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Dealing with Nonconvertibility And Other Financial Aspects Of Doing Business in China
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Deng Xiaoping’s trip to southern China last year to accelerate economic reform has touched off a frenzy of money-making in the country. The Chinese people seem to have adopted as a national slogan Deng’s statement that “getting rich is glorious.” This increased emphasis on money, and the growth that has accompanied economic reform, are changing the country’s financial system. China’s annual GDP growth rate was 12.8 percent in 1992. Within 20 years, it may surpass the U.S. and become the world’s largest economy, according to an Economist of London prediction. Despite these changes, the question of finance in China is not yet an easy one to deal with. Cultural factors and the changing government framework and bureaucracy make it a complicated matter, and one that poses a major challenge to foreign companies operating in the country.

This article examines China’s financial system, describes the financial aspects of doing business in China, and discusses some of the problems that the nonconvertibility of the local currency poses for foreign joint ventures in the P.R.C.

China’s Banking System

Since the late 1970s, China’s economy, including its financial system, has gone through a fundamental restructuring, with changes so substantial and sudden that it can be called a financial revolution. Previously, instead of private sector companies, China had state-run enterprises; instead of capital markets, it had subsidies and allotments according to state plans; and instead of foreign trade, it had a practically closed economy. In the last 15 years, this has all changed—at least to a large extent.

Before the financial revolution, the People’s Bank of China (PBOC) was the only bank in the country. It was China’s central bank and commercial bank, and it acted primarily as the budget supervisor. PBOC’s omnipotent role must be viewed against the background of China’s pre-communist history, when the economy was in a shambles, inflation was running as high as 700 percent per day, and several currencies were circulating outside the government’s control. By the late 1970s, however, the financial system had swung to the other extreme: a one-bank system that had become bureaucratic and inefficient and was completely irresponsive to the needs of growing sectors in the economy. Since 1979, China’s financial and banking framework has rapidly incorporated an increasing number of capitalistic principles.

In 1983, the State Council decreed that the PBOC would be solely a central bank that also controlled the so-called “specialized banks” that were established or reestablished in the financial reform process.

• The commercial activities of the PBOC, including its huge network of 25,000 urban branches, were handed over in 1983 to a new entity, the Industrial and Commercial Bank of China (ICBC).

• The rural branch network of the PBOC was absorbed by the Agricultural Bank of China (ABC), which was reestablished in 1979.

• The Bank of China (BOC) was revitalized (it was originally founded in 1912) and became China’s specialized bank for foreign exchange, which, because of the nonconvertibility of the local currency, was regarded as a special commodity. While its monopoly on foreign currency business was soon breached by other Chinese banks, the BOC is still the most internationally oriented P.R.C. bank, with branches in the U.S., Europe and Asia. It also manages a large part of China’s $46 billion in foreign currency reserves.

Other important banks that handle foreign exchange business are the People’s Construction Bank, formerly a department of the Ministry of Finance (MOF), the Bank of Communications, headquartered in Shanghai; the CITIC Industrial Bank, a subsidiary of the financial conglomerate CITIC (China International Trust and Investment Cor-
poration); and the China Investment Bank, which is mainly engaged in on-lending development loans from multilateral financial institutions.

In addition, most major provinces and cities have set up their own quasi-banks, usually named International Trust and Investment Corporations (ITICs), and in recent years, a number of smaller Chinese banks have been set up in the coastal regions. The "specialized" banks are not well known, yet they are huge, strong and cash rich. Foreign businesspeople may come across them as L/C opening banks or as on-lenders of loans.

Also, a number of foreign banks (around 25 banks) operate about 70 branches in China that assist foreign firms with foreign currency business such as documentary credits, loans, remittances, deposits, and so on. 1

Foreign Exchange

One of the most important features of China's financial system is that the local currency, the renminbi (RMB), is not convertible.

It could be said that until 1968, there was no foreign exchange problem in China: all international trade was conducted in pounds sterling. This changed when the British government devalued the pound overnight by 14 percent, effectively reducing the value of all Chinese exports. The Chinese were unable to make immediate price adjustments and suffered a great loss. From then on, all China trade was conducted in RMB. In theory, that is still the case today.

The RMB is pegged to the U.S. dollar. Before China's economic reform was initiated, the official exchange rate was symbolically set at one to one. The RMB has been devalued regularly over the last years, mainly in an attempt to boost exports. The official rate at the end of July was $1.00 = RMB 5.77.

Foreign Exchange Restrictions

Nonconvertibility was acceptable when China was not a part of the international economic community. But the number of Chinese companies involved in international business grew rapidly, and in 1979 Chinese authorities established a system of hard currency retention quotas to supplement the traditional allocations system. Basically, the quota system meant that companies still had to turn their foreign exchange in to the government but received a certificate in return that entitled them to purchase foreign exchange later. It soon became apparent that a mechanism was needed to redistribute unused quotas. Beginning in 1980, a small over-the-counter market for these quotas developed.

The arrival of foreign invested enterprises on the scene further complicated the matter. These enterprises were subject to the same rigid foreign exchange restrictions as Chinese companies (that is, they could not convert RMB to foreign exchange and freely remit it out of the country), but they had tremendous foreign exchange needs for imports of raw materials and equipment, royalties, expatriate salaries, the repatriation of profits, and so on.

Swap Centers

In response to these needs, regulations were issued in the mid-1980s by the State Administration for Exchange Control (SAEC) that in effect allowed foreign-invested enterprises (FIEs—joint ventures or wholly foreign-owned companies) to enter into the quota market, where they could trade with Chinese enterprises that had a surplus of U.S. dollars. These markets evolved into the Foreign Exchange Adjustment Centers, known as swap centers, or the "official black market." Currently, there are more than 100 swap centers across the country. Their total trading volume has increased rapidly, reaching $20.4 billion in 1991, and $25.1 billion in 1992.

The swap centers functioned relatively well until earlier this year, when demand for dollars far exceeded supply (local state-owned enterprises that trade at the centers became concerned about inflation and depreciation of the RMB against the dollar, and held on to their foreign exchange; foreign investment increased and FIEs' demand for foreign exchange increased). When the adjusted rate, the rate quoted at the swap centers, hit RMB 9.00 = $1.00 in February, the government intervened and set a rate ceiling of RMB 8.10 to the dollar. At this rate, nobody was willing to sell dollars.

As a result of the government-set ceiling, turnover at the swap centers plummeted. In the Shanghai market, for example, turnover fell 90 percent to $2 million per day, compared with the usual $10 million to $20 million per day. An active black market developed.

On June 1, the government was forced to lift the ceiling, and the rate bounced up to nearly RMB 11 to the dollar, almost twice the official rate and the highest level ever. As the government has sold dollars in the market, the rate has dropped to lower levels (RMB 8.8 = $1.00 at the end of July).

The gap between the official and swap market rates is one of the main problems for foreign investors and exporters doing business with China.

Foreign Exchange Certificates

With China's opening to the outside world, and the arrival in the country of large numbers of foreigners, the circulation of foreign currency increased dramatically. Concerned about the illegal flow of foreign currency into the country, the government created a freely convertible buffer currency, called foreign exchange certificates (FECs). Since 1980, all foreign visitors have had to convert their currency into FECs, at an officially posted rate of one RMB to one FEC.

However, since only FECs can be converted into hard currency, a black market in FECs quickly developed, just as was the case for hard currency. At the black market in Beijing, one can currently change an FEC for RMB 1.60.

Somewhat to the PBOC's dismay, three to four currencies are currently widely circulated in China, especially in the special economic zones in southern China: RMB, FECs, the Hong Kong dollar and the U.S. dollar. There have been rumors that the FEC will be abolished in the near future. However, converting the FECs to hard currency would put pressure on the state's reserves.

Capital Markets

China's economic reforms also led to the rebirth of the country's capital market. In 1981, the Ministry of Finance decided to resume the annual issue of Treasury Bills after a suspension of 22 years.
The first Chinese enterprise to issue shares to the public did so in 1984. The Shanghai Stock Exchange opened in 1990 and the Shenzhen Stock Exchange in 1991. The trading of shares has been concentrated in these two exchanges. Gradually, a national system of securities regulation is emerging (see page 9 of this issue for an article on securities regulation in China).

For many Chinese, investing in securities has become a favorite spare-time activity. Chinese citizens hold an estimated RMB 1 trillion in savings, or 38 percent of GDP. Demand for shares far exceeds the supply, and lotteries and other schemes are used to determine who can buy shares.

In 1991, China’s equity market opened to foreign investors, with the issue of so-called B shares, which are traded and settled in foreign currencies (as opposed to A shares, which are traded in RMB).

As of April this year, there were 72 listed companies in China, 22 of which had issued shares to foreign investors. Despite such problems as a lack of reliable information on the financial strength of listed companies, and accounting and reporting standards that do not meet internationally accepted standards, P.R.C. stocks have been popular among foreign investors.

The most recent step was the direct listing of P.R.C. companies on overseas stock exchanges, following the successful initial public offerings of China Brilliance Automotive on the New York Stock Exchange early this year and Tsing Tao Brewery in Hong Kong this month.

International Borrowing

China has also resumed international borrowing activities, and has gradually used more sophisticated instruments to tap the international market.

The first sources of foreign loans were the multilateral financial institutions such as the World Bank and the Asian Development Bank, and, at the bilateral level, the industrialized countries, eager to promote their own exports. China has become the World Bank’s biggest borrower, with accumulated outstanding loans of $13 billion. The Japanese OECF Fund is China’s largest bilateral creditor; it has committed $13 billion to China. Together, the World Bank, the ADB and Japan OECF Fund loaned $3.5 billion to Chinese projects in 1991.

When the Chinese economy started to grow, concessionary loans were supplemented by borrowings on a commercial basis from foreign commercial banks. China’s total outstanding commercial debt was $33.6 billion at the end of 1992.

At the same time, considerable amounts of foreign capital have flowed into the country through direct foreign investment in contractual equity joint ventures and wholly foreign-owned enterprises. In 1992 alone, foreign direct investment commitments amounted to a yearly record of $57 billion, exceeding the total of $48 billion pledged between 1979 and 1991.

Financing Business Transactions

Trade with the P.R.C.

The financing of trade transactions in China is now a relatively straightforward matter. The Chinese banks have extensive correspondent relations with foreign banks and generally follow international payment procedures. Foreign bank branches set up in China further facilitate the settlement of international trade, which takes place through any of the following methods:

- open account,
- advance payment,
- collection,
- guarantees, and
- documentary credit.

Open account and advance payment are relatively simple methods of settlement whereby either the buyer or seller gives credit to the other, and settlement takes place through direct payment. These methods are used by Chinese corporations mostly in the trading of foodstuffs, particularly in the trade with Hong Kong. Because the extension of credit is involved, these methods are normally accepted only if trust exists between the transacting parties.

Another relatively common method of trade settlement is the exchange of title documents through banks, known as “collection.” As these payment methods require the supplier to extend some credit, Chinese suppliers usually accept them only if they have a longstanding relationship with the foreign buyer and regard him as creditworthy.

The majority of Chinese exporters demand payment by letters of credit “at sight”—normally confirmed and irrevocable. Indeed, the largest part of China’s trade (S$167 billion in 1992) is undertaken through such documentary credits. Orders made through Hong Kong middlemen or associated companies outside the P.R.C. are commonly financed by back-to-back L/Cs or L/Cs opened against a guarantee issued by the associated organization in the P.R.C.

Although documentary credit is the most commonly used method of trade financing, China does not formally subscribe to the Uniform Customs and Practices for Documentary Credits (UCP 400), which govern such transactions internationally (China is not a member of the Paris-based International Chamber of Commerce, which formulated these rules). For foreign buyers, this poses no problem, but for those who export to the P.R.C., there are sometimes delays in payment.

For suppliers, the main attraction of L/Cs is that they assure payment from an independent party (a bank) if commercial and shipping documents are presented in accordance with the L/C, regardless of the underlying contract. This is called the “autonomy principle,” and it is fundamental to L/C law and the smooth flow of international trade. Since China is not legally bound by the UCP 400, however, the autonomy principle is not assured. There have been cases in China where shipping documents presented within the framework of a letter of credit were not paid pending the arrival of goods, completely negating the principle basis of documentary credits. In other words, the Chinese importer and the Chinese banks were uniting against the foreign exporter.

An interesting L/C case in this author’s experience illustrates how politics can play a role in trade. In the transaction, a bank in Hong Kong advised a back-to-back L/C to a Chinese receiving bank in Hunan. The bill of lading that was presented to the bank in Hong Kong stipulated that shipment was to take place at a Chinese port. Actually, the goods had instead arrived in Hong Kong harbor. The bank in Hong Kong pointed out that

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in view of the discrepancy, payment could not be made. The Chinese bank in Hunan was furious. It pointed out that Hong Kong was a Chinese port and always had been. The bank in Hong Kong responded that China had no sovereignty over Hong Kong, at least not until 1997. The argument began to escalate until the Chinese bank’s head office stepped in and resolved the dispute, agreeing with the bank in Hong Kong, but in the meantime, at the request of the bank in Hong Kong, the bill of lading was amended by the exporter.

Such incidents are increasingly rare, however. Chinese banks are becoming more concerned with their international reputations and have staffs with a larger number of well-trained people. The Bank of China is said to require its bills officers to comply strictly to the UCP 400. In recent years, several L/Cs originating in the larger coastal cities have had undertaking clauses that are in full conformity with the requirements under UCP 400.

As a rule, exporters seek to minimize their risk when an L/C issuing bank is in a distant country and unfamiliar to them. The advising bank in the exporter’s home country is commonly asked to add its confirmation to the L/C to take over the exporter’s risk. Chinese banks, however, do not allow foreign banks openly to confirm their L/Cs as this would imply that the foreign bank is questioning the Chinese bank’s creditworthiness. The Chinese banks insist that their strength is beyond doubt and that any foreign bank that implicitly questions this strength is not a suitable correspondent banking partner. Hence, in practice, the confirmation of L/Cs from China takes place silently—that is, without any disclosure to the Chinese issuing bank.

For similar reasons, P.R.C. banks make documents under L/Cs payable at their own counter. So, technically speaking, documents are found in order by the issuing Chinese bank.

**Lending to Entities in China**

The larger export transactions and the establishment of subsidiaries and joint ventures in China usually require loans from various sources, including foreign commercial banks. Some of the more common financing structures for foreign currency loans to entities in China are discussed below. As noted, the nonconvertibility of the RMB precludes foreign banks from dealing in local currency, so the discussion below is limited to foreign currency financing.

**Export Finance**

OECD countries and institutional creditors such as the World Bank and the Asian Development Bank (ADB) have used various instruments for concessionary loans or so-called mixed credits (soft loans combined with commercial funds) to China, including soft loans, interest subsidies, and credit insurance, or combinations of these.

While financing schemes differ from one creditor country to the other, the OECD countries have sought to prevent unfair competition in this area. Export credit finance is subject to OECD regulations, the Guidelines for Officially Supported Export Credits, known as the OECD Consensus. The Consensus regulates, for example, the level of interest rates charged on export credits from OECD countries, as well as financing procedures and structures. In most cases, these funds are borrowed in the form of buyer’s credits by the Chinese specialized banks (like the Bank of China, the China Investment Bank and the Ministry of Finance), which subsequently on-lend the funds to local enterprises.

Unlike many OECD countries, the U.S. has no specific aid program, and the lack of one has sometimes hindered American exporters competing with European and Japanese companies with support from export-tied soft loans. Last year, however, the OECD established criteria that limit the use of soft loans to projects that are “not commercially viable.” In theory, only infrastructural and some environmental projects that do not generate a return on investment or a foreign exchange cash flow are supposed to be eligible for tied-aid financing. For other soft-funded projects, like those supported by World Bank, ADB and OEFC funds, procurement is conducted through international bidding.

In some OECD countries, export credits are channeled through commercial banks. In the U.S., the export credit system revolves around the U.S. Export-Import Bank, which supports U.S. companies by providing insurance, guarantees or loans on a buyer’s or supplier’s credit basis, depending on the value of the export contract and the program that is being used. U.S. Eximbank finances up to 85 percent of eligible capital goods and services, with the remaining 15 percent paid in cash or borrowed from commercial banks. The Bank of China, PCBC and the Shanghai SITCO are usually the borrowers in such transactions, mostly on a long-term fixed rate basis.

Generally, the Chinese expect foreign exporters to bring along concessionary loans in hard currency to enable the Chinese to purchase the exporter’s products. When insufficient funds are available, co-financing with foreign commercial banks is possible. The ADB and the IFc, for example, offer such co-financing schemes, which have proved to be efficient means for securing large amounts of foreign funds.

In many cases, however, the foreign company is not able to secure soft loans and will have to arrange funding on a commercial basis from foreign commercial banks.

**Financing Structures**

Before a foreign bank agrees to extend a loan to a project in China, it naturally evaluates the risk involved and the viability of the project. To do so, the creditor scrutinizes the profitability of the business and the environment in which it operates, among other things.

Such information is easily obtainable in industrialized countries where the legal and administrative framework is well developed. In China, however, the situation is very different. The legal system is rooted in different concepts, and official policies and procedures are traditionally surrounded by a sense of “secrecy.” Many regulations are labeled as nei bu, or internal, and are therefore not disclosed to foreigners.

The term nei bu, in fact, is often used in business negotiations. To give an example from my personal experience, when I was negotiating a lease agreement with the Chinese, the company involved raised its price by 30 percent overnight. When asked why, the Chinese simply said that it was nei bu de shi, or internal affairs. They claimed...
that they had overlooked a "regulation" that had been issued by higher authorities, so the matter was simply nonnegotiable.

In Western countries, banks usually secure their loans by mortgages or other legal claims on assets of the borrower. In China, however, there is not yet a mature mortgage law protecting the interests of foreign banks. Nor—in case the claim would be respected by Chinese authorities—is there a developed secondary market where a foreign creditor can liquidate his legal title on the assets. Also, Chinese authorities generally regard legal claims by foreigners on Chinese property as a "political," and therefore sensitive, matter, involving not just legal arguments.

For these reasons, certain typical financing structures and procedures have been developed in the P.R.C. These are briefly described below.

**Guarantees and On-Lending**

So far, the most common structure for financing larger capital projects, whether joint ventures or not, has been a foreign loan guaranteed by a Chinese entity of considerable strength and repute, or by the foreign investor partner. Also common are loans that are borrowed by a Chinese bank or financial institution, which subsequently on-lends the proceeds to the end-user.

In these structures, the foreign lender's risk, legally speaking, involves not the project so much as the guarantor or on-lender. This does not mean that foreign banks do not scrutinize the viability of the project thoroughly.

In view of the RMB's nonconvertibility, foreign banks focus first of all on the capacity of the project to generate foreign exchange, either by exporting or by obtaining so-called import-substitution status. A project with import-substitution status can sell some of its products locally for hard currency. Other factors foreign banks consider essential include the experience and make-up of the management (which is of crucial importance in Sino-foreign joint ventures), the cost and availability of necessary raw materials, and the project's access to the domestic or overseas market.

**Approved Forex Borrowing Vehicles**

In the mid-1980s, the number of Chinese entities engaged in borrowing and guaranteeing foreign currency loans began to increase rapidly, and so did China's foreign debt, which swelled to $66 billion by the end of 1992. Also, there were a few defaults, especially in the hotel sector, which was hit hard by the sudden departure of foreign tourists following the violent Tiananmen Square incident on June 4, 1989. The case of the Golden Flower Hotel in Xian is a well-known example. The loan was guaranteed by a local financial company, but when lenders unhappy with the hotel's occupancy rate of below 20 percent sued, it appeared that the guarantor did not have the central government's support.

To regain control over foreign borrowing and to ensure punctual repayment, the State Council in 1989 designated 10 so-called "windows," including the larger banks and the so-called ITICs, as authorized borrowing/guaranteeing vehicles for international financings. These windows have "permanent" approval from the State Administration of Exchange Control (SAEC) to borrow foreign exchange. In recent years, other entities have obtained ad-hoc approval for international fund raising activities, including joint ventures that have "automatic" SAEC approval on the basis of their business licenses.

**Syndicated Loans**

Loans to or guaranteed by the approved windows have often taken the form of syndicated loans with participation by a number of foreign banks. These loans vary in size from $10-$20 million, for which a club deal with three to four banks is formed, up to as much as $200-$400 million, for which a syndication of 20 to 40 banks is required.

In these structures, a P.R.C. bank or ITIC is often involved as arranger or lead manager. By virtue of its establishment in the P.R.C., the Chinese financial institution is in a position to obtain legal title—on behalf of the foreign banks syndicate—to any collateral on assets located in China. This format can backfire in cases where the loan is rescheduled, as this author experienced when the P.R.C. bank participating in the syndicate "patriotically" took the side of the defaulting borrower and refused to demand payment or seize the collateral.

The term of such loans varies from five to 10 years, although the banks prefer to limit it to seven years. The loans normally carry a floating interest rate of LIBOR or HIBOR plus a margin.

Most of such China loan syndications have been put together in Hong Kong, which in this respect functions as China's offshore financial center. The large number of foreign banks established in Hong Kong, the financial infrastructure, with lawyers and accountants, and its proximity to China make it a natural location for this purpose. Many project financings involve setting up a special-purpose company in Hong Kong, which acts as the financing vehicle for the equity and debt contribution to the joint venture in China.

**Other Financing Structures**

The structures described above have generally been successful, but they are by no means the only financing structures used for deals in China. In fact, the way larger projects are funded has been changing in recent years as guarantees have been increasingly hard to come by. Because of the sheer number and scale of projects that are now proposed for state guarantees, the government has been forced to be more selective in issuing and approving foreign exchange guarantees.

**Limited Recourse Financing**. Borrowers and lenders have been turning to limited recourse financing for the funding of larger projects. These are deals in which money is lent principally on the basis that the project can generate a cash flow.

Occidental Petroleum's Pingshuo coal mine is China's most famous project financing, and it almost became China's most famous financing disaster. A depressed international price for coal and infrastructural problems in China forced Occidental to pull out in 1991. Fortunately, the $475-million foreign banks' syndicated loan was taken over by the Bank of China, a shareholder in the project,
thus keeping China's good international borrowing record intact.

In recent years, a few projects, mainly in the energy and infrastructure sectors, have been on a build-operate-transfer (BOT) basis. The $750-million Shajiao C power plant is a recent example (December 1992). Thirty-five banks eventually signed up for the loan, which will reach final maturity in about 10 years and is priced at one and three-eighths percentage points over LIBOR until project completion, when it drops to one percent.

In the BOT structure, the foreign bank has to look more closely at the project's inherent viability and weigh it against possible project risks. Typically, the foreign company or consortium will operate the project for a specified period of time. In the case of a power plant, the local power authority would contract to buy a certain amount of power at a specified price over the life of the deal, usually for 15-20 years. The main problem is that a sales agreement has to be negotiated, which sets power rates 20 years ahead of time on the basis of debatable assumptions about the price of fuel, future Chinese energy policy, and above all, foreign exchange movements.

The Shajiao power plant project circumvented the foreign exchange problem by getting the Guangdong provincial power bureau to pay half the future electricity fees in foreign currency. Lenders were still reluctant to join the deal until this off-take agreement was in turn guaranteed by the Guangdong ITIC. Because of this indirect guarantee, it is not strictly speaking a limited recourse finance structure, but it apparently satisfied foreign banks since 35 eventually signed up and the loan was oversubscribed. The arranger of an $800-million loan in the spring of 1991 for the Hopewell joint venture to build the Shenzhen-Guangzhou super highway had a more difficult time. It was the first such project financing after Tiananmen Square. Creditors are to be repaid with revenue from toll-paying customers.

**Leasing.** Leasing has been fairly popular with smaller Chinese buyers who cannot afford to buy expensive foreign equipment and want to limit the size of their assets. Leasing companies in China, several of which are joint ventures with foreign banks, can buy the equipment on behalf of the P.R.C. importer and lease it to the factory while keeping legal title. After the lessee has met its obligations, it can buy the machinery for a nominal fee. The absence of a developed secondary market for equipment is said to hinder leasing on a wider scale, and it is a relatively unexplored area on China's financial map.

**Equity/B Shares/Bonds.** Another way of raising foreign capital is, of course, through the issue of equity. Foreign invested enterprises with a profitability record have the option to issue B Shares on the Shanghai and Shenzhen stock exchanges. This method of financing is expected to become common in the future. In Hong Kong, several venture capital funds and companies specialize in the China market.

Recently, a number of P.R.C. financial institutions have chosen to issue bonds as a way to attract Eurodollars while circumventing the complex legal questions involved in project financings. The proceeds of the overseas listed bonds were passed on to industrial projects, which probably would not have been able to raise the funds on their own.

**RMB Financing.** Local currency financing, of course, is of great concern to foreign companies operating in China. While in many cases the local partner of the joint venture takes care of RMB financing, in some cases the foreign partner has to deal with this issue. Normally, the P.R.C. banks can provide short- and long-term RMB loans (against certain claims on the joint venture's assets). Because of worries about inflation, however, higher authorities increasingly have prevented local banks from making credits available.

In 1988, the Shanghai Volkswagen Automotive Company, one of China's most famous and successful joint ventures, became the first joint venture to issue local bonds with a RMB 29.5-million issue. Requirements for the issuance of bonds include that the company must have operated for a certain number of years, that the interest rate must be lower than the prevailing rate for loans, and that placement must be by the Bank of China. Volkswagen issued two kinds of three-year bonds, one to individuals, with 10-percent interest, and the other to enterprises, with interest at 5.4 percent plus an option to purchase a Volkswagen Santana car.

To overcome the reluctance of local banks to provide RMB loans, joint ventures, or their foreign banks, have sometimes deposited foreign exchange with the local bank as security for the loan. This structure is officially called a foreign exchange mortgaged RMB loan. Thus far, its use has been limited because local banks cannot exceed certain RMB loan quotas even though foreign exchange security deposits are made.

**Operating a Foreign Invested Enterprise**

As noted, the nonconvertibility of the Chinese currency poses a tremendous problem for foreign companies operating in China.

The ability to achieve a balance of foreign exchange is a criterion for approval of joint ventures and other foreign-funded projects. Since China's main objective in attracting overseas investment is to increase rather than decrease its foreign exchange reserves, joint ventures, in principle, should meet their hard currency needs through exports. For joint ventures that make products considered import substitutes or that introduce advanced technology, this criterion is relaxed, and they may sell their products in the domestic market for hard currency.

The primary mechanism for balancing foreign exchange is through the swap centers, discussed above. However, most swap centers are rather illiquid, as many companies, fearing further devaluations and inflation of the local currency, are holding onto their dollars. Moreover, the high rate of exchange for the dollar—it reached almost RMB 11 in June—represents a considerable loss for many investors, who made capital contributions to their joint ventures at the official rate of RMB 5.7 to the dollar.

The problems arising from the nonconvertibility of the RMB are likely to remain for the foreseeable future. In any event, foreign affiliates would be well advised not to rely solely on the swap markets, but to explore other options for foreign exchange balancing as well.
the methods used are the following:
- dollar invoicing of part, or all, of domestic sales;
- swapping RMB earnings for foreign exchange with the local government or central government department from their respective retained foreign exchange earnings;
- reinvesting RMB earnings into other projects in China, which will be considered foreign capital investment with preferential treatment;
- swapping foreign exchange with other joint ventures in the investor’s group;
- purchasing products made by Chinese enterprises with the joint venture’s RMB earnings and generating foreign exchange through exporting these products.

The methods of balancing foreign exchange are usually arranged during the initial approval of the project proposal. Most large joint ventures have special foreign exchange arrangements specified in their contracts. These include the proportion of total output for dollar-invoicing and so on.

Such promises are not always kept, however, as the American Motors Beijing Jeep joint venture found out. It was agreed that Beijing Jeep could sell its car locally, with 60 percent of the price paid in hard currency. When the local buyer saw its foreign exchange allocation reduced, however, it refused to pay in hard currency. The authorities resolved this problem only after the U.S. partner stopped shipping parts to the joint venture and production stopped.

Continuing Development

The question of finance certainly poses a major challenge to foreign enterprises operating in China. From a historical perspective, however, there is no reason to be discouraged.

In the past 15 years, China has come a long way in its ability to accommodate the demands of international commerce and finance. This movement is bound to continue, with the possibility of China’s reentry into the GATT and other developments pressuring the government to reform further the Chinese banking system and gradually move toward full convertibility of the local currency.

The continuing inflow of foreign investment into China’s service industry, including the establishment and increased activity of foreign banks in the country, will also help make the country’s financial system more transparent and accessible to foreign businesses.

Footnote
1ABN AMRO, with offices in Beijing and Shanghai, is one of a number of foreign banks in China. In addition to assisting with foreign currency transactions such as documentary credits, loans, remittances, deposits, and so forth, ABN AMRO also provides general counsel on the China market.

SINGAPORE

Goods and Services Tax

(Continued from page 8)

whether or not purchase invoices or sales invoices have been settled.

GST is therefore borne only by the final consumer. As each registered supplier pays only the GST attributable to the value added content of the goods and services during his particular stage of the production and distribution chain, the final amount of GST remains the same regardless of the number of stages in the chain. (See the example below.)

The Singapore GST will be charged at a single rate of three percent on the value of:
- goods and services supplied in Singapore by any taxable person in the course or furtherance of a business, including goods that the taxable person may take from his business for his private purpose; and
- goods imported into Singapore by any person. Imports of goods are liable to GST on their importation into Singapore regardless of whether the importer is registered with the Comptroller. GST will be levied on the value of the imports including customs duties. The tax will be collected by the Customs and Excise Department as agent for the Comptroller.

The government has indicated that it will keep the GST rate at three percent for at least five years. It has also indicated that even after the five-year period, it will not raise the rate so long as it does not need more revenue.

The proposed Singapore GST rate and the current GST or VAT rates in various Asian countries are listed below:
- Singapore—3.0 percent (proposed)
- Indonesia—10.0 percent
- Japan—3.0 percent
- Korea—10.0 percent
- Philippines—10.0 percent
- Taiwan—5.0 percent
- Thailand—7.0 percent.

Zero-Rating and Exemptions

An important feature of the GST is the distinction between exempt goods and services and zero-rated goods and services. Goods and services that are zero-rated are liable to GST, but the applicable rate of tax is zero. Therefore, a registered business that deals only in exports will be able to claim a refund of GST paid on all business inputs. However, a business whose activity is either wholly or partially exempt will not be able to claim any credits for GST paid on business inputs attributable to the exempt activity.

Only exports will be zero-rated. Although purchases of goods by tourists are effectively exports, the government does not plan initially to implement a system of refunds to tourists in view of the low GST rate and high exemption threshold. However, the government has indicated that if tourist shopping turns out to be badly affected, it will introduce a system of GST refunds for tourists taking goods out of the country.