

**MARKET MOVER:** Kim Jong-il's rocket launch caused stocks to fall

▶ “These sentiments may not even be rational, but they are there nonetheless,” said Philip Leung, China Business Committee chair at the American Chamber of Commerce in Hong Kong. “Some of the rationale we’ve heard is ridiculous, but it isn’t ridiculous to [the public].”

Public perception is a rather fickle animal and the chances of a business operating in Dongguan or Tianjin having the clout to influence opinion in Europe or the US are rather small. On the other hand, public perception in the US or Europe could seriously disrupt sales at a T-shirt manufacturer or a small electronics firm if it helps lobby groups push individual governments to erect new quotas or trade barriers.

Europe’s complaints, protectionist legislation in the US or Kim Jong-il’s rocket launches represent potentially expensive operational threats outside the sphere of control of investors and businesspeople in China.

### Strategic thinking

“Good planning requires that you think about things not going right, and perhaps going into crisis,” said former diplomat Runckel. “Thinking about how your company would respond, and putting this in writing and sharing this with others in your company is always a good management practice.”

The missile launch in North Korea was not unexpected. The government had been making veiled threats about testing a long-range missile for some time, while the US had been adamant that any such test would be a bad move. Still, when the missiles went up, stocks went down.

“The world market is at a point where it is highly uncertain,” said Leung.

For many light industries, the potential of interference from abroad does not even enter the list of risks they examine. Local economic and labor issues take much higher precedence.

Still, China is the third largest trader in the world. Its ratio of imports to GDP is double the US at 30% and its trade surplus with the rest of the world hit US\$102 billion in 2005. Any factor that may significantly affect foreign trade can seriously impact markets but, ultimately, it may be difficult to develop a single strategy to deal with these widespread risks.

When it comes to geo-politics, beyond being aware, the only solution is to consider a scattergun response strategy, spread the eggs around the baskets and keep an eye on business fundamentals.

“If these fundamentals are in place, the risks are small compared to the market potential,” said Leung. 🇺🇸



## ENERGY

# Looking at alternatives

**Fuel ethanol is already used in five provinces and Beijing seems ready to bankroll a nationwide roll-out. But is a bio-fuel mix a viable alternative to gasoline?**

**C**hina’s oil demands are already the stuff of legend. Urbanization, industrialization and a six-fold increase in private vehicle ownership over a decade have left the country dependant on foreign sources for 40% of its oil. This figure is expected to pass 60% in 2010 and 76% in 2020 as imports go from 4.6 million to 8.5 million barrels per day.

The price is not just financial – the International Energy Authority predicts China will account for 18% of global carbon dioxide emissions by 2025, up from 12% in 2000.

Beijing is taking action. Measures outlined in the 11th Five-Year Plan for 2006-2010 won’t end the dependency on foreign oil and dirty coal, but they should see wind, water, sunlight and nuclear power keeping the lights on for significantly more people than before. Those same people could also be filling their gas tanks with ethanol fuels.

“China needs to import a lot of oil so the government is looking at alternative fuels,” said Christine Pu, energy and chemicals analyst at Deutsche Securities Asia. “The advantage of ethanol is it’s good for the environment.”

Launched in 2000, China’s fuel ethanol industry is still in its infancy. According to GTZ, a German company that advises on energy management on behalf of the German government, total bio-ethanol production is around 4 million tonnes. Three quarters of it is edible ethanol and the remainder fuel ethanol.

“At present it’s largely limited to research institutions and there has yet to be much spillover from the labs into the marketplace,” said Frank Haugwitz of GTZ-China

By the end of 2005, Heilongjiang, Jilin, Liaoning, Henan and Anhui Provinces were wholly dependant on 10% ethanol-90% gasoline fuels (E10), with certain regions in Hubei, Shandong, Hebei and Jiangsu following suit. Studies have shown that using E10 reduces carbon dioxide emissions by up to 3.9%.

GTZ has calculated that a nationwide roll-out of E10 could see fuel ethanol demand reach 8.5 million tonnes per year by 2020.

### Impending expansion

The government appears ready to meet its goal. Four bio-ethanol plants, with production capacities ranging from 200,000-500,000 million tonnes per year, are under development. In the Jilin Fuel Ethanol plant, China already possesses what is believed to be the world’s largest fuel ethanol facility with a capacity of 600,000 tonnes per annum.

The vice-minister for finance said in July that China is committed to a long-term bio-fuel development program, noted Professor Liu Dehua of Tsinghua University’s chemical engineering department, who has been involved in China’s fuel ethanol program since its inception.

“By 2020, liquid bio-fuel production will be 20 million tonnes a year – comprising 15 million tonnes of ethanol and 5 million tonnes of bio-diesel.”

China has also cast its net wide in search of the key to success with fuel ethanol. Professor Liu has been to Brazil twice – most recently in April, accompanying officials from the National De-

velopment and Reform Commission and the Ministry of Science and Technology – to study a system under which all vehicles must run on fuel comprising at least 20% ethanol.

“China wants to learn from Brazil’s experiences in promoting fuel ethanol production and find out what impact using ethanol has on the environment,” said Liu. The officials were also keen to see Brazil’s flex-fuel vehicles that run on varying combinations of gasoline and ethanol.

Thirty years ago, Brazil faced some of the energy challenges that now confront China. It imported 75% of its oil in 1975 and received a series of economic body blows as the price of oil fluctuated during the course of the decade.

The development of fuel ethanol has greatly reduced this vulnerability.

However, experts warn against viewing the two countries as being at separate points on the same developmental path.

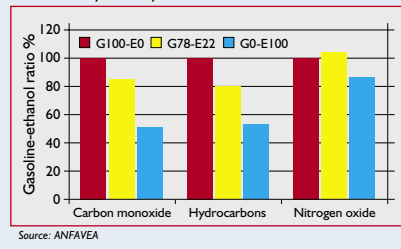
“Brazil used to import a lot of crude oil as China does now,” said Deutsche Securities Asia’s Pu. “But the big difference is that Brazil is a large producer of sugar cane while China uses corn for its ethanol.”

#### Agricultural issues

The situation is complicated by the high priority China attaches to food security. If it’s a choice between corn for food and corn for ethanol, the food need wins hands down. Three of the four large scale ethanol facilities under development will use sugar-based energy crops or sorghum – not only does this resolve the food-or-energy dilemma, but ethanol can be created more

#### Clean solutions

Brazilian study of comparative raw exhaust emissions, 2005



efficiently from these crops.

A GTZ report went so far as to identify potential planting areas in southern provinces such as Guangdong and Guangxi, where the climate is more conducive to growing sugar and sorghum.

“China has multiple choices,” said Professor Liu. “It wants to diversify and can grow corn in the north and sugar cane in the south.”

But the mounting pressure being placed on China’s deteriorating farmland by the growing food demands of an increasingly affluent population means that land use is a sensitive issue. China will be a net grain exporter this year on the back of bumper crops but in the long-term, imports will grow and grow. Despite the food supply pressures, Liu believes farmers will benefit from the fuel ethanol development whether they diversify into sorghum and sugar or stick with corn.

“When the government first started the ethanol program, the price of oil was not high and the attention given to the pollution situation was not great. The reason ethanol production was important was the impact it would have on farmers’ incomes.”

For Beijing-based independent energy analyst Jim Brock, fuel ethanol in China can serve the same purpose it does in the US as far as farmers are concerned – a means of insurance.

Surplus corn that decays before it can be transported elsewhere, or grain that fails to make the grade for human consumption or cattle feed suddenly has an end-use.

“There is not really any conflict between food supply and energy supply,” he said. “In almost all cases, the production value for food is much more.

“It all comes down to having a supply valve so the corn that cannot be used for food is used for energy.”

Ultimately, the rise of ethanol as a viable alternative fuel hinges on the price of oil. A GTZ price comparison earlier this year put fuel ethanol in the region of US\$460 per tonne, although this included a US\$175 subsidy per tonne of ethanol. Production

¥898

## 夏季

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**CLEAN OPTION:** Fuel ethanol is largely pollutant-free



**SECOND-HAND SOURCE:** Oil from KFC fryers can be used to make alternative car fuel bio-diesel

## Wild, wild waste: battling for bio-diesel

While investment in China's fuel ethanol industry tends to be large-scale, government-backed and heavily subsidized, the other arm of the bio-fuels industry, bio-diesel, remains on the outside. Total nationwide production was no more than 60,000 tonnes in 2004 and a national standard for the fuel has yet to be unveiled.

The bio-diesel industry operates under the radar. Rape, sunflowers, soybeans and peanuts – the crops best suited to creating it – are preferred for edible oil, leaving independent producers literally scrapping over secondhand oil from KFC. Welcome to the world of William Kao.

Kao, who for now works under the label of his father's Xiamen-based electroplating firm, first looked into producing bio-diesel from waste oil in 2004. He bought his oil from local suppliers until the unregulated market was monopolized and prices nearly doubled.

Unable to collect oil directly from sources in the major cities because local governments protected preferred operators, earlier this year Kao started sending out groups into the countryside and smaller urban centers. They collect oil wherever they find it: pig farms, kitchen scraps, garages and gutters.

"There is a very profitable after-use market in the food industry," he said. "KFC oil is very good quality and is easy to reuse. We are trying to build a system that can tolerate all different kinds of waste oil – lard, gutter oil, chili oil, palm oil."

From there, the oil is put through a high-heat, high chemical-cost process that removes fatty acids and other impurities, leaving bio-diesel. At least that is what is supposed to happen. "This industry is plagued by con men, people who say they can turn waste oil into bio-diesel, get cheap land and grants, and then get the money and run," said Kao. "The government allowed one man to sell bio-diesel tax-free so he just got standard mineral diesel and put bio-diesel stamps on it."

Kao – whose 30% profit per unit sold is eaten up by one and a half year's worth of spending on R&D and capacity growth – is crying out for better regulation. But he is not optimistic about getting direct government support. "Fuel ethanol has already received way too much in subsidies – it's a bottomless pit," he said. "The government is reluctant to subsidize bio-diesel because of its experiences with ethanol."

costs can be as much as US\$617 per tonne, 70% of it spent on raw materials. Gasoline was priced at US\$616-654 per tonne, although this too included a state subsidy.

Deutsche Securities Asia's Pu points to a rise in global oil prices, together with oil price liberalization in China and technological improvements in ethanol production, as factors that could drive the fuel ethanol bandwagon onwards. It would take a

sizeable spike in crude prices to make fuel ethanol truly competitive; otherwise, it is a question of how much Beijing is willing to spend to find the key to cost-effective ethanol production.

"Is China willing to subsidize ethanol to the extent that it has been in Brazil and the US?" asked Brock. "My impression is no – the government is willing to incentivize but not subsidize."

## MACROECONOMICS

### Walking a fine line

The economy may be red hot, but China's leadership has little appetite for a slowdown. A finely-tuned rebalancing is required

**N**ews that China's economy expanded 11.3% in the second quarter, its fastest rate of growth in 12 years, did nothing to quell the premonitions of a hard-landing if China does not take drastic measures to cool its economy.

The failure of curbs introduced after first-quarter growth hit an already strong 10.3% simply added to concerns.

"There is agreement that the economy is growing too rapidly for China's own good, that it is not a sustainable recipe," said Stephen Roach, global chief economist at Morgan Stanley. "The government has taken several actions, beginning late April, to deal with it. So far the actions have not worked and I suspect they will have to take more."

#### Positive outlook

Other economists are not convinced the growth is too hot to handle. Standard Chartered's Stephen Green cites low consumer inflation of 1.3% as reason for hope.

"It is difficult to see what the problem is really in terms of the macro economy," he said. "There are certainly imbalances and potential problems with the exchange rate, but apart from that the economy is growing and it's growing without inflation."

Green argues that major structural reforms in recent years, combined with surging productivity and a new middle class driving consumption in the eastern seaboard cities has given China a little leeway from traditional economic constraints, enabling it to grow faster without inflation, the traditional measure of overheating.

But even if growth numbers are sustainable, there is widespread agreement that imbalances are veering out of control.

Record trade surpluses of US\$13 billion in May and US\$14.5 billion in June, and an acceleration of capital inflows from foreign direct investment and speculative money betting on a stronger yuan, drove China's foreign exchange reserves to a record US\$941 billion at the end June.

In the same month, the money supply grew by 18.4% and fed accelerating investment growth, which rose by 30.8% in the second quarter, well above the govern-