

China Outlook*

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China Invests \$3 Billion in Private Equity Firm

According to an Associated Press report dated June 27, 2007, Blackstone Group L.P. (“Blackstone”) has completed its \$4.1 billion public offering as well as finalized the sale of a \$3 billion non-voting stake to the Chinese government. The Chinese government will make this purchase through a newly created, wholly-owned investment company.

The Xinhua News Agency, in an article dated June 22, 2007, mentioned that the agreed upon transaction would be for the newly created investment company to buy non-voting shares in the private equity firm at a 4.5% discount of its IPO price. According to this report, the agreement also requires the Chinese investment company to hold these shares for a period of at least four years. (See also www.chinaview.cn, June 23, 2007)

China Jiayin Investment Limited, a state-owned investment company previously in existence, is expected to merge into the newly formed investment company that will hold the Blackstone shares. In a May 21 Xinhua report, Chairman Wang Jianxi stated that the new investment company may also entrust its foreign exchange capital to other leading global asset management firms in order to seek higher earnings.

An Associated Press release dated May 25, 2007 reported the \$3 billion investment in Blackstone’s non-voting shares by the Chinese government as being made in connection with Blackstone’s US initial public offering. The article pointed out that New York Stock Exchange IPO will help Blackstone tap new sources of capital for their multibillion-dollar acquisitions while allowing Blackstone to directly buy into Chinese companies as that nation becomes more receptive to foreign investments. The article also noted the salient impact of this transaction, as many US financial firms, are looking to become a more important part of the Chinese economy while many Chinese companies are looking for experience in becoming global corporate players.

As indicated by another Associated Press article, early this year, China’s foreign currency reserves exceeded \$1.2 trillion with the balance growing by about \$20 billion a month as surging exports bring in a flood of foreign currency. This has forced the Chinese central bank to drain billions of dollars a month from the economy by selling bonds to reduce pressure for prices to rise. Some economists have suggested that as China starts holding its foreign currency reserves in more profitable private equity firms, it could affect Beijing’s purchases of US Treasury bonds.

China Outlook is a newsletter designed to provide you with insights into the China marketplace and how that can impact your business. We hope that this newsletter will be informative for you and would appreciate any feedback you would care to offer.

If you have any comments, please contact our editors: Alex Pan, Debbie Chan, and Peter Kao.

350 S. Grand Ave.
Los Angeles, CA 90071
(213) 356-6000

PwC Observations

China's investment in the Blackstone Group represents a major turning point in Chinese economic policy and how it uses its \$1.2 trillion foreign currency reserve to achieve its economic and monetary objectives.

With its foreign trade surplus, China's foreign exchange balance increases at the rate about \$20 billion each month. As a result of this increase, China is forced to issue additional local currency (RMB) in order to obtain the foreign currency earned by Chinese exporters. One of the key causes of China's recent overheated economy is this continued issuing of RMB. China's domestic stock market is also feeling the effects of this flood of currency and many fear major stock market adjustments.

With the fear of the bubble bursting in the stock market, and in order to stabilize growth in the Chinese economy, the Chinese government recently declared various measures to cool down its overheated economy. One goal of these measures is to reduce the RMB in circulation, thereby tightening the money supply and alleviating some of the pressures of having issued excess currency. The government believes that the establishment of a state foreign exchange investment company is key to fulfilling this goal.

The state foreign exchange investment company would operate by issuing bonds to Chinese domestic investors in exchange for RMB. The company would then use the RMB to purchase foreign currency from the Chinese government, providing it with the foreign funds needed to invest in overseas companies such as Blackstone. The Chinese government would then be able to retire the RMB it receives, eliminating it from circulation.

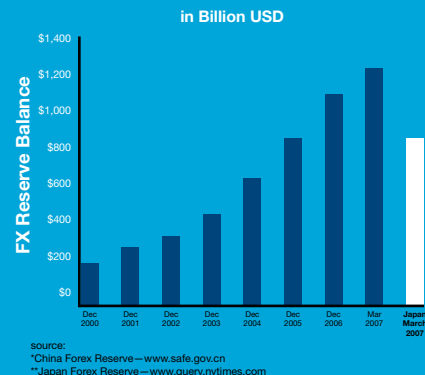
According to a Xinhua News Agency report dated April 12, 2007, China's foreign exchange reserve reached \$1.2 trillion by the end of March, up 37.36% from the same period last year. Based on the Xinhua report, China's foreign exchange reserve reached \$609.9 billion by the end of 2004, \$818.9 billion in 2005 and \$853.6 billion by February 2006, enabling China to surpass Japan to become the largest foreign reserve holder in the world. China's foreign trade has grown by more than 20% annually since 2002 and the ratio of foreign trade to China GDP has increased from 30% to nearly 70% from 2002 to 2007.

It is widely believed that China's trade surplus is one of the primary contributors to this huge foreign exchange reserve. This excessive foreign currency reserve balance had made some Chinese economists and policy makers uneasy.

In the Xinhua report, Mr. Cai Zhizhou, an economist with Beijing University, stated that although China needs foreign exchange reserves to avoid financial risks due to China's dependence on foreign trade, an excessive reserve balance may backfire as it has already brought discord from China's trade partners and could lead to the excess liquidity in China.

As indicated by another Xinhua report dated March 21, 2007, a high-ranking Chinese legislator, Mr. Cheng Siwei, shared his view that China only needs to keep about \$650 billion in foreign exchange reserves and that the Chinese government should facilitate the outflow of foreign currencies by allowing Chinese corporations and individuals greater access foreign currency.

The April 12 Xinhua report also predicted that by 2010, China's foreign exchange reserve balance could reach \$2.9 trillion. As a result, the Chinese government is planning to launch a state foreign exchange investment company to utilize some of its foreign exchange funds for overseas investment.



The government believes that this plan to divert its foreign exchange reserve in private equity firms like Blackstone rather than increasing its holding in US Treasury bonds provides the Chinese government with two principal benefits. First, it provides Chinese investors with a higher rate of return than currently provided by investments in US Treasury bonds. Secondly, it also provides the Chinese government with access to the expertise of world-class private equity fund managers.

Private equity firms such as Blackstone are known for their ability to make profit for their investors by acquiring ailing companies, turning them around, and then selling them at a profit. It is expected that some of the funds raised by Blackstone in its IPO may be used for investing in certain Chinese enterprises or foreign enterprises that produce products badly needed by Chinese companies.

At the current stage of China's economic development, there is no shortage of ailing Chinese companies and many of them could possess latent value that can be developed and utilized. We expect that with the successful conclusion of the Blackstone transaction, there may be an increase in the number of US based private equity firms actively seeking China investment opportunities.

The potential significance of China's investment in Blackstone should not be underestimated. Depending on subsequent developments, this transaction could signal the beginning of a change to the landscape of both the US and Chinese economies. China is currently a major investor in US Treasury bonds and this shift could result in an increase in cost of US Treasury bonds, making it more expensive to finance US fiscal deficits.

Currently, about 70% of China's foreign currency reserve fund is held in the form of safe but low-return US Treasury bonds, US dollar-denominated assets and other government debt. Early this year, high ranking Chinese officials announced that the Chinese government would put a portion of its foreign currency reserve into other investments with higher returns. The success of China's investment in Blackstone may represent a new era in the US-China economic relationship. Meanwhile, US-based companies could take advantage of the opportunities afforded by this change in policy to work with US private equity firms or seek strategic alliances with Chinese enterprises potentially targeted by private equity investors.

China Reduced Export Refund to Curb Overheated Economy and Trade Imbalance

Based on a Xinhua News Agency report dated June 19, China's Ministry of Finance made an announcement that they plan to cut or eliminate export VAT tax rebates on 2,831 commodities representing about 37% of export classifications. The reduced VAT tax refund rates became effective on July 1, 2007. (See also www.chinaview.cn).

During the news conference following the announcement, a ministry spokesman stated that the objective of this new regulation was just "one of a basket of measures to suppress overheated export growth and ease frictions between China and its trade partners".

According to the spokesman, the Chinese government will:

1. Completely abolish export VAT tax rebate benefits on certain "highly polluting products that consume heavy amounts of energy and resources" (e.g., salt, cement, and liquefied petroleum gas)
2. Reduce the rebate rates on 2,268 commodities which "tend to cause trade friction between China and its trading partners"
3. Modify the treatment for 10 commodities to VAT exempt.

Based on the details released, the new tax rebate system classifies export VAT rebate rates into five levels—17%, 13%, 11%, 9% and

5%. The spokesman pointed out that the cost of producing these 2,831 commodities is expected to increase as a result of the changes to the export tax rebate regime. "This would incite capital investment to move to other high value-added and high tech industries, but this would help China develop its industries that can sustain the long-term growth," the spokesman said.

Please see Table 1 for some of the categories of products affected by these new rules. The groups mentioned below also refer to Table 1.

For exporters of group A, the export would likely be deemed "domestic sales" by cancellation of their VAT rebates. The FOB price would be deemed to include the VAT and the "Deemed VAT" and be calculated as follows:

Table 1: Examples of Products Affected by the New Rules

Group	Latest Treatment	Examples of Products*
A.	Cancellation of VAT Rebates	<ul style="list-style-type: none"> endangered animals and plants (including products thereof, such as footwear, wool, furniture, etc.); certain wood panel and single use wood products; and fertilizers; etc.
B.	Reduced VAT Rebate to 13%	<ul style="list-style-type: none"> mixtures of odoriferous substances for the food or beverage industries; etc.
C.	Reduced VAT Rebate to 11%	<ul style="list-style-type: none"> articles of apparel and clothing accessories; footwear, umbrellas, walking sticks, artificial flowers; clocks and watches; certain furniture; toys, games, and sports equipment; and miscellaneous manufactured articles; etc
D.	Reduced VAT Rebate to 9%	<ul style="list-style-type: none"> golf cars, snow mobiles; motorcycles and parts, bicycles and parts; wheelchairs; and certain furniture; etc.
E.	Reduced VAT Rebate to 5%	<ul style="list-style-type: none"> rubber, plastics; paper products such as envelopes, cards, boxes, bags, packing containers, books, notebooks, labels, or toilet paper; certain articles of stone, steel, glass, metal, asbestos, mica and ceramic products; etc.
F.	VAT Exempt on Export	<ul style="list-style-type: none"> certain raw or processed nuts; paintings, drawings, original engravings, postage and revenue stamps; etc.

* As the applicable VAT rebate rate is assessed based on tariff code, which is highly dependent on the nature of the goods and is subject to Customs House's final approval, companies should seek professional assistance if there is any doubt regarding the classification of products.

$(\text{FOB export price} \times \text{RMB exchange rate}) \times \text{VAT rate} / (1 + \text{VAT rate})$

Although input VAT could be credited against the “Deemed VAT,” the total VAT cost on the FOB value would still become part of the cost of goods exported.

In groups B through E, the export VAT rebates would be 2% to 8% lower than the currently applicable refund rate. The difference between the export VAT rebate rate and applicable VAT rate (normally 17%) will become part of the cost of goods exported.

The VAT implications for group F would be that the entire input VAT paid before export would be non-refundable and non-creditable.

PwC Observations

Under the current China export VAT system, the reduction of VAT refund rates is expected to increase the costs to Chinese exporters and potentially make Chinese made goods more expensive for their foreign customers. Depending on the types of products manufactured and/or exported, Chinese enterprises and foreign investment enterprises (“FIE’s”) may suffer an increase in export costs ranging from 4% to 17% of their input VAT incurred during the manufacturing or distribution process.

The Chinese government seems to be imposing this measure in an attempt to direct development toward energy-efficient and environmentally

friendly industries. In addition, with the expected increase in export costs, Chinese government officials hope to use the measure to curb the increasing trade surplus.

It is uncertain what the effectiveness of the changes will be on defusing the tension between China and its trading partners, but with the increase in export costs on Chinese made products, FIE’s should reassess their cost structure and the potential impact on their global operations. Alternatives include considering a production processing upgrade in China or realigning the assembly operations to other Southeast Asian countries such as Vietnam or Cambodia.

Chinese Business Network Contacts

Partners

Alex Pan
Los Angeles
(213) 356-6394

Franklin Lopane
Charlotte
(704) 347-1684

Jim Tapper
Boston
(617) 530-6490

Michael Feder
New York
(646) 471-4555

Michael Ho
New York
(646) 471-0400

Mike Cannon
Houston
(713) 356-5238

Todd Landau
New York
(646) 471-5312

Directors and Managers

Cecilia Lee
Boston
(617) 530-6218

Erik Rosenfeld
Washington, D.C.
(202) 414-3853

Diana Boggess
Philadelphia
(267) 330-2379

Jenny Chong
Atlanta
(678) 419-2325

Jane Liu
San Francisco
(415) 498-5658

Debbie Chan
Los Angeles
(213) 356-6391

The Chinese Business Network

Who We Are

CBN is a US based group within International Tax Services at PricewaterhouseCoopers LLP. We work with our foreign offices to provide tax compliance and consulting services to multinational corporations with current or future operations in the greater China region.

China Outbound

Specializing in both US and China tax laws, we can provide a wide range of services for companies with interest in operating in China. Whether a company needs assistance with expanding their current China operations or with their first ever venture into the country, we have the expertise and knowledge to provide a comprehensive approach to their China operations. We are well versed in China’s income tax laws, value added tax and customs issues, as well as foreign exchange regulations.