
Eleven for '11: key things and events to watch for in China during 2011

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As China and the world bound into the Year of the Hare, it is worth examining key trends and events that are likely to shape events in China, as well as global perceptions of how China intends to utilize its growing economic, diplomatic, and military clout.

The eleven key items we choose as “things to watch” in 2011 are signposts to guide readers. We readily acknowledge China’s complexity and recognize that a multitude of other events will also define 2011 in China and look forward to maintaining a strong flow of detailed, interesting, and anticipatory research and analysis.

- 1) **Policymakers will continue dancing on the real estate market’s razor edge.** Housing prices have risen steadily in China during 2010, despite a number of policy initiatives including interest rate increases and increased down payments aimed at keeping real estate price inflation in check. Beijing has even gone so far as to allow families to only purchase one new home in order to curb speculation, according to the *The Economic Times*. The government is now in the unenviable position of seeking to keep housing affordable as millions of people move to cities each year, without crashing house prices in a country where real estate has become an increasingly important component of GDP and personal savings and investment. A misstep or sudden unexpected drop in real estate prices in China would likely chill global financial and commodity markets that increasingly look to China’s economic health as a benchmark.

- 2) **Food prices will keep inflationary pressures up.** China’s government is particularly mindful of inflation, given its role in helping to topple the Nationalist government after World War II. Food accounts for 1/3 of China’s CPI calculation, according to *Xinhua*. In the past six months, drought has curtailed grain crops and led Russia to halt grain exports. Floods hit Pakistan’s main agricultural region. Drought is also afflicting the U.S. winter wheat crop and wheat-growing regions of the Middle East, which may be forced to import supplies. These factors, in turn, will likely drive global wheat and grain prices higher and pressure consumers in China.

- 3) **Continued gradual currency revaluation.** A combination of foreign pressure and a desire to develop the domestic consumer economy and source raw materials at better prices are likely to drive a gradual but meaningful continuation of China’s recent incremental appreciation of the RMB against the U.S. dollar. Consumers should be careful what they wish for, as RMB revaluation will not bring manufacturing jobs back to

the U.S. from China and may also exacerbate inflationary pressures on consumers outside China.

- 4) **Car sales growth will slow due to parking & road infrastructure constraints.** Investment in highways linking Chinese cities has been phenomenal in the past 5 years. The country's network of expressways has grown from 7,450 miles in 2000 to more than 40,000 miles today. However, construction of urban roadways and car parking facilities has not kept pace and severe traffic congestion is resulting. Beijing is moving to drastically curtail growth in its vehicle fleet in 2011 and other large cities may follow suit as the problems of higher private car ownership begin to bite. Sales growth in second and third tier cities with less traffic congestion will still support growth, however.

- 5) **Chinese companies will seek to acquire more non-fuel mineral resources abroad.** CNPC, Sinopec, and CNOOC's overseas energy asset buying spree of recent years is likely to be matched by other firms looking to access greater supplies and economic returns that can be found in sectors such as iron ore, potash, and copper. For instance, Russian media say Chinese investors are interested in a copper deposit in the Magadan region of Northeastern Siberia. We also believe that Chinese firms will scout aggressively for potash resources, given potassium fertilizers' critical role in maximizing domestic grain production.

- 6) **U.S.-China trade tensions may sharpen as the U.S. economy continues to gradually climb from recessionary lows and election season nears in both countries.** China's top leadership will move cautiously on international agreements as the 2012 leadership transition draws near. Simultaneously, Chinese decision-makers will face even greater pressure to continue to implement domestic content requirements and other protectionist measures despite contradictions with WTO norms. China's increasing economic clout, market growth, and increasing concentration of key resources and production facilities for cutting-edge "green" products (e.g., heavy rare earth elements and factories to produce batteries for electric cars) will encourage them to believe that Beijing can get away with such approaches. Yet, with the 2012 Presidential election looming, it will be increasingly difficult for the U.S. government to make compromises on trade and currency issues. Congressional legislation is already targeting "currency manipulators" with trade sanctions and with continued high unemployment, attacking China on trade issues will be a tempting political tactic likely to resonate with significant portions of an increasingly frustrated U.S. electorate.

- 7) **China heavy truck & heavy equipment sales.** Sales of heavy trucks in China rose more than 50% year-on-year in 2010. Heavy truck and earthmover sales will be barometers of how robust infrastructure and housing construction are, and will be, for the next 12-18 months in China. They will also help clarify what level of diesel fuel and construction-related commodities (iron ore, cement, and copper) the Chinese economy will demand. If indeed there is significant softening in China's real estate market or economic growth more generally, we'll see early indications here.
- 8) **To what extent will rising labor costs & a more valuable RMB drive manufacturing from China?** As coastal labor costs rise in China and the RMB creeps upward in value, it will be telling to watch to what extent manufacturers move operations to lower-cost countries like India and Vietnam. Corporate actions thus far suggest that manufacturers regard China's interior provinces as attractive sources of low-cost labor. Electronics maker Hon Hai, for example, says it intends to have 50% of its workforce located in China's inland region within two years and 66% within five years, according to the *Wall Street Journal*. At present, only 20% of Hon Hai's employees are located in inland areas of China. As one of China's few major inland economic hubs, with direct container shipping access to the ocean via the Three Gorges Dam and Yangzi River—as well as dynamic leadership from [CPC Chongqing](#) Committee Secretary Bo Xilai—expect the municipality of Chongqing in particular to capitalize on domestic manufacturing distribution.

Security & diplomacy issues

- 9) **Photos of an indigenous aircraft carrier hull under construction will likely be published.** As a tangible symbol of China's growing military reach, an indigenous aircraft carrier would garner support from a nationalistic, technology-loving population that, based on blog posts and other written publications, is extremely supportive of such development. China has the physical shipyard size to fabricate a carrier and unconfirmed news reports claim that the decision has already been taken to build a Chinese aircraft carrier in Shanghai's new Changxingdao Shipyard. The former Ukrainian carrier *Varyag*, currently being refitted at a state-run shipyard in Dalian likely to serve as a training vessel, has already been featured in numerous photos. We believe there is a high probability that in the next 12 months, photos will emerge of a new, indigenous carrier hull. Nevertheless, China continues to develop far more significant anti-carrier than carrier capabilities, and that brings us to our next signpost.

10) **China's other military developments will come under closer scrutiny.** The advanced UAV models shown at the 2010 Zhuhai Airshow, the recent revelation that China's 'carrier killer' anti-ship ballistic missile (ASBM) has reached the equivalent of initial operational capability, and the recent photos of an alleged J-20 5th-generation fighter prototype all suggest substantial technical advances. Moreover, senior defense officials are taking a strong rhetorical stance regarding China's need for a stronger military. Defense Minister Gen. Liang Guanglie recently said China's military "needs to prepare itself for conflict from every strategic direction" over the next 5 years. In conjunction with signs of technical progress on various weapons systems, such remarks will provoke unease in Washington, as well as Tokyo, Seoul, Hanoi, and other regional capitals regarding China's intentions as its military capability grows.

11) **Tensions are likely to remain high in the East China Sea between China and Japan.** The East China Sea is a significant maritime flashpoint in East Asia. Beijing's fall 2010 diplomatic confrontation with Tokyo after the Japanese Coast Guard detained Chinese fisherman near the disputed Senkaku/Diaoyu Islands, as well as recent articles discussing aggressive behavior by Chinese aircraft and an increasing number of interceptions by the Japan Air Self-Defense Force are causes for concern. With more military platforms operating in close proximity to each other in an atmosphere of bilateral tension, the likelihood of a serious incident akin to the 2001 EP-3/J-8 collision near Hainan Island has risen. The South China Sea will likewise remain an area of ongoing strategic tension, though significant military incidents are somewhat less likely given the disparity in military capabilities between China and its neighbors there. Finally, there is a meaningful probability of an accidental encounter between U.S. and Chinese military platforms in the East or South China Seas. We hope such an event does not occur due to the negative results for both countries, but believe the potential for such an accident and the magnitude of possible consequences deserve close attention.

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China SignPost™ 洞察中国 founders Dr. Andrew Erickson and Mr. Gabe Collins have more than a decade of combined government, academic, and private sector experience in Mandarin Chinese language-based research and analysis of China. Dr. Erickson is an associate professor at the U.S. Naval War College and fellow in the Princeton-Harvard China and the World Program. Mr. Collins is a commodity and security specialist focused on China and Russia.

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