China’s Opportunities of Investment during Economic Downturn:
Study on Foreign and Outward Investment Activities

Hong Xie
Centre for the Analysis of Risk and Optimization Modeling Applications
Brunel University
Uxbridge UB8 3PH, West London, UK
Tel: 1-895-265-187 E-mail: Hong.xie@brunel.ac.uk

Abstract
Financial crisis from US heavy shocked great China’s economic, so that financial asset rapid decrease, job market goes down and international trade shrinks. Due to at the beginning of the crisis broke out, a lot of review thought that China economic will not be go out of balance and decreased fast, in adverse, China should to catch up the chance for adjust structure of industries and optimize economic development. In this paper we are going to study how to get the suitable opportunities for make crisis be a favorable factor to promote China economic reform get closely to expectation by the research of foreign and outward investment activities. Moreover through to this study to analysis China foreign and outward invest policy options.

Keywords: Economic crisis, Investment, Opportunities, Strategy options

1. Introduction
The current global financial crisis which began with the downturn of the U.S subprime housing market in 2007, current turmoil is confronting emerging market economies with two shocks—a “sudden stop” of capital inflows resulting from the global deleveraging process, and a collapse in export demand associated with the global recession—that in turn are leading to sharply tighter domestic credit conditions and slumping aggregate demand. This note discusses, in broad terms, the main policy options for emerging market economies confronted by these shocks, recognizing that specific prescriptions must be tailored to individual country circumstances.

Over the past several years, China has enjoyed one of the world’s fastest growing economies and has been a major contributor to world economic growth. However, the current global financial crisis threatens to slow China’s economy. Although its exposure to troubled U.S. sub-prime mortgage securities is believed to be relatively limited, China’s export industries and sectors dependent on foreign investment could be hard hit if the economies of its major trading partners, including the United States, experience a sharp slowdown. This possibility concerns the Chinese government, which views rapid economic growth as critical to maintaining social stability. China is a major economic power and holds huge amounts of foreign exchange reserves, and thus it could play a major role in responding to the current crisis. For example, in an effort to help stabilize the U.S. economy, China might boost its holdings of U.S. Treasury securities, which would help fund the Federal Government’s purchases of troubled U.S. assets. However, this could raise a number of issues and concerns for U.S. policymakers. This report will be updated as events warrant.

2. Current crisis impact on China economic
China’s economy is heavily dependent on global trade and investment flows. In 2007, China overtook the United States to become the world’s second largest merchandise exporter after the European Union (EU). China’s net exports (exports minus imports) contributed to one-third of its GDP growth in 2008. The Chinese government estimates that the foreign trade sector employs more than 80 million people, of which over 30 million works in foreign-invested enterprises. Foreign direct investment (FDI) flows to China in 2008 totaled more than $80 billion, making it the largest FDI recipient among developing countries and the third largest overall, after the EU and the United States.

A global economic slowdown (especially among its major export markets (especially among its major export markets –
the United States, the EU, and Japan) could have a significant negative impact on China’s export sector and industries
that depend on FDI flows. There are indications that the Chinese economy is already slowing down. Chinese real GDP
growth for January through September 2008 was 9.9%, which was 2.3 percentage points lower than growth in same
period in 2007.2 Global Insight, an international forecasting firm, projected in October 2008 that China’s GDP growth
would slow from 11.9% in 2007 to 9.8% in 2008, and to 8.4% in 2009.3 Some analysts contend annual economic
growth of less than 8% could lead to social unrest, given that every year there are 20 million new job seekers in China.4
According to the International Monetary Fund (IMF), China was the single most important contributor to world
economic growth in 2007.5 Thus, a Chinese economic slowdown could also have global implications.

3. Exposures from China to Crisis

The extent of China’s exposure to the current global financial crisis, in particular from the fallout of the U.S. sub-prime
mortgage problem, is unclear. On the one hand, China places numerous restrictions on capital flows, particularly
outflows, in part so that it can maintain its managed float currency policy. These restrictions limit the ability of Chinese
citizens and many firms to invest their savings overseas, compelling them to invest those savings domestically, (such as
in banks, the stock markets, real estate, and business ventures), although some Chinese attempt to shift funds overseas
illegally. Thus, the exposure of Chinese private sector firms and individual Chinese investors to sub-prime U.S.
mortgages is likely to be small.

On the other hand, Chinese government entities, such as the State Administration of Foreign Exchange, the China
Investment Corporation (a $200 billion sovereign wealth fund created in 2007), state banks, and state-owned enterprises,
may have been more exposed to troubled U.S. mortgage securities. Chinese government entities account for the lion’s
share of China’s (legal) capital outflows, much of which derives from China’s large and growing foreign exchange
reserves. These reserves rose from $403 billion in 2003 (year end) to $1.9 trillion as of September 2008.8 In order to
earn interest on these holdings. The Chinese government invests in overseas assets. A large portion of China’s reserves
are believed to be invested in U.S. securities, such as long-term (LT) Treasury debt (used to finance the federal deficit),
LT U.S. agency debt (such as Freddie Mac and Fannie Mae mortgage-backed securities), LT U.S. corporate debt, LT
U.S. equities, and short-term (ST) debt.9 The Treasury Department estimates that, as of June 2007, China’s holdings of
U.S. securities totaled $922 billion, making China the 2nd largest foreign holder of such securities (after Japan).10 Of
this total, $467 billion were in LT Treasury securities, $364 billion were in LT U.S. agency securities, $29 billion in LT
equities, $28 billion in LT corporate securities, and $23 billion in ST debt.

If China held troubled sub-prime mortgage backed securities, they would likely be included in the corporate securities
category and certain U.S. equities (which include investment company share funds, such as open-end funds, closed-end
funds, money market mutual funds, and hedge funds) which may have been invested in real estate. However, these were
a relatively small share of China’s total U.S. securities holdings. China’s holdings of Fannie Mae and Freddie Mac
securities (though not their stock) were likely to have been more substantial, but less risky (compared to other
mortgage-backed securities), especially after these two institutions were placed in conservatorship by the Federal
Government in September 2008 and thus have government backing.

The Chinese government generally does not release detailed information on the holdings of its financial entities,
although some of its banks have reported on their level of exposure to sub-prime U.S. mortgages.13 Such entities have
generally reported that their exposure to troubled sub-prime U.S. mortgages has been minor relative to their total
investments, that they have liquidated such assets and/or have written off losses, and that they (the banks) continue to
earn high profit margins.

For example, the Bank of China (one of China’s largest state-owned commercial banks) reported in March 2008 that its
investment in asset-backed securities supported by U.S. sub-prime mortgages totaled $10.6 billion in 2006 (accounting
for 3.5% of its investment securities portfolio). In October 2008, it reported that it had reduced holdings of such
securities to $3.3 billion (1.4% of its total securities investments) by the end of September 2008, while its holdings of
debt securities issued or backed by Freddie Mac and Fannie Mae were at $10 billion. Fitch Ratings service reported that
the Bank of China’s exposure to U.S. subprime-related investments was the largest among Asian financial institutions,
and that further losses from these investments were likely, but went on to state that the Bank of China would be able to
absorb any related losses “without undue strain.”

However, Chinese banks are not immune to financial problems.16 There are several indicators that China’s economy is
slowing, which could present difficult challenges for the banking system in the years ahead, such as a sharp increase in
non-performing loans. For example, the real estate market in several Chinese cities has exhibited signs of a bursting
bubble, including a slowdown in construction, falling prices, and growing levels of unoccupied buildings. This has
increased pressure on the banks to lower interest rates further to stabilize the market, but has raised concerns that doing
so could result in higher inflation (which, until recently, has been a major problem for the economy).

In addition, the value of China’s largest stock market, the Shanghai Stock Exchange Composite Index, fell by 67% from
Foreign investment companies in the Chinese market include Goldman Sachs, Carey and Prax, of which Goldman’s has $235m, almost double the $103m in 2007, and foreign investors took up more than half of the $235m. The influential $2.62bn within one week. Other data shows that in January 2008, 25 PE investments were reported with a total value of $4.3 Private Equities

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4. China foreign investment

China’s attitude to foreign investment in the current economic turmoil is turning out to follow dual tracks – straightforward financial investment is good, foreign control is bad. There are increasing signs of foreign investment being opened up in capital, particularly bond, markets, property and private equity. By contrast, foreign direct investment is only being welcomed in certain areas, and more restricted in others.

Foreign direct investment policy is more nuanced. More industries are being seen as ‘strategic’, such as automobiles and financial institutions, and the government wants to either protect the IP or control from foreigners. The non-strategic industries, such as logistics and services, are still open game, though, and restrictions on energy saving industries are being removed. Moreover, there is the ongoing battle between central and local governments over FDI, with local governments desperate to attract as much as possible, but central government more mindful of the economic and strategic impact of such investment. While the policies on foreign ownership of securities houses, asset managers and banks are unlikely to be lifted (particularly not after the recent ignominious exit of the foreign banks from the Chinese domestic ones), the main routes to encouraging greater investment are likely to be: (1) to raise the QFII limits substantially, (2) introducing more foreign currency products (such as foreign currency bonds through Hong Kong), (3) easing the examination and approval process for investment, and (4) to gradually improve convertibility of the Yuan.

4.1 QFII Investment

The main channel for investment in domestic securities is through the QFII scheme, which now extends to 70 institutions. The total amount of QFII has reached $30bn, of which $10.3bn has got official approval. The demand for QFII still exceeds supply, with a significant shortfall in quotas for 2009, even after the 65% fall in the equity markets in 2008, as private equity and bonds are more than making up the shortfall. While the policies on foreign ownership of securities houses, asset managers and banks unlikely to be lifted (particularly not after the recent exits of the foreign banks from the Chinese domestic ones), the main routes to encouraging greater investment will be a) to raise the QFII limits substantially, b) introducing more foreign currency products (such as foreign currency bonds through Hong Kong), c) easing the examination and approval process and d) to gradually improve convertibility of the Yuan.

4.2 China Equities

Foreign investment in China’s stock market has dropped significantly over the past few years. The main inflow came in 2006 when the four commercial banks were raising funds from international sources and is therefore a perfect example of capital retrenchment during the economic downturn. ICBC, Bank of China and China Construction Bank raised around $12bn in 2005 from large foreign institutions. Now, three years later, the lock-ins has expired and the original investors need to plug holes in their own balance sheets. Bank of America sold 2.4%, out of its total 19% stake, in China Construction Bank; UBS sold its 1.3% shareholding and billionaire Li Ka-shing his $511m stake in Bank of China. RBS is now expected to divest its £2bn shareholding in Bank of China, while ICBC’s shareholders, Goldman Sachs, Allianz Group and American Express have until 28 April 2008 to decide whether to divest their shareholdings.

Insert Chart 1 Here

While these investments are in some ways technically FDI, as the banks were expected to share technological and operational knowledge in return for the stakes, rather than foreign investment, they are indicative of the massive outflow of funds from the equity market by foreign investors either because of cash calls back at home, or disappointment with the precipitous falls in the Chinese stock markets during 2008.

A lot of the tweaking around the edges, such as the numerous changes to stamp duty, has had little effect on the market, but the announcement of the fiscal stimulus package has contributed to a 20% increase in the CSI 300 index, it may be the case that the government concludes that improving the economic fundamentals will make a greater contribution to the health of the equity markets, and the re-entry of foreign investment, than structural changes.

4.3 Private Equities

In February 2008, JP Morgan, Blue Ridge China II and Orchid Capital IV declared that they had raised as much as $2.62bn within one week. Other data shows that in January 2008, 25 PE investments were reported with a total value of $235m, almost double the $103m in 2007, and foreign investors took up more than half of the $235m. The influential foreign investment companies in the Chinese market include Goldman Sachs, Carey and Prax, of which Goldman’s has made 10 investments and Carey and Prax seven. They have mainly focused on education, catering, manufacturing,
media and new energy. In general, industries particularly favorable for foreign PE investment include manufacturing, transportation, energy, finance, service, resource industries, and retail. However, the restrictions on private equity investment are similar to those of corporate FDI, with strategically important sectors generally excluded from foreign investment, with a few notable exceptions. Moreover, the Chinese government prevents foreign private equity from holding the controlling proportion in investee companies. In addition, private equity must be conducted through the proper regulatory sources, and it is also the case that the government is actively trying to promote the development of domestic private equity, in order to counterbalance the foreign money.

Further foreign investment is now also being hindered by the financial crisis, as foreign private equity is facing financing difficulties for their deals, in common with most other countries, and the flotation of overseas-registered companies as red chips has been temporarily halted. With the IPO channel closed, private equity is instead turning to M&A to exit their investments, with 19 M&A deals totaling $2.6bn in the year to November 30, 2008, compared to $600m the previous year.

4.4 Foreign Direct Investment

Foreign direct investment has been a driving force for China’s economic growth since the 1980s, but the latest data show a significant slowdown in H2 08 and particularly Q4 08, as multinational companies are retrenching. Either they no longer have the capital to invest in overseas expansion, are being forced to close down non-profitable subsidiaries, or have lost faith in Chinese economic growth. As can be seen, along with many other economic indicators, the change in FDI was sharply negative in November 2008, down 36.5%, compared to 64% growth in H1 08.

5. The Outward Investment

5.1 The Build-Up of Reserves

The incredible build-up in foreign exchange reserves owing to the ever-widening trade surplus has only taken place in the last four years, indicating that it is not an insurmountable, or permanent, problem. Although on a medium- to long-term basis, the trade surplus is expected to continue, owing to the structure of the global economy and China’s role as a key manufacturer within that, over the short term, the size of the increase will lessen substantially and may even turn negative in 2009.

In February the trade declined to $4.8bn from $39.1bn in January 2009, owing to imports now falling at a similar rate to exports (-24.1% and -25.7% respectively). Exports decreased 17.5% in January, as opposed to the 43.1% fall in imports. Now that enterprises and the state have started buying commodities for both strategic reasons (of which more below) and use in infrastructure spending, imports are decreasing at a slower rate. This leads to expectations that the trade surplus could actually turn negative in the next few months, as exports continue to drop, but domestic consumption stages a slight recovery. On current outlook, this deficit would be too small to make a big dent in the forex reserves, but if trade significantly worsened then it could start falling just as quickly as it has grown.

In addition, over the longer term, around 94% of the trade surplus was caused by processing imported materials, amounting to US$276.6bn of the US$295.5bn surplus. If the government stimulus package works as intended, more of the imports should continue to go into the domestic economy, as domestic and infrastructure spending, replaces the export market. With less going out, but similar amounts going in, this inevitably leads to a longer term reduction in the surplus.

5.2 Diversifying

The key way in which the state can offset its forex reserves is by buying foreign assets for internal use. As China is a large consumer of commodities, which have reduced in value, buying up resources is an obvious solution. More nuanced is the IP/technology purchasing, where the country is specifically looking for IP to import, rather than empire-building.

5.2.1 Resource

The most high profile purchases of resources have been Chinalco’s $19.5bn investment in Rio Tinto in return for an eventual 20% stake, and Minmetals’ purchase of OZ Minerals for A$2.6bn (US$1.7bn), both of which are being studied.
by the Australian government.

With such purchases expected to continue (respective governments permitting), this has contributed to a 29% recovery in the Global Commodity Index from November 2008, against the 16% fall in the MSCI World Index, with larger rises of 46% for the TSX Materials index.

Aside from the company purchases, however, the State Reserves Bureau is gradually building up the strategic reserves of oil, steel and copper while the international prices are still low. It has not widely publicised these purchases, as it is conscious of the fact that any major buying will prompt price speculation; for example, it is conducting the oil purchases for the state reserve through Sinopec and PetroChina, rather than independently, and using Minmetals for non-ferrous metals.

The latest draft of the stimulus plan for the oil industry is suggesting that oil reserves be increased by 3m tons in 2009, 6m tons in 2010 and 10m in 2012, which at current prices means spending $1bn, $2bn and $3.4bn in those years respectively. China currently has oil reserve capacity of 14m tons at four storage sites, but is building another eight with 27m cubic metres of capacity this year. The Petroleum Commission recommended in December that the government should also use the estimated 200m tons of idle storage capacity in the private sector to build up more oil reserves.

In addition, China entered into an oil-for-loans accord with Brazil and Venezuela and Russia agreed last month to supply China with 15m metric tons of oil a year for the next 20 years in return for US$25 billion in loans.

Details over the copper reserves are more speculative, but the State Reserves Bureau has reportedly contracted to buy 300,000 tons of copper to build up its reserves and may buy up to 1.2m tones. Some of this will come from internal sources, but at current prices, building up a 400,000 ton reserve for the next three years would cost $1.45bn pa.

While there are also plans to build up other non-ferrous metals reserves, including aluminum, tin, zinc and lead, many of these commodities are domestically produced, so will not have an impact on forex reserves. The State Council has also drafted a plan to set up national coal reserves, with a capacity of around 3m tons, but as China exports more coal than it imports, this would only serve to support the local coal miners.

In total, China has in the space of a few months spent $30bn on resources from state, or state-owned sources (if one annualizes the $25bn loan) and is expected to continue to pursue these purchases, although may struggle to find similarly large-sized targets as Rio and Russian oil in an increasingly protectionist environment.

5.2.2 Technologies

The second main way to use forex reserves is by buying foreign technology for use domestically. While China has pursued this strategy for many years, this buy-in method using domestic SOEs as the overseas purchasers may now be seen to be a more attractive way of developing domestic markets than attracting FDI for joint ventures in China.

First, it is a better development path for SOEs and strengthens their positions in their markets as they will own the technology, rather than just trying to copy it.

Second, FDI has been falling in recent months as foreign companies and investors retrench and pull back their investment plans in China. Car manufacturers are among that are still planning to increase investment.

Third, foreign companies in dire financial straits may be more willing (or at least less reluctant) to sell some of their technology to the highest bidder in order to bolster their balance sheets. The best example of this is, of course, MG Rover in the UK, where the 2004 rescue of the company turned into farce, and SAIC was able to buy the company, but not the brand name, for £53m. It then released a car based on the Rover 75 model within a year.

5.2.3 SOEs Urged to be More Prudent

There were only 12 cases of Chinese enterprises’ buying American enterprises in 2006, amounting to US$70m, and 21 in 2007 amounting to US$8.5bn, including Morgan Stanley and Blackstone. In 2008 there were 22 worth a total of US$917m. Due to the financial crisis, however, these SOE overseas assets have suffered from heavy losses and have led to mounting debts.

As a result, SASAC’s overseas investment approval has become stricter, with new investments and acquisitions having to meet higher standards and the risk management strengthened. The central SOEs investing overseas are required to first beware of risks and SASAC says that the government requires central SOEs to be prudent in three areas: a) overseas investment and acquisition; b) investment with high risks, such as financial derivatives; and c) the strategic investment besides the enterprise’s major business. Of the three types, overseas investment is seen to have the highest risks.

Meanwhile the private sector accounts for around 11% of the number of overseas investments, and around 20% of the value in 2007, although public limited companies and private enterprises only had $3bn of foreign investment. Although private companies are being encouraged to invest overseas, many have been hit hard by the financial crisis, and probably will not step back into the market until 2010.
5.2.4 Importing IP

The main market speculation has been whether Chinese financial institutions or car makers will step in to save the ailing Western companies. There seems to be little chance of another financial sector transaction being approved under the stricter guidelines, following the losses on Morgan Stanley, Blackstone and Fortis. Although there is a desire for the expertise of long-established financial groups, the Chinese companies are still seen to be too wary of the potential losses from the sector, as well as the problems of trying to learn from and integrate companies whose whole business models are being undermined.

The car manufacturers hold more promise, as the technology can be transferred, but purchases such as Hummer would appear to be antithetical to the government’s pro-small car auto stimulus package.

So far, the most concrete move was the European trade trip, which focused on electromechanical devices and equipment, including autos, machine tools, telecom equipment, and aircraft engines. Enterprises engaged in the purchasing group included China Unicom, Hainan Airlines, China National Aero Technology Import and Export Corporation.

The total amount agreed was more than the $15bn yuan expected and included a $1.1bn deal between Hainan Airlines and Rolls-Royce, including flight stimulators, $2.2bn of orders for BMW and Mini cars, and $300m on Swiss machinery, chemicals and pharmaceutical products.

While direct imports of goods were the main deals announced, this trip demonstrated that the main focus for Chinese purchasing is domestic transfer of technologies. The key areas were 3G mobile phone technologies in Germany, aerospace technology in the UK and Germany, and energy saving technologies in Germany and Spain. As well as being areas of strategic focus for building domestic strength (the TD-SCDMA technology, the space plan, and the high installed renewable capacity), they are all readily importable technologies in areas where China does not yet have a domestic lead.

6. Retaining Value

The combined total of these commodity and technology asset purchases in 2009 alone is an estimated $45bn on an annual basis, equal to a total commitment of $77bn (including the entire Russian oil loan and all three years of the reserve purchase plan). While impressive, it only accounts for 2% of the forex reserves in 2009, or 4% overall. Although we expect the overseas purchases to continue, they may only reach a total of 10% by the end of the year, leaving 90% of forex exposure to manage.

Around 70% of this forex exposure is estimated to be in US$ securities, equivalent to US$1.3bn. The Chinese government is therefore stuck in a situation where it has to minimize losses on this exposure and choose the least value-destructive way of paying down some of these assets.

The largest holdings are US Treasuries, and it has so far continued to support the US government issues, notably in late 2008, when purchases went from around $15bn in July to $66bn in October during former Treasury secretary Hank Paulson’s last visit. The rate in November and December slowed down, however, with the amount in November $29bn and December around $15bn.

Although the Chinese does not want, or need, to keep buying Treasuries in such large amounts in 2009 it is expected to continue to fund purchases as this protects both the value of the bonds themselves as well as the value of the dollar.

*Insert Chart 3 Here*

The difference will be that China is expected to focus on the short end, as this will avoid the threat of future US inflation eating into the value of the holdings over time. This may lead to a shortage of demand at the long end and will also hinder the US in inflating its way out of debt.

There are, however, calls for some US$ assets to be sold both to fund domestic stimulus packages and overseas acquisitions. In the table above, the US Treasury figures show China to have very low holdings of corporate debt and equities in June 2007. There is general speculation that the holdings in equities surged during 2008 to substantially over $100bn by June 2008, however, while corporate debt is also considered to be substantially more than the figure reported in 2007.

For equities, with most of the holdings likely to be in Dow Jones index companies, the size of these shareholdings will have fallen by 42% since June 2008, leaving an estimated $80-100bn of equities remaining. Although selling these equities would realize these losses, this is potentially preferable to selling down Treasuries, as the total amount of losses would be 300bn-500bn yuan, rather than potentially over 1trn yuan.

Selling down equities is also more politically palatable, as there is the counter-argument that the Western governments are selling down Chinese equities. From a domestic perspective, this has taken the form of the Western banks selling the stakes they bought in the Chinese institutions in 2005, with 60% UK state owned RBS selling HK$18bn shares in Bank of China, UBS selling US$808m, US government-backed Bank of America selling US$2.8bn in CCB, and Goldman
Sachs, Allianz and American Express due to start reducing their stakes in ICBC in May. Instead of holding US$ equities, the $200bn state investment fund, CIC has instead suggested that it may keep a closer eye on the Taiwanese and Hong Kong markets as places for investment.

7. Conclusion
China has made great strides in its reforms to open up its market for foreign direct investment. Among developing countries, China is now the largest recipient of foreign capital. Foreign direct investment is still concentrated in the southeast and the coastal areas, even though we see a slow process of diffusion. Foreign-invested firms have played an increasingly important role in Chinese economic reform. It is also a large part of China’s trading activities with the rest of the world. While there may be some differences in interpretations with respect to the role of foreign investment in raising China’s GDP, few would deny that without foreign investment, China reform will eventually suffocate. China foreign and outward investments need a re-structure policy options during the crisis in the world.

References


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Chart 1: Foreign Investment in Chinese Equities

Source: SAFE

Chart 2: FDI by Month, 2008

Source: MOFCOM

Chart 3. Top 5 Holders of US Securities

Source: US Treasury
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<th>Sector</th>
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<td>Agriculture, Forestry, Husbandry &amp; Fishery</td>
<td>0.6</td>
<td>-17%</td>
<td>33%</td>
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<td>Manufacturing</td>
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<td>27%</td>
<td>24%</td>
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<td>Telecom and electronic equipment</td>
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<tr>
<td>Electronic Appliances</td>
<td>3</td>
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<tr>
<td>Non-Financial Service Industry</td>
<td>14.7</td>
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<td>Property</td>
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<td>98%</td>
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<td>Social Service</td>
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<td>104%</td>
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<td>Retail and Catering</td>
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<td>52%</td>
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<td>34%</td>
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<td>Financial Insurance</td>
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Source: SAFE