IHS COUNTRY RISK

China – IHS Country Risk Insight

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Key Summary

- **President Xi Jinping's elevation to ‘core’ leader status ensures his term until 2022 and probably his influence on policy beyond that.**
- **China will continue its gradualist approach to investment liberalisation except in oil and gas, energy, telecommunications, transportation, and banking, where state-owned enterprises will remain crucial instruments of policymaking.**
- **China continues to assert territorial claims in East and South China seas, although the resumption of dialogue reduces the risk of escalation and military miscalculation.**
- **China’s economy closed 2016 on a relatively high note, but progress on longer-term objectives such as rebalancing between investment and consumption was mixed.**

Risk scores

Risk Ratings		
Overall	2.1	ELEVATED
Political	1.6	Elevated
Economic	1.8	Elevated
Legal	2.2	Elevated
Tax	2.1	Elevated
Operational	2.8	High
Security	2.0	Elevated
Individuals	2.0	Elevated
Cargo and transport	1.5	Moderate

Low	Moderate	Elevated	High	Very high	Severe	Extreme
0.1-0.7	0.8-1.5	1.6-2.3	2.4-3.1	3.2-4.3	4.4-6.4	6.5-10.0

Structure and calculations

Analysts determine scores based on qualitative guidance. Each score represents the average expected level of risk over the coming year, and each outlook represents the projected direction of risk trends after that 12-month period. Overall risk scores are calculated as equally weighted averages of the six aggregate categories – Political, Economic, Legal, Taxation, Operational and Security. Risk is scored on a 0.1-10 scale. The scale is logarithmic, with intervals of 0.1 magnitude. This range is split into seven bands, ranging from Low to Extreme risk.

Business environment - strengths and weaknesses

Strengths	Weaknesses
Political stability will continue despite rising numbers of largely isolated economic protests and labour strikes.	China has a functioning legal system, but it remains heavily politicised.
China has a highly centralised national policy framework and stable government, which delivers comparatively predictable policy output.	Bureaucracy, corruption, and a lack of transparency are key obstacles to conducting business in China. World Bank data estimate it took 29 days on average to start a business in China.
The control exerted by the Chinese Communist Party (CCP) ensures that security risks are not a major threat to business.	Despite the leadership's vow to "let the market decide", the Chinese economy remains heavily state-dominated, and foreign companies are particularly vulnerable to heavy-handed state interventions.
The stimulation of growth in the interior and the western hinterlands, coupled with continued reform of the rump state sector, remains a central domestic policy priority.	By fuelling social instability in the form of protests across China, corruption poses one of the most serious (but still small) threats to the long-term political and economic stability in the country.

Country risk - overall statement

The government's high-profile anti-corruption drive will continue until at least the next Party Congress scheduled in the autumn of 2017, continually strengthening President Xi Jinping's hardline faction within the party. Increased use of social media and a slowing economy are likely to lead to more strikes, while protests over land disputes may decline because of pending land-tenure reforms. Punitive tariffs on Chinese imports and taxes on American companies manufacturing in China under US President Trump's administration, although unlikely, would prompt China to retaliate by intensifying regulatory harassment of US and probably other foreign companies. However, official US affirmation of the "One-China" policy reduces the risk of military escalation in the Taiwan Strait and South China Sea.

Detailed Analysis

President Xi Jinping's elevation to 'core' leader status ensures his term until 2022 and probably his influence on policy beyond that.

Power is centralised in the Communist Party of China (CPC), and authority within the party is effectively concentrated in the seven-member Politburo Standing Committee (PBSC). At the head of the PBSC is Party Secretary-General Xi Jinping, who has been in office since November 2012. President Xi has brought the People's Liberation Army (PLA) firmly under his control through a series of adjustments to its command structure, placing himself in direct command of the PLA, and appointing trusted officers to key command positions. Importantly, on 27 October 2016, at the end of a four-day plenum of the 18th CPC Congress, the party members were called upon to unite around the central committee with Xi as the "core". This apparent elevation of Xi – only Mao Zedong and Deng Xiaoping were referred to as core – has reinforced his authority within the CPC for the remainder of his presidency, which is almost certain to last until 2022.

Since assuming the presidency, Xi has made tackling corruption a priority, although the systemic causes of corruption remain largely unaddressed. Hundreds of officials have been censured, and although there were many such campaigns in the past, the current campaign is unprecedented in the extent of its reach. Several former top national leaders, including former PBSC member Zhou Yong-kang and top presidential-aide Ling Jihua, were indicted – Zhou was sentenced to life imprisonment, making him the most senior official to be punished for corruption in the reform era. Dozens of other senior officials at the ministerial-provincial level have been removed, and a number of senior military officers have also been charged with corruption, including the two most senior officers in the PLA under the previous administration. Through the anti-corruption campaign, Xi has successfully eliminated or weakened hostile factional interests, and the campaign is likely to maintain its current intensity until at least the 19th Party Congress, likely in late 2017.

China will continue its gradualist approach to investment liberalisation except in oil and gas, energy, telecommunications, transportation, and banking, where state-owned enterprises will remain crucial instruments of policymaking.

In most of the reform documents issued under Xi, however, limited scheduling details are provided, besides requiring the majority of reforms be implemented by around 2018, and full implementation by 2020. This gradual pace is due mainly to the party's regular interference in the regulatory environment, especially related to SOEs. A few specific examples include the planned expansion of free-trade zone trial reforms nationwide in 2018; implementation of a nationwide property tax in 2018; and for most systemic (rather than trial) SOE reforms to take place during 2018–20. The second term of President Xi coincides with the 13th Five-Year-Plan (2016–20). The government is planning a modest GDP growth rate of 6.5–7%, with an aim to derive most of its growth from the technology and innovation-related sectors. Greater inclusion of Macau and Hong Kong in the mainland’s economic growth, gradual liberalisation of the interest rate regime, and greater accountability and transparency in the party are some of main features of the five-year-plan (FYP).

Chinese officials have sent out a clear signal that the government will focus increasingly on welfare improvement, with a greater emphasis on the quality and sustainability of economic growth, rather than pure growth rates. Towards that end, the new FYP will continue the 12th FYP's (2011–15) focus on urbanisation, low-cost housing, inland development, and financial liberalisation. Development policy will emphasise the use of cleaner and safer technologies in manufacturing, generating more value added, and creating higher-paying jobs through the promotion of knowledge-based service industries. To counter the current economic slowdown, the government hopes to stimulate private business investment and household consumption through significant reductions in taxes and fees, thereby reducing the dependence on public-sector investments. However, market-oriented structural economic reforms will proceed more slowly than many had anticipated. State-owned enterprise reforms will be focused on the privatisation of smaller state-owned firms at the local level, while selected "strategic" sectors, including oil and gas, energy, telecommunications, transportation, and banking, will also only see some limited opening to private investment.

China continues to assert territorial claims in East and South China seas, although the resumption of dialogue reduces the risk of escalation and military miscalculation.

China is involved in a territorial dispute over the Senkaku/Diaoyu Islands with Japan. This was exacerbated in 2012 when the Japanese government purchased the islets from a private owner. In response, China launched regular air and sea patrols to the area, prompting repeated interceptions by Japanese vessels and aircraft. Following the resumption of high-level dialogue in 2014, incidents of air and naval confrontations declined significantly in 2015 and early 2016. However, on 9 June 2016, a Chinese frigate sailed within 24 nautical miles of the Senkaku Islands – the closest approach to date by a Chinese warship towards the Japanese-controlled islands. The move was likely intended to signal Beijing's displeasure with Japanese support for various Southeast Asian states involved in territorial disputes with China in the South China Sea (SCS). Although China prefers to avoid direct military conflicts with Japan, further such approaches by Chinese warships will be likely if Japan were to respond by deploying warships to the islands.

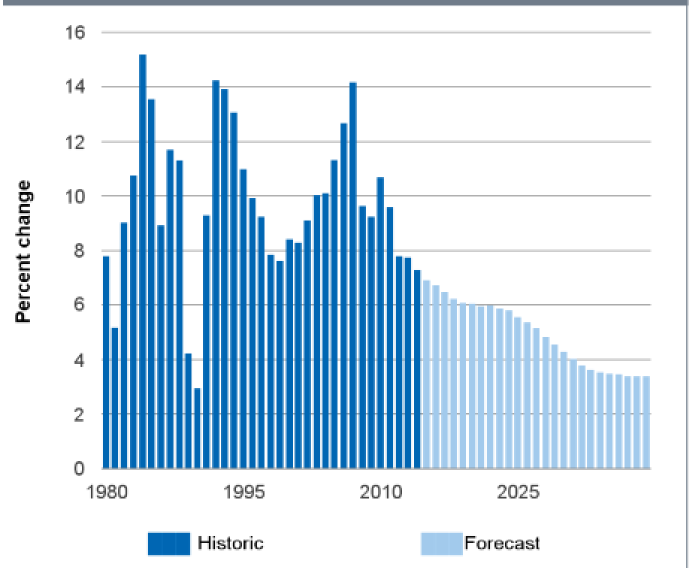
China claims most of the islets in the SCS, a claim actively disputed by five other regional states, including Vietnam and the Philippines. On 12 July 2016, an international tribunal in The Hague ruled in favour of the Philippines’ territorial claims in the SCS. Since then, however, Beijing has initiated bilateral talks with the Philippines' newly elected prime minister, Rodrigo Duterte. In exchange of economic aid and military support, Beijing has managed to soften Manila's stance in the SCS. Meanwhile, the continuation of military surveillance means that occasional disputes between China and the United States are likely – as witnessed on 19 December 2016, when China captured an American drone in the SCS.

In February 2017, US president Donald Trump confirmed the One China policy, which states that Taiwan and mainland China are inseparable parts of a single China. In a bid to focus on domestic labour and pension policy issues, in the meantime, Taiwan's ruling pro-democracy DPP party is unlikely to severe ties with China over the one-year outlook. As a result, despite occasional military drills and exercise, a full-blown war in the Taiwan Strait is unlikely.

China's economy closed 2016 on a relatively high note, but progress on longer-term objectives such as rebalancing was mixed.

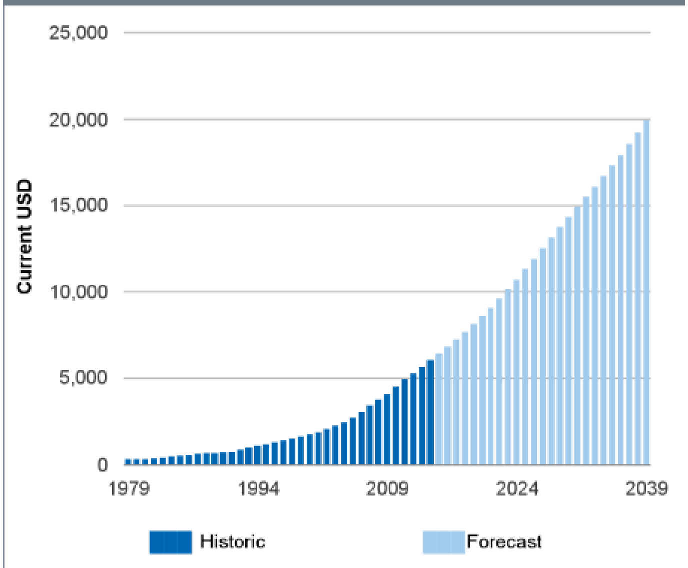
China's real GDP growth accelerated marginally in the fourth quarter of 2016 to 6.8% year on year (y/y) from 6.7% in the previous quarter. From the supply side, faster growth in the transport and other services sectors contributed to the fourth-quarter pickup. The construction sector that supported economic growth in the first half of the year slowed further in the final quarter. From the demand side, faster growth was due to easing export decline. For 2016 as a whole, economic growth slowed to 6.7% from 6.9% in 2015. Service sector growth, while still outpacing overall economic expansion, slowed to 7.8% in 2016 from 8.2% in 2015. Growth in the secondary sector (industrial and construction) slowed only 0.1% in 2016 to 6.1%. Within the secondary sector, industrial sector growth remained steady at 6.0% in 2016, while construction sector growth fell from 6.8% in 2015 to 6.6% in 2016. The service sector slowdown was largely caused by a deceleration in financial service sector growth from 16.0% in 2015 to 5.7% in 2016, which was expected owing to the high base effect from the stock market bubble and crash in 2015 that ramped up financial service sector activities. Real estate service growth, on the other hand, accelerated from 3.2% in 2015 to 8.6% in 2016, owing to the rebound in the housing market.

China: Real GDP



Source: IHS © 2017 IHS

China: Nominal per-capita GDP



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