Charltons - China News Alerts Newsletter - 13 August 2008

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# China News Alert Issue 253

## Capital Markets

### Compulsive forex settlement cancelled

China's modified foreign exchange (forex) rules allow domestic institutions to retain their forex income, and allow forex income to be deposited in other countries.

Previously, China had compulsive forex clearing policies, where domestic institutions must sell their forex income to designated forex banks, or gain approval to open a forex account with a designated bank.

The modified 'Regulations of the People's Republic of China on the Administration of Foreign Exchange' (Regulations), released on 6th August, encourages the outflow of capital, simplifies the administrative examination and approval procedures for overseas direct investment, and provides administration procedures for overseas entities to raise fund domestically, for domestic entities to invest in overseas securities and derivative product transactions and for domestic entities to provide commercial loans to overseas entities.

Also, the new Regulations improve the monitoring of cross-border funds and establishes an international guarantee system.

[Source: Lexis Nexis](http://hk.lexiscn.com/latest_message.php?id=4493) ([see archive](Compulsive_Forex_Settlement_Cancelled.pdf))

### New forex rules seek to balance capital flow

China's revised foreign exchange rules have been taken as an effort to curb speculative capital inflow, but analysts say they mainly aim to balance capital outflow and inflow, and close loopholes in the previous forex regime.

The new rules, which went into immediate effect on 6th August, will play a role in curbing the influx of speculative capital, analysts said.

The new regulations provide heavy penalties for improper currency transfer and conversion. Analysts said the regulations are in response to the fast growth in the country's foreign reserves, which have amounted to about US$1.8 trillion, part of which is believed to be speculative money aiming for exceptional returns as the yuan appreciates.

The regulation stipulates that authorities will impose penalties of up to 30 per cent of the capital involved in any unauthorised inward or outward foreign currency transfer; in severe cases, the penalties could be more than 30 per cent, but will be lower than the amount of the involved capital.

For those who fail to use the capital in the way they claimed, such penalties also apply.

Economists said that as China unpegged the yuan from the dollar in July 2005 and allowed it to appreciate gradually, a large amount of foreign speculative capital has managed to flow into the country seeking higher returns. Domestic traders, for example, can inflate their export claims so that they can settle more foreign currency as trade revenue.

Such capital could also enter the country disguised in foreign direct investment funds, analysts said. In the first half of 2008, China's realised foreign investment was 52.39 billion yuan, up 45.6 per cent year-on-year, while newly approved foreign investment projects dropped by 22.1 per cent. Although the conflicting data is attributed to the increasing investment scale of individual investment projects, there may be some speculative capital flowing in as investment funds, said Bian Xubao, a macroeconomic analyst from Qilu Securities.

After such money enters the country, it often goes into the real estate market or the stock market, pushing up asset prices. Once such capital starts to flow out of the country, it could cause asset price declines and could possibly lead to a financial crisis, as in the case of the 1997-98 Asian financial turmoil.

Such capital, also called "hot money", could inflate the country's money supply, increasing price pressure when China is fighting inflation.

Such "hot money" has started to flow into China on a large scale since 2003, said Lu Zhengwei, an economist from the Industrial Bank. Divided on the exact amount of such capital, economists estimate that it could amount to several hundred billion US dollars or even up to US$1.75 trillion, according to the highest estimates.

The new rules, amending those set in 1997, give authorities more control over trade transactions, allowing them to check invoices to ensure trade revenue is not being inflated as an excuse to bring unauthorised money into the country. Authorities are also allowed to expand reporting requirements for financial institutions, thus enhancing monitoring of illegal capital inflow.

The regulations also stipulate that when the country's international payments suffer severe imbalance or the national economy encounters a serious crisis, the country can take necessary safeguard measures to tackle the situation.

"It is the first time the country has put in place a mechanism for dealing with an international payment crisis," said Zhao Qingming, an analyst with China Construction Bank. The recent financial woes in the US, the eruption of a financial crisis in Vietnam and the recent signs of increasing inflow of speculative capital make such a mechanism very important, he said.

An important part of the new rules deals with outflow of capital, which used to be strictly controlled.

China used to lack foreign exchange reserves in the early years of its economic reform and opening up. The previous 1997 regulation, therefore, stipulates mandatory settlements of foreign currency to increase foreign exchange reserves.

Now that China's foreign exchange reserves have actually become an issue contributing to many liquidity-related problems, such as inflation, the new regulation has eased controls.

[Source: China Daily](http://www.chinadaily.com.cn/bizchina/2008-08/12/content_6926977.htm) ([see archive](New_forex_rules_seek_to_balance_capital_flow.pdf))

## Taxation

### Hong Kong citizens may have to pay tax for transfer of mainland stocks

China's State Administration of Taxation (SAT) has introduced regulations concerning Hong Kong citizen's income generated from the transfer of shares or other equities held in mainland companies.

If the beneficiaries have directly or indirectly held over 25% of the shares of the mainland company within the 12 months prior to the transfer, mainland tax authorities will require tax payment for the income.

The rule is contained in the SAT's second protocol to the 'Arrangement between the Mainland and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income'.

For Article 4 of the second protocol, stipulating that at least 50% of the property of related companies must be real property within 3 years prior to the share transfer by related share holders, the second clause of the exchange letter between the mainland and Hong Kong tax authorities emphasised that in practice the calculation should be based the book data at the end of a fiscal year.

[Source: Lexis Nexis](http://hk.lexiscn.com/latest_message.php?id=4511) ([see archive](Hong_Kong_Citizens_May_Have_to_Pay_Tax_for_Transfer_of_Mainland_Stocks.pdf))

## Corporate & Commercial

### Foreign banks allowed to increase loan quota

Foreign incorporated banks registered on the Chinese mainland can now apply for an increased credit quota on the basis of their current credit scale.

According to a notice from the central bank, the additional quota should be used to support small and medium-sized enterprises (SMEs), companies involved in the reconstruction in earthquake-hit areas of Sichuan, and agriculture-related companies.

Insiders from several foreign banks said they had not been notified of the details of additional quota, but most hoped that the scale would be flexible and favourable to banks focusing on SMEs.

In early August, an official from the People's Bank of China confirmed that the central bank would relax its credit policy toward domestic commercial banks. Based on their original credit scale, national commercial banks can extend their loan quota by five per cent while regional commercial banks have a margin of 10 per cent.

Analysts say that the "differential treatment" is set to help SMEs out of financial difficulties, as local financial institutions are the main source for SMEs' fund raising.

Most foreign banks regard enterprises as SMEs if they have an annual business volume of 20-30 million yuan (US$2.91-4.37 million). But the situation in China means that enterprises with such a business volume should be categorised as medium-sized enterprises, a foreign bank manager said.

In addition, it is also difficult to identify "earthquake-zone reconstruction" and "agriculture-related" in any detail.

"The regulators may set a quota for each bank, allowing us to act on our own standards", an insider said.

[Source: China Daily](http://www.chinadaily.com.cn/bizchina/2008-08/11/content_6924040.htm) ([see archive](Foreign_banks_allowed_to_add_loan_quota.pdf))

### Auditor to step up scrutiny of overseas State assets

The National Audit Office (NAO) will increase scrutiny of overseas State-owned assets, as well as fiscal revenue and social security funds, the office said in an online circular posted on 9th August.

"The office will also pay more attention to funds concerning key resources and energy as well as environmental protection," it said.

On the approval of the State Council, the NAO has established two new departments that will specialise in State-owned or central capital-controlled companies and overseas national assets.

Another department was set up to promote exchange and cooperation with international audit organisations.

The total number of departments decreased to 13 from 14 when the first institutional reorganisation of the NAO was carried out in 1998.

Also, as a result of the latest State Council decision, some of the functions of the NAO were removed. These included the examination of local audit regulations and the supervision of certain audit reports by social audit institutes.

[Source: People's Daily Online](http://english.people.com.cn/90001/90776/90884/6471452.html) ([see archive](Chinas_auditor_to_step_up_scrutiny_of_overseas_state_assets.pdf))

### Brokerage cleared for equity bids

HAITONG Securities Company shares inched up 0.17 per cent on 5th August in a declining market after the company received regulatory approval to test private equity investments.

On 30th June the China Securities Regulatory Commission authorised Haitong, the country's largest brokerage by market value, to buy shares in unlisted firms, Haitong said in a statement to the Shanghai Stock Exchange.

The brokerage will set up a subsidiary to run the new business, the statement said.

Haitong said in April that it would apply for a license from the commission to start direct investment with an initial registered capital of 1 billion yuan (US$145.8 million) in the subsidiary and an investment cap of 3 billion yuan.

The company's share price rose 0.17 per cent to 22.96 yuan while the Shanghai Composite Index plunged 1.86 per cent to 2,690.75 points.

China allows brokerages to allocate up to 15 per cent of their net capital for direct investments. Brokers applying for these investments must have assets of at least 2 billion yuan and have been the lead underwriter for more than 10 equity sales worth over 15 billion yuan in total in the past three fiscal years.

In September 2007, CITIC Securities Company and China International Capital Corporation became the first brokers allowed to test direct investment.

Both brokerages established a subsidiary with funds up to 15 per cent of their net assets to keep the business separate, helping to combat any concerns over insider trading or other ethical issues.

Nanjing-based Huatai Securities Company also received the same go-ahead for an initial investment of 200 million yuan.

Other brokerages, including Everbright, Shenyin & Wanguo, Ping An and Guotai & Jun'an, are also applying for a license from the commission, according to the Shanghai Securities News.

Buying company shares before they list can diversify brokerages' income sources in the sluggish stock market as domestic brokerages now earn money mainly by taking commissions from stock trading and share sales as well as from proprietary trading.

[Source: Shanghai Daily](http://www.shanghaidaily.com/article/?id=369425) (Link no longer active)

## Other

### China's new energy rule in the works

The government is drafting an energy regulation to stop new fixed-asset projects that do not meet national energy standards.

With the aim of curbing the investment frenzy and helping China to meet their energy-saving targets, the regulation means investors cannot be given the go-ahead for a project if they do not design detailed energy-efficient schemes.

Currently 10 provinces, municipalities and autonomous regions such as Beijing, Tianjin, Jiangsu and Inner Mongolia have started to put the rule into pilot operation.

"We are going to announce the draft regulation as soon as possible based on the experience gained by pilot regions," said Xie Zhenhua, vice-minister of the National Development and Reform Commission, which is coordinating energy-efficient projects and climate change issues.

If the new regulation is approved and implemented nationwide, it will mean that all new fixed-asset projects will be assessed by the government in accordance with their environmental impact and energy-saving potential.

Xie said the new regulation is drafted in line with China's Energy Conservation Law, which took effect on 1st April.

"Once the regulation is put in place nationwide, we can move closer to our energy-saving targets," Xie is believed to have said at a recent closed-door discussion on the new regulation. "If implemented properly, this can help us stop those energy-crunching projects right at the beginning."

The pilot regions, Xie said, have already made progress by assessing the energy-efficiency potential of new projects. For example, Beijing has strictly enforced the assessment system, which has helped it achieve annual energy saving goals.

However, in some other regions, Xie said there is a "lack of leadership" in implementing the practices stipulated in the energy conservation law. "We should not only monitor those factories in operation but also assess new projects."

Xie said this can require investors to push forward industrial restructuring and technical innovation to gradually weed out outdated production methods.

Currently, the government focuses on previewing and checking the energy implications of projects in real estate, the transport sector and government buildings to improve energy efficiency and reduce greenhouse gas emissions.

Under the 11th Five-Year Plan (2006-10), China has pledged to cut energy consumption per unit of GDP by 20 per cent, or 4 per cent each year. Official statistics show that in 2005, 27.5 per cent of China's energy consumption was in the construction sector, with transportation accounting for 16.3 per cent and government buildings, 6.7 per cent.

China needs "systematic reforms" to achieve its goals of cutting energy consumption, said Lin Yueqin, an economist with the Chinese Academy of Social Sciences. "And the focus should be designing an accountability system to change the local governments' mindset of blindly speeding up investment," Lin told.

Vice-Minister Xie Zhenhua said some local governments are investing heavily in resource-intensive sectors, ignoring the central government's directive to save energy and reduce emissions.

Though the national economy has slowed down, China's investment in fixed assets in the first half of 2008 such as roads and factories reached 26.3 per cent, up 0.4 percentage point year-on-year.

Since 2003, mainly due to local governments' investment frenzy, the growth rate has remained high despite the central government's determination to slow it down. This momentum is likely to continue in the second half of 2008 as the earthquake and blizzards have triggered demand for more construction.

"We should keep the necessary, environment-friendly and energy-efficient projects going," said Lin.

An official inspection last year discovered that only 53 per cent of projects under construction are actually keeping their energy-saving promises. Nearly all of them had pledged at the design stage that they would meet national standards on energy saving.

This disregard for energy conservation requirements by property developers poses a threat to meeting the overall green goal, in which the construction sector is expected to contribute almost 30 per cent of total energy savings.

"The findings are alarming," said Song Chunhua, chairman of the China Real Estate Association. "More tough measures are needed to achieve the national goal."

[Source: Xinhua](http://news.xinhuanet.com/english/2008-08/07/content_9013748.htm) ([see archive](Chinas_new_energy_rule_in_the_works.pdf))

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