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# RISKS TO WATCH

# CHINA

China has pulled through the global economic downturn with robust growth and enhanced international sway, but that is now creating strains of its own at home and abroad.

## CURRENCY AND TRADE DISPUTES

The United States and China have been wrestling over the level of the yuan, and the **G20 summit in Seoul did little to resolve currency pressures**, now compounded by Beijing officials' misgivings about Washington's fresh round of easy-money policies. The worst of the **recent political tensions over the yuan** may nonetheless have receded for now. Pressure from the U.S. Congress could ease after the Republicans made big gains in midterm elections. Republicans have generally been more reluctant than Democrats to impose trade sanctions against China over the currency dispute. Before it adjourned, the U.S. House of Representatives had passed a bill that treats the "undervalued" yuan as an export subsidy and allows the U.S. Commerce Department to impose countervailing duties on Chinese products. That bill is considered unlikely to become law. But China is not out of the woods yet. The U.S. Treasury has delayed a decision on whether China manipulates its currency until after the G20 summit.

Chinese President Hu Jintao is due to visit the United States in January, a symbolically important trip for him. That could **give the White House a little more leverage in seeking commitments from China**, and will probably discourage any sharp public bickering in the run-up to the visit. China has made clear it resents pressure to allow the currency to appreciate, but political considerations play an important role in its management of the yuan. Rising disquiet about Chinese trade policy in the United States could be exacerbated by broader tensions over Tibet and Taiwan and the South China Sea.

The recent settings of the yuan exchange rate suggest that Beijing may feel the worst of the recent pressure has passed. The yuan's appreciation has ground to a halt following a spike from September to early November.

### What to watch:

- The speed of the yuan's climb -- or lack thereof.
- Rhetoric from Washington and Beijing. Both sides want to avoid any serious dispute but also to protect domestic industry and maintain popular support at home.
- The debate in China. A top-down political system limits outright clashes between officials with rival views on the currency, but tracking public comments can provide useful hints on the direction of policy.

## REGIONAL TENSIONS, MARITIME DISPUTES

Tensions between China and Japan have eased, but **a confrontation between North and South Korea is proving troublesome for Beijing**, under pressure to rein in Pyongyang, which **relies on China for economic and political support**. The latest confrontation is unlikely to unravel into a wider military confrontation, but it could fester and add to discord with Washington, which has urged China to use its economic and political sway to bring its ally North Korea to heel.



Another worry for China is that the dispute will intensify unease in South Korea and Japan, already seeking to shore up ties with Washington. Seoul was already displeased by Beijing's non-committal response after a South Korea concluded that the North was responsible for torpedoing one of the South's navy ships in March. **Chinese diplomacy appears to be moving faster this time in an effort to mollify Seoul without offending Pyongyang.**

**A confrontation with Japan in September** after a Chinese fishing boat captain was detained after colliding with two Japanese patrol vessels in disputed waters in the East China Sea intensified **distrust between the two countries that continues to cloud their efforts to resume normal relations**. Because both countries claim the waters around East China Sea islets - called Senkaku in Japan and Diaoyu in China - the case inflamed their broader dispute over the area, which has plentiful fish and may be near valuable oil and gas reserves.

Both governments are now trying to put the dispute behind them but don't want to be seen as giving ground over territorial claims. Tensions could flare again. But Beijing and Tokyo will try to calibrate their sparring to avoid turning the quarrel into an outright rift, which could unsettle regional markets. **A serious falling-out could unnerve investors**, especially Japanese firms seeking access to Chinese markets and infrastructure spending.

Attendants stand in a line to pose for a picture outside the Great Hall of the People in Beijing, during the second plenary meeting of China's parliament, the National People's Congress (NPC) REUTERS/ Jason Lee

## RISK DATA

<b>Sovereign foreign currency:</b>	
S&P	A+ (stable)
Moody's	A1 (positive)
<b>World Governance Indicators:</b>	
Voice & Accountability	5.2
Political Stability	29.7
Govt Effectiveness	58.1
Regulatory Quality	46.2
Rule of Law	45.3
Control of Corruption	36.2
<b>Eurasia Group:</b>	
GPRI score	62
<b>IHS Global Insight</b>	
Country risk	2.87
Sovereign	A- (positive)
<b>Economist Intelligence Unit</b>	
Sovereign risk	BBB
Political risk	B
Country risk	BB

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**What to watch:**

- China's diplomatic footwork, attempting to ease tensions between North and South Korea without becoming embroiled in the standoff between the two countries, both of which Beijing would like to keep as friends.
- Flare-ups in tensions with Japan that could unsettle diplomatic cooperation and trade.

**RARE EARTH ANXIETIES**

China's dominance of rare earths used in high-tech products has prompted growing anxieties after evidence the government has curbed shipments, possibly out of political pique or because sharply reduced export quotas are petering out. Japanese companies have borne the brunt of these disruptions, while customers elsewhere have mainly reported jumps in prices. Some firms say they have stopped output because of the problems. The Japanese government has repeatedly expressed concern and other governments of consumer countries have also voiced worries, especially Germany and the United States. China produces about 97 percent of the world's rare earths. That means its policies in the sector ripple across the world, and companies and governments will be eager for clarity on the direction of policy. Delays could escalate the issue into a more volatile trade dispute, with the possibility of a complaint to the WTO. Chinese officials from Premier Wen Jiabao down have said that their government is not using its rare earths as a political weapon or a bargaining chip for trade advantage.

**What to watch:**

- Chinese policy announcements that could signal the outlook for export supplies; in particular, quota volumes and rules for next year and beyond.
- Indications from companies, especially in Japan, of the state of supplies, which could vary for different types of rare earth minerals. So far, companies appear to be reporting strains in supplies, but not outright exhaustion which could lead to serious production disruption. That could change.
- Signals that other governments are ratcheting up pressure over the issue beyond expressions of concern. That could turn the rare earths issue into a more contentious political dispute, or a trade row that could end up before the World Trade Organisation.

**MANAGING THE PACE OF GROWTH**

After worries about a housing bubble and unsustainable levels of local government debt in the first half of the year, some investors began to worry that government efforts to take the market off the boil could have a chilling impact on economy. But after slowing over the summer, the economy appears to be humming again. Food price rises have jumped to the forefront of government worries. Inflation is far from out of control. Consumer inflation, which rose 4.4 percent in the year to October, remains well below levels in early 2008. What worries Beijing is the sudden and unexpected jump in prices, especially for food, a touchy point for many Chinese workers. The government is paying close attention to the cost of food, which rose 10.1 percent in the year to October, pushing up overall consumer inflation to a 25-month high of 4.4 percent. The risk is that inflationary expectations could come unhinged if Beijing is seen to be sitting on its hands.

The country's history has plenty of stories of sharp price rises triggering unrest. That chances of that happening are slim, but Chinese policy-makers are always jumpy about even remote risks of protests that could challenge the ruling Communist Party. Beijing's recent measures to contain food price rises show that officials are aware of popular frustration and are ready to take serious action if necessary. Inflation worries are also likely to bolster hawkish policymakers who want more tightening. In November, the central bank raised interest rates once and reserve requirements twice.

**What to watch:**

- Hints from officials or state media that Beijing might step up its tightening campaign to tamp down on price pressures.
- Government data on everything from housing to factory output and prices, although sometimes flawed, offers the best indication of underlying economic trends.
- Signs that popular grumbling about prices are congealing into more persistent discontent.

**LABOUR UNREST AND SOCIAL STABILITY**

China was hit by a series of strikes in earlier months, especially in its southern manufacturing region, at factories making everything from car parts to air conditioners. Most ended with substantial wage increases for workers. Wider discontent among an estimated 150 million pool of migrant workers could undermine government authority or erode China's competitiveness as a low-cost factory hub. But the wage demands of the migrant workers have partly chimed with one of Beijing's main economic agendas - trying to boost domestic consumption and narrow the rich-poor gap, by lifting the share of national income taken home by workers.

China's Communist Party has so far maintained general authority and control. Outbreaks of discontent have remained brief and localised, and authorities have been toying with bringing usually toothless official unions into negotiations. But with the Party treating social stability as a crucial issue, even limited challenges to the Party's control can produce outsized policy reactions. If Beijing feels strikes are getting out of its broad control, expect a rapid crackdown.

Simmering tensions about land seizures and forced eviction remain another flashpoint, with several suicides by desperate homeowners in recent months stoking public anger. The government has laid out new rights for home and land owners, although it is yet to be seen whether they will be respected on the ground.

Ethnic tensions in Tibet and Xinjiang have distracted the central government and drawn international concern, but have not seriously threatened national stability.

**What to watch:**

- Emergence of any regional- or national-level protest movements. So far, protests have tended to be organised at individual factories or directed at local officials. Strict controls make it difficult to form organised national movements, but the internet played a role in spreading labour unrest as workers read about successful activism.
- Signs that urban public concerns about inflation and housing costs are congealing into broader discontent.

**KEY DATES**

- **December 13, 2010**  
Inflation data for November
- **January 2011**  
President Hu Jinto makes state visit to Washington
- **March 2011**  
National People's Congress due to approve Five Year Plan
- **October 2011**  
Chinese Communist Party 18th Congress

**RISK DATA**

<b>JLT Group</b>	
Strikes, riots & civil unrest	5
Terrorism	4
War & civil war	3
Economic risk	4
Currency risk	4
Sovereign risk	4
Expropriation	6
Contract repudiation risk	7
Legal & regulatory risk	7
<b>Coface</b>	
Country rating	A3
Business climate	B
<b>Transparency International</b>	
Corruption Perceptions Index Score	3.6
Rank (of 180)	79
<b>World Bank Doing Business</b>	
Rank (of 183)	89
<b>WEF Global Competitiveness</b>	
Score	4.84
Rank (of 133)	27
<b>Reporters Sans Frontières</b>	
World Press Freedom Index Score	84.67
Rank (of 175)	171

