

China Monthly Report



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North Korean transition poses challenges for Beijing

The advent of a new leader in North Korea, following the death of Kim Jong-il on December 17, raises economic and security problems for China at a time of heightened sensitivity in Beijing as it undergoes its own leadership transition. In the weeks since the elder Kim's death, Chinese leaders have sought to strengthen their influence over senior North Korean political and military officials, hoping above all to limit the risk of a destabilizing leadership struggle. Moreover, they are trying to maintain communication channels by announcing openness to a visit by the new North Korean leader, Kim Jong-un. Nevertheless, the effort is complicated by growing strains in the bilateral relationship that have been apparent in recent years:

- Chinese officials were caught flat-footed by North Korea's sudden shelling of South Korea's Yeonpyeong Island in 2010.
- Earlier in that year, China was put in an awkward position when South Korea and the United States accused North Korea of sinking a South Korean warship, the Cheonan, with a torpedo.
- Beijing currently shares western governments' frustration over North Korea's nuclear intransigence, as well as anxieties about the prospect of military confrontations being provoked by Pyongyang to bolster the legitimacy and credibility of Kim Jong-un as leader.

The transition in Pyongyang could offer Beijing **opportunities to reduce North Korea's isolation and belligerence**, according to influential Chinese academics -- and if so, to decrease incentives for Seoul and Tokyo to draw closer to Washington on security matters. Through its role as the principal conduit for luxury goods and financial flows to North Korean elites, China does have some ability to induce if not compel behavior it favors, and it may offer additional economic aid to encourage restraint.

Nevertheless, Chinese leaders almost certainly are vexed by **limited information over the internal state-of-play** among North Korea's elite factions, given the scramble in Pyongyang to orchestrate a succession earlier than expected and the apparent lack of preparation of Kim Jong-un to assume authority. China may be leagues ahead of other key players in obtaining current information on North Korean leadership dynamics, but it faces daunting challenges in assessing the intentions -- and prospects for internal schism -- of a notoriously opaque and unpredictable regime. This will be complicated even further if lines of authority in Pyongyang are in flux, perhaps marginalizing some of Beijing's erstwhile sources or agents of influence.

Uncertainty over market-oriented economic reforms in North Korea along Chinese lines, as well as tentative openings to foreign investment with which the elder Kim had flirted, increase the possibility of chronic instability or even economic collapse in the North if they should be abandoned altogether. Thus, prospects for the new Kim Jong-un regime will hinge on its ability to maintain economic stability, which in turn is largely in China's hands:

- China is North Korea's largest trading partner and chief benefactor, exporting mainly food and oil, which afforded a lifeline to North Korea after economic sanctions were tightened by the US and other nations in response to Pyongyang's nuclear weapons activities.
- Although trade data involving North Korea are imprecise, experts estimate that China and South Korea accounted for as much as 80% of North Korea's external trade in recent years. After the Cheonan sinking, most of North Korea's trade with South Korea stopped, making it even more dependent on China.

While Beijing is anxious to avoid destabilizing Pyongyang by pressing it too hard during the current transition, some within the Chinese leadership probably are warning that prospects of long-term economic reform in North Korea will evaporate in the absence of sustained coaxing from China.

Flurry of diplomacy. Having themselves been playing the nationalism card with gusto recently, Chinese leaders may have boxed themselves in somewhat, unable to risk stoking domestic popular ire if they should appear too accommodating of US, South Korean and Japanese security concerns in trying to rein in Pyongyang. Still, Beijing is moving ahead cautiously in bilateral discussions:

- On January 5, US officials called on their Chinese counterparts in Beijing to help restrain the new North Korean leadership from engaging in military provocations during the transition.
- South Korean President Lee Myung-bak arrived in Beijing today to meet with President Hu Jintao and Premier Wen Jiabao. China's official Xinhua News Agency said the two countries would discuss coordinating joint strategies to resume the stalled six-party talks over North Korea's nuclear program.

Tentative signs of turnaround in China's economy

Beijing is promising to stimulate domestic consumption to offset the effects of weakening exports and the downturn in the property market. Following a planning meeting at the start of the year, officials said new measures would aim to boost spending on energy-saving products, online shopping, and tourism. Expectations have increased that Beijing will ease monetary policy and step up fiscal spending in 2012 to bolster domestic growth, in light of the hit Chinese exporters have

taken in foreign markets from the effects of Europe's debt crisis and weakness in US consumption:

- Officials said last week that the trade surplus fell to about \$160 billion in 2011, the third consecutive annual decline.
- China's economic growth is likely to have slowed for a fourth consecutive quarter in the October-December period, receding from the 9.7% annual rate in the first quarter of 2011; AIG Global Economics projects GDP growth will decelerate to 8.89% in 2012 before returning to growth rates in the 9% range in 2013 and beyond.

The latest readings of manufacturing activity suggest that the risk of a sharp slowdown in the Chinese economy may be receding. The official purchasing managers' index (PMI) rose to 50.3 in December from 49 in November, which had been the first time since the depths of the downturn in early 2009 that the index had signaled a contraction.

Policy caution. A meeting of senior policymakers to discuss the financial sector last week did not result in major policy shifts, suggesting that while leaders recognize the need for changes in the way the financial sector operates, they are reluctant to introduce initiatives such as interest-rate liberalization until a soft landing for the economy has been ensured:

- Yesterday, state news media reported a statement by the central bank governor that moving to market-oriented interest rates now could cause problems by increasing pressure for destabilizing capital inflows.
- Beijing has stated it will maintain a 'prudent' monetary stance in 2012. Official data released yesterday showed growth in the broadest measure of money supply (M2) was up 13.2% year-over-year at the end of December, following the central bank's cut earlier in the month in bank reserve requirements -- its first such move in three years.

Inflation expectations among urban depositors are beginning to moderate as consumer price increases have abated since peaking at 6.5% in mid-summer, providing some leeway for further loosening of monetary policy. According to the central bank's latest quarterly survey, depositors expecting future price rises fell to 65.4% in the fourth quarter, down 16.3 percentage points from a year earlier.

Village revolt tests leaders' approach to unrest

A village takeover by irate citizens in southeastern China in December, sparked by allegations of local official corruption, attracted international attention and was followed by comments in the state-run press hailing the resolution as a model of government responsiveness to local dissatisfaction. Nevertheless, Communist Party officials have long discussed measures for dealing with localized protests, and hardliners within the leadership continue to press for the primacy of securing social stability over individual rights.

A senior Party official in Guangdong province engineered a resolution of villagers' grievances in Wukan that included reprimanding corrupt local officials for illegal land seizures. However, such practices are widespread as localities seek revenue to promote development, and any calming of social tensions is likely to be a temporary respite. Moreover, confrontations over local corruption increasingly will challenge security officials as activists in the countryside channel opposition through social media.

Authorities have also moved to crack down on illegal investment schemes after thousands protested in early January in Anyang in central China over losing their savings. Local Party officials, promising to tighten oversight of fraudulent private lending schemes, said that the problems sparking the Anyang protests are likely to be commonplace elsewhere.

Shale gas ventures with US firms expanding

China Petrochemical Corporation (Sinopec) announced last week a \$2.5 billion joint venture with Devon Energy Corporation to develop five shale fields in Ohio, Michigan, and elsewhere in the United States. The Sinopec deal parallels moves during the past two years by another Chinese energy giant, China National Offshore Oil Corpo-

ration (CNOOC), which bought stakes in shale fields run by Chesapeake Energy Corporation in Texas, Wyoming, and Colorado.

For the Chinese firms, the investments are likely to afford access to complex horizontal drilling and hydraulic-fracturing technology and experience with extraction techniques that could be adapted to unlock massive new energy reserves in shale formations in China. The US Energy Information Administration estimates that China has the biggest shale gas reserves in the world, enough to supply the country for more than 300 years at current consumption levels.

Looking ahead ...

Taiwan elections promise close race. Taiwan voters will go to the polls in presidential elections January 14, a contest that will be closely watched in both Beijing and Washington. Tsai Ing-Wen, leader of Taiwan's pro-independence Democratic Progressive Party (DPP), is seeking to unseat President Ma Ying-Jeou, who has stabilized cross-strait political and economic relations during his three years in power. Recent polls show Ma and Tsai in a very tight race, albeit with a high proportion of undecided voters. Some mainland analysts discern little difference between Ma and Tsai on substantive issues, but a DPP victory probably would impact Beijing's impending leadership transition by giving ammunition to internal critics of President Hu Jintao's Taiwan policy.

Pension fund seeking to expand investments abroad. China's national pension fund is seeking State Council approval for investing in foreign private-equity funds, according to reports in the Chinese press; currently, the fund managed by the National Social Security Council is limited to investing 20% of total assets abroad in stocks and bonds. Since its establishment in 2000, the fund has become a major institutional investor in Chinese stocks and renminbi-denominated equity funds within China.