



Ogilvy Public Relations Worldwide



Dragon Dynamics:

Prognostications for the Year of the Dragon

On Sunday evening, January 22nd, at the stroke of midnight, we will hop out of the Year of the Rabbit and into the Chinese New Year of the Dragon. For the Chinese, the Year of the Dragon is the most desirable year to give birth to a child, because Dragons are believed to be natural leaders - gifted with courage and wisdom. All of us at Ogilvy PR hope your Year of the Rabbit was a successful one. In what has become a tradition for us, we have worked to make sense of all of the predictions, rumors, hearsay and forecasts to share with you our views on what to expect in the Year of the Dragon.

It is common knowledge that the dragon is a symbol of power, closely associated with Chinese emperors past. When the world's geomancers write about the Dragon year, words commonly used include "wealth", "strength", "power", "magical" and "unpredictable" (difficult to see the head and tail of a dragon at the same time). Common themes among feng shui experts for the year include "change", "renewal" and "mixed feelings of joy and sorrow".

Although the 2009 science fiction film 2012 portrayed this to be a year of "Armageddon", we don't see that happening. However, like the film, we do believe China will figure prominently in the world in 2012.

A leap year, many predict 2012 will be "transformative", "highly energetic" and "full of changes". This paper explores many of the economic, political and social themes dominating discussion in China and offers our views on what to expect in the coming year. We also examine the implications of the upcoming U.S. elections and the ongoing Eurozone crisis on bilateral relations between China and these strategic partners.

Changing of the Guard

The Year of the Dragon will mark the high-point for activity and drama in a leadership transition which began in the Year of the Rabbit, 2011, and will formally conclude in the Year of the Snake, approximately March 2013.

Commentary and suspense are set to reach a peak in autumn of this year, as the nation's current and former leaders gather in the lead-up to the annual Communist Party Congress, when the new leadership will, quite literally, walk onto the national stage in a ritual showing of the new guard.

While the impact of the leadership transition will be felt broadly across every government body and Party organ, this year all eyes are turned to the country's top leadership group, the Politburo Standing Committee, where seven of the country's current top nine leaders face mandatory, age-restricted retirement.

The Standing Committee, which sits atop the Politburo, the Central Committee, and ultimately China's more than 80 million Communist Party members, forms the core of China's government and administration, overseeing the armed forces, administration, propaganda, security, and Party organizations. Needless to say, the balance and make-up of this consensus-led body will set China's course for the next decade.

The negotiation and horse-trading that determines succession is a tightly-guarded process that is guided and managed by current and former leaders and Party elders. The transition has been described by a senior official close to Ogilvy PR as "the grandparents selecting the grandchildren." This year's transition is significant for being the first leadership handover conducted without the guiding hand of Deng Xiaoping, who played a crucial role in selecting Hu Jintao. Should his health continue to hold strong, former President and Party Secretary Jiang Zemin could play a vital role this year.

With Vice President Xi Jinping and Vice Premier Li Keqiang as the only holdovers on the Standing Committee, there is a strong undercurrent of coded, behind-the-scenes campaigning currently taking place to fill the vacated seats with rising political stars. While Xi and Li have been broadly suggested for promotion to President and Premier, a few wild-cards remain in the leadership deck, including financial and economic star Wang Qishan, who is whispered to play a stronger role as China continues its emergence onto the international stage.

The remaining positions on the Standing Committee are set to be filled with a balance of leaders representing loosely labeled "factions" representing more market-oriented or society-oriented mandates. While the specifics of selection will determine the final direction and strength of the mandate, expert voices have begun to portray leadership by Xi Jinping as favoring economic growth and the market economy, while taking a stronger stance internationally that will protect and promote China's interests.

Personalities to Watch

People to watch for in the opening months of the Year of the Dragon include Governors of key provinces - Wang Yang from Guangdong and Bo Xilai from Chongqing - who are each promoting unique approaches to balancing economic and social development while reducing tensions arising from rapid growth. Also involved in the transition will be a number of key players in Party organizations.

In the Year of the Dragon we are predicting anything but predictability, but there are some things we can say with reasonable certainty. In the first quarter, we do not expect any surprises. We know that the leadership is putting great emphasis on what one insider describes as "an uneventful transition." The speculation and tension surrounding the leadership change has kept many people waiting on the sidelines to see who is selected and what the future will hold.

From April through October of this year, the leadership transition will turn from discussion on what legacy the outgoing leadership hopes to impart, to what the new leadership hopes to create. In whatever form it takes, we will see a continued focus on stability, balance, and new growth opportunities for a nation that is, in many ways, still a resource-limited developing nation. While the 12th Five-Year Plan will guide the way, and domestic issues will be at the forefront, emerging issues in the international environment, not least the U.S. elections, will throw new challenges and opportunities at this leadership class.

We're certain that the Year of the Dragon will have its share of surprises, transitions, and fireworks, and we will keep you well-informed as events unfold.

Economic Slowdown: Soft Landing or Crash?

Bulls and Bears are not found in the Chinese Zodiac, but their prognostications about the direction of China's economy will continue to influence fortunes in the Year of the Dragon. Everyone is predicting a slowdown. The question is: Will China ride the dragon in for a soft landing or come crashing down short of the runway, perhaps bringing the rest of the world with it?

The bears foresee a crash, citing declining exports as the world's other major economies continue to reel from financial crises, and point to an inability of the government to support another massive stimulus like it did in 2008-2009. They argue that RMB appreciation of 4.5% against the dollar in 2011 and climbing labor costs inevitably make exports uncompetitive. All of this, plus a looming property bubble and increasing inflationary pressures suggest to the bears that the Year of the Dragon will be characterized by a hard landing.

The bulls point to rapidly growing incomes and living standards in the mainland as creating conditions for a shift from an export-driven economy to one fueled by domestic demand and consumption that can sustain reasonable growth. They point to the government's aggressive management of its fiscal and monetary policies, its commitment to controlling inflation, its ability to set exchange rates and a continued housing shortage nationwide as offsetting localized bubbles as indicators of the likelihood of a softer touchdown.

Xuebin Chen, a Professor of Finance at Fudan University expects the RMB to appreciate in the range of 2%-3% in 2012 according to Reuters. Analysts cited by the state-run newspaper China Daily predict easing inflation and a declining CPI with a target of 4% due to monetary tightening and decreasing commodity prices as global demand weakens. The paper further predicts GDP growth at around 8.8%. In tandem, Standard Chartered has projected a growth rate of 8.5% for 2012-13, which is in line with the forecasts of most major banks.

It is Ogilvy PR's view that a crash is unlikely, and that opportunities will continue to exist for companies and brands in China even if the economic touchdown looks something between what the bulls and the bears predict. Increasing trade competition, disputes and protectionist policies in struggling economies will hurt exporters. Housing prices in major cities and in some pockets where "ghost cities" have sprung up are likely due for a correction. Inflation will be something to watch closely. There will be some pain.

But while slowing economic growth from more than 9% in 2011 to 8.5% or even 7.8% in 2012 may be dramatic on the percentage scale, a number of local financial experts argue it still represents growth more than three times faster than the other major global economies.

Domestic Consumption the Hidden Factor

Chinese consumers are awakening. They see real value in the products and services that improve their quality of life that were, until very recently, simply not available. Thrifty ways are falling by the wayside as credit cards and a multitude of ecommerce platforms facilitate spending on an increasing array of consumer products and the necessities of modern life. And, while the transformation of China's major cities, including Beijing, Shanghai and Guangzhou, still outpaces that of smaller urban centers, we predict that the changes will continue to penetrate more deeply into the second- and third-tier cities in the coming years.

The most significant growth opportunities will be outside the major metropolises, and the rise of the lower tiers will serve as a cushion against any decline likely to hit the tier-one cities hardest. For perspective, Suzhou, the once sleepy town celebrated throughout Chinese history in poetry and song for its bucolic gardens and canals, is today a metropolis of 10 million people with a GDP of US\$113 billion and a growth rate of 11% in 2010. It is government policy to develop such cities further as part of the 12th Five-Year Plan.

Furthermore, policymakers in cities such as Suzhou, Chengdu, Hangzhou, Dalian and many others are working to carve out their own niches in the national economy and attract foreign investment by improving infrastructure and the labor force, as well as by defining themselves as hospitable to foreigners through social and policy reforms, and highlighting the availability of foreign schools and hospitals that support an expatriate community.

Economic Wild Cards

Inflation and the CPI

In its last edition going to print before the Chinese New Year, the leading Party publication "Seeking Truth" put price inflation front and center in an article written by top statistician Ma Jiantang. Despite the slowing of CPI in recent months to a 15-month low of 4.1% in December, the issue of inflation remains a critical gauge for China's leaders as they adjust monetary policy and attempt to keep China's economic engine revving strong in the face of lagging international demand.

The prominent placement of this article reflects the level of concern as the truth behind the CPI numbers is that, even as inflation slows, the continued uptick in food prices, which grew 9.1% this year, is taking an increasingly larger bite out of the average consumer budget. Economists are divided on whether slowing inflation is likely to continue, but if and when it does reverse course, China's leaders may be forced to step in and act to protect a hungry and unhappy populace.

Long-term trends continue to point toward rising prices for land, labor, and resources while high international liquidity continues. For the moment, the CPI trend looks set to continue its steady downward trajectory in the months following the Spring Festival, while slight loosening in monetary policy and warming international economic growth level it out and perhaps push it higher in the middle of the year.

Analysts this year will be watching not only the CPI, but also reactions from the newly emerging government, carefully parsing how their response to this critical issue reflects their political and economic leadership. A lower inflation target and macro-controls will generally reflect a more serious attitude towards social equality, while a looser policy may favor the drivers of business and economic growth. Whichever way the wind blows, China's leaders always understand the importance of a full bowl of rice, and will maintain their focus on this issue.

Private Sector Growth Barriers

Among the many themes of China's continued economic growth is the role the private sector is expected to play and the imbalance that currently exists relative to the state sector. According to the State Administration of Industry & Commerce, China's private sector currently provides about 180 million jobs. From 2006 to 2010, the country registered 40 million private businesses and the private sector has employed 7.87 million workers laid off from state-owned enterprises. While the numbers seem promising, the private sector in China remains under-represented in some of the most lucrative industries.

As things stand, the private sector is dwarfed by the reliance China has on its state-owned enterprises. Protective licensing and regulation are the main barriers to the growth of the private sector. And restrictions placed on the private sector limiting access to certain industries have in fact increased in recent years. In the August 2011 rankings published by the All-China Federation of Industry and Commerce, of the top 500 private enterprises, 329 belonged to the manufacturing sector. In contrast, of the top 500 enterprises overall, there were only 184 private enterprises. The majority of top performers on this list belonged to the more lucrative sectors of energy, finance and telecommunications. There were only two private companies in the top 50.

Other barriers to the growth the private sector in China include: access to bank loans and uneven distribution of resources. May 2011 marks one year since the central government's launch of the "New 36 Guidelines" promoting the development of private industry. According to many, implementation of the guidelines has been ineffective, if not disappointing. The general consensus is that access to protected industries should be the number-one priority. Chinese state media the *Economic Observer* said: "We only need one guideline. The 36 Guidelines will only take effect if the government dares to resist lobbying from special interest groups."

The risks of a frustrated private sector can manifest themselves in a variety of ways. What we know is that great attention is being given to this topic by the current leadership as voices in the private sector can be loud and influential.

Other Systemic Risks

Citizen Activism and Social Stability

The number of “mass incidents” in China, indicating social unrest, has tripled in the past 10 years. In 2011, China “could have possibly seen more mass demonstration than the entire Arab world,” *The Atlantic* said in a recent article. However, unlike an Arab-Spring-style revolution, the Chinese protestors have rather pragmatic complaints, mainly confined to issues such as land seizure by developers, unpaid wages, abuse of power by authorities and factory pollution. *The Atlantic* concluded its article accordingly: “Chinese protestors want to work within the system, rather than topple it”.

This was demonstrated in a recent incident in Wukan Village in Guangdong Province, where villagers took a decisive stand against corrupt officials who sold their land to real estate developers without consent. The protesters demanded the return of their land and an open election for the Communist Party Secretary (highest level of leadership) of their village. While this was taking place, however, the protesters were clear in their efforts to seek retribution and justice from within the existing system. It was widely reported that the villagers taped a sign (in both English and Chinese) to the wall of their press center that read: “We are not a revolt. We support the Communist Party. We love our country.”

According to the *Guardian*, on January 16th, 67-year-old Mr. Lin, the head of the protest, was officially approved as the new leader of Wukan, one day after Premier Wen Jiabao “stressed the need for farmer’s rights to be protected” in an article published by *Qiu Shi* (“Seeking Truth”), an internal journal of the Communist Party.

The good news is that Chinese citizens feel increasing freedom to voice their discontent, and finding ways to address their grievances is a major preoccupation of the Central Government. This pattern will continue in 2012.

The Growing Wealth Gap

Among the many challenges facing China’s leaders, the growing gap between the rich and poor is at the top of the agenda and holds a key position in the 12th Five-Year Plan. The Plan aims to increase the disposable income of urban residents and the net income of rural residents by 7% annually. According to a Credit Suisse forecast, China’s household income is expected to rise to RMB 55.8 trillion (USD 8.8 trillion) in 2015, up from RMB 24.2 trillion in (USD 3.8 trillion)

2010. While the numbers suggest the rapid emergence of an enormous middle class with strong spending power, income inequality remains a serious problem.

According to the Global Wealth Report by Credit Suisse, wealth inequality has been rising strongly, due to “the increasing wealth of successful Chinese entrepreneurs, professionals, and investors.” Newspapers report that the number of Chinese billionaires has doubled in the past two years, and now China has more billionaires than the rest of the world, excluding the United States. While the speed of wealth accumulation is staggering, China still has 150 million people living at or below the United Nations poverty line of one U.S. dollar per day. According to data released by the China Development Research Foundation in February 2011, 85% of China’s poor live in rural areas, with about 66% concentrated in the west. While the per capita total income of urban households was RMB 6,472, the per capita cash income of rural household was only RMB 2,187, according to 2011 data from the National Bureau of Statistics.

While the rich in China continue to accumulate wealth faster than ever, their insecurity is growing as well. According to a survey conducted by China Merchants Bank and Bain & Co., almost 60% of China’s high-net-worth individuals with more than RMB 10 million in investible assets are either considering emigration or have completed the process. According to the same report, 27% of those with RMB 100 million or more have already emigrated and 47% are considering it. The stunning results confirm Hurun Report data released in November 2011 that 60% of China’s wealthy plan to live in another country.

The Year of the Dragon is likely to feature an increasing number of wealthy Chinese seeking investment opportunities outside of China. In an article published by the Chinese State media *Global Times* in March 2011, economist Zhong Dajun was quoted as saying: “We have been working hard to develop the economy in the past 30 years, but now these elite members of society are fleeing with the majority of the wealth. The loss may be even higher than all the foreign investment we have attracted.”

Changing Media Landscape and Government Control

It is no secret that China’s media environment is changing perhaps faster than any other country in the world. According to the January 2012 China Internet Report released by the China Internet Network Information Center (CNNIC), China now has more than 500 million internet users, a 38% increase from the end of 2010, and representing one quarter of the over 2 billion internet users worldwide. However, the internet penetration rate, standing at 37.7%, is

significantly lower than that of technologically advanced countries such as South Korea and Japan.

Social media is exploding. According to the CNNIC report, China has 244 million users of social networking sites, which is 47.6% of the entire Internet population. For every social networking platform type in the Western world, China typically has two or three. For example, the platform equivalents of Facebook in China are Xiaonei, Renren and Kaixin.

With Facebook and Twitter being credited with having accelerated many of the uprisings in the Middle East, we don't expect these companies to be operating in China anytime soon. What has transpired, however, is the rapid rise of "Weibo", a Chinese twitter-like platform, which has become a powerful channel for communication. As of 2011, more than half of Chinese Internet users (48.7%) are Weibo users, up 296% from 2010.

Many of the crises of 2011 originated via Weibo, and the platform's content, much like the global Internet community, contains a lot of rumors, hearsay and general chatter. That is not to discredit the fact that Weibo has also been an effective tool allowing Chinese netizens to voice their opinions, expose wrongdoing, report grievances and more.

Given the power of Weibo and its following, in late 2010, Sina Weibo, China's leading micro-blogging platform, established a "rumor control" department to address the issue of false information on Weibo. According to *China Daily*, the team has 10 staff members who maintain a 24 hour watch over the site. On December 16th, 2011, Beijing Municipality issued a notice requiring real-name verification for Weibo users. According to the new policy, only users who have verified their identities can post comments; anonymous users can only view posts.

In 2012, we expect to see an increase in government efforts to utilize Weibo as a critical social management tool. "Rumor Control" will remain a top priority on Beijing's agenda. In late November, Wang Chen, head of the State Information Office and a deputy minister of the Central Propaganda Department, published an article entitled "Actively Carrying out Microblog Public Opinion Guidance" in *People's Daily*, stressing the importance of managing Weibo sentiment.

Due to the breakneck pace of Weibo's growth in 2011 and increased government involvement, we expect Weibo to grow at a lower rate in 2012. In the commercial space, Weibo will continue to play an important role as a channel for brands. Currently, many Weibo celebrities with strong followings have been offered

payment to tweet about their benefits. This phenomenon is a growing concern and we are watching this space. Paid tweeting works against Ogilvy PR's view of authentic communications and our advice is for brands to work to find their way into tweets in authentic ways.

Other Media Platforms to Watch

In addition to Weibo, online video sharing is another strong growth area. According to the CNNIC report, China has more online video users (325 million) than Weibo users, and there is more space to grow. The makeup of online video users is interesting. According to a recent Nielson report, 31% of users in China are concentrated in the economically developed coastal areas while 15% come from Beijing and nearby areas. Other relevant figures include: 61% users are single; 67% users are male; and peak usage time is between 10 p.m. and midnight. We can thus conclude that a typical video site user in China is a young, single male who is relatively highly educated and has an income. He regularly visits online video sites in his spare time during the evening. By tracking online user demographics, brands can more effectively market themselves to reach targeted users within product and consumer categories.

Television also continues to be a powerful and influential medium in China, with CCTV (China Central Television) serving as the industry titan. According to media reports, companies committed to RMB 12.7 billion in advertising spend for CCTV in 2011; and in 2012, companies will pay an estimated RMB 14.26 billion. For some brands, CCTV remains the most powerful channel to reach its target audience.

Print media will feel more pressure from the growing popularity of online media. In the fight for readership, print media will be forced to shift their focus to creating deep and original media content. Successful print media will look at ways to diversify their channels and foster a bigger online presence.

Other Themes Defining China in 2012

Against the backdrop of a changing leadership, continued economic growth and volatile social dynamics, the Year of the Dragon will see other movements as well.

Approaching the Aging Curve

Watching the youth-driven movements of 2011, including the Arab Spring and Occupy Wall Street, China's leadership can't help but think of its own challenges in providing better jobs and livelihoods to the same domestic cohort.

Years of high single-digit and low double-digit growth have fueled a rapid expansion of wallets while inflating expectations for an increasingly educated and active student and young adult population. Born into the first generations of China's single-child homes, today's youth are unembarrassed about what they expect from society, and are unafraid to go out and take it.

Facing this cohort is a tilting demographic balance, where retired and retiring workers are beginning to weigh down the scales of economic growth while placing additional economic and social burdens on the government and families. With some forecasters calling for a peak in working age populations coming as soon as 2013, this year promises to be one of hard discussions regarding education, elder care, and loosening of the infamous one-child policy.

The Environmental Report Card

China's 2011 environment report card was bleak. In fact, Li Ganjie, Vice Minister of the Ministry of Environmental Protection called the situation "very grave". According to China's annual "State of the Environment Report" released by the Ministry of Environmental Protection in June 2011, surface water pollution across the country is "relatively grave": 23% of coastal marine waters failed to reach "gradable standard," 22% of natural reserves are damaged and less than 4% of the 471 cities monitored received top ratings for air cleanliness.

2011 saw increased social tension caused by further deterioration of the environment. More and more Chinese citizens are realizing the extent to which their life quality has been affected by the environment. Mobilized by the Internet, the Chinese people are becoming more vocal in expressing their concerns about environmental issues. Faced with an increasing number of environmental emergencies on a daily basis, information transparency and timely reporting are at the very top of the Chinese government's agenda.

For example, urged by the public, Beijing will officially release data on PM 2.5 (air particulates with a diameter of 2.5 microns or less) before the Chinese New Year begins. Currently, Beijing uses PM 10 to measure the air quality. According to a *China Daily* report, the public debate on PM 2.5 and PM10 first began when netizens realized the differences between air-quality monitoring results released by the Beijing Weather Forecast Station and those transmitted hourly via Twitter by the U.S. Embassy in Beijing.

According to China's 12th Five-Year Plan, the country will prioritize environmental issues involving air pollution, drinking water, heavy metal pollution and soil pollution. We expect to see a continuation of internal grassroots protests on various environmental issues in 2012. We will also see more Chinese officials and interest groups pushing the agenda of environmental protection, simply because nobody is left off the victim list of environmental degradation.

The 2012 Olympics

With the London Olympics less than six months away, the odds-makers are already laying out 2012 as a breakthrough year for China. As it currently stands, this year looks to be a triumph for China; the year where the Chinese will finally take the crown from American athletics, and collect more medals than any other nation.

Since their first Olympic endeavors in 1984, the Chinese have poured their heart and soul (and significant resources) into building their athletic prowess and stocking their trophy cases, so this year should be a quietly triumphant one for the state sports bureau. Perhaps more significantly, 2012 may mark China's breakthrough in some of the popular athletics events in which they have traditionally fared poorly. Whether it is in the pool, on the basketball court, or on the track, China's new generation of athletes are going toe-to-toe with the best in every sport, and are earning the grudging respect and recognition that they deserve.

London will also be a hard test for China's soft power muscle, as Chinese companies and the government try to use the Olympic stage to promote their own brands and businesses. Always a draw for human rights protestors and other issues advocates, the Chinese brand this year is set to breakthrough to touch the hearts and minds of the average viewer and consumer. Whether China handles that test with maturity and sophistication, or whether it descends into a

war of words, could well set the frame for how the world views China over the coming decade.

An Expanding China: China's Outbound Initiative

Will the year of the Dragon also be a turning point for Chinese Foreign Direct Investment ("FDI")?

Since the mid-2000s, China's FDI has dramatically increased. FDI outflow in 2005 was US\$12.3 billion, which was nearly 30% of the sum of the total outflows between 1991 and 2004. Moreover, from 2005 to 2010, the amount of FDI outflow went from US\$12.3 billion to US\$68.8 billion, representing an average annual growth rate of approximately 123%.

"Going global" continues to be the main theme that encourages the acceleration of state-owned or private investment abroad by Chinese enterprises. The slogan was originally coined in China by Jiang Zemin in 1997 and subsequently officially written in China's 10th Five-Year Plan as a national strategy, supporting Chinese firms to enlarge their economic cooperation with foreign countries. Released in March of 2011, China's 12th Five-Year Plan includes the strongest "go global" message of any of the plans and highlights the prioritization of acquiring leading patents and technologies, global brands, and full integration into the foreign market.

2012 may also be a turning point for how China manages its over US\$3.2 trillion foreign exchange reserves. While the composition of China's account surplus is unknown, it's widely believed to be mostly invested in sovereign debt, including U.S. Treasury Bonds, overseas acquisitions, especially in energy and natural resource sectors, and foreign aid. We believe that going forward, Chinese officials and academics will continue to push for the diversification of reserve investment into real assets and equities. In fact, Lou Jiwei, China Investment Corporation's ("CIC") Chairman, who has been tapped to be the next Finance Minister, wrote an Op-Ed in *The Financial Times* in November of 2011 lobbying for China's investment in developed countries' infrastructure. Mr. Lou wrote that he "believes that such an investment, guided by commercial principles, offers the chance of a 'win-win' solution for all." Others call for a greater portion of the reserves to be invested in U.S. equities, noting that the U.S. stock market can be a credible alternative and that blue-chip U.S. companies have been reporting relatively strong earnings over the last few years.

Financing, international management, safety and branding issues continue to be mentioned as some of the top concerns Chinese companies face when investing abroad. Chinese companies fear a lack of understanding about their product by consumers in foreign markets. They are unsure how to communicate the advantages and added value their products may bring. Chinese consumers and Western customers often view different aspects of products as important, so Chinese firms are often unsure how to communicate the value proposition of their merchandise. We expect this trend to continue and have set up a dedicated China Practice in the United States, staffed by Chinese speaking professionals to help serve Chinese FDI in the West.

China-U.S. Relationship: Economic Bedfellows and Frenemies

Beginning late 2011 and then again in early January, the U.S. unveiled what amounts to a major strategic pivot away from Europe towards the Asia-Pacific region. It signals what will be greater emphasis on the U.S.-China relationship and stepped up focus on revitalizing vital American alliances in the area.

In November, while on a trip through Asia, President Obama announced that the U.S. would deploy 2,500 Marines to Australia to shore up Asian alliances, a move that, according to *The New York Times*, restores “a substantial American footprint near the South China Sea, a major commercial route — including for American exports — that has been roiled by China’s disputed claims of control.”

The U.S. has had a major presence elsewhere in the Pacific region since the end of World War II with troops based mainly in South Korea and Japan and regular transits by U.S. Navy carrier battle groups. But the deployment to Australia would be the first major troop increase to the area since the 1990s since U.S. bases on the Philippines were shuttered.

President Obama told the Australian parliament that he had made “a deliberate and strategic decision — as a Pacific nation, the United States will play a larger and long-term role in shaping this region and its future.” The President said the deployment was in response to requests from allies in the region, from Japan to India.

At the same time, Mr. Obama has sought to reassure China in language similar to that of former U.S. presidents that the U.S. does not seek to isolate Beijing as it did during the Cold War against the Soviet Union.

“The notion that we fear China is mistaken. The notion that we are looking to exclude China is mistaken,” Obama said. “We welcome a rising, peaceful China.”

In January, President Obama’s top military adviser, Gen. Martin Dempsey, the Chairman of the Joint Chiefs of Staff, could not have been clearer about the shift in focus. “All trends are shifting to the Pacific. Our strategic challenges will largely emanate out of the Pacific region.”

The Obama White House in January published a 12-page document outlining the new strategic focus. It said the U.S. would continue to project power despite anti-access and area-denial threats from "states such as China and Iran."

Beijing has not greeted the attention -- and proximity to Iran in the same sentence -- with much enthusiasm.

"The accusations leveled at China by the U.S. side in this document are totally baseless," China's Ministry of Defense said in a statement. "We hope that the United States will flow with the tide of the era, and deal with China and the Chinese military in an objective and rational way, will be careful in its words and actions, and do more that is beneficial to the development of relations between the two countries and their militaries."

The U.S. has long accused China of developing military capabilities far beyond what is necessary for defense purposes. And many on the U.S. side accuse China of regularly targeting the U.S. with cyber-attacks, accusations denied by Beijing.

As the jousting suggests, the relationship between the U.S. and China is complex. And that relationship is more important than ever to the world, especially as nations struggle to recover from economic malaise.

China Growth, Additional Tension

China's rising economic standing poses a threat to some constituencies in the U.S. The recent Obama Asia-Pacific initiative concerns China. But there are numerous flash points where the U.S. and China may clash including intellectual property rights, currency policy, energy policy, climate change and military spending.

Given the vast amount of U.S. debt held by China, financial issues are at the top of the list of key topics in the relationship. U.S. Treasury Secretary Timothy Geithner has repeatedly indicated that China should take additional action and move more quickly to encourage increased domestic consumption.

"In some ways, the events of the last four years - a world in crisis with huge cliffs in external demand facing China - underscored the imperative of China moving in this direction," said Geithner. This would be a significant change in China's economic growth model.

Trade is another area that significantly affects the U.S.-China relationship. Currency is major aspect of trade and it will continue to be a hot button item.

However, there are many more trade-related issues that the U.S. is acting on including one that could put a strain on the relationship.

President Obama recently began pushing for a “Trans-Pacific Partnership (TPP),” which is ambitious and has intriguing implications for the U.S. business community. The TPP is clearly a major plank in the Obama Administration’s plan to increase its presence in Asia. It would create NAFTA-style trading structure across the Pacific and, thereby, open up a range of new markets.

But can this be done without China?

How will China react to the U.S. entering into a trade agreement with eight nations including Australia, Brunei, Malaysia, Peru, Singapore, Vietnam and, eventually, Japan while China is excluded?

The Obama Administration has said that the proposed Partnership – which would need to be on a very fast track if it is to be completed by its target date at the end of 2012 – is not an action directed to isolate China, but does that clarification matter?

Jagdish Bhagwati, a professor of economics and law at Columbia University in New York, said that the TPP “is also a political response to China’s new aggressiveness, built, therefore, in a spirit of confrontation and containment, not of cooperation.”

Hovering over all of this is the 2012 Presidential election in the U.S. Before the election year even began, leading Republican candidate Mitt Romney had published a blistering critique of China’s currency and economic policies in *The Wall Street Journal*.

While this was no doubt done to outflank his more conservative opponents, it was a clear signal that China will be a key issue in the presidential election. With the U.S. economy continuing to sputter and the Chinese economy continuing to grow (albeit more slowly), there will be a natural tendency for candidates to blame China in the heat of what is likely to be a closely contested election.

These political pressures will mean that the Obama administration will be under heavy scrutiny for any policies seen as tilting toward China or Chinese interests.

As a result, the growing criticism in some quarters of China’s increasing investment in the U.S. will almost certainly increase and could become a significant political issue in the election.

This will lead to even closer examination by the Administration of Chinese investment efforts in the U.S. Chinese companies investing in the U.S. should expect greater scrutiny and increased use of the CFIUS (Committee on Foreign Investment in the U.S.) process to determine final approvals of investments in a range of industries beyond traditionally sensitive areas such as technology and aerospace.

Given these dynamics, the Year of Dragon shapes up as a challenging one for the world's most important bi-lateral relationship.

China- EU Relationship in 2012

On January 5, 2012, the China Air Transport Association (CATA) announced that Chinese airlines, including flag carrier Air China, would not abide by the EU Emissions Trading Scheme for aviation, which entered into effect on January 1st. Answering to the European Commission (EC), which stated that an operating ban could be imposed on airlines breaching EU law, Chai Haibo, CATA's Deputy Secretary General responded that the China's government was considering counter-measures against the EU.

A few days later, the European steel producers' association, Eurofer, filed an anti-subsidy complaint with the EC against Chinese state support for exports of organic-coated steel to Europe. "Clearly the miracle of the Chinese steel industry which now counts for almost 50% of global steel production is not the result of free market forces," Gordon Moffat, Eurofer's Director General, said in a statement.

Do these early developments suggest that in 2012 EU-China relations will reach "maturity," as called for by Business Europe, the main horizontal business association at EU level? The association defines maturity of the relationship in terms that would seemingly put the EU-China relationship on par with EU-US relations, with, "both sides having the right to defend their interest strongly, but also deal with disagreement in a spirit of cooperation and transparency."

Despite the headline-grabbing trade battles, comments by EU leaders and the Chinese government indicate concurrence on one key point – their economies will become more interdependent. They agree there is a need to enhance

dialogue in order to uplift trust and mutual understanding, thus potentially boosting cooperation. The year provides myriad opportunities for diplomatic discourse via the regular EU-China Summits, the EU-China High Level Economic and Trade Dialogue, the High Level Political Party Forum, the High Level Strategic Dialogue and the existing 50 plus sectoral EU-China exchange and dialogue mechanisms.

Corporate Europe's Wish List

European corporations hope that during those policy meetings, issues problematic in their eyes - the strong Chinese apparatus influence on the market, weak IPR and certification enforcement, discriminatory treatment or forced technology transfer - will be tackled. European industry will continue to urge EU leaders to grasp every opportunity to push China to bring to an end its subsidy policy, e.g. by advocating for stricter multilateral rules on state aid and subsidies and/or by amending the EU public procurement legislation so that third-country bidders benefitting from subsidies are excluded. They also call for the EU and China to negotiate a bilateral investment agreement providing legal certainty for industry on both sides. Above all, European corporations demand that the 27 Member States show a greater European solidarity when China is at odds with one of them; contrary to China, the EU is not a fully-centralized political bloc and its Member States do not always speak in unison.

Strengthening EU-China Soft Ties

EU and Chinese leaders also agree there is a need to enhance communication at citizen level to further promote better understanding and consolidate popular support for EU-China relations. As such, both leaderships will work at maximizing the impact of the EU-China 2012 Year of Intercultural Dialogue. In the EU, the aim is, *inter alia*, to counter some recent negative narratives on China taking advantage of the European sovereign debt crisis to buy out Europe.

These narratives may very well be used as political arguments during the electoral campaigns, which will take place in some EU Member States (notably France, Greece, and Romania) in 2012. This may add temporary turbulence to EU-China relations over the year as rhetoric heats up and candidates look to gain support by playing up nationalist and protectionist themes.

A Weaker Europe = Turbulence for China?

The European zeitgeist is defined by the economic crisis; all issues are translated through its filter. Listening to the two leaders at the forefront of the Eurozone's efforts to turn the tide, one does not get a sense of ease about the prospects for 2012. In their New Year messages, German Chancellor Angela Merkel and French President Nicolas Sarkozy warned of danger and risks at every turn. The concern of a failed Euro this year, however unlikely, will color all of the bloc's bilateral relationships. Protectionism, lack of consumer spending due to higher taxes and fewer jobs and stagnant wage growth in China's largest trade partner (in aggregate) will increase pressure on China's economy to look domestically and at emerging growth markets to replace lost volume.

Let us nevertheless conclude on a positive note with Chinese Ambassador to the EU Song Zhe's (self-fulfilling) prophecy for 2012: "I strongly believe that as China and Europe join hands together, our relations will exhibit the overwhelming strength of a dragon, as they attain higher and more impressive breakthroughs".

Neighborhood Movements

While China's leadership is focused inward on a generational transition, the world is increasingly looking to China to play a role as an emerging "great power." World events in 2011 showed how quickly tides can turn, and how easily governments can be caught unawares. China's leaders have so far proven adept in handling themselves on the world stage, but the coming Year of the Dragon is fraught with challenges old and new from near and far.

Kim Jong Il/Un

While many in the Western media celebrated it as an early Christmas present, the untimely demise of North Korean leader Kim Jong-Il leaves China concerned about the stability of a neighbor filled with hungry mouths, unpredictable leadership, and enough nuclear and conventional weapons to lead the region into serious conflict.

As one of the few countries with strong diplomatic relations inside the DPRK, China is certain to be working hard behind the scenes to maintain stability and the status quo, but it is likely that their degree of influence and access is limited to what North Korea's insulated leadership will allow.

Some experts who have followed the North Korea relationship closely believe China hopes to leverage its influence inside North Korea to sell a gradual transition to the China model of reform and opening up, which they tried for years to promote to former leader Kim Jong-Il through state visits and a much-celebrated border development zone. This model of China as teacher would allow slow but accelerating change, while keeping the DPRK inside Beijing's sphere of influence, allaying ROK and U.S. suspicions, and landing a soft power victory for the "China Model" to nations around the world.

Despite China's committed interest in improving the day-to-day life of North Korean citizens, it is uncertain that they are earning much recognition in return. This is one relationship we will continue to watch in the year ahead.

Taiwan Elections

Closer to the domestic front, but still a short flight or boat-ride from the mainland, Taiwan continues its rapprochement with China, anchored by strong economic and cultural ties. With the recent re-election of President Ma Ying-Jeou, both sides could come out winners, as trust and acceptance of the status quo leave room for Taiwan to address its own domestic economic concerns, while China finds more constructive avenues for engagement.

Ma's insistence on his "Three No's": No Military Action, No Independence, and No Reunification, is rooted firmly in the changing economic dynamic between the two countries, with Taiwan's investors increasingly looking for opportunities on the mainland, while restructuring and moving up the value chain on the home front. Behind all the talk of partnership and cooperation, it's important to bear in mind that in an open market, Taiwan's workers are as much competitors to the mainland's workers as they are compatriots.

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In this paper we have tried to capture many of the main themes dominating discussion as we begin the Year of the Dragon. We hope we added to your reading pleasure this Chinese New Year, and may the Dragon Year prove to be magical and powerful for you and your business.

On behalf of everyone at Ogilvy PR, Happy New Year.

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