

General Political Environment:

At the 16th Congress of the Chinese Communist Party (CCP) in 2002, Hu Jintao was named the new General Secretary and subsequently confirmed as China's president. The 17th Party Congress, during which key Party appointments were made, was held in October 2007. The most significant appointments occurred within the CCP's top decision-making body, the nine-person Politburo Standing Committee (PSC). While President Hu was expected to solidify his position by surrounding himself with loyalists, what emerged from the Congress was a divided PSC with individuals from different (and sometimes competing) CCP factions securing PSC positions. Two potential successors to Hu from two different factions were appointed to the PSC in October and events over the next five years will determine who will be the next president.

The current leadership appears to recognize that the CCP's legitimacy (and hold on power) depends upon improving living standards, which in turn, depend upon continued economic growth. Economic primacy is, however, being tempered by the leaders' realization that they need to address the social costs of growth such as widening income gaps and environmental degradation. Particular emphasis is being placed on improving conditions for rural citizens via tax reform, social spending and the dismissal of corrupt local officials. While Hu has been keen on advancing this 'harmonious society' agenda, the divided PSC that emerged from the Congress may hamstring his action on this front to a certain extent.

China is deeply opposed to the pro-independence sentiments in Taiwan and has repeatedly threatened to attack the island (which it considers to be a renegade province) should it take steps towards independence. Cross-strait relations are expected to improve following Taiwanese elections in 2008.

Beijing will be hosting the Olympic Games in 2008 and has made efforts to improve its international image in the lead-up to the Games. At the same time the government has been taking steps to suppress dissent that may arise during the event. In spite of these efforts, increased protests highlighting various causes are expected to occur in 2008.

Investment Environment:

China's complicated and highly personalized commercial environment poses risks for foreign investors. Frustrations tend to focus on the lack of legal protection for investor and intellectual property rights, inconsistent application of regulations, corruption and bureaucratic meddling.

That said, China is working to encourage foreign investment by developing a more rules-based business environment. Recent changes include the passing of China's first-ever legislation protecting private property and an anti-monopoly law. While the passing of such legislation will provide further clarity to investors, implementation and enforcement of these and other changes is likely to be inconsistent across regions and industries for some time. Also significant is the fact that there is some evidence of 'pushback' against some reforms from within the CCP.

The on-going anti-corruption campaign being carried out by the central government reached a climax in 2006 with the dismissal of Chen Liangyu, the CCP party chief in Shanghai and Politburo member. Chen is the most high-profile official targeted to date. According to government figures, approximately 20,000 officials have been punished for corruption in 2006. The CCP recognizes the importance of tackling corruption among government officials to ensuring its legitimacy and as a result the anti-graft campaign will continue to receive significant attention.

In 2007 'Made in China' manufactured goods took a reputational hit when a wide array of goods produced for Western export markets were found to be unsafe. Although this did not have an overly significant effect on China's manufacturing sector, it did lead to the Chinese government launching retaliatory accusations against the safety of certain foreign goods entering the country.

Political Violence:

Demonstrations against local-level corruption and land seizures are becoming more numerous (over 87,000 in 2005) and violent but they do not yet pose a major threat to the CCP owing to their localized nature. Authorities have used deadly force to suppress demonstrations (for the first time since 1989) on at least two recent occasions.

Political

Political Structure

One-party rule

The Chinese Communist Party (CCP) rules at all levels of government. All other political organizations are illegal.

General Secretary of CCP and President

Hu Jintao

Premier

Wen Jiabao

Executive/Legislative Bodies (Government and CCP)

- State Council
- Politburo Standing Committee (PSC)
- Central Committee,
- National People's Committee (NPC)

Last Elections

- Presidential: March 2003
- State Council: March 2003

Next Elections

2008

Press Freedom Survey:

- 2006 Score: 83 (Not Free)
- freedomhouse.org

Control of Corruption Index:

- 2006 Score: -0.53 (-2.5: Worst; +2.5: Best)
- worldbank.org

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Political Outlook

Continued economic growth is still priority number one for the Chinese central government although this push for growth will increasingly be tempered by measures to help those who have failed to benefit from the country's economic restructuring process. As part of this effort, the central government will step up measures to deal with corruption on the part of local-level officials. The Party Congress held in October 2007 did not solidify President Hu's position to the extent expected which will likely result in increasing factionalism within the highest levels of the Party and will moderately constrain Hu's ability to act.

Economic

Credit Agencies

Moody's: A1
S&P: A
Fitch: A

Nominal GDP (2006)

USD 2,765 bn

Population (2005):

1,315 millions

Total Trade / GDP:

62.3%

Currency:

Yuan (Renminbi)

Exchange regime:

Pegged arrangement

Merchandise imports from Canada:

CAD 7,183 mn (2006)

Main sources of Foreign Exchange (excl. FDI):

Manufactured exports

Largest Merchandise Trading Partner:

United States (21%)
Japan (11%)

Main imports:

Industrial Machinery (21%)
Textiles (9%)

Risks to the Outlook


Strong foreign direct investment
Labour productivity
Robust consumption



Over-investment
Fragile banking sector
Risk of hard landing re-emerging

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www.edc.ca/economics

Market Spotlight: Recent data confirm China's economic expansion remains on track. GDP advanced 11.5% y/y in H1/07 just ahead of the 2006 pace. Industrial production continued to post solid advances, though retail sales appear to be easing up a notch in inflation-adjusted terms. So too, exports continue to post solid gains, albeit in the 20% y/y growth range, compared to 30% last year. The authorities remain preoccupied with shifting growth away from exports and into consumption and at the same time boosting the vibrancy of the rural regions while taking a spoke out of the urban boom. Speculation over China's exchange rate policy and its effect on bilateral merchandise continues, and EDC Economics anticipates that the authorities will remain focused on domestic economic factors to guide policy.

Recent Economic Developments: Industrial Production (IP) was up by 17.5% y/y in August, down slightly from the 18% rise in July, but still in line with gains posted over the first half of 2007 and up off of the 14.8% y/y rise in Q4/06. On the consumer front, retail sales climbed 17.1% y/y in August, after rising 16.4% in July. Overall, the data confirm that China is succeeding in boosting domestic growth. But adjusted for inflation, retail sales growth has softened a notch when compared to Q4/06. Indeed, CPI advanced 6.5% y/y in August, compared to about 4% for the year to date. Food costs in particular have been escalating and consequently are the key driver of inflation. The nature of China's inflation so far is largely due to consumer shortages – and as such producer prices have more or less remained in check. The money supply (M2) has also been creeping higher over the year – up 18.1% y/y in August compared to 15.9% y/y in January. The authorities have responded by forcing interest rates higher and pushing the banks' reserve requirement ratios higher.

Trade: China's rapid expansion has been accompanied by a surge in both merchandise exports and imports. Exports expanded 25% y/y on average during 2001-06 while imports shot up 24% y/y over this period. The more rapid pace of export growth has driven the trade surplus from US\$34 billion in 2001 to over US\$200 billion in 2006, and an even wider surplus approaching \$300 billion is expected this year. So far in 2007, exports have advanced 27% y/y, compared to a 19% rise in imports. However the pace of export growth to the US is weakening (16% y/y over the first 9 months, compared to 25% y/y in 2006).

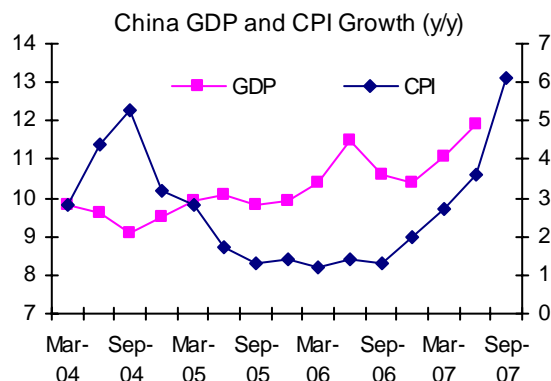
The current account has posted similarly impressive figures: widening from 1.3% of GDP in 2001 to over 9% in 2006. Not surprisingly, foreign exchange reserves have topped US\$1 trillion or with an import cover rising from 9.5 months to over 14 months respectively. The US and EU continue to pressure the Chinese authorities to allow the yuan to appreciate more rapidly. The yuan has gained 10% against the US\$ since being re-pegged in July 2005, but China appears to be following its own agenda regarding yuan appreciation – recently capital allowances for Chinese residents leaving the country were raised.

Medium-term Outlook: Despite a policy-induced tightening, economic activity remains robust – showing few signs of abating. The authorities are not expected to significantly modify the three main pillars of China's economic development strategy – urbanization, industrialization, and greater openness to trade and capital flows. This means that China should be able to maintain a solid 10% growth trajectory going forward. A shift in terms of increased government spending should help to alleviate a decline in the export sector's contribution to the expansion due to softer demand in the US.

Economic Indicators

	01-05 avg.	2006	2007(f)	2008(f)
GDP (% growth, real)	9.6	11.1	11.0	10.0
Inflation	1.3	1.7	4.5	3.5
Fiscal Balance (% of GDP)	-1.9	-1.2	0.2	0.1
Export growth (%)*	25.1	27.2	25.0	20.0
Import growth (%)	24.0	19.7	20.0	22.0
Current Account (% of GDP)	3.4	9.0	10.0	9.5
Reserves (month of imports)	10.8	14.3	16.0	15.5
External Debt (% of GDP)	12.9	11.4	11.0	10.5
Debt Service ratio	5.8	2.9	2.7	2.5
Currency (end of period)	8.2	7.8	7.5	7.2

*Five-year average for 2001-05 - Sources: EIU Data, EDC Economics



Source: Bloomberg