic and foreign demand has been sluggish and the yuan has appreciated as of recent, China's factories – the key drivers of China's export-driven growth in the past – have increasing difficulties in their pursuit of low cost and start moving either inland or abroad. Worker's compensation in such cases is often meager or non-existent. A survey of 4'000 employers conducted by Manpower reveals the severity of the situation, with a net employment outlook[36] that collapsed to 12% in Q2 2013, down from 18% in Q1 and the lowest level since 2009.[37] Resulting **anxiety among the labor force has turned into a heightened number of labor disputes incl. strikes in the first four months of 2013, recording with 201 cases almost double the figure of the same period in the previous year.** While the export industry was expected to face rougher times ahead (export growth in May 2013 was 1% YoY, while wages for migrant workers have climbed by 11.8% YoY[38]), labor disputes and resulting unrests are a sensitive issue the government has so far tended to respond to. At the same time, the rebalancing of the economy and industrial upgrade along the value chain means a structural change needs to be achieved and job opportunities must be created elsewhere. It remains to be seen what actions the government will undertake this time.

The challenge ahead for the Chinese government remains. **Does it want to pursue its reform agenda and keep the shadow banking risks at bay, it will have to sacrifice the high growth**

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31 Peterson Institute for International Economics: "China's Never-Ending Stimulus"; 9th June 2013

32 FT: „Surge in Chinese credit raises fears"; 8th February 2013

33 The China Perspective: "Inside China's Economy: Huge LGFV Debts Threaten Financial Soundness; Manufacturing Tipped to Slow"; 23rd April 2013

34 FT: "China local authority debt "out of control"; 16th April 2013

35 FT: „Fitch downgrades China's credit rating"; 9th April 2013

36 ***Net employment outlook:*** *The net employment outlook is the difference between the percentage of firms anticipating adding workers and the percentage planning to reduce head count in the quarter ahead.*

37 WSJ: „Strains Show in China's Job Market"; 10th June 2013

38 WSJ: „Strains Show in China's Job Market"; 10th June 2013

rates it got used to in recent years. In a system like the Chinese where most of the growth is driven by investment, rising debt increasingly becomes an issue. Economists[39] point to the fact that what we are currently seeing is a growth on the back of expanding risky financial products. So in order to avoid a financial crisis with the magnitude of what happened in 2008 in the USA, the rebalancing of the Chinese economy needs to cut down on credits, substantially slowing the economy possibly even to an even much lower rate than predicted, to an estimated 3-4%.

The challenges ahead are manifold and it remains to be seen how determined they are in pushing through the announced reforms against the strong opposition.

2.4 The big challenge of closing the gap

Stability, steady double-digit growth and spreading wealth, which lifted millions out of poverty throughout the past three decades, are core justifications for the dominance of the ruling Communist Party. However, some have gotten rich before others, fueling social unrest and widespread dissatisfaction, manifested in rising numbers of revolts, most prominently the 2011 Wukan riot. **This poses a significant threat for the new leadership's grip on power, which must now implement economic reforms to distribute benefits beyond the urban elite.**

According to newly published data, China's inequality is said to be on the decline. Pursuing the reduction of income inequalities remaining an imperative for the Chinese government, China in January for the first time in 12 years has published data on the country's Gini Coefficient,[40] providing a picture on the official data for the past decade. Is one to believe the official data, China has already managed to turn around the trend and relieve the pressure, bringing down the Gini Coefficient from its peak of 0.491 in 2008 to 0.474 in 2012, however remaining consistently above the 0.4 benchmark deemed a dangerous level of wealth inequality.[41] This would put China on a level of inequality that is worse than the USA. Others however suggest the picture looks much worse. Alarmingly unofficial figures calculated by the Southwestern University in Sichuan estimated the Gini coefficient considerably higher at 0.61 in 2012.[42] The Chinese Academy of Social Sciences (CASS) - one of China's top government think tanks – also comes to the conclusion that the structural imbalance in the country's growth model has worsened significantly, reaching 0.6173 by 2012.[43] The first local government to integrate the Gini coefficient into its Five-Year Plan is the Chongqing Municipal government, intending to reduce its Gini ratio to 0.35 from 0.42 by 2015.[44]

The widening chasm between rich and poor becomes particularly apparent with the number of Chinese USD-billionaires nearly doubling to 146 in 2011.[45] In 2004 former President Jiang Zemin invited private businessmen to join the Communist Party and most of the richest Chinese maintain some affiliation with the latter. Out of China's 1000 richest people, 152 individuals hold official political offices.[46] The rapid emergence of private wealth has further widened the gap, as a report has found that although the average wealth per Chinese citizen was USD 17,126 - almost double that of other high growth economies such as India - median wealth was just USD

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[39] See M. Pettis: "The challenges for China's new leadership"; 11th April 2013

[40] ***Gini Coefficient**: The Gini Coefficient can range from 0 to 1. Sometimes it is expressed as a percentage ranging between 0 and 100. A low Gini coefficient indicates a more equal distribution, with 0 corresponding to complete equality, while higher Gini coefficients indicate more unequal distribution, with 1 corresponding to complete inequality. When used as a measure of income inequality, the most unequal society will be one in which a single person receives 100% of the total income and the remaining people receive none (G=1); and the most equal society will be one in which every person receives the same income (G=0).*

[41] The Economist: "Gini out of the bottle"; January 26th, 2013

[42] U.S.-China Economic and Security Review Commission: "China's New Income Inequality Reform Plan and Implications for Rebalancing"; March 12th, 2013.

[43] CaixinOnline: "Economic Imbalance Worsening, Think Tank Warns", 14th December, 2012

[44] Caixin: "Government Refuses to Release Gini Coefficient"; January 18th 2012

[45] Forbes: " China's Rich Lists Riddled With Communist Party Members"

[46] Hurun Report: "Property is biggest source of wealth for China's property is biggest source of wealth for China's rich"; 22.9. 2011

6,327.[47] Striking is also the **income inequality between urban and rural dwellers**, for instance in 2012, the per capita rural net income amounted to 7,917RMB (1,200CHF), less than a third of per capita urban disposable income of 24,565RMB (3,800CHF).[48]

The wealth gap is further exacerbated by the Maoist-era institution of Household registration generally known as the "Hukou System". Citizens are registered in "urban" or "rural" households, under which social services such as public education, medical care and unemployment benefits fall. Resulting in an invisible barrier depriving migrant workers employed outside their *hukou* of welfare and social service benefits.[49] An estimated 275 million rural migrants live in urban areas, constituting one fifth of the entire population which possess no official *hukou* in their place of residence. **With no access to urban social benefits, migrant workers typically respond to job losses by either returning to the countryside or accepting lower pay. A separate survey shows migrant-worker wage growth slowed to 1.7% year-on-year in 2012, from 23% in 2011**. Of the army of 260 million migrant workers in 2012, only 43.6% signed an employment contract and 14.3% received retirement benefits, 24% work-related injury insurance, 16.9% medical insurance and 8.4% unemployment insurance.[50] Additionally migrants and their families face high registration barriers for senior secondary school and university.

A survey of 8'000 households, released in December 2012, shows the urban unemployment rate hit 8.05% in June, up slightly from 8% in August 2011 and nearly twice as high as the official 4.1% rate. The unemployment rate for China's army of 160 million migrant workers is estimated to have risen sharply to 6% in June 2012, up from 3.4% in August 2011. A loss of around 4.5 million jobs for China's migrant workers in **the past year has taken their unemployment level to 10 million, still well below the 23 million out of work in 2009**.[51] One important issue with official Chinese statistics is that the unemployment rate is based on urban residents registering for unemployment benefits. However, despite significantly higher rates of unemployment than reported by the government, China's labor market still appears to have weathered growth slowdown in 2012 relatively well.

During the global economic crisis the new leftists gained a growing voice, calling attention to the widening wealth gap, government corruption and what they see as exploitation of cheap Chinese labor, raising questions about the effectiveness of current leaders and whether the party has drifted too far from its founding principles. As a charismatic politician and former candidate for the Communist Party's standing committee, Bo Xilai served as the new left's most prominent associate. From the southwestern city of Chongqing, where he served as party chief from 2007 until March 2012, he launched popular social programs to help the city's poor, promoted an aggressive anticorruption campaign and restored Mao-era traditions. However, Bo was removed in March from his Chongqing post and subsequently expelled from the Communist Party in September.[52] The Bo case triggered a public debate on social media about the abuse of political power and corruption by government officials and their family circle. In 2012 the New York Times and Bloomberg published reports on the wealth amassed by the CPC leadership and their families, including former Premier Wen Jiabao's family controlling assets worth at least 2.7 billion USD and current President Xi Jinping's family having amassed hundreds of millions of USD, further adding to the scandal.[53] The new Chinese leadership has recognized the issue as a serious possible source of social unrest and started to address the problem in public. Underscoring this, President Xi introduced

[47] Credit Suisse: "Global Wealth Report"; October 2010

[48] Bloomberg: "China Rural-Income Gains Aid Shift Toward Consumption"; January 30th, 2013.

[49] University of Washington (2010): "Despite China's Modernization, the Inequitable Hukou System Remains"; August 2011.

[50] International Business Times: "China Now Has More Than 260 Million Migrant Workers Whose Average Monthly Salary Is 2,290 Yuan ($374.09)" : May 28th, 2013.

[51] The Wall Street Journal: "Chinese Survey Shows a Higher Jobless Rate"; December 7th, 2012

[52] The Wall Street Journal Asia: "China's 'New Left' Grows Louder"; October 5th; 2012

[53] The New York Times: "Billions in Hidden Riches for Family of Chinese Leader"; October, 2012.

an **anti-graft and anti-extravagance campaign** in the public sector, vowing to crack down on both powerful leaders and lowly bureaucrats.

After years of working on it, **China's State Council in February released a long awaited "Income Distribution Plan"**, a 35-point blueprint aimed at reducing inequalities, and by some seen as a strategically clever approach to boost more comprehensive economic reforms under the pretense of reducing inequality.[54] However, due to strong SOE opposition the majority of points were watered down to a general set of principles lacking timelines.

- The only concrete recommendation is the increase in dividend payments by SOEs to the state budget, to be increased by 5 percentage points by 2015. This could annually add RMB 50bn (7.5 billion CHF) to government funds, which could be used for pensions or health insurance.

- The **per capita income is to be doubled from 2010 to 2020**, although at current growth rates this was bound to occur anyways, and the minimum wages are to be raised up to 40 % of the local average. Government Official's Incomes are to be "restricted" and SOEs and officials' families to be increasingly supervised.

- **Various tax reforms, such as a property tax are aimed at reducing high housing prices.** For instance homes in Beijing cost roughly 20 times the average family income, forcing the majority of potential buyers to work for up to 50 years to afford an apartment, compared to 5 to 10 years in Western countries.[55]

- Furthermore, **rural land use rights and the land registration system are to be improved.** In China the state owns all land and farmers are merely granted land use rights, and are forbidden to sell or use this land as collateral for loans. **Since local governments are highly dependent on land revenues and not on taxes, for example in 2009, 36.6% of the local government revenue originated from land revenues, the instances of forced land requisitions have been increased and are estimated to affect 4 million rural residents annually.**[56] On average compensation for land requisitions was RMB 18,739 per mu (3,000 CHF per 650 sqm), while authorities would earn 778,000 RMB per mu (12,000 CHF per 650 sqm). These land confiscations often resulted in violent clashes, according to the Chinese Academy of Social Sciences, 50,000 mass protests in 2012 were caused by disputes over land grabs.[57] The Income Distribution Plan states that land requisition should be based on the principle of voluntary agreements, but fails to specify how this farmer's rights will be protected and enforced. According to the OECD farmers need to be given the same property rights as urbanites.[58]

- The plan also intends to increase the Social Safety Net Program, such as by increasing migrant worker participation in the pension system. **The Chinese government is committed to creating a comprehensive pension and healthcare system by 2020**, including benefits for rural and migrant workers, in an attempt to reorient the economy towards increased consumption and away from saving. Currently China spends only 5.7% of GDP on social security and benefits paid remain low. For healthcare only 50% is reimbursed and pension schemes vary enormously between urban and rural areas, Eastern and Western provinces as well as the private and the public sector. In some rural counties the basic pension can be as low as 55 RMB per month.

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[54] U.S.-China Economic and Security Review Commission: "China's New Income Inequality Reform Plan and Implications for Rebalancing"; March 12th, 2013.

[55] Dohem, Bert: „China's Strong GDP Growth is a Mirage", Forbes, January 20th, 2012 (Retrieved: 29.01.2013).

[56] China Daily: „Reliance on land sales ‚must be reformed'", 7th January 2013 (Retrieved: 16.01.2013).

[57] SCMP: "Land grabs are main cause of mainland protests, experts say", December 20th, 2012 (Retrieved: 14.03.2013).

[58] OECD: "Economic Surveys China"; March 2013.

Finally, urbanization shall be the new growth engine that will boost incomes and consumption as well as provide employment. With 20 million Chinese migrating to urban centers every year, the government intends to reach an urbanization ratio of 70% by 2020 (in 1978 it was still at a meager 18%). Beijing, for instance, saw its population sky-rocket from 10.8 million in 1990 to a staggering 17.6 million in 2009. Crucial for this will be to implement **inclusive urbanization**, meaning that the provision of local public services will be disconnected from local registration (hukou). Linked to this, the 36 million affordable housing units which are to be built by 2015 under the "Social Housing Program" should also be made available to migrant workers and not, as is currently the case, only locally registered citizens.[59]

2.5 The need for financial sector reforms

In September 2012 China's State Council announced the **12th Five Year Plan for the Development and Reform of the Financial Industry** covering the period between 2011 and 2015. The new government has not touched this plan so far, therefore it can be expected to be pursued as foreseen. The Plan covers seven core areas which are aimed to face the current challenges of the financial industry in China:

- Establishing controls of the financial industry
- Optimizing rules for financial institutions
- Building diverse financial markets
- Deepening financial reforms
- Promoting reform and opening of the financial industry
- Maintaining the stability and safety of the financial industry
- Strengthening the infrastructure for the financial industry

The plan has been elaborated in a common effort of the five main financial regulators: the People's Bank of China, the China Banking Regulatory Commission (CBRC), the China Security Regulatory Commission (CSRC), the China Insurance Regulatory Commission (CIRC), and the State Administration of Foreign Exchange (SAFE).

The plan sets **two measurable objectives to be achieved by 2015. The first objective is the share of the financial sector to the GDP which should reach 5% (the share between 2001 and 2010 was 4,42%).** To set this target, the USA and Japan have served as reference for similar stages in their economic development during the past, e.g. Japan reached a level of 4,9% in 2010[60]. **The second objective is to increase the percentage of total social financing[61] by nonfinancial corporations to 15% by 2015.** While the share of yuan-denominated loans declined substantially since 2002, it dominates still the total social financing with a share of 58,2% in 2011, compared to foreign currency-denominated loans of 4,5% in the same year. A significant growth in bond's share followed the introduction of commercial papers (2005) and the medium-terms notes (2008) into the interbank bond market.

Nevertheless the 5 largest commercial banks[62] still dominate the financial intermediation by holding 47% of total commercial bank assets end of 2011. The opening up of the financial sector to foreign investors is still limited to 25% of foreign shareholding for non-listed Chinese banks.[63]

The channels for financing investments private and corporate alike are manifold in China. According to estimates by the People's Bank of China which started to monitor all-system

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[59] Chiang, Langi: „Politics push China's property tax toward Beijing", Reuters, March 13th, 2013 (Retrieved: 13.03.2013).

[60] Nomura Journal of Capital Markets, Vol. 4 No. 4, Spring 2013.

[61] The total social financing is a monetary policy indicator established by the People's Bank of China referring to the total amount of funding in the real economy within a specified time frame. Total social financing includes yuan-denominated loans, foreign currency-denominated loans, entrusted loans, loans from trust companies, banker acceptances, corporate bonds, and domestic stock issued by nonfinancial corporations.

[62] ICBC, ABC, CCB, BOC and BoComm

[63] UBS: PPT Chinese Financial System: Current Status and Future Focus, 5th June 2013.

financing aggregates in 2010**, official banking loans cover only 58,3% of total loans, which implies that the rest is financed by shadow financial activities**. The reason for this relative high level of informal lending has to do with the government imposed ceiling of the interest rates for deposits what makes it relatively difficult for banks to raise money and very attractive to give it away on large scale, which does not match with SME needs.[64] However, microloans costing on average 20-24% interest rates don't substitute for much more than 1% of the shadow banking market. A far more **important source for financing illiquid firms is over other (non-financial) companies by "entrusted" loans via a bank or trust company**. Uncountable wealth-management products raise money from better-off investors in a pool and lend it to credit-starved companies. Like banks, shadow banks gather assets on one hand to lend credits on the other hand. The difference is that the provenance of their assets is not transparent, the liabilities tend to be riskier, regulations are not clear and due diligence not granted. In addition, there is no official safety net, e.g. lender of last resort or a share of liabilities in case of bankruptcy. Nevertheless, potential losses stay mainly with the lenders and are cushioned by collateral and unmagnified by leverage.[65]

After the peak in China's central government gross debt-to-GDP ratio in 2010 of 33,5%, it is continuously sinking with 25,47% in 2011, 22,85% in 2012 and expected 21,3% in 2013.[66] Yet this picture does not capture the situation of the local governments that suffer from a net revenue outflow due to their obligations vis-à-vis the central government and the prohibition for them to borrow money directly on the official market. As a consequence they use special purpose vehicles issuing e.g. bonds under the vehicles' names to fund infrastructure projects or investment companies owned by local government sell bonds. The latter ones sold in the first quarter of 2013 more than double the total of the same period last year.[67] Such increase in public expenditure usually is expected to boost the economy, not observable in China in the same period, which suggests that a lot of these new bonds have been used to rollover old credits. Bonds issued by government-owned investment companies receive top credit ratings as being understood as guaranteed by the governments that own them. But even from the side of China's accounting association doubts are expressed whether this guarantee would be applied in any case.[68] Given the fact that the debts of all Chinese provinces, cities, counties and villages are estimated to a total of 20-40% of the GDP, this becomes a serious factor to consider.

2.6 RMB as internationally used currency

The question regarding the "right" value of the RMB is an ongoing concern as serving as one basis to determine if the Chinese trade balance surplus is based on an undervalued exchange rate or a comparative advantage of the productive industry. Fact is that since the exchange rate reform in 2005, the RMB has continuously appreciated to 32% against the USD up to a current level of around 6.3. According to a Beijing-based Think Tank, **China expects a further appreciation of its currency by nearly 10% until 2017.**[69]

Despite the significant increase in the share of China's international trade volume settled in RMB, it is still quite modest with 12%, including moreover the intercompany payments between Chinese corporations and their offshore subsidiaries. In order to boost this share further, **China has accelerated the conclusion of currency swap arrangements recently**, which originally started end of 2008 with South Korea. By the end of 2012, 18 additional trading partners in the region (Hong Kong, Malaysia, Indonesia, Mongolia, Singapore, Thailand, Pakistan, New Zealand, Australia, Belarus, Uzbekistan, Kazakhstan, and Ukraine) as well as outside the region (United Arab Emirates, Turkey, Iceland, Argentina and Brazil) have been

[64] Zhang, Joe: "Inside China's Shadow Banking: The Next Subprime Crisis?", 2013.

[65] Bedford, Jason, KPMG: in The Economist: "China's shadow banks: The credit kulaks", Hongkong, 1st June 2013.

[66] IMF: World Economic Outlook Database, April 2013.

[67] Financial Times: "China local authority debt "out of control", Beijing, April 16th 2013.

[68] Zhang, Ke, China's accounting association in: Financial Times: "China local authority debt "out of control", Beijing, April 16th 2013.

[69] West Brothers Economic Research Institute in Caixin Online: Yuan will appreciate to 5,7 against the USD", May 11st 2012.

added. In March 2013, China has concluded currency swap agreements with the UK and France in order to allow RMB in the eurozone as trade settlement currency.

The traditional offshore centers for the RMB in the region (Hongkong, Singapore and Taiwan) become more and more complemented by new ones outside the region with London in forefront, followed by Paris[70] and Luxembourg.[71] In addition, the Paris branch of the Bank of China increased its cross-border RMB settlement to the largest amount outside Chinese mainland (except Hongkong).[72]

Between January 2012 and January 2013 the RMB gained 7 places on the list of the most used currencies in international trade and is now number 13.[73] This trend will continue as China's government want to see the RMB among the world leading currencies. The recently concluded currency swap arrangements with UK and France are a facilitating milestone in this regard.

3 China as a global player

From concerns about the US "fiscal cliff" to a sharpening growth-versus-austerity debate, political tensions are weighing on the global economy. Despite more encouraging economic data in the US and signs that Chinese growth is reviving trading conditions remain difficult in many countries. **Political tensions are compounding the problems facing the global economy and policy cooperation remains stressed for many reasons. Anti-austerity protests, especially in euro-zone-countries have become common and the slow recovery from recession has sharpened ideological tensions between the political left and right, triggering protectionist reflexes in several parts of the world**.

A large proportion of Chinese economic activities and production are intertwined with those of other trading partners thanks to value chains. For instance, the cooling down of China's real estate market has a direct impact on international steel prices and investment plans of Australian and Korean producers, the purchase decisions by COFCO impact US and Brazilian soybean producers and without China's participation, the expansion of the WTO's Information Technology Agreement will not be commercially viable, as China already accounts for over 25% of global trade in IT products.[74] In a rapidly changing world, it is increasingly hard for powerful economies such as US and China to address their domestic issues without global policy coordination or to devise domestic economic policies without them having a global impact. **As the second largest economy, China definitely has a huge stake in making sure that multilateral systems work effectively**. So far, China has actively participated in various configurations of global economic governance. **But it has not yet taken a proactive role**. China is still a "partial stakeholder" in global governance, although a member of the UN Security Council or of the G20. The trade-related areas in which China should play a more active role are firstly investment because China, being a large recipient and a large investor, has strategic interest in leading towards a Multilateral Investment Framework. Secondly, China could contribute effectively to foster a balanced and international monetary system as the RMB gains more weight in the international exchange of goods, services and capital. Thirdly, China is in discussions towards joining the WTO Government Procurement Agreement, being an effective instrument to curb corruption. Fourthly, China should play an active role in regulatory convergence in the area of technical standards, food safety regulations and sanitary and phytosanitary measures.[75]

[70] China Daily: "Paris vies to be yuan hub", Beijing, April 19th 2013.

[71] Tageblatt: "Luxembourg ist ein RMB Offshore Center", April 17th 2013.

[72] At the same time the Bank of China (Switzerland) has been integrated into Julius Bär as not successful on its own. (www.finenews.ch : Julius Bär übernimmt Bank of China (Schweiz), July 23rd 2012.

[73] Quelle: Graphik PwC Swift, January 2013.

[74] http://www.wto.org/english/news_e/sppl_e/sppl274_e.htm

[75] Ibid.

China's WTO accession in 2001 is widely believed to have substantially contributed to China's drastic growth over the past decade. The other side of the coin is that **China is being involved in a high number of cases brought up to the WTO for dispute settlement** which, however, certainly relates to the fact that the scope for trade friction increases as countries trade more. In line with a broader shift of emerging markets - whose share of world trade is steadily increasing and thus show growing confidence using the dispute-settlement system WTO as a complainant - China exhibits an increasing propensity to bring disputes to the WTO. At the same time the average number of formal disputes per year has fallen since 2001, mostly because rich countries spend less time fighting each other. Between the WTO's founding in 1995 and the end of 2000, the USA and the EU initiated exactly half of the cases brought to the WTO. But between 2001 and 2008 they brought only 27.2% of cases. Over half of the cases were initiated by developing countries.[76]

A cold wind descended for instance over EU-China relations after the **European Commission decided on June 4th to impose provisional anti-dumping duties on imports of solar panels, cells and wafers from China**. This decision came after nine month investigation during which the EU Commission found that the favorable industrial policy enables Chinese companies to sell solar panels to Europe at far below their normal market value, which causes significant harm to EU solar panel producers. The fair value of a Chinese solar panel sold to Europe should be 88% higher than the price to which it is actually sold. The dumped Chinese exports exerted undue price pressure on the EU market, which had a significant negative effect on the financial and operational performance of European producers. Highly innovative EU companies are indeed exposed to threats of bankruptcy because of unfair competition from Chinese exporters, who have taken over more than 80% of the EU market and whose production capacity currently amounts to 150% of global consumption. In 2012, China's excess capacity almost doubled total EU demand. The EU Commission's assessment indicates that imposing provisional measures will not only secure the existing 25,000 jobs in EU solar production, but also create new jobs in the sector.[77]

In immediate response to the EU Commission's anti-dumping measure, **China retaliated by launching an anti-dumping and anti-subsidy investigation into European wine imports suspected of benefiting from illegal subsidies**, aimed firmly at France, Spain, Italy, Portugal and Greece, being the five EU countries with the strongest record of supporting anti-dumping action. China is well-aware of the fact that Europe is highly divided over anti-dumping measures; they thus interact directly with the Member States rather than through the EU Commission. In this context, Premier Li Keqiang secured Germany's opposition against tariffs on solar panels, with a further 17 out of the 27 members adding their voices against the EU Commission's action, including the UK, the Netherlands and Sweden. The division in the EU is indeed high, with France being a leading exponent of tough action against perceived unfair competition from China and other Asian economies on one side and Germany calling the EU Commission's decision a serious mistake.[78] The move indeed sparked outrage in France, which in 2012 accounted for more than half of the total annual $1 billion volume of EU wine exported to China, excluding Hong Kong. The trade dispute may escalate over other goods as the European Car Industry Association (ACEA) is now worried that Beijing may look into **complaints about luxury cars imported from the EU** after Chinese authorities received complaints over related subsidies. China's move however appears largely symbolic and less severe than if China had targeted industrial exports such as Airbus aircraft made by Toulouse-based European aerospace group EADS.[79] China has been subject to hundreds of protectionist measures against its commercial interests in recent years and punitive tariffs should not lead to a trade war with long-term consequences.

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[76] The Economist: "When partners attack China will test the WTO's dispute-settlement system"; February 11th 2012

[77] http://europa.eu/rapid/press-release_IP-13-501_en.htm?locale=en

[78] http://www.ft.com/cms/s/0/008cfcd2-cf72-11e2-be7b-00144feab7de.html#axzz2VtJfBtlH

[79] http://www.reuters.com/article/2013/06/05/us-china-eu-solar-idUSBRE95403020130605

Other tensions arose over a trade issue between the EU and China in January 2012 as the EU required airlines to hand over emissions data in the scope of a controversial carbon levy on air travel that took effect as of January 1st, 2012. According to official statements by the EU, there had been a very high degree of compliance with the EU requirements, except for eight Chinese and two Indian airlines, which refused. **The two BRIC-States have attacked the EU scheme, calling it a unilateral trade levy disguised as an attempt to fight climate change**. In November, India barred its airlines from complying with the EU carbon tax, joining China in resistance. According to the EU the tax aims at helping it to achieve the goal of cutting emissions by 20% by 2020. The EU further stated that if the airlines failed to hand over the requested data until the new deadline mid-June, it would be up to the member states to apply penalties.[80] However, Beijing remained firm on its stance of settling the carbon tax dispute with the European Union through a multilateral approach, when the EU sent a delegation to Beijing for discussions on the **Emissions Trading Scheme**, often called the carbon tax, during the third round of the EU-China Strategic Dialogue in July 2012.

In this context, **Beijing's plans to test out carbon trading are still forging ahead although carbon trading schemes elsewhere have faltered, most recently with the near collapse of the carbon market in the EU.** China's seven pilot schemes – in the cities of Shenzhen, Beijing, Shanghai, Tianjin and Chongqing, and the provinces of Guangdong and Hubei – represent the first step towards what might become a nationwide carbon trading scheme after 2015. The Shenzhen Carbon Exchange, China's first pilot carbon trading scheme, covers 635 industrial and construction companies, accounting for 38% of Shenzhen's total emissions in 2010.[81] One of the thorniest issues for China's exchanges is that prices for electricity – which accounts for the bulk of carbon emissions – are tightly controlled by the state. Without freely floating electricity prices, imposing a carbon price on electricity producers becomes meaningless. **China's government will need to fundamentally reassess its economic model, which is heavily based on resources that could be penalized under the trading scheme**.[82]

South Korea is also planning to implement a trading scheme that will be tested next year and go into force in 2015. Despite the setbacks in the EU, whose carbon trading scheme is by far the world's largest, California launched an emissions trading scheme at the start of this year and is due to link it with a similar system in Quebec, Canada. Australia passed legislation in 2011 for an emissions trading scheme, which the government says will be linked with the EU scheme in 2015.

At the BRICS Summit in Durban in March this year, the key theme led by China was to create a **BRICS Development Bank which could ultimately challenge the influence of the Bretton Woods institutions** and represent a test of whether the club of emerging economies can develop beyond a loose political grouping.[83] This new bank, which is to be launched at the BRICS Summit in Brazil next year, would be an embodiment and enabling instrument of an alternative model of global governance, however explicitly stated to be complementary to and not in contradiction to the existing Western model. A great deal of uncertainty nevertheless remains around the creation of a BRICS Bank including where it will be located, how it will be financed and led, the kind of projects it will fund and its longer term impact on development cooperation. The BRICS nations are clearly dissatisfied with the *status quo* structure of international development finance and the role they play in the IMF and World Bank, in particular China which has long demanded a larger role in the Bretton Woods institutions. **China however has a model of its own in offering no-strings development aid, particularly in Africa, as opposed to the tied or limited aid that usually comes from the development banks. The western world is concerned by the fact that its own development aims are undermined if aid recipients can get unconditional deals from China.** The BRICS Development Bank could

[80] EU Business: "EU issues warning to carbon tax rebels China, India"; May 15th 2012

[81] http://www.ft.com/intl/cms/s/0/9221daf4-c221-11e2-ab66-00144feab7de.html#axzz2VzgogaL9

[82] http://www.rtcc.org/chinas-emissions-trading-scheme-in-line-for-2020-launch/

[83] http://www.ft.com/intl/cms/s/0/2bcbd6e0-96e5-11e2-a77c-00144feabdc0.html#axzz2VzgogaL9

enhance China's influence in places perceived as outside of its current realm of influence, allowing China to render services via the other four BRICS. By establishing a multilateral bank, as opposed to financing development ad hoc through national budgets, the BRICS will be forced to make the conditions of their lending transparent. They will also need to publicly agree on the goals and intentions governing their credit policy. Furthermore, they will be obliged to make each other accountable for the money they contribute to their common cause. In short, they will have to **create a system of governance, rules, and transparency**. It remains difficult however to square the geopolitical goals of each BRICS nation respectively.[84] In the end, the BRICS will not be able to offer an alternative model of global governance. The very forces that have made these countries great in the first place will limit their potential to offer an alternative to Western principles. And a bank broadly built on norms of sound economic governance and multilateral transparency cannot, in the long run, function as a political tool to build alliances against the liberal world order.[85]

The Bank of Japan announced in April that it would **double its monetary base to 270 trillion yen by March 2015 by purchasing 7.5 trillion yen of government bonds every month in order to end Japan's two decades of deflation.** Many of China's top economists are livid at this effective currency devaluation by Japan and are calling on the People's Bank of China to retaliate by weakening the Yuan to defend itself in what they see as a new **currency war**. Chinese economists see Japan's plan to double its monetary base within two years as "blackmail" and warn that Japan's move would reignite the so-called carry trade, under which investors borrow in low-interest yen and invest in high-interest markets.[86] According to Tsinghua Professor Li Daokui, China could accelerate the freeing up of its capital account by boosting outbound investment in overseas equities markets, which could be an effective way of coping with Japan's latest measures.

Emerging markets express a particular concern that efforts made by the US, EU and Japan to spark growth could devolve into a currency war in which nations compete to devalue their currencies for economic advantages. Leaders in emerging economies, led by Brazil, have long criticized the US for launching successive bond-buying programs to stimulate the American economy since the financial crisis in 2008. Such bond-buying measures, known as quantitative easing, have held down interest rates and caused investors to flock to emerging markets in search of better returns, driving up their asset prices and exchange rates.

The focus on Japan and the yen has taken some heat off China, long accused by critics of artificially holding down the value of the yuan to make its goods more competitive in overseas markets, though that criticism has ebbed somewhat as the yuan has risen in recent years. However, according to an adviser to PBoC, **China will face inflationary pressure in the second half of the year mainly due to steps taken by other central banks to prop up their economies by buying bonds.**[87] The weakening yen has caused export products, such as textiles, to become less competitive in Japan. Due to these changes, the USA has become Japan's most important trade partner, for the first time supplanting China since 2009. This runs against Japanese plans, which had intended to integrate more with fellow Asian economies.

Subsequent to the purchase of the **Senkaku/Diaoyu Islands** by the Japanese government, numerous violent protests erupted in China, flights and hotel bookings were cancelled on a regular basis in both directions, and Japanese products were boycotted. Coupled with the disruption of trade ties due to the 2011 earthquake and slowing Chinese GDP growth, bilateral trade decreased substantially. According to China Custom Statistics, total trade decreased by 3.9% in 2012. Imports fell by 8.6%, whereas Chinese exports to Japan rose 2.3%. Japan's share of China's total imports tumbled from 11.2% in 2011 to 9.8% in 2012. **The impact of the territorial dispute on the economic relation was further exacerbated by China's economic**

84 http://carnegieeurope.eu/strategiceurope/?fa=51524

85 Ibid.

86 http://www.scmp.com/news/article/1208127/japan-stimulus-plan-will-start-currency-war-say-china-economists

87 http://online.wsj.com/article/SB10001424127887324034804578343913944378132.html

slowdown. GDP growth slowed to 7.8% in 2012 from 9.3% in 2011. In the first quarter of 2013 China's GDP growth remained at 7.7%.

Despite a general down-turn, anti-Japan sentiment appears to be subsiding and sales of Japanese automobile companies, such as Toyota, Honda and Nissan have been recovering, though demand from the government and SOEs still remains low. Furthermore, Japanese firms have begun to diversify operations and reduce their over-exposure to China, which may eventually backfire on the Chinese labor market. They have begun to expand overseas, for instance to South East Asian countries such as the Philippines, Thailand or Indonesia. Due to Japan's relatively low share of total Chinese trade, accounting for 8.52% in 2012, the impact of the Senkaku/Diaoyu island dispute had a muted effect upon China. Experts agree that the greatest risks lies in the perceived instability will affect rating agencies' assessments of future operations.

The destinations of new Chinese leaders' first foreign visits are carefully chosen and reflect the foreign policy priorities. **Russia**, China's close neighbor and former ally, was the first, followed by **Tanzania, South Africa** and the **Republic of Congo**, seeking to reconsolidate friendship with a Russia antagonized by the West, with Africa to reinforce its developing-country identity and solidarity with the developing world, and with other emerging economies to align their collective power in a new global order. Furthermore, Xi Jingping's most recent trip at the beginning of June brought him to **Trinidad and Tobago, Costa Rica, Mexico and the US**, representing the first visit of a Chinese Head-of-State to the English-speaking Caribbean.

China lent Costa Rica nearly US$400 million made through the Import-Export Bank of China. **Costa Rica is China's only ally in a region where Beijing has traditionally vied with rival Taiwan for influence** and it recently backed China in its dispute with Taiwan in votes at the UN. In addition, Costa Rica is applying for a loan from China to buy 5,000 solar panels. China is Costa Rica's second-biggest trading partner after the United States. China also awarded Trinidad and Tobago a US$250 million loan to build a children's hospital and seeks to further promote the **cooperation in the energy sector**, in particular in order to allow China's access to the Caribbean nation's abundance of **oil and gas resources**, as well as infrastructure development, minerals, agriculture and telecommunications. [88] **China's generous loans however raise questions about what China is expecting in return.**

Xi's stops in Costa Rica and Trinidad & Tobago mirrors Obama's and Biden's recent trips and demonstrates that **China's growing presence in Latin America adds a new competition trend for the US** in the region as China hopes to avoid falling behind.

Much of President Xi's visit with President Enrique Peña Nieto of Mexico revolved around bolstering the states' commercial ties. Though trade relations between the two countries have been difficult in recent years, owing to Mexico's large bilateral trade deficit and China's increasing importance to the US economy, the two leaders signed a number of agreements that **solidify China's place as one of Mexico's top trading partners.**[89]

The **Obama-Xi Summit** taking place very early in Xi's new term proves that the **US-China relations** are at the top of the priority list with new dynamics in view. Xi rightly observed that the US-China relationship, arguably the most important bilateral relationship in the world, is at a "critical juncture".[90] The world's two largest economies, energy consumers and Pacific powers, the world's largest creditor and its largest debtor are indeed deeply intertwined. Besides trade issues, the key issues that can redefine the relationship are the **development of rules and a Code of Conduct for Espionage in the Cyberspace; agreeing on the respective US and**

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88 http://csis.org/publication/chinese-president-xi-jinping-tours-americas-why-does-it-matter?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+CSIS+(NEW+%40+CSIS.ORG)

89 http://www.chinadaily.com.cn/china/2013xivisit/

90 http://www.acus.org/new_atlanticist/us-and-china-explore-new-relationship

Chinese security postures in East Asia; and demonstrating real cooperation on strategic issues such as North Korea. Current reality is driving a strategic competition cycle of action-reaction as the Pentagon fears China is pursuing an anti-access strategy to curb the US role in the Pacific whereas China fears the US seeks to deny China its role as a dominant actor in the Pacific.[91]

Furthermore, Chinese Premier Li Keqiang's first foreign visit to **India, Pakistan, Switzerland and Germany** was characterized by financial diplomacy, regional peace and promotion of bilateral trade with India and Pakistan, fueling further economic and trade cooperation with Germany and signing the MoU on the conclusion of the FTA negotiations with Switzerland.[92]

4 Economic agreements

4.1 China in the World Trade Organization (WTO)

The global economic recession posed the most serious challenge to China's dependence on export-led growth. Meanwhile, Chinese exports also became the major target of worldwide protectionist measures. 49%, or 1053 of the 2197 import-distorting measures such as state bailouts, local content requirement and subsidies taken by countries during the current global downturn since 2009 directly or indirectly affected exports from China.[93] The crisis, however, also gave China the opportunity to introduce numerous structural reforms aimed at diversifying its economic structure, promoting private sector participation and competition in the economy and developing a more efficient capital market.

Since becoming a member of the WTO twelve years ago, China not only increased the universality of the organization but also implemented most of its WTO commitments. Foreign companies have continued to profit from reduced tariffs, the elimination of import licences and quotas, the opening of more sectors to foreign participation, and the easing of restrictions on business operations. **Nevertheless, concerns related to market access remain, but they are now focused on China's laws, policies, and practices that deviate from WTO's national treatment principle, the insufficient protection of intellectual property rights, the deficient transparency of legal and regulatory processes, and the opaque development of technical and product standards that may favour local companies.**[94] Indeed, SOEs still enjoy more preferential treatment with low interest rates.

So far, **China has leant towards being an advocate of free-trade within the WTO**, demonstrating a strong commitment in issues typically affecting emerging markets such as the liberalization of agricultural markets. China wants to give the image of an active WTO-member and many countries expect China to take over more leadership, even though Beijing has been criticized for not engaging hard enough to find a compromise in the paralyzed Doha negotiations.[95] China supports most emerging and developing countries in pressing the USA and the EU to open their agricultural sectors. The WTO has not been able to prevent new trade measures against China. Penalties and enforcement are still relatively weak despite the changes to dispute settlement achieved in the Uruguay Round. China's recent experience with the WTO's Dispute Settlement Body (DSB) suggests that the country is gradually internalizing the non-

[91] Ibid.

[92] http://www.globaltimes.cn/content/782644.shtml

[93] http://www2.lse.ac.uk/IDEAS/publications/reports/pdf/SR012/li.pdf

[94] Economist Intelligence Unit, China Country Report, 2012

[95] Centre for International Governance Innovation, John Walley: "Can the WTO Help China With Its Future Trade Policy Challenges?", 11 April 2011, available at http://www.cigionline.org/publications/2011/4/can-wto-help-china-its-future-trade-policy-challenges ; http://yaleglobal.yale.edu/content/wto-doha-round-do-or-die

discrimination principle embodied by the multilateral trading regime, committing to comply with all DSB rulings and redress its WTO-inconsistent policies in a number of cases.[96]

China is seeking to play a **leading role** in view of the upcoming **9th WTO Ministerial Conference in Bali in December**. At the end of April, China convened together with Australia for the first time in three years a meeting with the WTO-senior officials of all capitals with the objective to identify the required flexibility for the relevant topics to be discussed in Bali, namely trade facilitation, agricultural products and development issues. In this context**, China is positively perceived as an active and constructive partner.** Furthermore, China seeks to a certain extent to **play a mediation role between the two main antagonists India and the US, for instance with regards to the G33 proposal concerning the exemptions on commitments for product specific subsidies in developing countries**, which G33 countries call an improvement of food security. China promotes a compromise in between which would temporarily resolve the specific Indian problem without however modify or interpret the agricultural agreement.

While China keeps engaging in multilateral trade discussions and protecting its interests within the WTO, it is also actively exploring trade opportunities through bilateral and free trade agreements (FTAs) with strategic partners. The financial crisis led to a lower reliance on western markets for exported Chinese goods and made China adjust its development strategy towards increasing domestic demand and market diversification, resulting in heightened attention to regionalism in East Asia. As China has become a dominant trading nation, the government sees bilateral agreements as a useful tool to pursue the country's strategic interest, signing the Framework Agreement on China-Association of Southeast Asian Nations (ASEAN) Comprehensive Economic Cooperation in as early as November 2002. Since then, China has signed ten FTAs with 18 countries and regions and established a large FTA network. In addition, FTAs between China and GCC, Australia, Norway, SACU, South Korea and Japan are being negotiated.

4.2 China and ASEAN

Including eleven countries (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) with a market for 1.9 billion people, a combined GDP of $6 trillion and a total trade volume of $4600 billion, **the China-ASEAN Free Trade Agreement (CAFTA) ranks as the world's largest free-trade area by population to date. In terms of economic value, this is the third-largest regional agreement, following the EU and the NAFTA (North-American Free Trade Agreement).** In 2002, China and ASEAN signed the Framework Agreement on Comprehensive Economic Cooperation - an umbrella agreement providing general provisions on the establishment of an ASEAN-China Free Trade Area (CAFTA). Under the CAFTA, a zero-tariff market came into force in 2010 for China and the six original ASEAN members[97] and expanded by including the newer and less developed ASEAN members.[98] Together with an agreement on trade in services that was signed in January 2007, the CAFTA came into effect on January 1st, 2010.

CAFTA reduced tariffs on 7'881 product categories or 90% of imported goods to zero. This reduction concerns China and the six original ASEAN-member States (Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand). The average tariff rate on Chinese goods sold in ASEAN countries decreased from 12.7% to 0.6% on January 1st 2010. The average tariff rate on ASEAN goods sold in China decreased from 9.8% to 0.1%. The six original ASEAN members also reduced tariffs on 99.11 % of goods traded among them to zero. China and ASEAN have defined 11 major fields as directions for future cooperation, including agriculture, information and communications technologies (ICTs), transport, tourism, Mekong River

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[96] http://www2.lse.ac.uk/IDEAS/publications/reports/pdf/SR012/li.pdf

[97] Brunei, Indonesia, Malaysia, Philippines, Singapore, Thailand

[98] Cambodia, Laos, Myanmar, Vietnam

exploitation, energy, culture, human resources, and the environment.[99] Customs data in 2012 show a 10.2% increase in China-ASEAN trade and an 18.1% YoY increase in Q1 of 2013[100]. China has kept its place as ASEAN's largest trading partner for three years and ASEAN is China's third-largest trading partner after the EU and the USA. While government officials from all parties emphasize the win-win situation expected from the CAFTA, some sectors which directly rival with Chinese products (such as textiles and garments, tires, steel and footwear) fear they cannot keep up with Chinese competitors.[101]

A significant proportion of the ASEAN-China bilateral trade is physically routed, arranged or financed through Hong Kong. Joining the CAFTA is thus in the intentions of Hong Kong whose participation would improve the efficiency of such trade, more generally the flow of capital, entrepreneurship, technology and people within the region, enhancing the overall competitiveness of the CAFTA. As the world's fifth largest and Asia's second largest provider of FDI, being a preeminent offshore RMB-centre and with more than 3700 multinational companies having set their HQ or regional offices in Hong Kong, the proportion of investments going into ASEAN might increase significantly after Hong Kong becomes a party to the CAFTA.[102] ASEAN however counter-proposed engaging Hong Kong bilaterally for a Hong Kong-ASEAN agreement.103

ASEAN+3 (or APT: ASEAN Plus Three)

It follows from China's tightening ties with ASEAN that the country would press for further **regionalism**. In the wake of the 1997 Asian Financial Crisis, the framework of **ASEAN+3** (China, South Korea and Japan) endeavoured to strengthen regional financial stability in East Asia by initiating new mechanisms for crisis prevention and resolution in the region.

The APT Heads of State first met in 1999 to enhance the "self-support mechanism of East-Asia", materialized by the respective Finance Ministers under the *Chiang Mai Initiative* in 2000 and coming into effect in the *Chiang Mai Initiative Multilateralization Agreement* between the APT members and Hong Kong in March 2010. Overdependence on short-term foreign currency-denominated financing was addressed by emphasizing **regional bond market infrastructure development and surveillance** in the *Asian Bond Market Initiative* signed in 2003.[104] Furthermore, APT countries engage in **BSA (Bilateral Swap Arrangements)** addressing balance of payment and short-term liquidity difficulties in the region by supplementing the existing international financial arrangements. The multilateral currency swap totalling $120 billion shall address balance of payment and short-term liquidity difficulties in the region by supplementing the existing international financial arrangements.[105] The **economic surveillance mechanism is based on the ERPD (Economic Review and Policy Dialogue)** in which members, as well as ADB and IMF experts discuss policy measures to mitigate risks in the *Technical Working Group on Economic and Financial Monitoring* meeting yearly.

Beyond financial and economic cooperation, central themes also include energy diversification, counter-terrorism, environmental protection, political security or even food security, the latter for instance addressed through the APTERR (*ASEAN Plus Three Emergency Rice Reserve Agreement*) signed on July 12th this year, an initiative initially proposed during the APT Agricultural Minister's Meeting in 2001.

Following the 21st ASEAN Summit, the **15th ASEAN+3 Commemorative Summit Meeting** took place on November 19th 2012 in Phnom Penh, Cambodia, reviewing the progress made since

[99] Global Times: "China-ASEAN ink investment agreement", 17 August 2009.

[100] China Customs Statistics

[101] L.A. Times: "Blaming China: Indonesian garment makers say free trade pact leaves them on brink of collapse", 26 April 2010.

[102] http://www.tax-news.com/news/Hong_Kong_Looks_To_Join_ASEANChina_FTA____57532.html

[103] http://www.chinadaily.com.cn/china/2013-04/27/content_16454483.htm

[104] http://www.bot.or.th/English/AboutBOT/index/Pages/ASEAN3.aspx

[105] Bank of Japan, Joint Press Release: "Chiang Mai Initiative Multilateralization (CMIM) comes into effect", 24 March 2010.

the 1999 and 2007 Joint Statement on East Asia Cooperation.[106] On November 19th, the **US-ASEAN Expanded Economic Agreement (E3) initiative** was also launched. E3 will focus on joint development of Investment Principles addressing essential elements of investment policies including market access, non-discrimination, investor protections, transparency and responsible business conduct. It will also focus on trade facilitation including simplified customs procedures and increased transparency of customs administration, as well as standards development and practices for SMEs, trade and environment, as well as the joint development of Information and Communications Technology principles guiding policymakers on the role regulatory bodies, cross-border information flows and localization requirements.

China does not really appreciate the expansion of other powerful countries into the region, such as the participation of the USA and Russia at the **East Asia Summit (EAS)**. Japan and ASEAN try to neutralise China's influence in including other powerful countries. Therefore, as a consequence of China's dominance in the ASEAN+3 and on Japan's initiative, ASEAN+6 (Australia, China, India, South Korea, Japan and New Zealand) has been created, which has been expanded to **ASEAN+8** in 2010 thanks to ASEAN's ambitious endeavours, including the USA and Russia. Japan thus favours the reinforcement of the **Comprehensive Economic Partnership for East Asia** (**CEPEA**: ASEAN+6), whereas China privileges the **East Asia Free Trade Area** (ASEAN+3).[107]

Regional Comprehensive Economic Partnership (RCEP or ASEAN+6) vs. Trans-Pacific Partnership (TPP)

Increasingly worried about being surrounded by USA-minded economies and countries, China has also been promoting the Regional Comprehensive Economic Partnership (RCEP) that would include ASEAN and the six countries that have an FTA with the group – India, Japan, China, South Korea, Australia and New Zealand.

After the adoption of the RCEP's Guiding Principles and Objectives for Negotiations by the Trade Ministers of each country in August 2012, **RCEP negotiations were officially launched at the 21st ASEAN Summit on 20th November 2012. The RCEP would become the largest regional trading arrangement in the world to date encompassing 16 countries and almost half of the global market with 3 billion people as well as almost a third of the global economic output with 30% of world exports and a combined GDP of $19.78 trillion.**

RCEP is an ASEAN initiative aiming at a **partial WTO-plus arrangement** gathering the already existing FTAs with external trading partners to establish deeper economic cooperation in opening up more trade in goods and services, eliminating trade barriers, gradually liberalizing services and providing for greater FDI as well as covering intellectual property rights, environmental protection, labor, financial services, technical barriers to trade and other regulatory issues.[108]

The **TPP is a broad trans-pacific trade and investment pact with the ambitious target to be concluded in October this year and currently involving 11 countries with a combined population of 658 million people.**[109] It was created out of an agreement between New Zealand, Chile, Brunei Darussalam and Singapore in 2005; the USA, Australia, Peru, Vietnam and Malaysia have since become additional members, as well as Canada and Mexico who joined in October and June 2012 respectively.[110]

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[106] http://www.chinadaily.com.cn/world/2012-11/19/content_15942633.htm

[107] Report "Arbeitstreffen von Botschafter Beat Nobs mit Dr. Suri Pitsuwan, Generalsekretär der ASEAN", Zürich, 21. Mai 2011, Political Affairs Division II, Asia-Pacific.

[108] http://www.wto.org/english/tratop_e/region_e/con_sep07_e/kawai_wignaraja_e.pdf

[109] http://www.whitehouse.gov/the-press-office/2012/11/19/fact-sheet-us-asean-expanded-economic-engagement-e3-initiative

[110] http://www.international.gc.ca/media_commerce/comm/news-communiques/2012/10/09a.aspx?view=d

The TPP negotiations call for deeper economic integration than RCEP and aim at establishing at least a regional FTA which will further liberalize trade in the Asia Pacific. For now, the USA is strongly encouraging further expansion among APEC countries, possibly as a way to isolate China economically and geopolitically in reducing the Asian countries' dependence on China.[111] The USA' ultimate goal is nevertheless to integrate China into the TPP in the longer term as it could subject China to new, higher standard rules and discourage China from trying to weaken the existing trade rules through other channels.[112] New Zealand is actually the most supportive country of China joining the TPP. From a Chinese perspective, TPP is above all a crucial component of USA's pivot strategy of a return to Asia and their direct measures against China's expansion of military power.[113] Though some Chinese analysts do see certain economic intentions behind the heightened activity of the USA in the region, others consider those economic benefits rather marginal and instead emphasize the USA's intention to establish a dominant role in the region as a rule-maker, seeing TPP as a challenger to the existing multilateral trade system that has failed to reach a consensus under the WTO framework. On a general basis it will be challenging to maintain the TPP's consistency of standards since the involved economies are at different stages of development.[114] The **TPP and RCEP may come into conflict due to the tension between China and the USA**, as both want to shape economic cooperation in the Southeast and East Asian regions in order to secure its economic interests. Rivalry between China and the USA might indeed become a predominant factor in the development of the regional economic architecture and might undermine the crucial driving force role that ASEAN plays, especially if ASEAN does not respond effectively to any potential competition between the TPP and RCEP.[115] Chinese policy circles maintain that the TPP's current member countries are mainly US military allies.[116] Furthermore, in their view the TPP would result in trade diversion from a more efficient exporter towards a less efficient one, consequently posing a severe threat to China's exports to the USA.[117]

China's rising domestic interests will increasingly complicate its own ability to see its FTA strategies through to fruition. Large Chinese SOEs, which are afraid of their vested interests being damaged and who possess a disproportionately strong lobbying power over the central leadership, and the cleavage of interests among different Chinese ministries would both constrain the Chinese government's ability to move forward on its FTA agenda. China's domestic and strategic considerations make its FTA agenda difficult to predict, but it is worth pointing out that China has not closed its doors towards the possibility of joining TPP itself. If the Chinese government feels that the benefits of joining outweigh the costs, then China may indeed apply.

Japan announced in March this year that it would also join the TPP talks, which was approved by the USA and the other TPP countries in April 2013. However the consultation period in the US Congress takes 90 days and Japan will only be able to join the negotiations from the end of July onwards. Japan thus missed the last round in Peru in May but will may the next round in Malaysia in July. By allowing Japan to join the TPP, the USA can make the TPP even stronger,

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111 Yang Jiemian, „Meiguo Shili Bianhua yu Guoji Tixi Chongzu," (The Change of America's Power and Restructure of International System), Guoji Wenti Yanjiu (International Studies), No.2, 2012, p.57, http://mall.cnki.net/magazine/Article/GJWY201202008.htm

112 Matthew Goodman, Former White House Coordinator for APEC and EAS cited in Wen Jin Yuan, The Tran-Pacific Partnership and China's Corresponding Strategies, Freeman Briefing Report, Center for Strategic & International Studies, Washington DC, June 2012, http://csis.org/files/publication/120620_Freeman_Brief.pdf

113 http://csis.org/files/publication/twq12FallSongYuan.pdf ; http://www.eastasiaforum.org/2013/05/05/japan-us-and-the-tpp-the-view-from-china/

114 Ibid.

115 http://www.eastasiaforum.org/2012/11/28/will-rcep-compete-with-the-tpp/

116 Song Guoyou, "TPP Dui Zhongguo You Naxie Yingxiang," (How will TPP affect China), Shenzhen Shangbao, November 13, 2011, http://szsb.sznews.com/html/2011-11/13/content_1821684.htm ; Li Xiangyang, "TPP, Zhongguo Jueqi Guocheng Zhong De Zhongda Tiaozhan," (TPP: A Serious Challenge for China's Rise), Guoji Jingji Pinglun *(International Economic Review),* No.2, 2012, pp.17-27,
http://iaps.cass.cn/upload/2012/04/d20120404000752112.pdf

117 Ibid.

attracting more countries and turning it into the biggest free trade area in the Asia Pacific, even eclipsing NAFTA in size and scope. De facto this would create a USA-Japan FTA undermining other member states, since 91% of the total GDP would be from Japan and the USA.[118] However, RECP's combined GDP, population and trade volume would still be higher. In China's view, **Japan follows where the USA leads and is attempting itself to become a leader and setter of international trade rules in order to maximise its national benefits and guarantee its voice in the international discourse**.[119] This is to be considered against the background that the idea of APEC turning into a FTA has not materialized, potentially leaving the USA marginalized.[120]

Joining the TPP talks would generate more leverage for Japan in negotiating a trilateral Japan-China-ROK FTA. Compared to the TPP, the trilateral FTA would nevertheless yield far greater trade benefits for Japan and would be less politically sensitive at home.[121] However, China's rise as regional and global power raises both economic and strategic fears among ASEAN countries already rooted on historical mistrust.[122] In this context, China is also leveraging monetary resources to attract ASEAN countries in offering generous packages in for instance technology transfer or maritime cooperation. In view of the difficulties to reach a comprehensive multilateral agreement, China opts for more accessible regional agreements.[123]

Although **South Korea** shows interest in joining the TPP in the medium-term, it prioritizes RCEP. Since South Korea has already signed FTAs with most current TPP members and is engaged in FTA negotiations with those remaining, most effects of the FTAs that it has worked hard to conclude would diminish significantly if it joins the TPP.

The **Philippines and Taiwan**, have also expressed interest in joining the TPP.[124] According to Supachai Panitchpakdi, Head of the UN Conference on Trade and Development, Thailand or Taiwan should be dissuaded to join the TPP and should rather concentrate on RCEP.[125] While most Asian countries prioritize on RCEP, Singapore, Malaysia and Vietnam focus on the TPP.

4.3 Bilateral Free Trade Agreements concluded

While multilateral trade has been developing rapidly, China is negotiating several bilateral free trade agreements to be signed in the coming years.

The **China-Costa Rica FTA** entered into force on August 1st, 2011 and is the 10th FTA China concluded. The negotiations were launched in January 2009, the agreement was signed on April 8th, 2010 in Beijing and the implementation followed in the second half of 2010 after both governments have concluded their respective ratification procedures. Tariffs are being gradually eliminated on over 90% of the products[126] traded between the two countries. The trade in services, based on the respective WTO commitments, covers 45 service sectors and sub-

118 http://www.sharnoffsglobalviews.com/japan-trade-032/

119 http://www.eastasiaforum.org/2013/05/05/japan-us-and-the-tpp-the-view-from-china/

120 *Ibid.*

121 http://online.wsj.com/article/SB10000872396390443819404577632953734008664.html#

122 Wen Jin Yuan and Melissa Murphy, "Regional Monetary Cooperation in East Asia – Should the United States be Concerned?", CSIS Report, November, 2010, http://csis.org/files/publication/101129_Yuan_RegionalCoop_WEB.pdf

123 Susan S. Schwab, "After Doha -- Why the Negotiations Are Doomed and What We Should Do About It," *Foreign Affairs,* Volume 90, No. 3, May/June 2011, http://pagines.uab.cat/jbacaria/sites/pagines.uab.cat.jbacaria/files/16_Schwab_pp104_117_Blues.pdf

124 Office of the United States Trade Representative, "Trans-Pacific Partnership Announcement", December 2009.

125 http://www.bangkokpost.com/news/local/322261/asean-leaders-begin-rcep-negotiations

126 For China, trade in goods covers products from textile and light industry, machinery, electronics, automobiles, chemicals, leather, vegetables and fruits. For Costa Rica, it covers coffee, beef, pork, pineapple juice, frozen orange juice, jam, fish powder, minerals and hides.

sectors of Costa Rica[127] while China covers seven sectors, including IT, real estate, market research, translation and interpretation and sports. The two countries also reached agreements on issues such as IPR, rules of origin, customs procedures, TBT (Technical Barriers to Trade) and SPS (Sanitary and Phytosanitary Measures), dispute settlement, trade remedies, as well as health and plant inspection and quarantine.

China and **Pakistan** signed an agreement on trade in services in February 2009 which took effect in October the same year. The pact leads to a China-Pakistan comprehensive free trade zone including trade in goods, trade in services and investment. A free trade agreement on goods between the two countries was already signed in 2006. Specifically, Pakistan will relax its shareholding restrictions on China's investment in sectors of construction, telecom, finance, distribution, health care, environmental protection, tourism, transportation, research and development and IT education. The sectors that China will open mainly include mining, environmental protection, health care, tourism, sports, transportation, translation, real estate, computer, marketing consultancy. [128] China's specific provisions of low tariffs and other exemptions to ASEAN countries have eroded the FTA preferences of Pakistani exporters in the Chinese market.

China and **Peru** concluded negotiations for a free trade agreement in November 2008. The pact was signed on April 28th, 2009 and entered into force at the beginning of March 2010. It will gradually reduce tariffs on about 90% of goods traded between the two countries.[129] China is Peru's second largest commercial partner and its investment in Peru has exceeded the amount of 1.2 billion USD, the largest among Asian countries.[130] A significant percentage of Peru's exports have enjoyed preferential access to China since the FTA went into effect; tariffs on 61.2% of the products that make up 83.5% of Peru's exports to China were reduced to 0% from day one. Furthermore, 94.5% of the products that make up 99% of Peru's exports to China now have access to this market at a lower tariff rate. Finally, 62.7% of the products that make up 61.8% of imports coming from China will enter Peru's market tariff-free.[131]

The **China-Singapore Free Trade Agreement (CSFTA)** was signed on October 23rd, 2008, after eight rounds of negotiations held over 2 years, making the first comprehensive bilateral FTA between China and another Asian country. The agreement covers areas including trade in goods, rules of origin, trade remedies, trade in services, movement of natural persons, investment, customs procedures, rules of origin, technical barriers to trade, sanitary measures, economic cooperation, dispute settlement. The CFSTA entered into force on January 1st, 2009. Flagship projects in bilateral cooperation, including Suzhou Industrial Park and Tianjin Eco-City, have seen remarkable achievements. Three changes arose from the CSFTA Amendment Protocol[132] signed on July 27th, 2011, namely: 1) China will recognise Singapore companies' inventory management method for interchangeable finished products exported under preference; 2) China will recognise Singapore Custom's administrative practice of stamping "issued retrospectively" on the preferential certificate of origin three days after loading date and 3) ASEAN-China FTA Package 2 Services Commitments[133] is to be extended to Singapore ahead of ASEAN. Singapore enjoys numerous FTAs with Australia, New Zealand, India, Japan, Korea, ASEAN, Hashemite Kingdom of Jordan, Panama, Peru, EFTA, US, and the Trans-Pacific SEP (Brunei, New Zealand, Chile).

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[127] Including telecommunication and commercial services, construction, real estate, distribution, education, environment, IT and tourism.

[128] Ministry of Commerce: http://fta.MOFCOM.gov.cn

[129] Ibid.

[130] Ministry of Commerce: http://fta.MOFCOM.gov.cn/enarticle/enperu/enperunews/201003/2235_1.html

[131] http://www.lexology.com/library/detail.aspx?g=acde30fa-d069-4d71-85f3-86df00996d65

[132] Available at http://www.fta.gov.sg/csfta/csfta_amendment_protocol_factsheet.pdf

[133] The ACFTA Services Agreement mandated that a second package of specific services commitments be concluded in order to progressively liberalise the service industries. ASEAN and China have agreed on this package and the relevant documents are slated to be signed in August 2011 and will enter into force in January 2012.

China and **Chile** signed a supplementary agreement on free trade in services in April 2008 which entered into force on August 1st, 2010. Both states committed themselves to opening up their service sectors in accordance with WTO rules, under a supplementary agreement to their formal free-trade pact signed in 2005. The service free-trade agreement covers 23 sectors in China, including computers, management consulting, mining, sports, environment and air transport. Moreover the two countries have already completed six rounds of negotiation talks in regard of a FTA in investment.[134]

New Zealand and China celebrated their 40th anniversary of diplomatic ties and their 5th anniversary of the China-New Zealand FTA's signature in April this year with a high-level delegation including their Prime Minister and six Ministers. The agreement, signed in April 2008 and into effect since October 2009, marked the first such deal between the biggest developing country and a developed economy. This FTA is one of New Zealand's greater successes as the bilateral trade more than tripled in the five first years. New Zealand Trade and Enterprise, the country's trade promotion agency, forecasts that over the next two decades the FTA will lift New Zealand exports to China by between 20% and 39%, or 260 million and 400 million NZ$ (US$317. 91 million), a year over and above what would be the case without an agreement.[135] The so-called New Zealand Inc Strategy launched by Prime Minister John Key aims at doubling exports by 2015. The Inc Strategies are plans of action for strengthening New Zealand's economic, political and security relationships with key international partners such as China, India, the USA, Australia, ASEAN, GCC and the EU.[136] Under this FTA which has been jointly reviewed in November 2010, New Zealand will phase out all tariffs on imports from China (textiles, clothing and footwear) until 2016 and will make an annual duty saving of $115.5 million, based on current trade. China will remove tariffs on 96% of its imports from New Zealand until 2019 with tariffs on some products (especially dairy products, meat, wool, etc.) being cut to zero. The agreement covers not just goods but also services, from insurance and banking to education and labour supply as well as investment. China sends more students to New Zealand than any other country and is its fourth-largest source of tourists. Strong export incomes support New Zealand's gradual economic recovery. China is the fastest growing export market for New Zealand with exports accounting 14% of the total, up from just 7% three years ago. While bilateral trade with China is growing rapidly, New Zealand ran an unexpected overall trade deficit of $199 million.[137] New Zealand's exports to China are led by primary products – dairy (40%), wood, wool, seafood and meat. The export profile is diversifying, however, with machinery, aluminum, plastics, wine and high technology products (especially telecommunications products) featuring in New Zealand's non-agricultural exports to China. However, the challenge is how to better diversifying the exports and educate SMEs on the best way to benefit from the FTA. New Zealand's largest imports from China are electrical machinery and equipment, textiles, clothing and footwear, toys, and a wide range of light consumer goods.[138] Chinese investments in New Zealand, in particular the purchase of 16 dairy farms by the Shanghai-based *Pengxin Group Co. Ltd.* raised concerns among media wrongly claiming that China would own more land than anyone else in the country. The case ended in the High Court of New Zealand however in favor of China as it approved Pengxin's bid.[139]

FTA negotiations between **Iceland** and China began in April of 2007, and by May 2008 four rounds of negotiations were completed. Due to Iceland's application for EU membership in July 2009, no further talks took place until Iceland, facing some fishery disputes with the EU Commission and thus delaying Iceland's accession to the EU, resumed the FTA-negotiations with China after Wen Jiabao's visit to Reykjavik in April 2012. The fifth round took place in December 2012 in Iceland and the last round in January 2013 in Beijing. The agreement was

[134] http://fta.MOFCOM.gov.cn

[135] http://www.chinadaily.com.cn/bizchina/2012-07/11/content_15569557.htm

[136] http://www.mfat.govt.nz/NZ-Inc/1-About/index.php

[137] http://www.stuff.co.nz/business/industries/6489292/Exports-to-China-booming

[138] http://www.mfat.govt.nz/Countries/Asia-North/China.php

[139] http://usa.chinadaily.com.cn/business/2012-12/04/content_15983720.htm

signed on April 15th 2013 by Icelandic Prime Minister Johanna Sigurdottir and the 2013 by Iceland's Foreign Minister Ossur Skarphendinsson and Trade Minister Gao Hucheng and witnessed by Iceland's Prime Minister Johanna Sigurdardottir and Chinese Premier Li Keqiang. Iceland is the first European country to sign a free trade agreement with China. The FTA is in essence similar to other FTAs that Iceland, as EFTA member, has already concluded. With the entry into force of the FTA, tariffs on most goods between the two countries will be removed. For a small number of products, Chinese tariffs will be dismantled during a transition period of 5 or 10 years, but Chinese exports into Iceland will be duty-free as from the entry into force.[140] Both China and Iceland exclude a limited number of products from tariff preferences – Iceland excludes, for example, dairy and meat products, while China will exclude certain paper products.

In January 2004, the **Closer Economic Partnership Arrangement (CEPA)**, the first regional trade agreement between China and **Hong Kong** as well as between China and **Macao**, came into effect. The CEPA initially covered the three areas of trade in goods, trade in services, and investment. It has since been expanded several times. Supplement VI went into effect on 1 October 2009, and shall give firms from Hong Kong and Macau greater and easier access to the mainland market for certain service sectors.[141] The Supplement VII between Hong Kong and mainland China was signed on 27 May, 2010 and entered into force on 1 January, 2011. It further relaxes Hong Kong's market access to the mainland in 14 service sectors such as medical services, technical testing, analysis and product testing and social services.[142] The CEPA is a successful application of the "One Country, Two Systems" principle and is the first FTA to be fully implemented in the Chinese mainland.

China signed in October 2008 a trade deal with **Senegal** to offer zero-tariff treatment to more than 400 categories of goods imported from Senegal.[143]

4.4 Free Trade Agreements under negotiation

After having concluded a Joint Feasibility Study on a possible FTA in May 2010 and after a total of seven years of preparations, China and **South Korea** jointly announced the launch of the bilateral FTA negotiations on March 2nd 2012. Since then, five rounds of negotiations took place in Beijing, Jeju Island, Weihai, Gyeongju and Harbin. The fifth round was the first to be held after leadership change in both nations respectively. Besides talks in trade in services, investment, rules of origin, trade remedy, IPR, government procurement, TBT and SPS, a first expert meeting on a possible chapter on environment was held.[144] The negotiations are divided into two phases. During the first phase, both governments shall define the FTA's scope of application, as well as the tariff modalities in elaborating a list of three different categories divided into "Normal Sensitive Items" (NSI), "Sensitive Items" (SI) and "Highly-Sensitive Items" (HIS), whereas SI shall be discussed during the first phase, HSI (such as for instance rice) shall be removed from the negotiations and NSI shall enjoy a tariff protection of 10 years after which it will be partially or completely lifted. Both governments also agreed not to apply tariff to the manufactured goods from the offshore processing zones. During the second phase, requests and offers will be exchanged and the concrete content of the chapters will be discussed. South Korea is geographically very close to China and is the second most important importer to China after Japan (Japan: 11.2% and South Korea: 9.3% of all imports). If the trend continues, Korea might overtake Japan and become the first importer to China. Furthermore, China faces some fishery disputes for illegal fishing in South Korean waters. Chinese agricultural and fishery products being much cheaper than the South Korean ones, there is a strong resistance in the threatened South Korean fishery and agricultural sectors, as according to the Korean Agricultural Economy

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140 http://www.tax-news.com/news/Iceland_Signs_Europes_First_FTA_With_China____60464.html

141 Xinhua: "Chinese mainland market opened wider to HK businesses", 9 May 2009.

142 South China Morning Post: "Cepa boosts six pillar industries", 28 May 2010.

143 "China signs zero-tariff trade deal with Senegal", Africa Economic Development Institute, Africa Trade Agreements, Xinhua, 18 October 2009. available at http://africaecon.org/index.php/trade_agr/view_trade_agreement/34/0/_/0

144 http://www.china.org.cn/business/2013-04/29/content_28692417.htm

Research Institute, a FTA with China will increase the agricultural import from China by $108 million and the domestic agricultural production would drop by 14.7%.

If South Korea signs the FTA with China, it would be the only country in Asia to have signed bilateral agreements with all three major economic zones (USA, China and EU).[145] Furthermore, South-Korea has signed free trade agreements with more countries than any of its neighbors, including India, Chile, Peru, ASEAN, Singapore and EFTA. According to a joint FTA research report, the bilateral trade agreement would induce an expansion of 0.395% for China's GDP and a 2.72% gain for South Korea. The combined growth would go further up to 0.584% for China and 3.31% for South Korea respectively. A separate study by the Samsung Economic Research Institute shows that South Korea's GDP will expand 2.72% after the FTA with China takes effect, surpassing the projected gain of 0.56% from South Korea's FTA with the US and a boost of 1.02% from its FTA with the European Union.[146] Great importance is attached to this bilateral FTA since it endeavors to become a model for ASEP and RCEP. Nevertheless, analysts in Seoul predict that like the FTA with the US, only the electronics sector would genuinely stand to benefit for the Sino-Korean FTA.[147]

The trade ministers of **China, Japan and South Korea** agreed in May 2010 to complete a Joint Feasibility Study and in May 2011, a Joint Declaration on a regional FTA was signed by representatives of the three nations. Despite recent territorial and long-lasting historical issues among the three countries, the **trilateral FTA negotiations were launched during the 7th East Asia Summit in Phnom-Penh on November 20th, 2012, the first round took place March 26-28th 2013 in Seoul and the second is scheduled for July in China.** The goal is to conclude the FTA within two years with 2-3 negotiation rounds per year. China is the most important trade partner of Japan and Korea and the three countries are now Asia’s largest, second-largest and fourth-largest economies with trade volume between them amounting to USD 690bn in 2011.[148] This FTA would become the 3rd largest after the EU and NAFTA and would be ranked before CAFTA, creating an economic zone populated by about 1.5 billion people. Still, while the countries account for approximately 20% of the global GDP and 70% of East Asia’s GDP, China, Japan and South Korea have an intra-regional dependency rate of a mere 25%.[149] China, Japan and ROK are complementary trade partners, as China has advantages in agricultural products while ROK intends to export steel and automobile products among other. Trade among the three accounts for 11% of their total foreign trade volume, suggesting there is much potential for further development of trilateral trade.[150]

The economic effect of the FTA is estimated to add 0.74 % points to Japan’s GDP, 2.27 points to that of export-dependent China and 4.53 points to South Korea’s.[151] The negotiations may prove complicated due to real economic concerns such as the flood of cheap Chinese agricultural products or China’s resistance to lowering automobile tariffs, but also due to political distrust, territorial disputes and diverging investment policies, as well as region wide worries about China's expanding military power. While Korea prioritizes on the China-Korea bilateral FTA, China has a particular interest in this trilateral FTA in order to gain weight **opposing the US-led TPP** since policymakers in Beijing worry that US influence could erode Chinese sway across the region.

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145 Korea Herald, Song Sang-ho: “Korea moves on FTA talks with China”, 9 January 2011

146 Samsung Economic Research Institute, Kwon Hyuk-Jae: “Obstacles to the Korea-China FTA”, 8 May 2012, available at http://www.seriworld.org/

147 “South Korea sets negotiations for China FTA”, PressTV, 22 May 2012, available at http://www.presstv.com/detail/240568.html

148 http://www.scmp.com/news/china/article/1201948/china-japan-s-korea-conclude-first-round-trade-talks

149 http://jp.fujitsu.com/group/fri/en/column/message/2012/2012-01-11.html

150 http://fta.mofcom.gov.cn

151 http://www.asianewsnet.net/China-S-Korea-keen-on-FTA-with-Japan-44673.html

A **trilateral Agreement on promotion, facilitation and protection of investment**, the first economic deal between the three Asian powers, was signed during the 6th trilateral Summit in August 2011.

A framework agreement was signed between China and **Australia** in October 2003 and talks began in May 2005, after the conclusion of a feasibility study. After more than eight years of negotiations, the 19th round took place during the first week of June 2013. The 18th round took place in May 2012 and since then intersessional meetings in specific groups such as IPR took place. The visit of Australian Prime Minister Gillard promoted the continuation of the free trade talks, which were stalled mainly by China's demand that its SOEs be allowed to invest up to $1 billion in Australia without receiving approval from the Foreign Investment Review Board, an exemption that only the USA and New Zealand enjoy so far.[152] The Chinese government's demand for parity with the USA and New Zealand also suggests that it may be seeking recompense for the Australian government's decision to bar the Chinese SOE Huawei, from participating in the construction of the National Broadband Network for security reasons. Furthermore, a possible new negotiating mandate will be in place after the upcoming elections in Australia this fall. While current Australian Trade and Competitiveness Minister calls for a comprehensive "high-ambition" FTA with China, some Australian officials instead signal a lighter version of the FTA securing greater access to Chinese market for Australia's agricultural exports while reducing the Australian economy's reliance on exports of iron ore, coal, gold and crude petroleum in diversifying in other categories such as services.

China is Australia's largest two-way trading partner, with total bilateral trade amounting to $127.5 billion. Australia's major imports from China are telecom equipments and parts, computers, clothing, furniture, mattresses and cushions.[153] Chinese investments, in particular in infrastructures and mining, have witnessed a 70% increase at the end of 2011 compared to 16% increase in services. The mining investments whose major sources are SOEs include low-cost labour force packages working on site during the whole project, an offer mainly practiced in developing countries and which is unacceptable under Australian labour standards.

Australia and China also announced during Australian Prime Minister's visit in April the start of an **offshore RMB-hub** with direct trading between the Australian dollar and the Chinese RMB in order to encourage greater bilateral investment and to ensure that Australia follows China closely on its path towards the internationalization of its currency.

Norway and China completed a feasibility study and launched the official Sino-Norway FTA negotiation in October 2008. The 8th round of negotiations took place in September 2010 and included discussions on commodity, trade in services, trade in goods, investment, rules of origin, plant hygienic standards, SPS/TBT, settlement of disputes, trade remedy, facilitation and IPR. However, the negotiations have been suspended due to the Peace Nobel Prize incident in 2010. The Sino-Norwegian relations seemed to witness some progress since the Norwegian Prime Minister Jens Soltenberg met his Chinese counterpart, Wen Jiabao at the 9th ASEM (Asia-Europe Meeting) on November 19th 2012 in Laos. On May 27th this year, Assistant Minister Yu Jianhua announced that the two nations were negotiating a trade deal, but no further round has been scheduled yet. According to Yu's statement, which reflects the Chinese status since the last round in 2010, Norway has raised demands difficult to Chinese industries for which neither side has proposed solutions. The negotiations are still halted and Norway would welcome any Chinese initiative to resume them. At the beginning of May, Norway supported the granting of Arctic Council observer status to China in order to normalize their bilateral relations.

In July 2004, China and the six-nations (Saudi Arabia, UAE, Kuwait, Oman, Qatar and Bahrain) of the **Gulf Cooperation Council (GCC)** announced the launch of FTA negotiations. Until now, five rounds of negotiations have taken place with the last round held in June 2009. An

[152] EIU Country Report, May 2013

[153] http://www.dfat.gov.au/geo/fs/chin.pdf

agreement was reached on the majority of issues concerning trade in goods. Negotiations on rules of origin, technical barriers to trade, sanitary and phytosanitary measures, economic and technological cooperation are also launched.[154] Nevertheless, the Chinese insist on making the first phase of the proposed deal restricted to goods, thus excluding services. During his visit to the Persian Gulf countries in January 2013, outgoing Premier Wen Jiabao called for a rapid conclusion of the FTA negotiations as Sino-GCC bilateral trade contributes to 70% of Sino-Arab trade, but no further round has been held so far.[155] China however signed several important energy deals with the UAE. China surpassed the USA to become the world's largest net importer of oil, rising to 6.12 million barrels in December last year. According to the UAE Ambassador to China Mr. Omar Ahmad Adi, the China-GCC FTA may be signed this year.[156]

China is also a signatory to the **Asia-Pacific Trade Agreement (APTA)**, along with Bangladesh, India, Lao, ROK and Sri Lanka. The Asia-Pacific Trade Agreement (APTA) is a preferential trade arrangement among developing countries formerly known as the Bangkok Agreement, signed in 1975 as an initiative of the UNESCAP (United Nations Economic and Social Commission for Asia and the Pacific). Since September 1st, 2006, the outcome of the third round of tariff cut talks was successfully implemented by all APTA members. In December 2009, the Participating States entered into the Framework Agreement on the Promotion, Protection and Liberalization of Investment and the Framework Agreement on Trade Facilitation and in August 2011 entered into the Framework Agreement on the Promotion and Liberalization of Trade in Services. Bangladesh, China, India, Republic of Korea, Lao People's Democratic Republic and Sri Lanka are signatories and Mongolia is currently in the process of accession to APTA. UNESCAP functions as the secretariat for the Agreement. At present, the fourth round of negotiations is underway and it involves tariff concessions of trade in goods, trade in services, investment, trade facilitation, and non-tariff measures.[157]

In June 2004, China and the **Southern Africa Customs Union (SACU)**[158] announced the launch of free trade negotiations. So far, no negotiations have taken place.

4.5 Free Trade Agreements under consideration

China follows a trend of proposing to most of the countries it maintains cooperation with the possibility of negotiating a free trade agreement, be it the EU, but also India, Brazil, Mexico, among others and President Xi Jinping or Premier Li Keqiang mentions the idea during their high-level visits abroad. Trading with emerging markets and FTA members indeed allows China to recover some of the export losses resulted from lower demand in developed markets such as the EU and the USA. The global FTA trend involves almost all WTO members and half of the trade in goods takes place in FTAs.

In May 2010, China initiated feasibility studies for a FTA with **Mongolia**. China is the main importer of mineral products from Mongolia and wants to strengthen its cooperation with Mongolia in mineral resources exploration, including coal, copper, uranium and rare earth minerals, as well as in infrastructure construction and in the financial sector. An agreement in economic and technological cooperation was signed during the visit of China's top legislator Wu Bangguo to Mongolia in January 2013, being the first high-level visit to Mongolia in 16 years.[159]

Canada is also considering launching FTA negotiations with China after the conclusion of an investment protection agreement in May 2012. A survey was launched by the Asia Pacific Foundation of Canada at the *Canada China Business Council's 34th Annual General Meeting*

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154 http://fta.mofcom.gov.cn

155 http://gulfbusiness.com/2013/04/china-and-gcc-growing-ties/

156 http://www.china.org.cn/business/2013-04/18/content_28577564.htm

157 http://www.unescap.org/tid/apta.asp

158 South Africa, Botswana, Namibia, Lesotho, Swaziland

159 http://usa.chinadaily.com.cn/world/2013-01/31/content_16188990.htm

and Policy Conference in Montreal, Quebec on November 28th, 2012 with results showing that of the respondents, 47% placed negotiations with China as a priority, followed by Japan (16%), India (15%) and the EU (11%).[160] 82% respondents supported potential FTA negotiations with 39% agreeing that such an agreement would give Canadian manufacturers and exporters significant opportunities to expand and build new business activities in China. Another 83% agreed that the conclusion of such an agreement would increase their business activity. Chinese trade tripled and investment in Canada has increased 36-fold in 10 years,[161] reaching $10.7 billion at the end of 2011, while Canadian investment in China topped $8.3 billion.[162]

In 2003, **India** and China established a Joint Study Group to examine the potential bilateral economic engagement. The related feasibility study on their proposed China-India Regional Trading Arrangement (RTA) on trade in goods, trade in services, bilateral investment, trade facilitation and economic cooperation has been completed in fall 2007. On the occasion of the visit of Chinese Premier Li Keqiang to India in May 2013, he expressed the desire to start FTA negotiations in order to mitigate trade imbalance between the two countries and to facilitate the access of Indian products on the Chinese market. The trade deficit has indeed increased from $39.44 billion in 2011-12 to $40.78 billion in 2012-13, despite a contraction in total trade by 10.27%. In 2012, bilateral trade between the two countries was $66 billion, a decline from over the $74 billion mark in 2011 and the exports have fallen from $18.08 billion in 2011-12 to $13.53 billion in 2012-13.[163] Indian industries as well as the government are seriously concerned about this trade deficit and are opposed to a FTA with China because of the concern of cheap Chinese goods influx after the tariff barriers have been lowered.[164] According to the NDRC (National Development and Reform Commission), this FTA would help a South-South Cooperation model as well as a greater role for both countries in the global economy.

During the first China-Eurasia Expo held in Urumqi, Xinjiang, in September 2011, Vice-Minister Zhong Shan called for a FTA among **SCO (Shanghai Cooperation Organization,** founded in 2001) member nations (China, Kazakhstan, Kyrgyzstan, Russia, Tajikistan and Uzbekistan with Mongolia, Pakistan, Iran and India as observer states) which might even include Afghanistan. SCO countries have a population of 1.5 billion, a combined GDP of $7.6 trillion and a trade volume that reached $90 billion in 2011. According to Sun Ping, vice-president of the Export-Import Bank of China, China's investments to the other five member countries accumulated to nearly $6 billion by 2011, while the investments in China from the other member countries reached $2 billion. During the 12th Meeting of the Council of Heads of Member States of the SCO held in Beijing June 6-7th this year, Vice-Premier reiterated that amidst a challenging recovery of the global economy, SCO should strengthen coordination in macro-policies and promote trade and investment exchanges as inked in the medium-term development plan.[165] In response to fluctuation of commodity prices and increasing trade protectionism, SCO countries consider establishing a *SCO Growth Fund* and a *SCO Development Bank*, which symbolize an important step in the internationalization of the RMB [166] Potential multilateral financial cooperation, e-commerce and enlargement of home currencies in bilateral trade to boost regional trade and investment are also explored.

Launching a **China-USA FTA** would be in line with China's strategy of FTA expansion. The Chinese market is indeed becoming more and more important for USA's exports. During the past decade, the USA's exports to China grew rapidly by 468%, while its exports to other countries only grew by 55%.[167] According to a primary estimation, if China and the USA had

160 http://thediplomat.com/the-editor/2012/07/27/canadas-asia-pivot/

161 http://www.bloomberg.com/news/2013-04-13/canada-china-trade-to-maintain-rapid-pace-of-growth-fast-says.html

162 http://www.asiapacific.ca/sites/default/files/filefield/canadian_busineses_in_china_survey_2012.pdf

163 http://www.indianexpress.com/news/china-ready-to-talk-fta-with-india/1118892/

164 The Economic Times: "China-ASEAN FTA may hit trade balance: Scindia", 23 April 2010.

165 http://www.globaltimes.cn/content/730801.shtml

166 http://usa.chinadaily.com.cn/china/2012-05/18/content_15325430.htm

167 http://www.chinausfocus.com/finance-economy/china-us-fta-talks-should-be-initiated/

established a FTA and hence had reduced their tariffs by 10%, their economic growth rates could have increased by 3.93% and 0.45% respectively in 2011.[168] The USA-China Strategic and Economic Dialogue committed to promoting trade and investment, financial supervision, consumption and savings rates adjustment could include discussions on establishing a China-USA FTA.

Since the **Transatlantic Trade and Investment Partnership (TTIP)** was announced to be launched this June between the USA and the EU and to be concluded within two years, China is also strongly pushing for a **China-EU FTA**. The EU remains China's biggest export market (17%) and China is the EU's second biggest (9%), two-way trade has grown four times in the past decade and by 50% since 2008 and two-way investment flows have increased more than sevenfold in the China-EU direction and are still growing.[169] On the other hand, the USA and the EU are already each other's most important trading partner and a TTIP would represent more than 45% of global GDP, 30% of global trade and 50% of in- and outward FDI stock.[170] The USA-EU FTA idea was proposed as early as 1997 by USA scholar Clyde Prestowitz and the persisting global crisis since 2008 accelerated this trend.

4.6 Relations between China and Taiwan

After over ten years without any negotiations, cooperative meetings between Chinese and Taiwanese representatives have taken place since Ma Ying-Jeou took office as Taiwan's president in 2008 and renewed his mandate in January 2012. In 2009, different agreements to strengthen cooperation were signed in order to facilitate mainland investment in Taiwan's financial markets, increase flight connections, strengthen cooperation for crime fighting and cooperation in agricultural quarantine inspection, industrial product standards and inspection and certification.

Negotiations on an **Economic Cooperation Framework Agreement (ECFA)** started in 2010 and although the ECFA was highly controversial in Taiwan, the deal was signed on June 29th, 2010, after five rounds of negotiations. The ECFA is widely regarded as a **milestone in institutionalising Cross-Strait relations** as it provides for the first time a legal framework for the economic ties that have developed over the past three decades. Under ECFA, which took effect on September 12th, 2010, tariffs on 539 Taiwan-made products and 267 mainland goods in the early harvest list are reduced and eventually eliminated in three stages over two years and starting this year, all items on the early harvest list will enjoy zero tariffs. Furthermore, both sides seek ways to further strengthen economic cooperation in areas such as financial cooperation, IPR, customs cooperation, among others.[171]

In **June** this year, the **ECFA Service Trade Pact of ECFA** should be signed between newly appointed President of the Association for Relations Across the Taiwan Strait (ARATS) and former Chinese Trade Minister Chen Deming and Taiwanese Traits Exchange Foundation (SEF) on the occasion of the ninth high-level cross-strait meeting since 2008 and the first since Lin and Chen assumed their current positions in September 2012 and April 2013 respectively.[172] Taiwan will mainly open its financial, medical care and travel agency services, while Mainland China will in addition open up its e-business, creative culture and sea and air transportation service.[173] Chen Deming's criticism however points on the fact that despite Beijing's concessions, Taiwan did not grant China MFN treatment in many areas since ECFA was signed.

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168 Ibid.

169 http://blogs.lse.ac.uk/europpblog/2013/05/29/china-eu/

170 http://www.chinadaily.com.cn/opinion/2013-04/10/content_16388400.htm

171 Xinhua: "Landmark cross-Strait economic pact takes effect", 13 September 2010.

172 http://focustaiwan.tw/news/aeco/201305240010.aspx

173 http://www.taipeitimes.com/News/taiwan/archives/2013/05/25/2003563135

ECFA has increased business revenues, spurred growth in Taiwan's GDP, and lowering the unemployment rate. In the long term, ECFA redefines Taiwan's position in the Asia-Pacific region and dispels the fear that the economy of Taiwan is becoming marginalized.[174] Critics fear the agreement will lead to a flood of cheap Chinese goods, an exodus of well-trained professionals and especially a growing dependence on China. Taiwan is aiming at concluding free trade agreements with other nations and began negotiations with Singapore in 2011 on an economic partnership agreement, completed a feasibility study with New Zealand in 2012 and other feasibility studies are under way with India and other major ASEAN economies. In 2012 also, an Investment Protection Pact was inked with Japan. South Korea being Taiwans' main trade competitor, Taiwan is closely looking at the effects that the South Korea-EU FTA, EU's first trade deal with an Asian country, has on Taiwan's economy after coming into effect on July 1st 2011. Taiwan is thus strongly aiming at launching an Economic Cooperation Agreement with the EU and at resuming talks with the USA under the Trade and Investment Framework Agreement (TIFA).[175]

4.7 Relations with Switzerland

On the occasion of the official visit of **Federal Councillor Leuthard to China in July 2007 a joint declaration on economic cooperation** was signed. The declaration shall strengthen the bilateral relations on trade, investment and intellectual property rights. Additionally, Switzerland **recognised China as a market economy** on this occasion.

In January 2009, Chinese Prime Minister Wen Jiabao made an official working visit to Bern during which the further strengthening of economic cooperation was also discussed. **Both sides agreed on the preparation of a joint feasibility study on a possible FTA between Switzerland and China**. Both sides started to draft the Joint Feasibility Study at the beginning of 2010. The joint study group met three times between February and August and managed to conclude the study.[176] On the occasion of the visit of President Leuthard to China in August 2010, **a MoU was signed stating that the joint feasibility study was concluded and that both parties agreed to launch negotiations in the near future**. **The negotiations were officially launched on January 28th, 2011**, by Chinese Minister of Commerce Chen Deming and Swiss Economy Minister Johann Schneider-Amman at the margin of the WEF in Davos. The first round of negotiations was held in April 2011 in Berne, followed by eight other rounds alternately held in China and Switzerland, with the ninth and last round held in Berne in May 2013. During the last round, the Swiss delegation was led by Ambassador Christian Etter, Federal Council Delegate for Trade Matters and the delegation of the People's Republic of China was led by Assistant Minister YU Jianhua from the Chinese Ministry of Commerce. At the end of the three days, negotiations were concluded at a technical level.

On the occasion of the visit of **Chinese Premier Li Keqiang** to Switzerland on **24 May 2013**, the **Memorandum of Understanding on Concluding the Negotiations for a Switzerland-China Free Trade Agreement was signed between Swiss Federal Councillor Johann N. Schneider-Ammann and Chinese Minister of Commerce GAO Hucheng.**

Both sides are currently examining the draft agreement from a technical, legal and linguistic perspective so that it is ready to be signed on the occasion of the visit of Federal Councillor Johann N. Schneider-Ammann to China in July this year.

The FTA contains chapters on trade in goods, trade in services, rules of origin, customs procedures and trade facilitation, technical barriers to trade (TBT) and sanitary and phytosanitary measures (SPS), trade remedies, intellectual property rights, competition, investment promotion, government procurement, trade and sustainable development, dispute settlement, legal and institutional matters, economic and technical cooperation.

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174 Taiwan Today: "The Challenges of ECFA", 2 July 2010.

175 http://www.europeanbusinessreview.eu/page.asp?pid=1056

176 For the Joint Feasibility study, please refer to: http://www.seco.admin.ch/themen/00513/02655/02731/04118/index.html?lang=de

The conclusion of the FTA process is not only a mutual benefiting achievement in merely all trade related matters. It is far more as it marks a milestone in a very strong and fruitful relationship based on a trustful cooperation between the two countries. The overall positive dynamism that such a historic achievement boosts in any bilateral relations should not be underestimated and will positively affect the working climate, as well as other sectors in the public and in the private field as e.g. the image of Switzerland and its touristic attractiveness. What is at stake goes thus far beyond the content of the agreement.

In January 2009 a **revised bilateral investment protection agreement was signed,** which provides notable improvements especially with regard to the transfer of returns on capital and investment, compensation for expropriation and dispute settlement procedures. The revised agreement entered into force on April 13th, 2010.[177]

Furthermore, China and Switzerland initialed the **revised bilateral agreement on the avoidance of double taxation** in July 2012. After the signature has taken place, the ratification process will be initiated, including the passing before the Parliament as well as the eventual opening for a facultative referendum of 100 days. If the agreement passes the ratification process on both sides without delay, it may be expected to enter into force in the second half of 2014.

5 Foreign Trade in 2012

5.1 Trade in goods[178]

Although Chinese exports and imports are still growing in absolute terms, the growth figures follow a downward trend and the trade surplus is narrowing, as foreign trade development faces a complicated and severe situation at home and abroad, import and export growth slid to single digits. In this context, the Chinese Government adopted a series of policy measures to stabilize foreign trade growth and balance the trade structure.

In the light of the difficult situation for Chinese exporters and rising imports, China's trade statistics were nearly balanced in the first quarter of 2012. With exports scrambling before the Chinese Spring Festival and mass imports following the Spring Festival, China even recorded a trade deficit of 31.48 bn USD in February.[179] However, the momentum of a more balanced foreign trade structure was again in the later stages of the year 2012.

In 2012, Chinese exports reached 2,048.5 bn USD (+7.92 % YoY) and imports stood at 1,817.8 bn USD (+4.26% YoY), resulting in a total trade volume of 3,866.8 bn USD (+ 6.2% YoY) and leaving a trade surplus of 231.1 bn USD (+49.1% YoY). Due to a pickup in global market demand and progressive implementation of policy measures to stabilize foreign trade, the import and export growth in September rebounded with export rising 9.9% from 2.7% in August and import growth rising 2.4% from a decline of 2.6% in August, the monthly trade and export scale reached an all-time high.[180]

5.2 Trade in services

According to the White Paper on China's foreign trade **China's international competitiveness in services trade has been enhanced**, especially since its WTO entry. From 2001 to 2010 **China's total services trade value (excluding government services) witnessed a more-than-five-fold growth from 71.9 billion USD to 362.4 billion USD.** [181] China's share in world

[177] For the agreement, please refer to: http://www.eda.admin.ch/eda/de/home/topics/intla/intrea/dbstv/data59/e_20092659.html

[178] Data mainly based on China's Custom Statistics, October 2011, see Appendix 3 and Mofcom: Regular Press Conference of the Ministry of Commerce on November 16th, 2011.

[179] MOFCOM: "Report on the Foreign Trade Situation of China"; Spring 2012.

[180] MOFCOM: "Report on the Foreign Trade Situation of China"; Autumn 2012.

[181] Information Office of the State Council: White paper "China's Foreign Trade"; December 7th, 2011.

total exports is 4.61% with 170.2 billion USD and its share in world total imports is 5.47%, worth 192.2 billion USD.[182]

5.3 Trade with Switzerland

As of January 1st 2012 the **Swiss Federal Customs Administration adapted its calculation concept with the aim of harmonizing its foreign trade statistics with international standards**, newly taking into account the country of geographic origin, other than the country of production.[183]

Under the former concept of the country of production, in international trade flows a good was attributed to the country where it was declared in, even though it had been produced in a different country. Typically, countries in which important trade hubs for the Swiss international trade are located, such as Germany (e.g. port of Hamburg) or the Netherlands (e.g. port of Rotterdam), accounted for a larger share of imports than under the concept of the country of geographic origin.

The regulation substantially impacts on the Swiss trade balance with certain countries. For instance, when retroactively calculating the figures for the year 2011 according to the concept of the country of geographic origin, the imports from the Netherlands would stand **lower** than they were published. This applies amongst others to Germany, France, Belgium or Ireland.

On the other hand, the imports from countries which typically ship their products to Switzerland through international trading hubs will rise under the new method. This applies for example to the US, Japan, Turkey or India. **In particular the same effect applies to China leading to the consequence that according to the concept of the country of geographic origin, in the year 2011, Switzerland actually exhibits a trade deficit instead of a trade surplus, with the imports from China rising from 3.6% to 5.6% as a share of Switzerland's total imports.**

The introduction of this new calculation method follows a recommendation of the United Nations regarding the calculation of foreign trade statistics and also results from a bilateral agreement between Switzerland and the European Union regarding the cooperation in the field of statistics.

Although both calculation methods have their respective advantages in terms of capturing certain economic realities, the change appears reasonable, since the production country concept may have biased the effective trade relations with certain countries. In the short term the change causes difficulties for statistic consistency as it reduces the comparability between the older and the newer trade figures. In the case of China the new system generates a level shift of 3 billion CHF per year, which needs to be taken into account when comparing 2012 with previous years.

From January to December 2011, the volume of bilateral trade between Switzerland and Mainland China accounted for 18.5 billion CHF, which corresponds to an increase of 9.4% from 2010. In the same period the Swiss trade deficit stood at 775 million CHF, compared to 1.9 bn CHF in 2010 and 2.6 bn CHF in 2009. These figures base on retroactive calculations according to the new method.

From January to December 2012, Swiss exports to Mainland China amounted to 7.8 bn CHF while imports stood at 10.3 bn CHF, resulting in a trade volume of 18.1 bn CHF and a Swiss trade deficit of roughly 2.5 bn CHF.

While Switzerland's exports of machinery, watches, pharmaceuticals and chemicals to China cumulatively account for roughly 65% of total exports in 2012, it imported mainly machinery, textiles, watches, furniture and toys, amounting to roughly 77% of total imports in 2012. This reveals an interesting feature of Sino-Swiss bilateral trade, which is that the two countries trade

[182] WTO: "Country Profile China"; October 2011.

[183] Data mainly based on: Swiss Federal Customs Administration, June 2012, see Appendix 4.

essentially the same products, but in different price classes[184]. In 2012, Swiss exports to Hong Kong mainly comprised of watches, jewellery, precious metals and gemstones (83%) and imported products of the same class (84%).

As for Hong Kong, even under the new calculation method of geographic origin, Switzerland still records trade surplus which in 2012 stood at 6.5 bn CHF at a trade volume of 10.1 bn CHF. From January to April 2013 the bilateral trade with Hong Kong amounted to a volume of 3.1 bn CHF and left a trade surplus of 1.9 bn CHF.

Therefore, regardless of the trade deficit vis-à-vis mainland China, it is worth noting that Switzerland still has a positive trade balance vis-à-vis Greater China, with a surplus of 3.0 bn CHF for 2012 and one of 0.84 bn CHF for January to April 2013.

6 Direct investments

6.1 Development and general outlook

The financial crisis negatively affected foreign direct investment (FDI) to China, not because of suppressed market prospects for China but because foreign investors were facing financing problems in their domestic countries. In 2009, FDI fell by 2.6% to 90 billion USD.[185] However, FDI recovered well in 2010, the number of newly approved foreign-funded enterprises in China increased by 16.94% compared to 2009, and actual used foreign investment increased by 17.44% year-on-year. **The FDI growth decreased considerably in 2012.** The number of newly approved foreign-funded enterprises in China totaled 24'925, down by 10.6% from 2011 and the actual used foreign investment reached 111.716 billion USD, down by 3.7% year on year.[186]

According to Chinese statistics the top ten countries investing in China, accounting for 91.4% of foreign capital input in 2012 were: Hong Kong *(71.289 billion USD)*, Japan *(7.38 billion USD),* Singapore *(6.539 billion USD)*, Taiwan *(6.183 billion USD)*, USA *(3.313 billion USD)*, South Korea *(3.066 billion USD)*, Germany *(1.471 billion USD),* Netherlands *(1.144 million USD),* UK *(1.031 billion USD)* and Switzerland (*878 million USD*)[187].

Since 2006, China's FDI policy has shifted from export led growth to quality investment supporting domestic led growth. The shift is a result of the general economic policy adopted in the 11th Five Year Plan which set out in detail the Utilization of Foreign Investment. Therewith, **China has decided to shift its policy of attracting foreign business from "quantity" to "quality" and to push its industry up the value chain**.

In a move to create a tax neutral FDI policy, the new Corporate Income Taxation Law (CIT), which went into effect on January 1st, 2008, removed many of the preferential treatments foreign companies previously enjoyed to create a more equal environment[188].

In April 2011 a new draft of the "Foreign Investment Catalogue" was released and the final version was published in December 2011. The new version came into effect on January 30th, 2012, replacing the previous version updated in October 2007. Initially introduced by the NDRC and the Ministry of Commerce in 1995, the catalogue is usually renewed in intervals of three to four year.

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184 Swiss Federal Customs Administration.

185 National Bureau of Statistics; "Statistical Communiqué of the P.R.C. on the 2009 National Economic and Social Development"; February 26th, 2010.

186 MOFCOM: "Statistics of FDI January-December 2012"; January 23rd, 2013.

187 MOFCOM: "Statistics of FDI January-December 2012"; January 23rd, 2013.

188 FDI Invest in China: "Five Major Changes of the New Corporate Income Tax law and the Impact on Foreign Investment in China": June 5th, 2008.

Stipulating “encouraged,” “restricted” and “prohibited” categories into which specific foreign invested projects fall, the Catalog has long been a major guideline of China’s market openness strategies. In order to **continue the promotion of “quality over quantity”**, the following five investment areas shall be further encouraged: high-end manufacturing industry, high-tech industry, modern service industry, new energy industry and energy-efficient and environmentally friendly industries. Preferential policies for land use and tax breaks shall help attract foreign investment into these encouraged categories.

The **new revisions have added more environmentally-friendly and high-end projects to the “encouraged” category**. New energy utilization is rising as one of China’s top interests while attracting foreign investment. New energy-related industries, including high-tech green battery manufacturing and the construction and operation of renewable water plants, have all become new additions to the “encouraged” Catalog. The **newly added “prohibited” items are highly related to China’s current social issues and national interest**, such as foreign investment related to the real estate industry.

Furthermore China is showing a special interest to **channel foreign investment to its central and western regions.** In order to enable these regions to experience a similar development as the coastal areas, tax breaks and labour intensive industries are now formally encouraged in the central and western regions. The final version of the catalogue came into effect in January 2012.[189] .The government also **allows local authorities to approve foreign investment projects up to an amount of 300 million USD**. Previously the cap was set at 100 million USD. Since the cumbersome approval through the central authorities has always been regarded as a major impediment, this change is expected to have an immediate positive effect. Although there are proposals to improve the foreign exchange management for foreign invested enterprises, they unfortunately do not provide concrete instruction on how this should be implemented.

The government also proposes **to expand the scope of utilization of foreign capital** by, for instance, encouraging the participation of foreign capital in the reform and restructuring of domestic enterprises, by means of equity participation, mergers and acquisitions (M&A) and allowing A-share listed companies to receive investment from both domestic and foreign strategic investors[190].

At the beginning of March 2010, **the administrative measures for the establishment of foreign-invested partnerships** (FIP), promulgated by the State Council in December 2009, became effective. China’s Partnership Enterprise Law has been in force since June 2007, but only Chinese domestic enterprises or individuals could become partners. The new measures now provide a framework for foreign-invested partnerships – partnerships between two or more foreign entities or individuals, or jointly with Chinese individuals, legal persons or other Chinese organisations – and therewith a new vehicle for foreign investment. The government will **encourage foreign companies and individuals possessing “advanced technologies” and “management experience” to establish FIPs in China**. Nevertheless, the definition of these two features remains unclear. The current restrictions regarding foreign investments in certain industries also applies to FIPs, however for the allowed industries the FIP measures facilitate investment to China by eliminating the requirement for prior approval by the Ministry of Commerce or its local offices[191]. Partnerships, including FIPs, are not subject to statutory minimum capitalization requirements. The Partnership Enterprise Law provides for a more liberal scope of recognized capital contributions compared to the more restrictive rules for *Equity Joint Ventures* (EJV), *Cooperative Joint Ventures* (CJVs) and *Wholly Foreign Owned Enterprises* (WFOE). However, PRC regulations are unclear about the new structure’s approval processes and downstream investment options[192].

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[189] MOFCOM: “Several Opinions of the State Council on Further Utilizing Foreign Capital“; April 6th, 2011.

[190] FDI Invest in China: “Several Opinions of the State Council on Further Utilizing Foreign Capital”; April 6th, 2011.

[191] FDI Invest in China: “Degree of the State Council of the People’s Republic of China No. 567”; November 25th, 2009.

[192] The China Business Review; September – October 2010; Page 2.

The adoption of China's first Anti-Monopoly Law (AML) in August 2008 was received with mixed feelings by many foreign businesses. Multinational companies feared the law could serve as a tool to allow protectionist measures against foreign companies in China. A main concern is the broad and vague provisions which leave much scope for decision making to the responsible Chinese authorities. From 2008 to 2010, the MOFCOM concluded 214 reviews of concentrations under the AML. The first eight months of 2011 saw 142 filings submitted, and the year-end number is expected to exceed 200[193]. **Regulators appear to use a fairly conservative approach, not using the law exclusively against foreign companies**. So far, only Coca Cola's attempt to acquire Huiyuan – China's largest juice producer – was blocked.[194]

At the end of 2010 the National Development and Reform Commission (NDRC) and the Administration of Industry and Commerce (SAIC) released additional rules that came into force in February 2011 and supply specific standards in determining the activities with respect to price monopoly, reaching monopoly agreement abuse of dominant market position, and abuse of administrative authorities. Additionally the rules also provide relevant authorities with the procedures for the investigation of monopoly-related cases[195].

As of **March 2011, the *Notice Regarding the Establishment of National Security Review Mechanism for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* ("NSR") came into effect**. It covers **all foreign invested M&A touching** either the military and related enterprises or other companies dealing with **national security in a broad sense**, encompassing also M&A that could cause risks to the domestic productivity, the sound economic development or the social order in China. Furthermore, it also includes investment in major products or projects in the fields of farming, resources, energy, infrastructure, transportation, technology and equipment manufacturing. Foreign investment subject to the review includes all transactions which involve foreign investors obtaining "actual control" over domestic enterprises and goes beyond the simple case, where the investor secures the majority of the shares, and also includes cases such as the foreign investor exercising control through Intellectual Property Rights, etc[196].

It remains unclear whether this new regulation is only the written record of the practice unofficially followed in the past or possibly a new tool for blocking unwanted foreign investment, since both the scope of concerned enterprises as well as the criteria which qualify a foreign investor obtaining "actual control" over a domestic business, are kept fairly broad. In either way, **Foreigners are still excluded or confined to a minority participation in particularly sensitive or strategic sectors** of the economy[197]. Furthermore, the withdrawal of capital and profits from China is possible, but barriers remain and make the process complex and tedious for businesses.

Foreign companies are increasingly voicing concerns **that the business environment in China is deteriorating and foreign investment is no longer welcome**. Especially the State Council's attempt to promote "indigenous innovation" – a plan to support the creation and commercialization of domestic technology by requiring products to have Chinese intellectual property in order to qualify for the government procurement catalogue – was strongly criticized[198]. In April 2010 the government decided to soften those rules and pledged that foreign companies shall not be discriminated in the Chinese market[199]. **On different occasion, high-level officials underlined China's commitment to foreign investment**. In September 2010,

[193] Jones Day: "Antitrust Alert: China Publishes Two New Merger Decisions Under Anti-Monopoly Law"; November 2011.

[194] Financial Times: "Life after China's Antimonopoly Law", October 20th, 2010.

[195] Wenfei Attorneys at Law Ltd.; "China Legal Report April 2011", Page 2.

[196] Hogan Lovels: China Alert on 14 March 2011: "MOFCOM releases implementing rules on national security review".

[197] FDI: "Decree of the State Development and Reform Commission, the Ministry of Commerce of the People's Republic of China, No. 57".

[198] Wall Street Journal: "Beijing revises procurement policy", April 13th, 2010.

[199] China Daily: "Wen assures Europe on trade, investment options in China", 30 April 2010.

Premier Wen Jiabao assured foreign investors that China is striving to create an open and fair environment for foreign investors. Wen promised that “all enterprises registered in China according to Chinese law are Chinese enterprises” and that equal treatment would be given to products from foreign and Chinese invested companies in government procurement[200].
Nevertheless, China remains a top FDI destination. According to estimates from the CIA World Factbook, **by December 2012, China’s accumulated FDI stock amounted to 1.344 trillion USD**, in a global comparison ranking second behind the USA (2.8 trillion USD).[201] According to the Ministry of Commerce, FDI to China will continue to grow in the long-run due to increasing domestic demand and improving labour quality. However, concerns remain regarding how to maintain a high FDI growth rate in the short-term as China is adjusting its FDI policy in order to channel more investment into the service sector and to its central and western regions[202]. China's foreign direct investment inflows fell 17.5 percent in 2012 from a year ago, extending the longest run of declines since the depths of the global financial crisis[203]. However, the “Capital Confidence Barometer" released by Ernst and Yong China, demonstrated that the Chinese Mainland is still the most attractive investment region in the world, followed by India, the United States, Brazil and Indonesia[204]. According to the MOFCOM, China's inflows of foreign investments have entered an adjustment period; however the quality and structure of investment inflows have improved[205].

Besides the foreign investment coming into the country, **China has also become a source of outward direct investments (ODI)**. By the end of 2012, the total stock of Chinese offshore investment stood at about 502 billion USD, roughly on par with Italy and double Taiwan’s stock[206]. From 2004 to 2011, China’s outward investment grew substantially from 5.5 billion USD to 75 billion USD a year, and is expected to reach 150 billion USD by 2015[207]. According to MOFCOM statistics, the accumulated non-financial overseas direct investment amounted to 58.17 billion USD between January and October 2012, which is an increase of 25.8% in comparison to 2011[208]. Chinese offshore investment began to take off in the past decade, primarily spurred by a drive to secure resources for its industry and need to productively deploy cash reserves, accumulated through exports and profits at home[209]. Chinese companies have taken over stakes in Australian mining enterprises and other outbound resource investment has gone to state-controlled companies, including large deals with Russian and Venezuelan oil companies. China’s investment in Africa attracted attention again in May 2010, when the country announced multi-million investments in the development of cement plants in South Africa and Mozambique, an oil refinery in Nigeria and the mining sector in Zambia.[210]

With its growing foreign reserves, **China’s ODI is likely to grow further in the coming years**. Overall, China's offshore investments are booming. For instance, one third of the Peruvian minerals sector is Chinese owned. Between January and October 2012, Chinese ODI grew 31% in ASEAN nations, 32% in Russia, 16% in the USA and 15% in Japan[211]. Even though the data on China’s outbound foreign direct investment show that Europe accounts only for a relatively

[200] People’s Daily: “Premier Wen assures foreign firms in China”, 14 September 2010.

[201] The CIA World Factbook: “Stock of direct foreign investment - at home” (data retrieved on June 11th, 2013).

[202] China Daily: “Foreign investment slows down”, 16 October 2010.

[203] Reuters: “China January-September FDI slips as officials warn on trade“; April 19th, 2012.

[204] People’s Daily Online: “China still most attractive for FDI”, May 22nd, 2012.

[205] Reuters: “China January-September FDI slips as officials warn on trade”; April 19th, 2012.

[206] The CIA World Factbook: “China” (data retrieved June 11th, 2013).

[207] The Economist: “FDI with Chinese characteristics”, September 6th, 2012.

[208] MOFCOM: “Brief Statistics on China’s Non-financial Direct Investment Overseas in January – October 2012”; November 23rd, 2012.

[209] Financial Times Asia: “Chinese offshore investment set for take-off”; May 5th, 2011.

[210] Economist Intelligence Unit, Country Report China, May 2010.

[211] Xinhua: “China’s ODI surges 25.8% Jan.-Oct.”, November 20th, 2012.

small portion of the country's stock of such assets[212], this share is growing at a fast pace. For instance FDI flows from China increased from about 130 million USD in 2009 to 900 million USD in 2010[213]. The EU is China's largest global trading partner and like the United States, European trade with China remains persistently imbalanced. However, Europe is likely to feel the force of China's outward expansion earlier than the US as European firms arguably have a greater need for cash than American ones and China's huge holdings of US Treasuries give it an incentive to diversify away from its dollar assets, whereas the euro zone is the natural alternative. Surprisingly, China's ODI in the EU fell by 21% year on year to 1.58 billion USD between January and October 2012[214].

Since not only the large state-owned enterprises but also private Chinese companies are often closely intertwined with the Chinese government, **it is sometimes difficult to see where the company stops and the government begins**, which may cause skepticism towards Chinese direct investments abroad and to some extent reflects the difficulties foreign firms are facing in China in terms of mergers and acquisitions. In particular the US and China seem to linger in a Cold War episodes with regard to mergers and acquisitions, as a series of planned acquisitions have died in the hands of bureaucrats or politicians in Beijing and Washington. Other ideas haven't seen the light of day because of fear they would also be blocked.[215]

6.2 Investment flows from and to Switzerland

At present, about 400 Swiss firms with over 900 branches are represented in China, employing several tens of thousands people. **According to Chinese statistics**, Swiss direct investments in China in 2010 amounted to 260 million USD, a decrease of 13% from 300 million USD in 2009. The cumulative Swiss investment in China grew to 878 million in 2012, leaving Switzerland on the 4th rank among European countries and 10th overall.[216]

The **figures on Swiss direct Investments in China published by the Swiss National Bank, differ significantly from the data released by the MOFCOM** as shown by the fact that Swiss direct investments to China amounted to 1.824 billion CHF in 2010 and 4.554 billion CHF in 2011, while the stock of Swiss direct investments stood at about 12.500 billion CHF in the same year according to Swiss statistics.[217]

Switzerland has economic agreements with China regarding investment protection and avoidance of double taxation. **A revised investment protection agreement was signed in 2009 and came into force on April 13th, 2010**. This updated investment protection agreement will allow a higher protection of Swiss and Chinese investments in the respective host country. The main provisions of the agreement cover the handling of foreign investments by the host country, the transfer of capital and investment income, compensation for expropriation and the introduction of new dispute settlement procedures such as the possibility for a company to unilaterally submit disputes to international arbitration.[218]

So far, Chinese direct investment in Switzerland is still modest but started to increase significantly in the past years. As of today there are about 60 larger Chinese companies established in Switzerland. According to Chinese statistics, Chinese investment flow growth reduced by 40% in 2011 reaching 16 million USD.

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212 The Economist; "Capital and companies from China are sidling into Europe"; June 30th, 2011.

213 Economist Intelligence Unit: "Country Report China", December 2012.

214 Xinhua: "China's ODI surges 25.8% Jan.-Oct.", November 20th, 2012.

215 Reuters: "Special Report: The US and China start an M&A Cold War", April 12th, 2011.

216 MOFCOM

217 *Data on FDI are always collected on two sides, in the country that places the direct investment and the country where the direct investment takes place. Since the institutions collecting the data in both countries cannot exchange information on investments due to reasons of confidentiality, the figures issued by different countries cannot be aligned and may therefore vary substantially as it is the case for Swiss and Chinese data on FDI.*

218 EDA: "Bilaterale Abkommen"; December 6th, 2012.

7 Promoting Switzerland in China

7.1 The Swiss Business Hub China (SBH China)

The Chinese leadership regulates all the country's economic activities to the detail and since the state remains the owner of whole areas of the industry, it is also one of the most important actors within the economy. **Regular contact with the authorities at every level is thus crucial for Swiss companies established in China. The official representations of Switzerland – the Embassy in Beijing and the Consulates General in Shanghai, Guangzhou and Hong Kong – therefore have to take on a particular role in the arrangement of such contacts**.

The SBH China is part of the worldwide "Switzerland Global Enterprise" network (formerly named OSEC) and has been operational since March 2002 at the Swiss Embassy in Beijing with a branch at the Consulate General in Shanghai and one at the Consulate General in Guangzhou. The specially trained consular and local SBH-staff offer **services to Swiss SME in their endeavours of strengthening and developing their business relations with China** (services include: market and product analyses; search of distributors, representatives and import partners; individual consulting and coaching; reports on presentation and trade fairs).

Since the beginning of 2010, the Swiss Business Hub also assumes the mandate for foreign investment promotion. The SBH China now also manages the promotion of Switzerland as a business location for potential Chinese investors. The aim is to inform and build on the firm Sino-Swiss relationships which have been established and raise awareness of Switzerland as a first-class business location for setting up regional and European headquarters among the Chinese business owners, entrepreneurs and investors.

7.2 The Swiss-Chinese Chamber of Commerce and SwissCham China

The Swiss-Chinese Chamber of Commerce and the SwissCham China are private organisations registered in Switzerland and China respectively. Among their members are the leading Swiss companies in the trade, industry and financial sectors. The network consists of about 800 companies and individual members. The Swiss-Chinese Chamber of Commerce was first set up in Zurich in 1980 and established a branch in Beijing in 1995. The latter obtained the status of an independent chamber of commerce according to Chinese law in 2001. As a result, two national organizations are operated today with three regional branches in Switzerland (Zurich, Geneva, Lugano) and three in China (Beijing, Shanghai and Guangzhou). **Their purpose is to promote and support the global success of the Swiss business community in China.** Simultaneously, SwissCham China assists a growing number of China-based enterprises in their dealings with Swiss partner companies. Besides the two Chambers, experienced private consultants offer similar services to interested clients.

7.3 Education promotion

The **Swiss public education sector and its institutions have become increasingly attractive among Chinese students.** Despite the fact that Switzerland is mostly known for its hotel management education and that it is considered as one of the most expensive countries, the number of Chinese students in Switzerland has been growing steadily. In 2011 there were 1'358 Chinese nationals enrolled in Swiss education institutions.[219] The good positions of our institutions in various rankings and the fact that more and more programmes on the Master level are taught in English contribute to this growing interest in China. The Swiss representations are actively involved in promoting Swiss education opportunities throughout China. This includes participation at the China International Education Exposition and other similar educational events such as conferences, workshops and presentations at top-universities in China. Identification and selection of the top students is increasingly becoming the main challenge. On the other hand, interest of Swiss students in studying in China is also growing. Apart from language and

[219] Bundesamt für Migration

culture, a few Swiss follow classes in art, traditional Chinese medicine and engineering. Chinese universities also host increasing numbers of Swiss students for semester long academic stays as part of university exchange programs. In 2011 the number of Swiss students pursuing university courses in China reached 673.[220]

A "**Memorandum of Understanding" on Higher Education Cooperation** was signed by Swiss Federal Councillor Alain Berset and Vice Minister Du Zhanyuan in 2012. The declaration of intent aims to consolidate and intensify cooperation between the two countries in the fields of science and research. The memorandum concerns the promotion of academic exchange programmes for young researchers through government scholarships, The new memorandum raises the number of scholarships offered by both countries from 20 to 25 per year. Up to 30 tuition waivers will also be available.

7.4 Research promotion

An increasing number of Swiss and Chinese scientists are engaged in joint research projects. Swiss and Chinese research institutes are collaborating more and more on an institutional basis, for instance by means of regular exchange of faculty and staff. Several funding instruments are promoted in this context, including the instruments of the Swiss National Foundation, the EU Framework program and others. The **Sino-Swiss Science and Technology Cooperation (SSSTC)**, a joint venture of the Chinese and Swiss government, is an additional bilateral instrument which aims at encouraging and strengthening academic cooperation between the two countries. The Swiss Federal Institute of Technology in Zurich (ETH) functions as the leading house of the program. The program is designed to promote lasting cooperation between Chinese and Swiss universities and research institutions in the priority areas of life sciences, environment, sustainable urban development, material sciences and medicine (2008 – 2011) as well as renewable energy/cleantech and nanotechnology (2012). On his visit to China in April 2011, Federal Councilor Burkhalter signed a ***Joint Statement on Sino-Swiss Science & Technology Cooperation***, enhancing the scope of bilateral research-collaboration. The new badge for the program is planned for 2013 – 2016. Focus of the upcoming call for project proposals will be the topic of translational biomedicine and medical technology, which is planned for early 2014. Other themes will be identified over the next few months. With this development, the Swiss research community can be part of the rapid raise of China to become one of the leading S&T powerhouses.

7.5 Swissnex

In order to **strengthen bilateral cooperation in the field of higher education, research and innovation**, a swissnex office was opened in Shanghai in August 2008. Swissnex is an initiative of the Swiss State Secretariat for Education and Research and the Ministry of Foreign Affairs, similar offices already exist in Boston, San Francisco, Singapore and Bangalore. The swissnex network is a key component of the Swiss strategic scientific policy for the promotion of bilateral cooperations set by the Swiss Federal Council. It is closely linked to the network of Science & Technology Counsellors and S&T Offices within Swiss Embassies. swissnex China's mission is to create and promote awareness of Swiss excellence in science, technology, innovation and culture, to connect academia and business and to facilitate cooperation between the two countries. Swissnex China has been mandated by various universities and institutions like ETH Zurich, University of Zurich, Universitätsspital Basel and others to fulfill a common mission in China.

7.6 Investment promotion agencies

Switzerland's strengths as an investment location are currently promoted in China by the Swiss Business Hub. Beside this the cantons have their own investment promotion agencies. The Swiss Business Hub, which carries out systematic market analysis and development has

[220] Ministry of Education of the People's Republic of China

organised some high-level seminars, elaborated brochures, manuals and presentations and assists cantons in their own endeavours in the very demanding Chinese market. Switzerland is most actively advertised with emerging globalizing Chinese companies as a location for international headquarters and business control centres. Cooperation opportunities with the very innovative export-oriented Swiss economy are also highlighted. With a number of recent Chinese investments in different parts of Switzerland **the joint efforts of Switzerland Trade and Investment Promotion, the cantons and the service sector have already generated results**. Main competitors in Europe include Belgium, France, Germany, the United Kingdom, the Netherlands and Sweden. Like in other Asian countries, Switzerland is perceived as a prime location in the heart of Europe, but high living-costs and barriers for entry of Chinese workforce are on the flip-side.

7.7 Interest for Switzerland as a financial location, potential for development

Switzerland's reputation as a financial location is generally positive, especially within the Chinese Government, the National Bank and the regulatory bodies of the financial sector. The Swiss Banking Association has been conducting an annual dialogue with Chinese financial authorities since 2006 on issues of mutual interest to Chinese and Swiss financial services industries. The leading Swiss banks, which have acquired minority participations in Chinese banks and insurance companies, regularly receive Chinese officials and financial sector professionals for trainings and know-how exchange.