

**CHINA ANNUAL REPORT 2011**  
**OBSERVER RESEARCH FOUNDATION**

**ECONOMY**

GROWTH

If Deng Xiaoping's idea of "crossing the river by feeling the stones" were the guiding principle of Chinese macroeconomic policy in 2011, nimble footed policymakers seemed to have achieved it to a certain extent by controlling the movement of the three most important indicators in domestic economic policy in the year viz., the CPI (inflation index), GDP growth trajectory and PMI (purchasing managers-indicating industrial production).

However global torrents of uncertainty, coupled with worrying trend of moderating growth might leave the situation more precarious in 2012.

The central question at the beginning of 2011 was whether the attempt to control inflation rates would lead the economy to a hard or a soft landing. It took until the third quarter for the inflation rates to peak out, therefore the focus of the monetary policy continued to be on controlling liquidity. This is evidenced by the fact that in a bid to reign in inflation the government increased reserve requirement ratio (RRR) for banks six times in 2011.

Growth became focal point immediately after the CPI index had established itself on the downward trajectory after peaking at 6.5 per cent in July, overshooting the government's rather optimistic target of 4 per cent and registering an overall inflation rate of 5.4 per cent for 2011.

As the effect of the numerous reserve rate hikes kicked in, the attention of the policymakers turned to the first signs of moderating growth, that is the falling Purchasing Managers Index (PMI) signaling manufacturing slowdown. Central bank was quick to respond by infusing 96bn renminbi into markets through bills and repurchase agreements while also voicing possibilities of quantitative easing towards the end of the year.

MANUFACTURING

In January 2011, the manufacturing sector purchasing managers index (PMI) fell to a five month low of 52.9 per cent, compared with 53.9 per cent in December 2010, and continued its drop below the flat line of 50 to 47.8 in September, denoting contraction ,setting off alarm bells. This happened primarily due to tight monetary policy which led to an increased cost of borrowing.

Even though it recovered slightly to 50.3 in December 2011 the policy challenge had by now clearly shifted to sustained growth. Small and Medium Sized Enterprises (SMEs) in particular found themselves caught between stubborn levels of inflation on one hand and a high cost of credit on the other.

Analysts suggested that traditional means of turning a profit through low labour costs had come to an end in China's coastal regions, which would force SMEs to master core technologies, elevate products' added-value, and move to the upper end of the industry chain in the course of business transformation.

Industrial output is slated to slow down further from 11.7 per cent in 2011 to 8 per cent annually until 2015. This prompted the State Council to declare its industry restructuring policy focusing on increasing productivity, spurring research and augmenting energy and water use.

Income gap between urban and rural residents narrowed to 3.13:1 in 2011 from 3.23:1 in 2010. Per capita income for Urban residents rose by 8.4 per cent in the year as opposed to 11.4 per cent for their rural counterparts.

## DEBT

By the end of 2011, overall debts both from the central government and local governments were estimated at about 15 trillion renminbi. Regulators planned to shift 2- 3 trillion renminbi of debt off local governments. This was aimed to reduce the risk of defaults that could threaten financial stability in the country. This was in line with IMF's warning in its Global Financial stability report of China's domestic loans amounted to 173 per cent of its GDP.

The IMF noted that a credit boom could lead to write downs in the book value of local government debts and warned that any further depression could decrease Beijing's capacity of fiscal stimulus. Thus this could pose yet another challenge to ongoing growth recovery process.

## BANKING

After a slew of rate hikes, the end of the year post the Central Economic Work Conference in December saw loosening of monetary policy and the cutting of reserve ratios for the first time in three years. This came amidst the manufacturing slowdown in November, clearly acquiring overriding priority over inflationary concerns.

There was some relief to the banking sector as Standard & Poor's Financial Services LLC (S&P) gave the Bank of China Ltd (BOC) and the China Construction Bank Corp (CCB) grade A up from A-, which is higher than their US counterparts.

International Monetary Fund has warned that Chinese lenders could face systemic risks if credit, property, currency and yield curve shocks took place simultaneously. Thus the next year will see the policymakers having to contend with more than a few indicators and will need a flexible and reactive policy to liquidity movement.

## REFORMS

One of the most symbolic reforms was the raising of the poverty line threshold to 2,300 Yuan (\$362) in terms of the annual net income of farmers, up 92 percent from that of 2009. It almost doubled its standard for defining the poverty line of the nation's farmers to benefit at least 100 million people. This however is still below the World Bank prescribed \$1.25 a day.

The 2011 Central Economic Work Conference also agreed on tax reforms as part of the 2012 agenda intended to restructure and balance the economy to highlight the role of fiscal tools, including "structural tax cuts.

Early in the early part of the year World Bank had projected China's real GDP at 9.3 per cent in 2011 and at 8.7 per cent in 2012, as normalized macroeconomic stance, inflation and relatively slower global growth was likely to be partly offset by corporate investment and a robust labour market. Meanwhile the IMF predicted growth for the economy at 9.5 per cent in 2011 as well as in 2012.

The challenges proved to be larger than estimated and growth finally moderated nearer to 9 per cent. This would by extension suggest a downward revision for the year 2012.

## **EXTERNAL ECONOMIC RELATIONS**

### **TRADE SURPLUS**

China has now become the world's largest exporter and second-largest importer. Its foreign trade volume which exceeded the symbolic 1-trillion-US-dollar mark in 2004 and breached \$2 trillion in 2007 exceeded \$3 trillion on November 2011. It surged 22.5 percent in 2011 from a year earlier to \$3.64 trillion, according to the General Administration of Customs (GAC). The country's exports totalled \$174.72 billion, up 13.4 percent year-on-year. Imports increased 11.8 percent year-on-year to \$158.2 billion in 2011.

Trade surplus registered a decline of 14.5 percent year on year to \$155.14 billion in 2011, showing the trend for the third year in succession. In the first ten months of the year China's overall trade surplus fell to less than 1.4 per cent of GDP from under 3 per cent in 2010. Officials from the Bank of China went so far as to suggest that China could even see a trade deficit within the next two years.

Even though some analysts cautioned that the figures could be reflective of increased import costs, figures and interpretation offered by the GAC suggests that the declining export markets in US and Europe were the causal factor, this continues to pose long term downside risk to the economy. This is corroborated by the fact that the import figures also posed a corresponding decline.

International concerns on China's trade surplus prompted the first white paper on foreign trade which sought to highlight Chinese trade deficit vis-à-vis the South East Asian countries as a counterpoise to its surpluses with U.S and Europe.

### **BILATERAL**

European Union (EU) remained China's top trading partner, with bilateral trade amounting to \$567.21 billion, up 18.3 percent year-on-year. The third China-EU High Level Economic and Trade Dialogue in Beijing witnessed EU's considerations on lifting its 21-year ban on arms sales to China.

China's trade with the United States, the country's second largest trading partner, rose 15.9 percent from last year to \$446.65 billion. Trade talks continued to be on

track and the third round of the Strategic and Economic Dialogue (S&ED) between China and the U.S focused on the Chinese currency's exchange rate, intellectual property rights and access to the Chinese market. People's Bank of China (PBOC) timed a Yuan's reference rate hike of 6.4988 per dollar on the eve of the S&ED, which now seems to be evident before most major events where lack of Chinese currency appreciation is likely to be questioned.

Trade between China and the Association of Southeast Asian Nations (ASEAN) rose by 23.9 percent year-on-year to \$362.85 billion in 2011. China-Japan trade relations were affected by Chinese restriction on rare earth export quotas as also the Fukushima disaster.

South Korea, China's third largest trading partner is considering the impact of the Free Trade agreement with China. China has been pushing for the FTA for years now however South Korea has been slow to react given domestic opposition from several quarters.

Meanwhile estimated trade volume between China and Russia reached US\$78 billion, which suggested a steep hike from US\$55.4 billion last year. By 2020, China plans to invest US\$12 billion in the Russian market to boost bilateral trade. China- Arab trade was reflected as being at an all time high totaling \$120 billion, up 36 percent year-on-year in September 2011.

The search for new markets bore fruit with New Markets in Central and Eastern Europe trade with trade increasing tenfold since 2001 and an annual growth rate of 32 per cent. Countries like Hungary, Poland and Bulgaria are a few of the nations which are responsible for the surge. However most all nations with the exception of Germany suffer from increasing trade deficits vis-à-vis China.

### FOREX RESERVES

Even as the year started with the buying of more US federal bonds taking the total to US\$ 1,153 billion, during the course of the year there were fears that excessive reserves would flood the market with liquidity and add pressure to the government's central bank operations. Forex reserves which amounted to US\$ 2.9 trillion at the start of the year, by the end of the third quarter amounted to US\$3.2 trillion and registered a decline in the fourth quarter ending at US\$3.18 trillion.

Towards the end of the year there was reduction in its holdings of US treasuries by \$36.5 billion, or 3.1 percent. The cut was the first since a 0.8 percent decline in February. Despite the cuts, China's long term holdings on U.S debt grew to US\$1.4 trillion and overall short and long term treasury holding grew to US\$1.5 trillion. Even as trade surplus with U.S widened, China attributed this to structural imbalances and export restrictions in the U.S economy.

## CURRENCY

Appreciation of the Yuan continued to be the controversial highlight of Chinese and to some extent the world economy.

For an export-led growth model of a country which arguably draws its political legitimacy from economic gain, Chinese currency appreciation can only set a pace which would allow for an orderly transition - to reorient industry to cater to internal demand. While also ensuring that its largely underpaid workforce, a natural byproduct of an export-oriented, managed exchange rate growth model, also achieved the purchasing power to sustain the demand.

However, while all this facilitates an orderly transition within the economy, the brunt of this transition was being borne by China's trading partners, both at a bilateral trade and at globally competitive levels. This is substantiated by various studies which estimate that Chinese currency, to be undervalued and in need of upward revision.

Repercussions were evident when the issue of slow the rate of appreciation featured prominently in the third round of the Strategic and Economic Dialogues (S&ED) between the US and China . Even as China made plans to reject any WTO move to discuss renminbi appreciation and asserted that it was "not within WTO jurisdiction" the inability US Federal Reserve to declare China an official currency manipulator and the weak U.S senate endorsed Yuan served only political ends.

There were reports on contrasting views within the CCP on the pace of convertibility of the Yuan which has left uncertain the rate of appreciation even in 2012.

The Australian and Canadian Dollar joined seven others that are allowed to be traded on China's interbank foreign exchange market. Meanwhile China- Russia commenced trading in local currency and the Sanya BRICS summit declaration also expressed interest in a local currency trading arrangement.

## INVESTMENT

The country attracted \$86.68 billion in foreign direct investment (FDI) in the first three quarters of the year, up 16.6 percent year-on-year. Its non-financial outbound direct investment (ODI) also rose 1.8 percent year-on-year to \$60.07 billion in 2011.

FDI in China reached \$116 billion in 2011, up 9.72 percent year-on-year. The country plans on opening wider to the world by encouraging foreign companies to invest for the first time in certain industries under a new draft regulating foreign investment. The select industries in the recently released Foreign Direct Investment Industry Guidelines include clean energy, aerospace & aviation and new materials, These however are restricted in number.

With over \$300billion invested abroad it is globally the fifth largest foreign investor. Latin America especially Brazil and Argentina, Japanese Government bonds, Russian Far East and East Siberia, Indian power sector, Canada and Australia were highlights of Chinese overseas investments.

### BUSINESS, M&A

Chinese companies continued on their global acquisition path with Chinese company, Wolong Holding Group Co. Ltd, announced its \$ 137.83 million takeover of Europe's third largest electric motor manufacturer, Austrian electric motor manufacturer, ATB.

However the acquisition of American firm 3Leaf Systems by Huawei Telecom ran into troubled waters after the Committee on Foreign Investment in the United States (CFIUS) prompted "national security concerns" against the acquisition. Meanwhile China enhanced its 'strategic market' status with business confidence survey's such as European Union Chamber of Commerce suggesting majority company growth and rise in net profits with an expression of confidence in the roadmap set out by China's 12th five year plan.

### AID/LOAN

Africa benefitted from Chinese debt waivers, in particular the 50 per cent waiver of the 988 million for the Tanzania-Zambia railway line built in 1976 and US\$700 million to the Zimbabwean economy.

Senior officials also expressed Chinese willingness, albeit reluctant, to buy European bonds in coordination with the IMF bailout effort, however this did not materialize.

Thus the year 2011 saw China maintain a strong external front despite multiple problems domestically. The trade surplus continued its downward trajectory which is likely to continue atleast in 2012 with depressed US and European markets but its forex reserves continued to increase except for a marginal drop at the end of the last quarter. Given that inflationary concerns are linked to foreign currency flows, the forex reserves might see some plateau-ing in 2012.

## **SOCIAL ISSUES**

With the leadership set to change in 2012, stability and social security become even more important cornerstones for China's policies in 2012. In 2011, the most pertinent issues affecting society continued to be those of environment, urbanisation, increasing scope for grassroots' participation, transportation, land use and food security. Even as China's social financing dropped by 1.11 trillion yuan (\$176 billion) year-on-year to 12.83 trillion yuan in 2011, registering a decline of around 8 percent, the government, keeping prevailing issues in mind announced a series of policies.

### ENVIRONMENT

Public concern over air quality continued to rise in 2011. Keeping this in mind, Beijing began releasing hourly air pollution data. It was also announced that the Beijing Municipal Environmental Monitoring Center would publish readings for the levels of sulfur dioxide, nitrogen dioxide and PM 10 - particulate matter smaller than 10 micrograms - detected by its 27 air quality monitoring stations.

### MIGRATION, URBANISATION AND RESIDENT PERMITS:

Policies allowing voting without resident permits were reflective of the modernisation of Chinese politics and changing nature of regulations on migration. China's urbanisation rate already reached about 50 per cent in 2011, and migration controls remain in need of further change.

### PUBLIC TRANSPORT AND SUBWAYS:

Beijing earthquake authorities revealed in September '11 that an early warning system was being developed to connect to the city's transit system. Also, three new subway lines were opened at the end of the year in an attempt to further ease traffic pressures. In order to curb traffic accidents, China's Ministry of Transport ordered local governments to launch thorough safety overhauls. This was announced immediately after a high speed train crash in Zhejiang province.

### REDRESSAL OF ISSUES THAT AFFECT GRASSROOTS, AND ATTEMPTS AT QUELLING PROTESTS:

Senior officials of the Ministry of Finance said the country would invest more into five sectors- education, rural and urban basic health insurance, healthcare institutions, social security and policy based housing and water conservation facilities. Chinese journalists and news organisations were asked to improve awareness of the national situation with a better coverage of grassroots' stories, and a campaign was even designed to get more grassroots' stories through news reporting.

### LAND MARKETS

Possibility of a real estate bubble and potential property market slump especially in cities like Beijing, Shanghai and Guangzhou, led the government to tighten restrictions on home purchases besides taking a series of steps to boost land supply and promote low cost housing.

Government also made attempts to cool the runaway property market, taking steps to increase down payment for mortgages, institution of new property taxes, tightening measures against speculation, and making plans for building 36 million housing units for low income families in the next five years. Unauthorised conversion of arable land for infrastructure projects is also likely to be tightened further. In 2011, the State Council approved the use of only 4,00,000 hectares of land.

### FOOD SAFETY:

A number of scandals affecting food safety standards in the country erupted in 2011. Authorities arrested farmers for adding clenbuterol to meat products. Towards the end of the year milk products made by a leading dairy company- Mengniu were found containing high levels of aflatoxin- a cancer causing toxin. 62,000 cases in all were found concerning substandard food. Authorities ordered 43,000 businesses found illegally operating without licenses to cease production while revoking the licenses of 576 operators during the period, as stated by the State Administration for Industry and Commerce. A total of 251 cases were handed over to judicial organs during the same period.

## **CHINA'S ARMED FORCES**

2011 turned out to be significant for the Chinese military in more than one way. The military conducted sea trials of the country's first ever aircraft carrier, revealed the stealth fighter Chengdu J-20 and made significant achievements in the informationization of the military. By the end of 2011, Chinese military in overall terms was able to make considerable advancement in its modernisation drive. A lot of attention was given to the use of information networks for conducting drills, many of which were performed under real time "battle" conditions. China consciously increased its presence in the Indian Ocean Region by participating in international missions and by increasing its military engagement with several countries in the region.

### NAVY

The ambiguity about China's aircraft carrier finally came to an end in 2011 with Beijing unveiling its first-ever aircraft carrier, a Soviet-era vessel named Varyag. The aircraft carrier which was originally purchased from Ukraine underwent significant refurbishing once it touched Chinese waters. The carrier has since then conducted sea trials in the ocean and it has also been reported that Chinese pilots are being trained for operating specialized planes for launch from the carrier. Rejecting speculations that the carrier would be used for offensive purposes, statements from the Chinese Ministry of National Defence claimed that it would only be used for training and experimental purposes.

However, it was also carefully sounded that if the need be, the carrier could be used for defensive purposes as well. The induction of the Varyag aircraft carrier is a significant achievement in the modernisation drive of the PLA Navy. Once the Varyag is operational, China could engage in producing more carriers to offset US superiority in the region. Unconfirmed reports indicated that China might be developing an indigenous aircraft carrier at the Changxing Island shipyard in Shanghai. This would seriously challenge the current security environment in the South China Sea and the Indian Ocean, with increased sense of insecurity among the smaller nations that have disputes over the maritime territory in the South China Sea.

December 2011 marked the third anniversary of Chinese naval anti-piracy escort missions in the Gulf of Aden. China has so far conducted more than 400 escort missions in the troubled waters. As on early 2011, there were eight Chinese fleets operating in the region. Although the fleets were engaged in providing security in

the region against pirates, the anti-piracy missions have boosted PLA Navy's knowledge and ability to perform in the Indian Ocean Region, something that China was seeking for a long time. China's naval fleets made port calls at Yemen, Oman, Sri Lanka and Pakistan among others while conducting anti-piracy missions. Certain naval vessels, such as the Wenzhou and Ma'anshan frigates in the eighth fleet also took part in the multi-national naval exercise in Pakistan – AMAN 2011, while on their way to the Gulf of Aden.

The Chinese have also stepped up diplomatic and economic ties with these countries. These developments indicate that China will continue to use such ports at least as resupply facilities. Beijing may not be willing to enter into a formal agreement with these countries for providing support for its navy, but it is likely that it would continue to develop closer relations with these countries to ensure a support network for its navy in the Indian Ocean.

#### ARMY – DRILLS UNDER "BATTLE" CONDITIONS

China carried out certain near the Indian border in the Chengdu Military Area Command (MAC) testing the capabilities of its forces to perform under real time battle conditions in the high altitude plateau regions. Using information network based multi-type aircraft plateau training systems, the aviation troops under the Chengdu MAC conducted actual troop drills in high-altitude and highly-frigid areas.

These drills that were based on information networks designed to test the joint operational combat capability of the forces. The PLA Daily called the plateau flight training a groundbreaking project. It was also reported that the Chengdu MAC, which covers the Eastern sector of India-China border, had refurbished several aircrafts in recent times for better performance and adaptability in plateau regions. The MAC had also conducted several training programmes for pilots and extended the training time of troops stationed on the plateau. Drills also were conducted to enhance the capabilities of the PLA to capture and retain enemy outposts in high altitude terrains of the Tibet plateau in 2011.

The PLA tested its ability to function under electromagnetic conditions in 2011. For the first time, an actual troop and equipment drill was conducted in an electromagnetic environment near the foot hills of Yanshan Mountains. The drill tested the preparedness for tasks such as establishing command posts and network of wireless equipment, assembling personnel and equipment, direction finding and positioning of interfering signals. The drill which was conducted under the background of actual combat was aimed at assessing PLA's wartime capacity for electromagnetic spectrum management and control.

The PLA conducted a long range transport support drill in eight cities falling under the Jinan Military Area Command (MAC). 13 military offices responsible for

waterways, roadways and air routes participated in the drill under "battle" conditions. The civilian transport system was also utilised for the drill which involved the railways from Jinan and vessels docked in Yantai port.

### AIR FORCE

The PLAAF revealed the J-20 stealth fighter in April 2011. The aircraft which is designed to evade radar detection attracted a lot of international attention. China claimed it to be a step forward in their modernisation drive, however, the ability of the Chinese to move the project forward from being a prototype to actual production has been debated. It was alleged that the Chinese had utilised parts of the US F-117 Nighthawk that had crashed in Serbia on a NATO mission during the Kosovo War. It is believed that China might have used some of the technology that it had accessed from the wreckage of the stealth aircraft.

The PLAAF also developed new training programmes for its pilots. The pilots will now have to go through a shortened 5-7 years training programme instead of the previous 10 year programme allowing China to train more pilots in lesser time. The total number of the pilot training course graduates increased by 94.3 percent in 2011. The new programme will also increase flying hours for the trainees by 42 percent.

The Chinese Air Force has developed a new lubricant for their third generation fighter planes which would allow the aircraft's engine to start instantly and take off in extremely low temperatures. According to China's Fuel Research Institute of the People's Liberation Army's Air Force (PLAAF), the lubricant will also ensure lasting performance even in high temperature zones. The new lubricant is designed for use at extreme temperature both 20 degrees higher and 20 degrees lower than its predecessor, increasing the efficiency of China's fighter planes.

## **SCIENCE AND TECHNOLOGY**

### SPACE CAPABILITIES

Last year proved to be significant for China's space programme with Beijing achieving a feat accompanied by only two countries so far – space docking. The event was celebrated by Chinese leadership and was reflected in the news articles and statements that followed.

The space docking mission was accomplished in November 2011 has boosted China's confidence and has reflected China's ambition for dominance in the space arena. The docking was part of China's plans to establish a space lab by 2016 and to complete the space station by 2020. Currently the Tiangong-1 space lab has been docked with Shenzhou-IX spacecraft and will be docked with two more spacecrafts in 2012, with one of them likely to be a manned mission. In December the testing for presence of toxic gases had begun. More tests and experiments for determining a safe environment for astronauts will be conducted in 2012.

Due to the rising energy demands, China has drafted its plans for harnessing Space Based Solar Power (SBSP). Beijing has already done a feasibility study to highlight the cost-benefit factor of harnessing SBSP. As it appears China will go forward with its plans of exploring this new source of energy. It also intends to complete the project and commercialise it by 2030.

In addition to this, China also launched satellites for other nations on a commercial basis. It had launched satellites for Pakistan and Venezuela in 2011. The telecommunications satellite launched for Pakistan is reportedly for augmenting the country's communication systems.

China's space programme also saw the addition of new satellites into its indigenous global navigation system – Beidou. Towards the end of 2011, Beidou had started producing data, which China is likely to use on a commercial basis. There are reports that suggested that Pakistan would be a likely customer for this data. Beijing aims to cover the Asia-Pacific region by 2012 and the world by 2020, through its Beidou navigation system. Beidou system is being designed to provide accurate, reliable all-time, all-weather positioning, navigation and timing services.

Towards the end of the year, China issued a document which highlighted all these developments in space including its ambitions in the future. In the near future, China is set to augment its capabilities in space significantly. Although the current advancements are mostly distanced from military arena, certain projects could have

military benefits, especially the manned space station and the Beidou navigation system. These achievements and revelations by China in 2011 only underline the need to study these developments closely in the coming years.

## **INTERNET**

### MICROBLOGS

In what was intended to become the Chinese version of Western social networking and microblogging websites (Twitter), Weibo unintentionally became a portal for the common Chinese citizens to directly connect with the government. The surge in the number of users of Weibo in 2011, challenged the government's censorship infrastructure.

Large number of polls that were conducted on these websites indicated the resentment in people due to the government's inaction and underplaying the train crash incident. This compelled Premier Wen Jiabao to order a swift probe into the matter. More incidents occurred that saw the government giving into people's demands echoed through these microblogs. For instance, the government's opaque policies on pollution control were questioned by the people due to rising pollution levels, leading to implementation of better policies.

In the last year Microblogs have found a place close to the heart of most of the modern Chinese citizens. They are now being used for commercial as well as social purposes apart from being used as a portal to communicate with the government. On one hand, sensitising the authorities over impending issues has become easier and on the other, microblogs have also transformed into forums for gathering support for people in need. Often it was witnessed that stories about people in need were posted on Weibo attracting large number of citizens who contributed monetarily for the needy.

Unsurprisingly, the Chinese government is tightening its control on the Internet and Weibo by introducing real name registration systems. Time and again, warnings were issued asking users not to spread "rumours" on the internet and cause unrest. Users were also warned of stern action being taken against them if they were found commenting anything that was against the interest of the country.

At the same time, Beijing realised the advantages of the microblogs as they enabled the government to connect directly at the grassroots. The government also ensured that it was able to broadcast its version of news and incidents as and when required, through Microblogs. This might have been one of the reasons that the government decided not to completely ban the use of these services inside the country. The Chinese government, today, operates more than 40,000 microblogs to provide information to the citizens to address their queries. It was also advised

that these networking services should also be used for the works of the Communist Party of China.

Internet users in China touched the 500 million mark in 2011, with more than 300 million users of microblog services. China today is the country with the largest Internet population. Although internet connectivity is yet to reach far-off places in China, Beijing has laid plans to connect each and every corner of the country through internet. In 2011, a new form of governance through the use of internet was seen in China which is likely to continue and develop.

## **INTERNATIONAL RELATIONS**

President Hu Jintao has defined the objective of China's foreign policy to "jointly construct a harmonious world." China's relations with its neighbours and regional security remained a priority issue and the focus of its foreign policy agenda in 2011. The emphasis on nationalism within the country by the government was matched by rising assertiveness in international relations. The year also saw China host the BRICS summit in Sanya, in the month of April.

### SOUTH CHINA SEA

China's rising level of assertiveness in its foreign policy was most visible in relation to the South China Sea dispute. South China Sea, where Vietnam, Philippines, Taiwan, Malaysia, Indonesia and Brunei have competing claims with China continued to be an area of contention. Premier Wen Jiabao used the Association of Southeast Asian Nations (ASEAN) summit, in November, to warn external powers, especially the United States, from getting involved in the dispute. Relations with Vietnam remained strained due to the territorial dispute. The issue remained one of the highlights of China's regional policy in 2011.

The month of July saw an agreement between China and ASEAN to set guidelines to resolve the disputes in the South China Sea. The members also agreed to cooperate in marine environmental protection and safety of navigation. A consensus was also reached on implementing the 2002 Declaration of Conduct in South China Sea. Another proposal suggests establishing three committees for research and environmental protection, navigational safety and search & rescue operations and combating transnational crimes at sea.

China and Vietnam came together in September and recognised the need to work on resolving sea disputes and work out a mutually agreeable solution as early as possible. The Chinese Foreign Ministry repeated its claims of having "indisputable sovereignty" over the South China Sea and objected to oil exploration by India's public sector company Oil and Natural Gas Limited (ONGC)'s overseas investment arm ONGC Videsh Limited.

### UNITED STATES

China's relations with U.S, which had been marred with tensions in 2010, saw an improvement. The year began with a visit by US Defence Secretary Robert Gates to China as part of restoring military ties which had been stalled after Chinese opposition to the Taiwanese arms deal. This was soon followed with a visit to U.S by Chinese President Hu Jintao which resulted in an agreement between the two countries to advance cooperation to counter violent extremism; to prevent the

proliferation of nuclear weapons and to address cyber-security concerns. China, however, continued to keep the South China Sea agenda out of China-U.S talks.

The sale of arms to Taiwan came up as a contentious issue when a delegation from China's National People's Congress (NPC) visited the US as part of the US-China Inter-Parliamentary Conference Mechanism in July. The delegation said that the Taiwan issue was the most important and sensitive issue in the US-China relations and hoped that the US would handle this with caution. About the Tibet issue, the delegation said that it hoped that the US will avoid supporting and tolerating anti-China activities by Tibetans.

## INDIA

Termed as the "Year of China- India Exchange", 2011 witnessed both highs and lows in China-India relations. The BRICS Summit in China brought the heads of the two states, along with the other three countries, together to work towards increasing cooperation and establishing positive ties for a greater good.

Concerns were raised when U.S published a report about China's new missile system and its possible usage as a deterrent against India. The reports were denied by the Chinese Foreign Ministry and by December, the Chinese Ministry of National Defence held defence talks with India. There was a steady rise in the presence of Chinese firms in India's electricity sector. Chinese side led by Gen Ma held talks with Indian Defence Secretary Shashikant Sharma.

High official visits were made to China during the year by BJP leader Nitin Gadkari, Bihar Chief Minister Nitish Kumar, CPM leader Sitaram Yechury and Gujarat Chief Minister Narendra Modi.

## JAPAN

Relations with Japan, which had soured after the Diaoyu Islands boat collision in September, 2010, improved as both countries showed interest in deepening the bilateral relations. Official visits, such as the one made by a delegation from Japan, in July, and Japanese Foreign Minister Koichiro Gamba, in November, took place. A diplomatic tussle between the two countries, however, occurred in August after Tokyo alleged that two Chinese fishery patrol boats entered the waters around the disputed Diaoyu Islands.

China and Japan held their 12th strategic dialogue on December 2. The two sides agreed that they should fully implement the consensus reached earlier between the leaders of the two nations. They also agreed to strengthen their dialogue, exchanges and cooperation, and enhance their mutual trust. Prime Minister Noda Yoshihiko visited Beijing in the end of December, thus, becoming the first Japanese Prime Minister to visit China since the October 2009 visit by Prime Minister

Hatoyama Yukio. Both Beijing and Tokyo have committed themselves to celebrating the 40<sup>th</sup> anniversary of normalization of diplomatic relations in 2012 as both governments will make every effort to manage sensitive territorial and sovereignty issues.

### NORTH KOREA

Continuing with the trend established in 2009, China deepened its economic, political and military ties with the Democratic People's Republic of Korea. China and Democratic People's Republic of Korea (DPRK) vowed to maintain close ties and enhance cooperation on regional security issues during the visit of Public Security Minister Meng Jianzhu's to DPRK in February.

### PAKISTAN

China vowed to maintain the all-weather friendship with Pakistan in 2011. There were high level visit on both sides such as Pakistani Prime Minister Yousuf Raza Gilani's four day visit to China in May. In an attempt to display its support, China made a public statement to consistently support Pakistan's efforts in safeguarding its national independence, sovereignty and territorial integrity.

The announcement was made in relation with the NATO bombing of Pakistan's border posts in a northwest tribal area bordering Afghanistan on November 26. Reacting to the incident China stated the need to respect Pakistan's independence, sovereignty and territorial integrity. It also backed Pakistan's bid to seek full membership in the regional security grouping of the Shanghai Cooperation Organisation (SCO) at the 10<sup>th</sup> summit.

The relations hit a bump when the Chinese authorities claimed that at least one of the leaders of the two terrorist attacks that took place in China's Xinjiang region had received terrorist training in Pakistan.

Military ties between the two countries were also strengthened during the year and a joint anti-terror military exercise YOUYI-IV was conducted in November near Islamabad. Relations in energy sector also took a positive step as nuclear agreements between the two countries for building two new nuclear power reactors in Pakistan were approved the International Atomic Energy Agency (IAEA) in March.

### MYANMAR

A series of economic deals were signed, in the month of May, between China and Myanmar including an agreement for a US \$763 million line of credit from the China Development Bank, when Myanmar's President Thein Sein, visited Beijing in his first ever state visit after his government came into power in March 2011.

However the relations soured when President Thein Sein, announced the suspension of construction of the Myitsone, Chinese funded dam, in Myanmar on September 30.

As a part of \$20 billion seven-dam project to be built on Irrawaddy River by China, Myitsone is to be the largest dam and almost entirely funded by China. Under the deal signed between the two countries in 2006 the main investor is the state-owned China Power Investment Corporation. About 90 percent of the electricity generated from the project is expected to go to China, with the Myanmar government receiving about \$500 million annually, around 20 percent of the revenue. Vice President Myint, however, soon vowed to cooperate with China to find a proper solution to the issue.

### AFRICA

2011 saw an increasing level of Chinese involvement in Africa. Ties were strengthened with African countries like Zimbabwe, Sudan, Malawi, Ethiopia, Ghana and Democratic Republic of Congo through official visits and investments in the economy. China signed an agreement on trade and economic cooperation with Ethiopia which stated that China will provide a loan of US\$ 100 million to Ethiopia.

The country also made their contribution in providing aid to the famine hit areas in Horn of Africa. Emergency grains and funds worth \$70 million were sent to famine hit regions. China also made a \$16 million donation to the United Nations World Food Programme. The denial of a visa to Dalai Lama for his planned trip to South Africa reflected the growing closeness between South Africa and China and was followed by Chinese President Hu Jintao's statement that China would enhance its cooperation with the African country. In an effort to maintain the positive momentum in its foreign policy, China supported the anti-piracy efforts by sending out naval fleets to Somalia waters and Gulf of Aden.

## ENERGY

### OVERVIEW

2011 saw a paradigm change in both China's approach and the world's perception on China being the fastest growing monolith energy consumer. This image was moderated considerably as China took major steps taking the global renewable energy market by storm posing a challenge to traditional players like Germany and US. It took the energy efficiency targets seriously, going to the extent of shutting down factories in case of non compliance.

It began 2011 on a deterministic note assuring to take measures to ensure energy supplies to meet the growing demand. China Energy Research Society (CERS) predicted that while overall energy supply and demand would be in balance, central China would suffer from energy shortages. Other analysts however suggested that the country could experience an energy shortfall of more than 30 million kilowatts in 2011.

The demand for energy in central China was likely to be high due to the ongoing shift of manufacturing from the eastern part of the country to the central and western parts of the country. The projected crude oil consumption was about 460 million tons while gas consumption was projected to rise to about 130 billion cubic meters.

Coal supply was slated to improve with the construction of 14 large coal bases and increased imports. China's power consumption rose 11.7 percent year-on-year to 4.7 trillion kilowatt hours in 2011. China intends to maintain its focus on offshore oil and gas exploitation during the 12th Five-year Plan (2011-2015) period.

On fossil fuels, China was aiming to raise energy efficiency in using coal, maintain the current volume of domestic oil production, and facilitate a rapid increase in the production of natural gases.

China National Petroleum Corp (CNPC), the country's largest oil company by output, put into service the second West-to-East natural gas pipeline, which with a combined length of 8653 kilometres is the world's longest. When fully completed in June 2012, the pipeline will be able to carry 30 billion cubic meters (cu m) of natural gas annually from Central Asia and the Xinjiang Uygur autonomous region to the Yangtze River and Pearl River deltas. The entire project will eventually traverse 15 provinces and regions and provide 30 billion cu m of natural gas annually.

China plans to build a third West-to-East gas pipeline project, allowing the transfer of more than 20 billion cu m of natural gas annually from Central Asia. Eventually a fourth and fifth line could follow. Moreover, China will construct oil and gas

pipelines of about 150,000 kilometres in the next five years. The pipelines include a gas pipeline to central Asia and oil pipelines to Kazakhstan and Myanmar.

### OIL & GAS

Rising international crude oil prices mandated a two time gasoline and diesel hike during the year, with provisional subsidies for farmers and public transportation systems. Government rejected the deregulation option suggesting that the move would not be prudent given global volatility in oil market. Despite the price hikes consumption of oil products was predicted to be 265 million tons, an increase of 8 per cent from 2010.

The nation's dependency ratio of foreign crude imports hit a new high of 55.2 percent in the first five months of 2011 surpassing the 53.5 percent in the United States. Import dependence which is seen as a key strategic vulnerability was attempted to be offset by the expediting the construction of petroleum reserves, with the capacity reaching a 36-day consumption level in the preliminary phase.

China intends to double natural gas use to around 8 per cent of energy consumption by 2015 to reduce reliance on more polluting energy sources, such as oil and coal, conserve energy and cut greenhouse gas emissions. The national gas demand may rise to 230 billion cu m in 2015, from the current 130 billion cu m. With the supply gap slated to surpass 120 billion cubic meters by the end of 2015, imports are likely to increase. Keeping in line with the projections, natural gas imports doubled in the first seven months of 2011, to 16.8 billion cu m, according to the National Development and Reform Commission.

Another aspect of concern is that China may not be able to improve its exploration and production technologies for unconventional gas such as shale gas and coal-bed methane (CBM) in time to ensure adequate supplies. To fill the gaps in supply, China has been in talks with Russia since 2006 to obtain 68 billion cubic meters (cu m) of natural gas annually for 30 years.

Auction of shale-gas blocks was slated at the end of this year in a bid to accelerate the pace of exploration and development of the fuel. China is estimated to have 31 million square kilometers of recoverable reserves of the fuel. The 12th Five-Year Plan (2011-2015) includes exploration and development of shale gas as a key component of the nation's strategic energy plan.

China's petroleum and chemical industry was valued at 8.88 trillion Yuan (\$1.38 trillion), putting it second place in the world behind the United States. Of the 8.88 trillion Yuan, 5.23 trillion Yuan was accounted for by the chemical industry, putting it in first place by value globally.

## COAL

Net coal imports declined 13.56 million tons, or 27.2 per cent year- on- year in the first four months of 2011. Rising international coal prices, about 100 Yuan more for each ton were the main cause of the decline.

By mid year, five of the biggest power companies which together provide half the power generated in the country reported increasing losses in thermal power business ventures as rising coal costs continued. This was despite electricity rate hikes by the government by 16.7 Yuan per 1000 kilowatt hours to ease financial pressures on the country's power companies.

Overseas markets also looked uncertain after the Mongolian government decided to 'rethink' development plans for the Tavan Tolgoi mines, the world's largest untapped coal mine, with an estimated reserve of 6 billion tons of coal. Earlier, Shenhua ,China's largest mining company by output was slated to have a 40 per cent stake in the development of the mine.

## NUCLEAR

Nuclear energy accounted for only about 0.8 percent of all primary energy sources in 2010. China has made clear its strategy of accelerating the development of technology over the next five years, and is aiming for a 2.2 percent nuclear energy share in the total energy mix by 2016.

China resumed the construction of its nuclear reactors which it had halted in March following the Fukushima disaster in Japan. Capacity at the end of 2010 stood at 10.9 GW, but projects already under construction would have pushed the total up to 40 GW by as early as 2015.

Pakistan meanwhile undertook discussions with Chinese companies for imports of the third-generation nuclear technology – the Chinese indigenous CAP 1400 pressurized water reactor.

## BILATERAL

China, signed an accord with Kazakhstan to expand the capacity of a pipeline network delivering natural gas from Central Asia by more than 80 percent to deliver 10 billion cu m of gas a year.

Energy-rich Turkmenistan decided to increase its natural gas deliveries to China by two-thirds under an agreement to increase annual gas deliveries by 25 billion cubic meters a year, bringing the annual total to 65 billion cubic meters .This is equivalent to more than half of China's entire natural gas consumption in 2010.

On Jan 1, 2011 Russia started to supply China with 300,000 barrels of oil daily via the first stage of the East Siberia-Pacific Ocean pipeline. Tariff disputes plagued the relationship between the two and a deal to supply with up to 68 billion cubic meters of Russian gas annually over 30 years has been subject to delay due to pricing disagreements.

Specified proposals were explored with Brunei to cooperate on offshore oil and gas exploration, as well as upstream and downstream energy cooperation. Brunei is the third-largest oil exporter in Southeast Asia and the fourth-largest natural gas exporter in the world.

China and Qatar meanwhile firmed up cooperation on LNG. China National Petroleum Corp (CNPC) signed long-term supply contracts with domestic and overseas partners for 320 million tons of LNG, equivalent to importing 22 billion cubic meters of LNG annually for 25 years.

CNPC's overseas expansion will continue to focus on the upstream division with Canada and Australia as the major targets. It meanwhile won a bid to develop an oilfield in northern Afghanistan, beating rivals from Australia, the United Kingdom, the United States and Pakistan. However it suffered a projected a loss of 1.2 billion yuan (\$187.4 million) after six big projects in Libya and Niger were terminated due to the unrest. .

### OVERSEAS ACQUISITIONS

China's rising demand for energy to support its strong economic growth is expected to trigger a new wave of overseas expansion, led primarily by the nation's large oil companies. China Petrochemical Corp agreed to pay \$3.5 billion for a 30 percent stake in the Brazilian unit of the Portuguese oil company Galp Energia SA, the company's latest move to buy into oil and gas reserves in the South American country.

This follows Sinopec's earlier purchase of a 40 percent stake in the Brazilian unit of the Spanish oil company Repsol YPF SA for \$7.1 billion in 2010. Sinopec, also acquires Canada's Daylight Energy Ltd for \$2.16 billion. China National Offshore Oil Corp (CNOOC), China's biggest offshore oil company, recently failed to acquire a stake in the Argentine crude producer Pan American Energy LLC, held by BP PLC due to legal issues.

Analysts suggest that through its "going overseas" strategy, China is aiming to build up first-class domestic enterprises with global competitiveness

## CLEAN ENERGY

China aimed to increase the proportion of non-fossil fuels in overall primary energy use to 11.4 per cent from the current 8 per cent by 2015. It announced goals of building 235 million kilowatts of power generation capacity from clean energy forms in the next five years, in an effort to trim the country's heavy reliance on fossil fuels. At least 70 million kW of wind power capacity and five million kW of solar power capacity is proposed to be created in the next five years, according to the draft plan.

China aims to cut carbon intensity by 40 to 45 percent from 2005 levels by 2020. Specific goals are set in the draft 12th Five-Year Plan (2011-2015), including cutting energy consumption by 16 per cent and carbon dioxide emissions by 17 percent, per unit of GDP from 2010 levels as well as slashing major pollutant emissions by 8 to 10 percent. During the year, China Power Investment Corp completed the setting up of the Carbon capture and storage (CCS) facility with an annual capacity of 100,000 tons.

## ENERGY EFFICIENCY

The energy intensity for every unit of GDP in China is still twice as much as the average level of developed countries, despite a sharp drop in energy intensity. Between 2000 and 2010, China's energy intensity fell 44 percent.

China is set to unveil a plan to impose controls on total energy consumption. The new plan, together with an energy-intensity target that has already been set for the period between 2011 and 2015, will provide policy guidelines for energy conservation and the reduction of emissions. The controls will be allocated to provincial governments.

Analysts suggest that the controls on total energy consumption will be tougher indicators than the energy-intensity targets, because there are loopholes through which local governments can achieve their energy-intensity targets by expanding the GDP base accordingly. China also laid out detailed plans to control greenhouse gas emissions in the coming five years, with the national target allocated to provincial governments.

China continued to be in a comfortable position as compared to other developed countries with large energy companies with good bargaining power in the global markets and on the efficiency front doing at times, more than the developed markets. However, as the country enters the second year of the 12th plan period, the enormity of the challenge continue to magnify and in all likelihood China is going to have to spend 2012 and the years ahead in serious pursuit of new energy sources and supply infrastructure.

**(Contributors:** Priyanka Mehrotra (International Relations), Rahul Prakash (Military and Science & Technology), Akhilesh Variar (Economy and Energy), Sriparna Pathak (Social Issues)).