



The Bank for International Settlements' Report: Potential Global Crisis By Justine Davidson

"...the BIS addresses certain issues in the current global economy that could possibly lead to serious problems in the near future."

This report is based on the Bank for International Settlements' 77th Annual Report released June 24, 2007, in Basel, Switzerland.

The Bank for International Settlements (BIS) forecasts all manner of dismal future trends in its 77th Annual Report. The BIS telegraphs through their report that current global growth is not sustainable and there is a strong probability that the credit boom may ignite a long-lasting global crisis not unlike that of the Great Depression of the 1930s or the East Asian Financial Crisis of the 1990s.

The Bank (BIS) states that recently "real growth has been maintained around levels that are among the highest recorded" and "despite significant upward shocks to most commodity prices, underlying inflation levels have generally remained subdued." The Bank also affirms that "real interest rates and risk premia of all sorts have remained uncharacteristically low" and "global trade imbalances have thus far been easily financed and exchange rates have been generally quite stable." Although some economists believe that this exuberant growth is sustainable, the BIS addresses certain issues in the current global economy that could possibly lead to serious problems in the near future.

Although inflationary pressures are suppressed right now, the threat of global inflation is real as growth in industrialized countries is slowing and growth in developing countries is rapidly increasing. The Annual Report highlights the Chinese

government's failed attempts to slow growth by tightening monetary policies perpetuating "robust broad money and credit growth" that could increase inflationary pressure and has "raised questions for some central banks about sustainable growth." Currently bankers' willingness to extend risky credit to corporations with inflated debt levels is increasing. In addition to increased sovereign, corporate and personal credit around the world, the cost of raw materials is increasing, which will only add to global inflationary pressure. Despite the signaling of these cautionary markers in the Annual Report, the long-term effects of this credit boom are unknown.

Another important uncertainty in the global market is the effect of the all-time high ratio of house prices to rents in the United States. According to the BIS, wages are not increasing sufficiently to support the increase in consumer spending and investment, citizens are increasing personal debt, and mortgage rates continue to rise. If housing prices decline there may be steep deceleration in US growth and dire consequences for social infrastructure. The United States economy still has a large impact on the world economy and any downturn in the US housing market could have significant effects on global growth. According to the United Nations' "World Economic Situation and Prospects 2007," the occurrence of a plunge in US housing prices will considerably weaken global growth and cause problems in financial markets around the world.

Inside This Issue

The Bank for International Settlements' Report: Potential Global Crisis	1
Corporate Social Responsibility: The Asian Impact	3
China's Reformed Tax Code: Striving For More Than Just Growth	4
Private Equity Firms in Asia: An Emerging Presence in Emerging Economies	6
China's Energy Crunch	7
China's Financial Sector Reforms: The Story So Far	9

(Continued on Page 2)



The Bank for International Settlements' Report: Potential Global Crisis

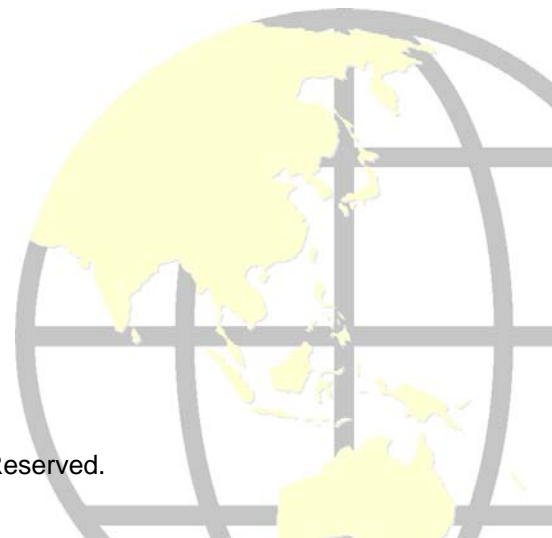
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The Bank comments that global trade imbalances are important medium-term uncertainties. Many economists believe that the US external imbalance is unsustainable and will eventually adjust. According to the Annual Report, the uncertainty lies in the possibility of "large and perhaps abrupt movements in exchange rates" or whether "capital inflows needed to finance such deficits will be available" in the future.

The Bank asserts two reasons to explain how public sector inflows may become unreliable. First, country currencies may rise as a result of government "hands-off" policies rooted in distorted beliefs regarding effects of government intervention. Second, current holders of large reserves of US dollars may start to favor reserves in other currencies.

The Bank acknowledges that many people believe "individual asset price increases are justified and therefore more likely to be sustainable" but it also portends that "market reaction to good news might have become irrationally exuberant." If the latter is the case, purchasers of risky investments could be vulnerable in the long run. Banks, global players, and companies have been encouraged to invest in risky instruments based on low expected loss, but there is a probability of an unwelcome shock that would have massive consequences.

Based on the above excerpts from the Annual Report and the economic analysis of all the issues affecting the conclusions stated in the report, it appears that the global economy is vulnerable and growth may not be sustained.





Corporate Social Responsibility: The Asian Impact By Shivani Singh

Over the years, Asian companies have begun to realize the significant effects that corporate social responsibility can have on businesses, employees and stakeholders alike. The move towards building more socially responsible enterprises has been gradually gaining momentum across the region. In recent years, many Asian governments have initiated a series of measures aimed at encouraging private organizations to participate more effectively in community development projects.⁽¹⁾ This, they believe, will not only help raise the economic welfare of the local populace but also result in a more equitable distribution of domestic economic resources. Such steps are critical if the end goal of preventing the lopsided concentration of economic power in the region and ultimately promoting social stability are to be achieved in the near future.

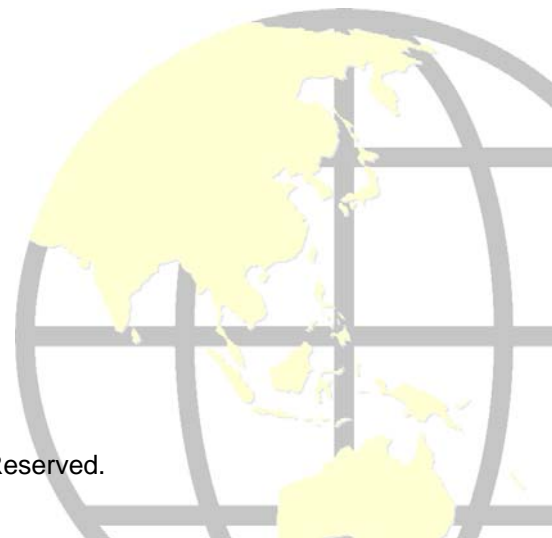
CSR: The Story So Far

Corporate social responsibility (CSR) is not an entirely unknown concept in the Asian region. In the past, national leaders like Indira Gandhi of India and Lee Kuan Yew of Singapore, have stressed that local businesses should act with a greater sense of responsibility and consider the social, moral and environmental consequences of their enterprises and their resultant effects on the safety and well-being of the communities which they serve⁽²⁾. However, the overall record of many countries on the ethical business front has been disappointing. This has been attributed to factors like poor work conditions prevalent in many factories existing in the low-cost manufacturing hubs of the region and the lack of concerted efforts on the part of local governments to enforce stricter compliance standards for both domestic and foreign companies. In recent years, much criticism has been directed toward developed countries for using developing nations as a dumping ground for “e-waste” and other environmentally hazardous materials. There has been a spike in the number of mass protests and demonstrations being staged by international and local human rights groups to highlight the abysmal work conditions and massive exploitation of human labor being carried out in particular countries. Also, certain organizations like India’s ICICI (Industrial Credit and Investment Corporation of India) are already leading the way in terms of incorporating more employee-centric policies and promoting a greater degree of transparency in their financial reporting and public accountability standards⁽³⁾. These organizations clearly believe that the private sector should play a greater role in improving infrastructure, health and safety standards in the local economies and act as a

catalyst in the broader economic development process. Even corporate heavyweights like Nike have started implementing better corporate standards in Indonesia after the backlash they received in the international news media over the unfair labor standards.

Future of CSR in the Region

Despite all the above measures, the overall success on the CSR front remains largely limited. There are several corporations who believe that advancing the greater common good and realizing bigger profits are mutually exclusive goals. Also, questions have been raised about the efficacy of the CSR initiatives undertaken by the companies in the region. It is believed that the kind of CSR that merely goes through the motions, delivering no new resources to worthy causes gives the firm’s workers or customers no good reason to think more highly of it (perhaps the opposite) and may ultimately involve a net loss of welfare.⁽⁴⁾ This occurs when the costs of enforcing the requisite CSR measures outweigh the overall social welfare gains realized.⁽⁵⁾ Therefore, organizations that desperately want to be perceived in a flattering light by the general public must rationally consider the potential costs and resultant benefits arising from the various socially responsible initiatives that are implemented. Only then can corporate social responsibility truly fulfill its role of achieving a fairer distribution of resources, thereby disseminating the benefits of social welfare across the various strata of society across the Asian region.





China's Reformed Tax Code: Striving For More Than Just Growth

By Ryan Tang

Since the 1970s, China has sacrificed domestic growth for export growth through foreign investment. By the close of 2006 China had approved 594,000 foreign enterprises with a total investment in China of USD 691.9 billion.⁽¹⁾ Such sacrifices have rewarded China handsomely with consistently high GDP growth.

One of the catalysts that has driven such enormous volumes of foreign direct investment has been the dual income tax law, providing large tax concessions to foreign enterprises and putting domestic enterprises at a huge disadvantage. When China first opened up, the large tax advantages granted to foreign enterprises provided the necessary level of attraction to drive much needed foreign investment.⁽²⁾ But domestic competitiveness, WTO compliance, corruption issues, and a dynamic socioeconomic environment have culminated in a recent transformation of the tax code that will level the playing field for domestic and foreign enterprises.

Problems Arising From Current Enterprise Tax Law

For years, the dual income tax system has heavily favored foreign investors to domestic ones, creating a disparity in tax burdens between the two classifications of enterprises. The average effective income tax burden for domestic enterprises is 25 percent versus 15 percent for foreign enterprises. When tax holidays and other incentives are added into the equation, the effective tax rate for foreign enterprises can be as low as 10 percent.⁽³⁾ Not only are domestic enterprises at a huge disadvantage; the government is as well. Such comparatively large concessions granted to foreign enterprises have meant a significant loss in government tax revenue, resulting in low revenue yields.

To add insult to injury, corrupt domestic enterprises gain foreign enterprise status by simply transferring funds, most notably to the British Virgin Islands where there are low corporate tax rates, and reinvesting the funds in China in order to take advantage of the "tax refund for reinvestment" law. Under this law, investors that put their money in a foreign enterprise are eligible to receive a 40 percent tax refund on the investment. This tax law has resulted in the British Virgin Islands' status as the second largest source of foreign investment into China by 2006, with half of all registered companies in the British Virgin Islands being of mainland China origin.⁽⁴⁾ Such disproportionate tax rates have culminated in China's placement as one of the ten worst business tax systems around the globe,

as ranked by the World Bank.⁽⁵⁾

Enterprise Tax Reform

Beginning January 1, 2008, foreign enterprises will not have such an advantage. Nearly three decades after China started promoting foreign investment, political leadership has finally decided to take a step back, and in timely fashion as economic and social conditions have dramatically changed since dual taxation went into effect. A new enterprise income tax law, which was passed on March 16, 2007, and goes into effect on January 1, 2008, will begin to gradually phase in income tax increases for foreign enterprises. This will happen in an incremental fashion over five years, at which point the income tax rates offered to foreign and domestic enterprises will be unified at 25 percent. Foreign enterprises will not only face a 10 percent hike in their income taxes, but the elimination of other tax incentives like pre-tax reduction and tax refund for future re-investment. Still, the new income tax rate of 25 percent is comparatively low when weighed against global standards.⁽⁶⁾

In lieu of the recent G-8 Summit, it is encouraging to note that China has decided to keep tax incentives for foreign enterprises engaged in environmental protection. Other projects in which tax incentives will continue to be awarded are necessities such as agricultural development, water conservation, production safety, high-tech development and projects concerning public welfare. Small companies with low profits are eligible for a 5 percent tax break while high and new technology companies get a 10 percent tax break, signaling China's continued advocacy of high technology and its benefits. China has moved away from wholesale concessions towards strategically targeted geographic areas and specific industries that are poised for growth. Minister of Finance Jin Renqing hails the tax reform as an "institutional innovation adapted to the new development of China's socialist market economy and a subsidiary measure supporting the country's sustainable development strategy."

Implications of New Enterprise Tax Law

For many reasons this is a good policy. Indeed, a rapidly growing domestic market that has been fueled by higher levels of consumption, corruption directly linked to the enterprise tax laws, and China's accession to the WTO has rendered such large concessions to foreign enterprises unnecessary and problematic. One of the main advantages to the new legislation is that it

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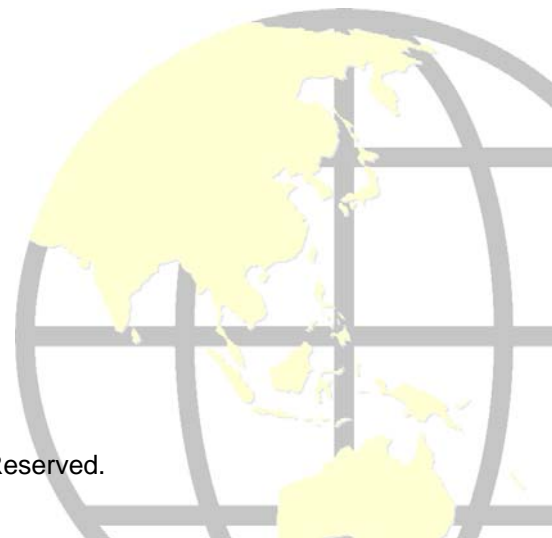
China's Reformed Tax Code: Striving For More Than Just Growth

Continued from Page 4

will provide a healthy boost in domestic competitiveness as a result of their reduced relative tax burden. The increased competitiveness in the domestic market will result in higher growth and ultimately increased profitability, resulting in even greater tax revenue for the government.

The reformed tax code should serve as a catalyst for greater scientific and technological advancement and cleaner environmental practices instead of a constant focus on back-breaking GDP growth that some experts say has caused or will cause an overheating of China's economy. Indeed, multinational firms are already starting to respond to the new law with business strategies even though the law does not go into effect until the beginning of next year. General Electric China, for instance, recently announced a USD 50 million investment in their state-of-the-art technology center located in Shanghai that will fund environmental protection projects such as energy-saving light bulbs, wind power generators, seawater desalination technology, and airplane engines with higher efficiency. The new projects have been termed "eco-imagination" by Steve Bertamini, CEO of GE North East Asia who believes that China's future lies in the business of being "green".⁽⁷⁾

Many experts such as Liang Hong, chief economist for Goldman Sachs in China, and Joseph Lee, a tax and business advisory partner at Ernst & Young, believe that the 10 percent tax increase will not cause a slowdown in foreign investment. China's immense market prospects, operational cost advantages and constantly improving business climate will continue to make China a favorable investment option.





Private Equity Firms in Asia: An Emerging Presence in Emerging Economies

By Shivani Singh

Over the past decade, the amount of private equity deals in Asia has grown exponentially. According to Dealogic, the total value of private equity deals in the Asia-Pacific region, excluding Japan, tripled in 2006 to USD 26 billion.⁽¹⁾ This has been attributed to factors like strong economic growth in the region, severe competition for deals in the developed markets of Europe and America and more efficient local capital markets in the Asian region. Moreover, there exists a vast network of domestic companies in these emerging economies that have an immense desire to acquire global recognition via the expertise and network of foreign investors⁽²⁾. Factors like shoddy infrastructure, poor corporate governance standards, hostile local governments, severe shortage of skilled personnel and a relatively higher cost of borrowing, however, may tend to severely disrupt the current pace of expansion.⁽³⁾ It is critical for the governments of these emerging economies to take the requisite measures to remove the aforementioned shortcomings if they still hope to remain attractive investment destinations in the near future.

Challenges to Growth

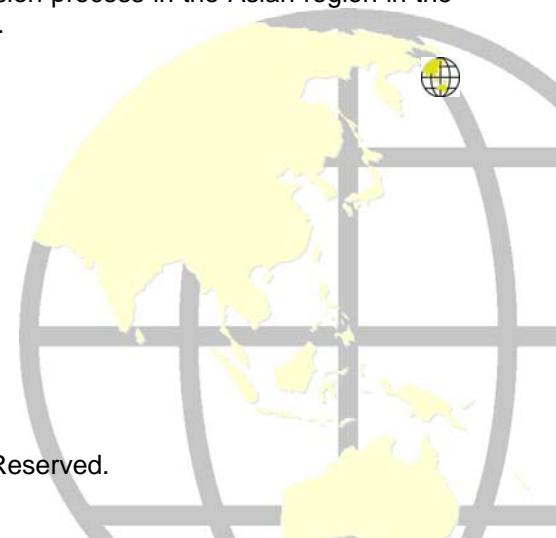
Private equity firms primarily function as follows: They purchase publicly traded companies, take them private, restructure the acquired firms in the hope of reselling these companies at a huge profit a couple of years later. Yet in countries like India—despite the active presence of several heavyweights of the private equity arena like the Carlyle Group, Kohlberg Kravis Roberts & Co, the Blackstone Group etc.—the size and volume of the deals have been comparatively smaller as compared to similar deals being struck in North America and Europe. In fact, most of the big private-equity deals in India so far have involved the purchase of small, passive stakes in companies.⁽⁴⁾ This is an unusual strategy for most of the big players who prefer to call the shots by acquiring a controlling stake in the target companies. In India, this can be explained by the fact that most large, publicly traded companies are family-owned, which makes it extremely difficult for a foreign company to aspire to buy a majority stake. Even more, these private equity firms are viewed with a considerable degree of suspicion by local governments and local citizens. The massive restructuring steps that typically accompany any large private equity deal invariably do result in countless jobs being lost and other cost-cutting measures. Another factor limiting the size of the deals in the region is the fact that most

emerging economies of Asia like China and India remain grossly overvalued, which drives up the prices that the acquirer would have to pay for deals being struck with potential targets. According to a survey conducted by the Tuck School of Business at Dartmouth, most of the private equity firms seek returns of at least 25 percent on their investments in the emerging economies⁽⁵⁾.

One principal reason why bank shares in a country like Taiwan seem particularly attractive to the private equity players is the fact that these shares are some of the region's least expensive, trading at an average of 1.1 times 2007 book value as compared to 1.5 for the South Korean banks and 2.8 for the mainland China bank shares⁽⁶⁾.

What Lies Ahead?

Despite the above setbacks, Asia still has immense growth potential as a region for several private equity players. Industry giants like Texas Pacific, which has earmarked roughly USD 4 billion for the future in the region, desire to make continued investments in Asia⁽⁷⁾. Although these private equity players are driven primarily by the profit motive, they can still prove to be an advantage to the local economies they invest in. They possess the requisite global expertise, immense international experience, a highly professional code of conduct and a wide network. All these strengths can be leveraged by ambitious domestic firms who partner with these firms in the hope of eventually growing into full-fledged thriving global players in the years to come. Thus, the influx of long-term capital into Asia, coupled with the potential advantages that can be realized by the local firms via mutually advantageous partnerships with foreign firms, can help to further accelerate the economic expansion process in the Asian region in the immediate future.





China's Energy Crunch By Ryan Tang

It is well documented that China's energy demand has been increasingly rapidly and at a pace that some say is unsustainable. A study released by the Netherlands Environmental Assessment Agency said that in 2006 China had already taken over the United States as the largest emitter of carbon dioxide: the byproduct of fossil fuel combustion and the greenhouse gas best known for its significant effect on global warming.

China is much less efficient too. For every US dollar of GDP, China uses three times more energy than the global average and 4.7 times that in the United States. In the near future, energy demand will only continue to grow alongside standards of living, as per capita energy consumption is still only one-eighth that of the United States. The alarming fact of all this is that China would exceed total worldwide carbon emissions by 22 percent if it reached the per-capita energy consumption levels of the United States.

Energy Demand

The energy problem derives largely from the fact that much of China's output comes from energy intensive industries. Known as the "factory to the world," China has the largest coal consumption of any country in the world by an extensive margin, consuming 40 percent of the world's coal and nearly twice that of US consumption. Coal generates 80 percent of China's electricity and 65 percent of all energy consumption, supplying nearly all of China's heavy industries.

As the growing middle class buys more cars, demand for oil has also seen a sharp rise. Indeed, China has become the third largest market for automobiles. This rapid expansion will only continue, as forecasts expect this number to increase six-fold by 2020. An oil exporter fifteen years ago, China now ranks as the world's third largest importer. The number of automobiles in the country has tripled since 1995, making car purchases a very large portion of economic activity.

The Problem

China's large appetite for energy can have detrimental effects to consumers and the global environment. On the consumer side, air pollution made respiratory and heart disease the number one cause of mortality in China at 400,000 resulting deaths in 2004. Anecdotal reports liken inhaling China's air near industrial epicenters is equivalent to smoking two and a half packs of cigarettes per day. This can be largely attributed to rapidly increasing use of automobiles that

run on dirty fuels brimming with high sulfur content.

China's environmental spillovers also affect the global community. Already, China's emission pollutants such as sulfur are floating to neighboring countries. The global problem, of which China is in the spotlight, is that the environment will not be able to continue absorbing greenhouse gases resulting in an increase in global temperatures. While it is difficult to determine the magnitude of the effect of global warming on extreme weather changes, rising global temperatures do lead to glacial retreat and a worldwide rise in sea-level. Being the largest emitter of greenhouse gases, China has an environmental obligation to use energy more efficiently.

What is Being Done

China is fully aware of the climate change problem and is taking steps to mitigate its effects. Outlined in their most recent 5 year plan, China hopes to improve its environmental situation through improvements in energy intensity. China's first national strategy on climate change, introduced June 4, 2007, set out to further develop energy efficiency through reforestation, public education and improving regulatory enforcement. While making no formal reduction guarantee, China hopes to improve energy efficiency by 20 percent by 2010.

Air quality is one of the main objectives. China is making efforts to increase the efficiency of automobiles through higher fuel economy standards and a new 20 percent tax on automobiles with low gas mileage and emissions standards. China's fuel economy standards are higher than those of the United States. China has improved mass transit, making it more effective and efficient in order to provide consumers a feasible alternative to automobiles. These steps will certainly reduce emissions and may even reduce oil demand in the transportation sector. China has also been making the transition to natural gas and has put pollution control devices on coal power plants to control SO_x and NO_x, the main causes of smog and acid rain. Fuel Tech, an international leader in air pollution control and boiler fireside and fuel treatment, has worked extensively with China in improving energy efficiency through emissions reduction. As China's Vice Premier noted at an energy conference in Beijing, "Energy efficiency is not just one of our core strategies; it has to be the core energy strategy."

What Needs To Be Done

Despite China's efforts, investment in energy efficiency

(Continued on Page 8)



China's Energy Crunch

Continued from Page 7

as a percentage of total energy sector investment has dropped considerably over the past two decades to one-third of the level it spent at its peak in 1983. China needs to continue promoting renewable energy and adopt carbon sequestration methods.

Furthermore, China needs to continue discussions with the international community on how they can work together to combat climate change. An international market-based approach, akin to the European Union's Emissions Trading Scheme (ETS), could be one solution. While price volatility in ETS has caused some concern over its viability, the addition of China and other countries into the fold will increase the number of market players and thus reduce volatility.

In the absence of an international agreement, China should pursue a carbon tax. Most estimates find that a USD 20 to 25 price per ton of carbon dioxide would reduce climate change to sustainable levels. Through what is called the revenue recycling effect, China could use the funds generated from a carbon tax to improve health care, the pension system, or to re-invest the money into clean energy technologies.





China's Financial Sector Reforms: The Story So Far By Shivani Singh

The Chinese economy has witnessed spectacular economic gains over the past two decades. Several factors like the integration of the nation's domestic economy with the world markets, sound infrastructure, high productivity growth rates, and the recent membership of the WTO have greatly helped the process of rapid economic growth. These factors aside, a complete overhaul of the country's financial system is desperately needed if China hopes to realize long-term stability and sustainable growth of domestic output and employment.⁽¹⁾ In particular, financial sector reforms would help achieve balanced economic growth and result in a more equitable distribution of the nation's productive resources.

The Benefits of Financial Sector Reforms

Currently, China's economy has access to an abundant supply of cheap domestic capital. This has primarily been attributed to its high national savings rate amounting to approximately half of the gross domestic product⁽²⁾; however the crucial problem arises because of the inability of the financial intermediaries to effectively allocate these savings to their most efficient end-users. Moreover, most of the resources available for investment have been concentrated in relatively unproductive sectors such as steel, cement, etc., which may result in the build-up of excess capacity in the nation.⁽³⁾ Because of the lax lending practices of Chinese Banks, many loans are available to the poorly performing domestic state enterprises. This factor, in turn, has compelled the government to spend huge sums of money in order to reduce the levels of non-performing loans currently plaguing China's financial sector.⁽⁴⁾

Extending greater funding to the highly profitable private sector in the nation would generate a significantly higher return for the same amount of investment, thus raising China's GDP by up to USD 259 billion, or 13 percent a year.⁽⁵⁾ Beyond growth rates, such wide-ranging financial sector reforms would generate higher returns for the average Chinese investor, leading to better living standards and higher consumption in the nation.

Areas of Improvement

The Chinese government has initiated a series of measures as part of the broader financial sector reform process. Recently, there has been some degree of progress in improving bank supervision and disposing of the existing nonperforming loans.⁽⁶⁾ Steps have also been taken to tighten corporate governance standards in the banking sector. Additionally, it is imperative to

establish time-bound restructuring programs whereby Chinese banks can be held accountable for their performance levels, especially with respect to meeting their stated targets.⁽⁷⁾ China's recent interest rate liberalization is gradually helping domestic banks to make more commercially oriented lending decisions under which loans are extended to the most efficient users of funds. Also, development of the broader financial sector (including the equity and debt markets) would provide healthy competition to the banks by giving both domestic savers and corporate borrowers access to a broad range of investment and borrowing opportunities.⁽⁸⁾

Still, the path ahead is laden with challenges. The primary among them is the fixed exchange rate regime currently existing in China. Because of the sharp influx of capital inflows into China, the government is compelled to keep interest rates low in order to stem the resultant pressures for appreciation in the domestic economy.⁽⁹⁾ This in turn leads to cheap financing becoming readily available to companies and banks, forcing the government to take steps to control the rapid growth in the supply of capital. This becomes problematic because the principal goal of the banking restructuring process is to enable the banks and the state enterprises to respond effectively to the market incentives.⁽¹⁰⁾ In addition, higher interest rates would limit the amount of funding to the most unprofitable enterprises in both the private and public sector. Therefore, to effectively realize the overall gains that such a broad financial restructuring process entails, the Chinese policymakers have to take much stronger steps to deal with the challenges arising in the financial-sector development process.





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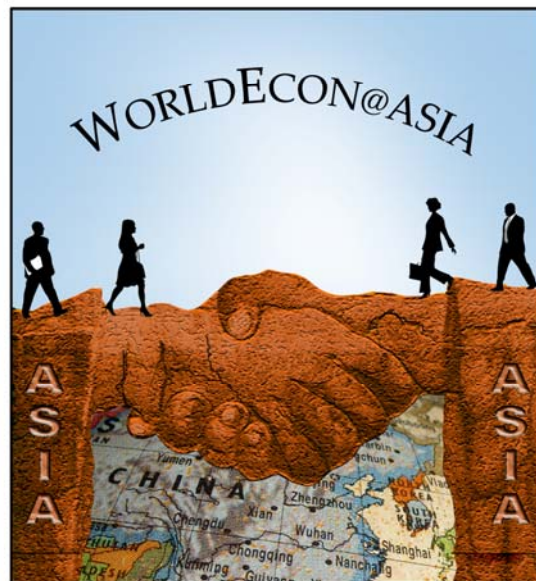
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