

CHAPTER 1
THE U.S.-CHINA TRADE
AND ECONOMIC RELATIONSHIP
SECTION 1: TRADE AND ECONOMICS
YEAR IN REVIEW

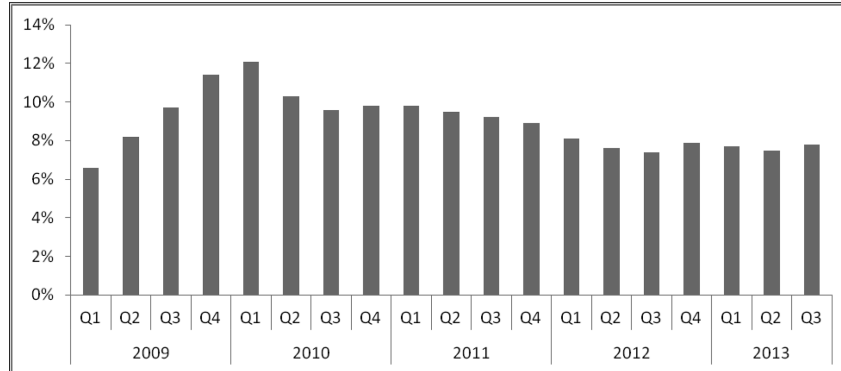
Introduction

China's economy grew at a 7.66 percent annualized rate in the first three quarters of 2013, continuing a three-year trend of decelerating output (see figure 1). This marked a significant decline from the three decades of growth in the 1980s, 1990s, and 2000s averaging 10 percent annually. Demand for China's exports stalled, and the domestic economy adjusted to a drop in government spending on massive infrastructure projects—undermining the two main pillars of China's economic surge over the previous decade.* The slowing of the world's second-largest economy rippled through much of the world, hobbling the economies of commodity-exporting countries. While the economic slowdown matched the central government's stated numerical target for growth, the change was not necessarily the result of a deliberate government policy. Rather, China's growth decline largely stemmed from the effects of a government-induced credit crunch, a precipitous drop in manufacturing, volatility in banking and real estate, a declining rate of growth in household incomes, the strain of meeting interest payments on a growing debt burden, and uncertainty about the new government's direction after a once-a-decade leadership transition. This section will explore the factors behind China's changing economy, the evolution of China's economic policy, and their implications for the United States.

*During the decade that ended with 2011, China's share of global exports rose from 7 percent to 21 percent. James R. Hagerty, "U.S. Manufacturers Gain Ground," *Wall Street Journal*, August 18, 2013. <http://online.wsj.com/article/SB10001424127887323423804579020732661092434.html#printMode>.

Figure 1: China's Quarterly Gross Domestic Product (GDP) Growth, 2009Q1–2013Q3

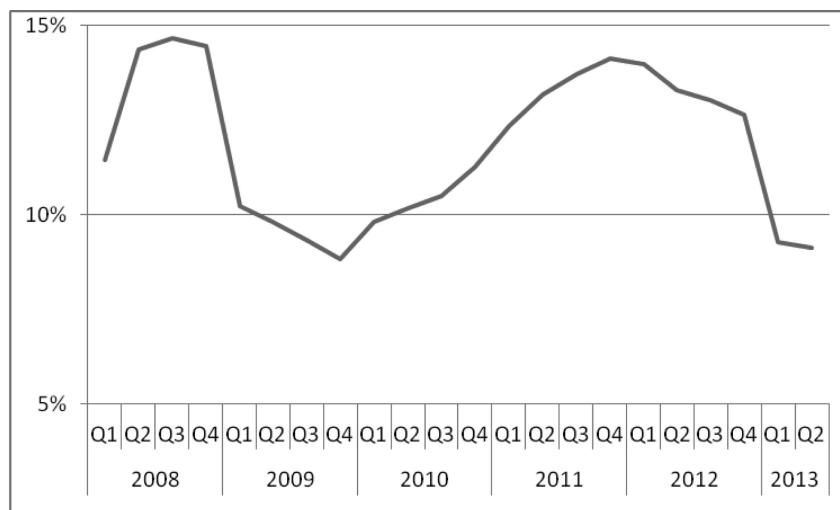
(percent year-on-year growth, real terms)



Source: China National Bureau of Statistics, via Trading Economics. <http://www.tradingeconomics.com/china/gdp-growth-annual>

In order to rebalance the domestic economy, Chinese policy-makers say they intend to raise household income and consumption, but the past year saw limited progress on this front. In urban areas, growth in disposable income, the measure of personal income minus taxes, fell to its lowest levels since the global financial crisis, suggesting that urban wages did not rise at the same rate as in previous years. Urban households, which have very high savings rates, thus had less capacity to raise their consumption expenditure (see figure 2).¹ Growth in Chinese retail sales slowed, and the share of the economy represented by consumer spending declined in the first half of 2013 compared to the same period in 2012. As a share of gross domestic product (GDP), China's domestic consumption remained half that of the United States—following an established pattern.²

Figure 2: Urban Household Disposable Income Growth, 2008–2013Q2
(quarterly, percent year-on-year growth)



Source: China National Bureau of Statistics, via CEIC database.³

In China's repressed financial system, households still deposit the bulk of their savings in low-yielding bank accounts. According to estimates from the investment bank Nomura, China's household debt was only 20 percent of GDP last year, compared to 86 percent in the United States. Still, China's debt burden increased from 121 percent to 155 percent of GDP in 2008–2012—a rapid build-up similar to the United States before the subprime mortgage crisis. Given the explosion of China's shadow banking sector, actual debt levels are likely even higher. Debt is concentrated not among households, but among state-owned industrial enterprises, government-backed property developers, and local governments. The debt-to-asset ratio of property developers, for example, increased from 40 percent to 71 percent in 2009–2012. Unlike the United States, China's households act as net lenders to the rest of the economy, subsidizing the state sector with easy credit.*

Chinese leaders vow to deemphasize exports as a source of income. Export growth in China has slowed as demand in much of the world dropped, though not enough to correct the country's external imbalances. China still sends five dollars' worth of goods to the United States for every dollar in U.S. imports. In 2012, the U.S. deficit with China in goods reached \$315 billion—the highest on record. In July 2013, China's monthly bilateral surplus with the United States surpassed \$30 billion for the first time.⁴ China's vast

* In the United States prior to the subprime mortgage crisis, the overall debt ratio rose by 30 percentage points of GDP, from 214 percent in 2003 to 244 percent in 2007. Zhang Zhiwei and Wendy Chen, "China: Rising Risks of a Financial Crisis" (Hong Kong, China: Nomura International (Hong Kong) Limited, March 15, 2013), pp.4–7; Federal Reserve Bank of St. Louis, "Household Debt to GDP for United States" (St. Louis, Missouri: October 2013). <http://research.stlouisfed.org/fred2/series/HDTGPDUSQ163N>; Tom Orlik, "Debt Binge Threatens China Growth," *Wall Street Journal*, August 27, 2013, p. c1. <http://online.wsj.com/article/SB10001424127887324906304579036592255182758.html>.

current account surplus, coupled with restrictions on its capital accounts and exchange rate, has caused the central bank to accumulate foreign currency reserves exceeding \$3.66 trillion, by far the largest in the world.

Leadership Transition and Economic Policy

In the spring of 2013, Xi Jinping became president of the People's Republic of China (PRC). Li Keqiang, in turn, was appointed the premier and Communist Party secretary of the State Council, China's cabinet. No prominent political or economic reformers were elevated to the Politburo Standing Committee, China's highest decision-making body, though the backgrounds of Wang Qishan and Zhang Gaoli* suggest that they might be open to further economic reform.⁵ Protégés of former PRC President Jiang Zemin captured more spots than the allies of former President Hu Jintao (the sole protégé of Hu Jintao on the Standing Committee is Premier Li Keqiang).† Although Jiang Zemin's era is associated with more economic reform than the subsequent Hu Jintao period, when many reforms were rolled back,‡ there are few signs of a renewed push for reform. (For coverage of the leadership change relating to foreign policy and military matters, please see chap. 2, sec. 1, of this Report.)

The uncertainty over the prospects for economic reform is the result of contradictory statements and actions by the new leadership. On the one hand, there are signs that President Xi and Premier Li are preparing a package of reforms that will be unveiled at the Third Plenary Session of the 18th Central Committee scheduled for November 2013. On the other hand, President Xi has been reaffirming the role of the state in the economy and introducing Maoist-style ideological campaigns aimed at stamping out political liberalization. A Chinese Communist Party (CCP) leadership statement approved by President Xi, "Document No. 9," enumerates seven perils for China, among them, "Western constitutional democracy," human rights, media independence, and market-based "neo-liberalism."⁶ The fundamental conflict is that the economic liberalization the leadership expounds is impossible to achieve if the government continues to expand its ownership of and control over the economy.

Before handing over the reins, President Hu delivered a joint report at the beginning of the 18th Party Congress. Speeches delivered to the Party Congress are considered guides to future policy,

*Zhang Gaoli was appointed the PRC executive vice premier (Wang Qishan was widely expected to be appointed to this position), in charge of economics and domestic policy. Mr. Zhang has extensive leadership experience in economically advanced regions (Shenzhen, Shandong, and Tianjin), but he has kept a low profile, and his views on further reform are unclear.

†For a more detailed assessment of China's new leadership lineup, see John Dotson, *The China Rising Leaders Project, Part 2: Outcomes of the Chinese Communist Party's 18th National Congress* (Washington, DC: U.S.-China Economic and Security Review Commission, December 21, 2012), pp. 19–20. http://origin.www.uscc.gov/sites/default/files/Research/18th-CCP_Party_Congress_Overview.pdf.

‡The state sector has prospered in the past decade, with financing, market access, and various policies aimed at protecting its interests. The consolidation and concentration of economic power in the government's hands has given rise to the catch-phrase "The state advances, the private [sector] retreats." For a detailed discussion of the Chinese government's role in and control over the Chinese economy, see U.S.-China Economic and Security Review Commission, *2012 Report to Congress* (Washington, DC: U.S. Government Printing Office, November 2012), pp. 47–72.

especially during a power transition, because they are drafted by both incoming and outgoing leaders. The outgoing president's speech was interpreted by many analysts as a blow to economic reform. For example, the report contained strong language on the need to strengthen the state-owned portion of the economy. The departing President Hu said China would "unwaveringly consolidate and develop public ownership" and "steadily enhance the vitality of the state-owned sector of the economy and its capacity to leverage and influence the economy."⁷ The report proclaimed that state-owned enterprises (SOEs) are the principal part of the Chinese economy and that they will increase their investment in areas of the economy that impact national security and core national interests.

Six months earlier, Mr. Xi had made his first trip as leader to the southern Chinese city of Shenzhen, in a gesture interpreted as more reformist, because it paralleled a similar trip by Deng Xiaoping during his famous "southern tour" to the same area 20 years ago.* President Xi followed up with trips to the countryside to highlight the plight of the rural poor.

Premier Li, who is broadly responsible for formulating and implementing economic and domestic policy, gave an early speech at a meeting of representatives of the 11 national "Comprehensive Reform Pilot Areas," which was interpreted by some western analysts as signaling his commitment to economic reform.⁸ In particular, the speech started off noting that "reform is like a boat beating against the current; if you don't move forward, you will slip backwards." At the March 2013 annual Party Congress, Premier Li gave his first news conference. He pointed to the need to "shake up vested interests," stating that "however deep the water may be, we will wade into the water."⁹ The government would have to enact a "self-imposed revolution," which would be "very painful and even feel like cutting one's wrist."¹⁰ The reformist tone aside, Premier Li has loyally supported former President Hu's policies, which have hindered or reversed economic reform.

The New Economic Leadership Team

The National People's Congress meeting in March 2013 revealed the makeup of the economic leadership team that will be in charge of crafting economic policy for China's new administration. The lineup appears encouraging for economic reform; however, these individuals, though involved in policy-making, are not on the Standing Committee and, therefore, do not set the direction of China's economic policy. Much will depend on whether these individuals will be willing and able to sway the leadership toward economic reforms. Three top decisionmakers are highlighted below.

*During his 1992 southern tour, Deng Xiaoping stressed the importance of continuing economic reforms launched in 1978 and criticized those who were against further economic and openness reforms.

The New Economic Leadership Team—Continued

Zhou Xiaochuan was asked to stay on as head of the People's Bank of China (PBOC), the central bank. Observers were surprised by the announcement that Mr. Zhou will remain in his position since he turned 65 in January 2013, the ordinary retirement age for a minister-level official. According to insiders, the move is aimed at ensuring continuity in financial-sector policy-making and signals a desire to stay on course with the kind of financial reforms Mr. Zhou has championed, including a more flexible renminbi (RMB) exchange rate and market-based interest rate system.¹¹

Lou Jiwei was appointed minister of finance. Mr. Lou, best known abroad as the former head of China's most public sovereign wealth fund, the China Investment Corporation (CIC), was a deputy finance minister for ten years and is known for his support of financial liberalization.¹² His comments at the 2013 Strategic and Economic Dialogue (S&ED) talks in Washington generated some controversy when Xinhua, the official CCP propaganda arm and news agency, censored his remarks regarding China's target GDP growth in 2013. Mr. Lou said, "There is no doubt that China can achieve the growth target, though the 7 percent goal should not be considered as the bottom line," but Xinhua changed that to "7.5 percent" (the official target) in its reporting.¹³

Liu He, long recognized as the key economic adviser to Xi Jinping, was confirmed as the official head of the Leading Group for Financial and Economic Affairs of the CCP Central Committee.¹⁴ Mr. Liu will also hold an appointment as a vice head of the National Development and Reform Commission (NDRC), China's chief economic planning body. As the head of the Leading Group for Financial and Economic Affairs, Mr. Liu will lead the writing of the official documents framing economic reforms planned over the next five years.¹⁵ According to Cheng Li, a China scholar at The Brookings Institution, Mr. Liu was a "major collaborator" in last year's World Bank report¹⁶ that advocated accelerating market-driven change and is a proponent of financial liberalization.¹⁷

Economic policymakers have identified and registered some limited successes in addressing problems that threaten to foment unrest among Chinese citizens who are not part of the urban coastal elite. In recent months, the government has introduced some important initiatives aimed at addressing some of the country's growing inequalities of wealth and opportunity.

Inequality: Even as President Xi and Premier Li's rhetoric indicates a reformist bent, resistance to reform from entrenched local interests and the export sector remains strong.¹⁸ Although the Chinese government has been successful in lifting millions out of poverty, China's level of inequality has been steadily rising. In February 2013, the State Council released a new plan aimed at curbing inequality and redressing some of the worst gaps in develop-

ment between urban and rural populations.* The plan includes an ambitious agenda for expanding the social safety net, improving healthcare and education, limiting the power of SOEs, and tackling corruption by government officials.

The 35-point “Income Distribution Plan” is aimed at boosting minimum wages to at least 40 percent of average salaries, loosening controls on bank lending and deposit rates, and increasing spending on education and affordable housing.¹⁹ Other reforms include a requirement that SOEs contribute more of their profits to the effort of reducing inequality and a commitment to push through market-oriented interest rate reforms to give savers a better return and more security. In theory, these measures signal an attempt to shift the economy toward increased domestic consumption as an underpinning for economic growth. As with most sweeping Chinese government plans, everything depends on implementation. For example, past proposals to encourage higher dividend payments from SOEs collapsed under fierce resistance from the politically powerful heads of the SOEs, who are also ranking Communist Party members. Similarly, corruption is endemic among local government officials, and addressing its manifestations, such as land seizures from peasant farmers, might undermine the stability of the CCP (see below).

Corruption: A Pew Research Center poll last year showed a rise between 2008 and 2012 in Chinese public concern about corrupt officials. The anticorruption group Transparency International last year ranked China number 80 out of 174 countries in terms of perceptions of corruption in the public sector, worse than Liberia, Italy, and South Africa. Transparency International excluded China from its 2013 survey on corruption because local polling survey firms, which are licensed by the government, said they would have to omit certain questions in order to be allowed to conduct the survey.²⁰

Upon becoming president last November, Mr. Xi vowed to eliminate the “tigers and flies” (i.e., high-ranking as well as low-ranking officials) who had enriched themselves through bribery and patronage. He denounced the prevalence of corruption and said officials needed to guard against its spread, or it would “doom the Party and the state.”²¹ Some observers took Wang Qishan’s assignment as the director of the CCP’s watchdog agency for corruption, the Central Disciplinary Inspection Commission, as a sign of the government’s seriousness about the issue. Mr. Wang’s previous experience in banking and international trade might have made him a better fit in an economic position, but reformers applauded Mr. Wang’s choice because he has a strong reputation as a “firefighter” and capable problem solver.²²

In the past, the Chinese government has paid lip service to tackling corruption without undertaking any actual reform. The current anticorruption campaign appears similarly aimed at placating the public anger or eliminating political enemies rather than creating genuine change. For example, the focus on Chinese officials and ex-

*For an in-depth analysis of the new reform plan, see Nargiza Salidjanova, *China’s New Income Inequality Reform Plan and Implications for Rebalancing* (Washington, DC: U.S.-China Economic and Security Review Commission, March 12, 2013). <http://origin.www.uscc.gov/sites/default/files/Research/China%20Inequality%20-%203%2012%2013.pdf>.

ecutives at China's big, state-run companies appears to be politically motivated.²³ The head of the State-owned Assets Supervision and Administration Commission, the agency responsible for supervising state-owned assets, was recently removed for "serious disciplinary violations." He is a close associate of Zhou Yongkang, former domestic security chief, who is also targeted in the current campaign.²⁴ Four senior managers at PetroChina have been removed amid separate investigations by authorities; one of the executives is a former aide to Mr. Zhou.²⁵

President Xi has spearheaded an austerity drive, banning banquets, gift-giving, and other lavish trappings of Chinese officialdom. There are signs that this is having a real impact: First-class airline ticket sales have dropped by a tenth in recent months; luxury goods dealers have reported a 20 percent to 30 percent decrease in sales; and restaurants surveyed in February experienced a 60 percent drop in reservations over the same period in 2012.²⁶

The Chinese government also issued a directive banning the construction of government buildings for the next five years. The new directive is a continuation of the anticorruption campaign, describing the ban as "important for building a clean government" and improving the ties between the party and the people.²⁷ Grandiose official galas, which often feature variety shows and celebrity appearances, are likewise banned, because they are "wasteful" and had "damaged the image of the Chinese Communist Party and the government, triggering public complaints."²⁸

The affected local governments are finding ways to side-step these bans. According to a report in Xinhua, local government officials in some provinces are reclassifying government buildings in order to avoid notice. For example, in Jiangsu Province, the government power company offices have been renamed "dispatch centers," and public security offices have been renamed "technical investigation centers."²⁹ Furthermore, the construction ban does not address the proliferation of so-called "luxurious canteens," or deluxe cafeterias in government offices.

While the anticorruption efforts have appeared in the headlines, the reality presents a more confusing picture. For example, a proposed regulation that would require top officials to publicly disclose their personal assets has stalled.³⁰ Moreover, just as the prohibition on new government buildings was being announced, the government started to round up and prosecute activists who called on officials to disclose their wealth and the wealth of their families. In the most celebrated case, Xu Zhiyong, a prominent human rights activist, was charged with "assembling a crowd to disrupt order in a public place."³¹

Despite official proclamations, so far the CCP has demonstrated "little inclination" to pursue any fundamental reforms to root out corruption, according to Elizabeth Economy, director for Asia Studies at the Council on Foreign Relations. Instead, the latest measures will most likely follow an established pattern: "a number of high-profile arrests, no institutional change [...], and an endless cycle of anticorruption campaigns."³² According to Minxin Pei, professor of political science at Claremont McKenna University, President Xi does not actually want to end corruption, because it is the lifeblood of the Chinese government: "The Communist Party is a

patronage machine and patronage by definition is corruption.”³³ In other words, while fighting corruption might endanger the party, cracking down on the appearance of corruption is a good measure to address the “public relations nightmare that accompanies corruption.”³⁴ Party officials remain staunchly opposed to disclosing their assets, and both *The New York Times* and Bloomberg websites were blocked in China after reporting on the wealth amassed by the families of former Premier Wen Jiabao and Xi Jinping, respectively.

Urbanization: Premier Li has made urbanization the core of his agenda, calling it “the biggest development potential.”³⁵ Government departments are drawing up policies to guide rural citizens into cities over the next decade.³⁶ The hope is that urbanization will become the next growth engine, initiating a new wave of investment, adding to the consumer class, and creating a surge in demand for housing and infrastructure.³⁷ The urbanization drive may also boost Chinese efforts to make more land available for agriculture and improve farming efficiency (for more on the government’s agriculture modernization efforts, see chap. 1, sec. 4, of this Report).

The effect is likely exaggerated. For example, in many cases urbanization will simply entail the reclassification of rural areas as urban and not boost consumption or investment.³⁸ In addition, unscrupulous officials might use the excuse of urbanization to seize village land, which they then may sell to developers without compensating the farmers.

The key test of the Chinese government’s ability to push through greater urbanization will be how it plans to pay for it. The Chinese Academy of Social Sciences, a government think tank, estimates the cost (including spending on healthcare, housing, and schools) at \$106 billion a year, the equivalent of 5.5 percent of fiscal revenue in 2012.³⁹ Local governments cannot pick up the check for the expansion of such costly spending since they do not have a steady tax revenue stream: By law they must give most tax receipts to the central government. As a result, most local governments rely on land seizures and sales to fund spending, already a large contributor to public perceptions of corruption since farmers receive comparatively little from the government,

No urbanization initiative can be fully successful without first tackling one of the key factors behind the rural-urban disparity: China’s system of household registration, known as *hukou*.^{*} People from the countryside with a rural registration, or *hukou*, are restricted from enjoying the far better education and health benefits available to those with an urban *hukou*. Allowing migrants to the cities to obtain an urban *hukou* has been met with strong resist-

^{*} Created in its current form in 1960, China’s modern *hukou* was first developed after 20 million migrants rushed to China’s urban cities during the Great Leap Forward (1958–1960) in order to fill a perceived labor gap. The *hukou* system requires the registration of all citizens in China at birth and then limits access to government services based on the residency permits issued after registration. Citizens’ residency permits fall into one of two categories, urban or rural *hukou*, and entitle a holder access to social services in the town or city to which their *hukou* is registered. For more on the *hukou* registration and its impact on migrant workers, see “China’s Internal Dilemmas” in U.S.-China Economic and Security Review Commission, *2011 Report to Congress* (Washington, DC: U.S. Government Printing Office, November 2011), pp. 107–128. www.uscc.gov/Annual_Reports.

ance from local governments that fear being overwhelmed by a flood of new migrants.⁴⁰ There are small signs of change. A report issued by the State Council suggests that the government is considering relaxing *hukou* in small cities “in an orderly manner” in tandem with the urbanization drive, to be followed by bigger cities.⁴¹

The Mini Stimulus

In July 2013, the Chinese government announced a package of measures aimed at boosting the slowing economy while at the same time staying away from the massive investment drive. It also appears aimed primarily at small- and medium-sized private enterprises rather than SOEs, which were the main beneficiaries of the 2008 stimulus package. A statement by the State Council described a three-pronged approach: a temporary tax cut (scrapping all value-added and operating taxes) for more than six million small- and medium-sized enterprises; reduction of approval procedures and administrative costs for exporting companies; and more investment in railway construction in China’s central and western regions.⁴²

In recent decades, the CCP has derived its legitimacy from growth, so the government’s willingness to tolerate slow growth may be finite, particularly if unemployment rates rise. A major test for China will be how the rest of the global economy performs. Many analysts believe the top priority for the new leadership is not reform but making sure that growth does not deviate far from the official 7.5 percent target. If the economies of China’s biggest trading partners, the United States, the European Union (EU), and Japan, remain weak, the pressure on the Chinese economy may force the new government to return to such policies as further credit expansion or infrastructure investment, which shore up growth in the short term but also create more problems in the future, such as inflation, overcapacity, excessive debt, and economic uncertainty.

Rebalancing China’s Economy

Economic rebalancing is a multifaceted challenge for China that not only entails lowering investment and increasing overall consumption but also scaling down the role of the state sector, reducing speculative investment in real estate, altering the way credit is allocated, and speeding growth of the services sector. Some economists predict that effective rebalancing of China’s economy will result in more sustainable long-term growth.⁴³ Failure to make necessary reforms to rebalance China’s economy may result in reduced output, widespread defaults, stress on the banking sector, and social unrest.⁴⁴ But in the past year, China has made little progress toward its stated goal and, in some cases, has regressed to the old, short-term solutions: ramping up exports through subsidies to exporters and borrowing to undertake infrastructure projects and increase factory output.

Although China marginally reduced its massive trade surplus in the years immediately following the 2007–2008 global financial cri-

sis, this progress was temporary and largely attributed to domestic stimulus and slowing demand in western economies. Rebalancing China's domestic economy has lagged even more so, as some positive trends proved to be short-lived.

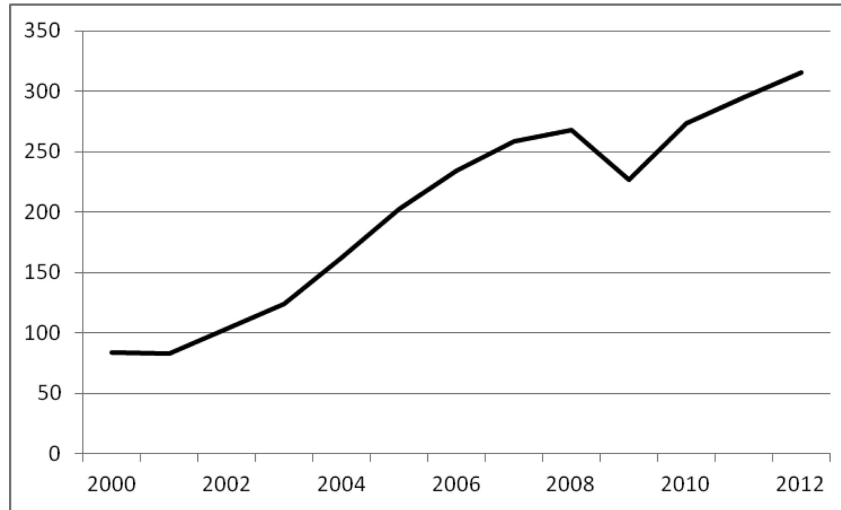
There are good reasons for the Chinese government not to try to boost growth with additional stimulus or policies to expand exports: A GDP slowdown may help Beijing tackle some of the structural problems with the economy, once described by former Premier Wen Jiabao as "unbalanced, uncoordinated, and unsustainable." Patrick Chovanec, an economist who has written extensively about the Chinese economy, says that "if China slowed for the right reasons, by being more selective with their investments, and moving toward more consumption, a slight slowdown would actually be a good thing."⁴⁵ Proper economic rebalancing, however, cannot happen without a significant decrease in medium-term growth rates, and the government's willingness to tolerate slow growth on a sustained basis is untested.

External Rebalancing

Balancing China's external accounts with other nations—or reducing China's massive trade surplus by increasing the import share of total trade—is a key element in rebalancing China's economy. Following the global financial crisis, China made progress in reducing its global trade surplus, which fell as a share of GDP from a peak of 10 percent in 2007 to 2.7 percent in the first half of 2013.⁴⁶ However, the decline in China's trade surplus with the world is not necessarily an outcome of deliberate structural rebalancing. In the first half of 2013, China's goods exports outpaced goods imports by 4 percentage points, causing its trade surplus with the world to grow by 40 percent year-on-year to \$157 billion.⁴⁷ The International Monetary Fund (IMF) projects that China's current account surplus will rise from 2.7 percent to 4 percent of GDP by 2018. This forecast assumes that there will be a gradual recovery in global demand, minimal appreciation of the RMB, and limited progress in domestic rebalancing.⁴⁸

The United States is among the countries most affected by China's export surplus (see figure 3). The U.S. cumulative bilateral deficit with China has risen to more than \$3 trillion since 1979.⁴⁹ For the first six months of 2013, China's goods trade surplus with the United States was \$148 billion; a decade ago, that figure stood at \$54 billion. While China sold 17 percent of its total goods exports to the United States in 2012, it purchased just 7 percent of total U.S. exports.⁵⁰ More strikingly, China in 2012 was responsible for nearly three-quarters of the U.S. trade deficit in non-oil products.⁵¹

Figure 3: U.S.-China Trade Deficit in Goods, 2000–2012
(US\$ billions)



Source: U.S. Bureau of Economic Analysis.

To be sure, U.S. manufactures exports to the world improved slightly in the first half of 2013, registering a lower deficit than in the prior year. Some industry experts have interpreted this as a sign of rising competitiveness in U.S. industry, driven in part by low energy prices.⁵² Nevertheless, the only manufacturing sector in which the United States registered a substantial trade surplus with China was transportation equipment (\$3.6 billion), which comprises automotive, aircraft, and ship products. Other sectors with a substantial surplus were agriculture (\$6.3 billion), waste and scrap (\$4.2 billion), and minerals and ores (\$1.3 billion). The United States has a persistent trade deficit with China in advanced technology products. Although exports to China have improved in the first half of 2013, the total value of trade in those sectors is small (see table 1).

Table 1: U.S. Trade Balance with China in Advanced Technology Products, January-June, 2012–2013
(U.S. millions)

	Ex-ports	Im-ports	YTD Balance Jun'13	YTD Balance Jun'12	Change 2012–2013
TOTAL	7,828	42,327	–34,499	–35,418	919
(01) Biotechnology	122	25	97	58	39
(02) Life Science	901	667	234	156	78
(03) Optoelectronics	102	1,335	–1,233	–2,429	1,196
(04) Information & Communications	1,375	38,607	–37,232	–35,717	(1,515)
(05) Electronics	1,439	1,049	390	163	227
(06) Flexible Manufacturing	713	278	435	185	250
(07) Advanced Materials	77	70	7	15	(8)

Table 1: U.S. Trade Balance with China in Advanced Technology Products, January-June, 2012-2013—Continued
(U.S. millions)

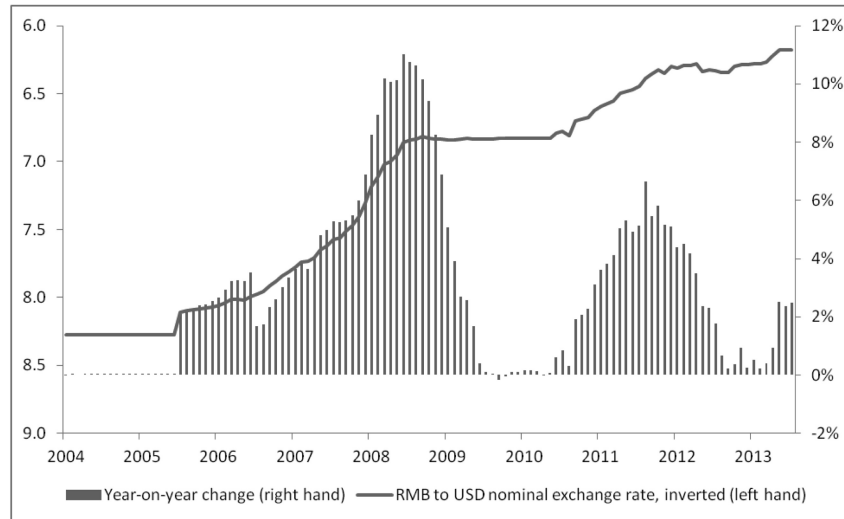
	Ex-ports	Im-ports	YTD Balance Jun'13	YTD Balance Jun'12	Change 2012-2013
(08) Aerospace	2,901	256	2,645	2,162	483
(09) Weapons	1	39	-38	-34	(4)
(10) Nuclear Technology	199	1	198	23	175

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

There are four important preconditions for increasing China's imports as a share of total trade. First, China must further open its market to imports in order to allow increased competition to stimulate consumption. At the China Development Forum held in March, Premier Li acknowledged as much, promising that "China will expand its opening-up policy, and the nation needs to promote domestic consumption through continuing to open up its markets."⁵³ Second, the RMB must continue to appreciate against the dollar, to lower the price of U.S. goods and services in China. Third, household disposable income must continue to grow to create sufficient domestic demand. Fourth, China must reduce its household and corporate savings rate. Money that is not saved or invested is necessarily spent, often on imports. In 2012, however, China's private savings rate reached the world's highest level, surpassing 50 percent, well above the global average of 20 percent. The high savings rate is largely attributed to China's low level of government safety net spending on health, education, and old age pensions, high down payment requirements for securing mortgages, negative or low real interest rates on ordinary bank deposits, and capital controls that restrict Chinese citizens from investing abroad.⁵⁴

RMB Revaluation

The RMB has continued to slowly appreciate against the dollar, gaining less than 2 percent in the first half of 2013.⁵⁵ This represents a slowdown in appreciation from previous years, particularly when compared to the period 2005–2008 (see figure 4). The rise of the RMB is still not controlled by market forces; the PBOC resets the value of the currency at the start of each trading day, allowing only 1 percent daily fluctuation. In January, strong market pressures to appreciate the currency were offset by interventions in the international currency market by the central bank and China's state-owned commercial banks, which purchased a record \$110 billion worth of foreign exchange within a matter of days.⁵⁶

Figure 4: Appreciation of the RMB, 2004–2013H1

Note: "2013H1" includes data from January to June 2013.

Source: China State Administration of Foreign Exchange, via CEIC database.

The Commission in past years has characterized the value of the RMB as "manipulated" by the Chinese central bank in an effort by the government to discount its exports to the United States and raise the price of U.S. exports to China. The intended purpose is to create and maintain an artificially high surplus in China's bilateral trade with the United States. The U.S. Treasury Department chooses not to use this technical term in order to avoid mandatory countermeasures dictated by U.S. law* but acknowledges that China's exchange rate "continues to be tightly managed" and "continues to exhibit significant undervaluation."⁵⁷

As in previous administrations, the U.S. Treasury Department has taken up the issue with China during bilateral talks and received assurances from top Chinese officials that change will be forthcoming and that market forces will be allowed a "bigger role" in determining the value of the RMB. However, China still refuses to publish data on exchange rate interventions by the central bank, in contrast to other G-20 members. Such interventions, combined with China's subsidies to exporting industries, have helped China accumulate the world's largest foreign currency reserves—\$3.66 trillion by the end of September 2013—almost as large as the total amount of foreign exchange reserves held by all advanced economies combined.⁵⁸ The monthly U.S. trade deficit in goods with China hit a record \$30.1 billion in July.⁵⁹

*The U.S. Treasury Department is required by the Trade Act of 1988 to report to Congress twice yearly on the exchange rate policies of major trading partners and to identify countries that "manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade." The Administration would be required to open negotiations with any country so designated.

Further Developments in RMB Internationalization

As part of a push to internationalize the RMB, China has been developing an offshore market for it as a precursor to allowing global firms, banks, and asset managers access to its domestic market. China has currency swap lines* with around 20 countries, mostly small, emerging economies that have natural resources, such as Argentina and Indonesia, but no major economic powers like the United States or EU countries. That may be about to change as China established two important swap agreements with major trade partners. First, the Bank of England, Britain's central bank, and the PBOC established a currency swap line in June 2013. The agreement will initially last for three years and has a maximum value of 200 billion RMB (\$32.6 billion).⁶⁰ Then, in October 2013, China agreed to swap euros and RMB with the European Central Bank, China's second largest swap deal. The swap agreement has a maximum size of RMB 350 billion (\$60.8 billion) and is valid for three years.⁶¹

In January 2013, Taiwan and China formally established a direct RMB-clearing system between them, following a signing of a cross-strait currency clearing last year. Taiwan will become the third place with such a clearing arrangement with China, after Hong Kong and Macau. Under the agreement, Taiwan's and China's central banks will be able to settle directly in RMB payments without first converting their currencies into U.S. dollars, which is the current practice.⁶²

On April 25, 2013, the government in Hong Kong loosened restrictions on interbank trading of the RMB, a move that is intended to enhance Hong Kong's status as an offshore RMB trading center, a segment that is witnessing competition from other financial centers.⁶³ Global use of the RMB for trade settlement is limited but has been rising steadily. By June 2013, the volume of RMB used to settle trade was 174 percent higher than in January 2012, when the policy was first introduced.⁶⁴ The Chinese currency now ranks 13th in the world for cross-border payments, up from 20th this time last year, according to SWIFT, the global payments company.⁶⁵ True RMB internationalization stays out of reach, however, as long as China's capital account remains closed, which makes use of RMB for trade settlement and investment difficult.

Domestic Rebalancing

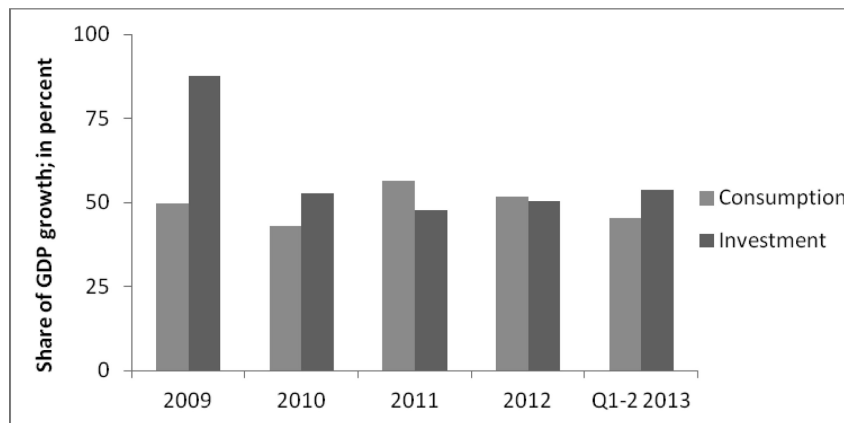
As of 2013, imbalances in China's domestic economy remain substantial. Beijing's economic policy has resulted in what the IMF calls a "pattern of growth [that] has become too reliant on investment and an unsustainable surge in credit, resulting in rising domestic vulnerabilities."⁶⁶ Rebalancing toward consumption-driven growth can only be achieved if consumption continually grows faster than investment for many years. Yet while private and govern-

*Under a swap agreement, central banks agree to exchange each other's currency and can then lend the money to domestic banks to improve liquidity.

ment consumption accounted for more than half of China's GDP growth in 2011–12, the trend reversed in the first half of 2013.⁶⁷ Nicholas Borst of the Peterson Institute for International Economics rated China's progress in rebalancing a grade of "D" and "F" for the first and second quarters of 2013, respectively.⁶⁸ His perspective summed up the consensus that China has experienced no significant domestic rebalancing this year.

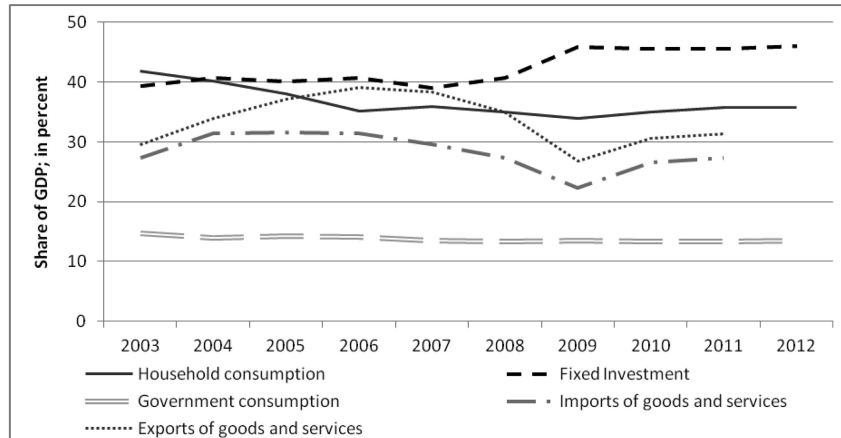
In the first half of 2013, consumption's contribution to economic growth fell below investment for the first time since 2010. Consumption contributed 45.2 percent to GDP growth, down 15.4 percentage points from the first half of 2012. Investment, however, increased to 53.9 percent, up 2.7 percent from 2012 (see figure 5).⁶⁹ In China, consumption's share of GDP remains low compared to other countries. Globally, it represents about 65 percent of GDP, and China's share of consumption is still far lower than developed western economies, where consumption accounts for over 70 percent of GDP (see figure 6).⁷⁰

Figure 5: China's Consumption vs. Investment, 2009–2013
(as share of GDP growth; in percent)



Source: China National Bureau of Statistics, via CEIC database.

The IMF has warned that if credit-fuelled investment in the manufacturing sector remains high, resources are likely to be wasted and nonperforming assets will accumulate, because such investment will only add to China's industrial overcapacity.⁷¹ Numerous examples of overinvestment and excess supply resulting in overcapacity have already arisen in the steel, shipbuilding, and solar manufacturing industries, which has resulted in insolvency and employee layoffs for many companies.⁷² This slowdown in the manufacturing sector has resulted in diminishing returns on the government's investment. Beijing has expressed tolerance for slower economic growth while it claims to be directing China's economy toward more domestic consumption.⁷³ Despite this, independent analysts believe that China's new leaders lack the political will to adopt an ambitious rebalancing agenda.⁷⁴

Figure 6: Composition of China's GDP, 2000–2012

Note: 2012 data for “imports of goods and services” and “exports of goods and services” were not yet released by the World Bank at the time of publication.

Source: World Bank China data (Washington, DC: 2013). <http://data.worldbank.org/country/china>.

The most important—and most challenging—element of domestic rebalancing is increasing household consumption as a share of GDP.* Households’ consumption has declined as a share of China’s GDP for decades while the share of fixed-asset investment has grown. Although year-on-year growth of urban household consumption has been expanding at a steady rate of 9.7 percent for the past ten years, in the first half of 2013, growth in urban household consumption dropped to 7.2 percent.⁷⁵ Meanwhile, fixed-asset investment grew by 20 percent.⁷⁶ Although for the past decade real annual growth of household consumption in China has outperformed a dozen major economies, including Brazil and India,[†] as long as fixed-asset investment is growing faster than household consumption, it will be difficult to rebalance China’s domestic economy.

An important factor in increasing household consumption’s share of GDP is sustained growth in disposable income minus any increase in the household savings rate.⁷⁷ If disposable income grows and the household savings rate remains stable or declines, this will result in more spending by Chinese consumers—a positive sign for domestic rebalancing. In the first half of 2013, however, the opposite occurred. Growth in nominal median urban household income took a dive, declining by 5.8 percentage points. The urban household savings rate remained high, reaching 35.6 percent, up 1.1 percent from 2012. And, most notably, there was lower growth of real

*Household consumption is generally defined as expenditures for goods and services by a household, excluding the purchase of a home but adjusting for “imputed rent” or the amount that a household would pay to rent the same residence. It includes healthcare and education—even that portion supplied by the government—but does not include taxes paid to government nor does it include savings or investments by the household.

†According to Daniel H. Rosen and Beibei Bao of the Rhodium Group, it is unreasonable to expect household consumption to grow faster than its current rate. They argue that effective rebalancing will not depend on a growth in household consumption but on reduced and better managed investment growth. Daniel H. Rosen and Beibei Bao, “China Has Problems, But Household Consumption Isn’t One,” *Caixin*, September 20, 2013. <http://english.caixin.com/2013-09-20/100584374.html>.

urban disposable income.⁷⁸ These three factors—slowing income growth, an increasing household savings rate, and a drop in growth of urban disposable income—cut into overall household consumption. In turn, the slowdown in household consumption contributed to an overall slowdown in retail sales. Year-on-year growth in retail sales for the first half of 2013 was down to 12.7 percent from 14.4 percent in 2012.⁷⁹ On a quarterly basis, growth in retail sales was down an average 1.3 percent from last year.*

Financial reform is also integral to rebalancing China's economy. Continued reform in China's banking system is a precondition to increasing access to credit and providing higher returns on household deposits. The new leadership made progress toward financial reform in July 2013 when the PBOC announced it would eliminate the floor on lending rates, allowing banks more freedom to compete by offering cheaper loans.⁸⁰ As a result, loans may become more accessible to small- and medium-sized enterprises. Although removing the floor on lending rates is a major step in financial reform, the PBOC did not remove the more important ceiling on deposit rates. The ceiling limits the rate that banks can pay depositors and ultimately stymies growth in household disposable income.⁸¹ The PBOC acknowledged that removing curbs on deposit rates would have a greater effect on consumption than lending rate reform.⁸²

Maintaining positive real interest rates would also play a role in increasing the returns for China's households. Interest rates on one-year deposits lagged behind inflation and were thus negative from 2010 to 2011, which adversely affected household consumption by cutting into disposable income. Depositors find that their savings have less purchasing power over time when inflation exceeds their return on savings. Although real interest rates have been positive since peaking at 1.5 percent in June 2012, they dropped to 0.3 percent in 2013.⁸³ As a result of the low interest rates, many seeking higher returns will favor alternatives in China's property sector, a cycle that will only result in increased fixed-asset investment and further inflation of China's real estate bubble.

China implemented a new set of controls in March 2013 on the housing market that were targeted at curbing speculative investment in real estate.⁸⁴ However, growth of investment in residential real estate continues to exceed real GDP growth, and reports of excess housing stock have indicated that it is unlikely that real estate investment is driven by actual demand.⁸⁵

Monetary Policy

Management of Foreign Exchange Reserves

The reserve assets held by China's central bank grew by \$169 billion in the first half of 2013—\$37 billion more than in all of 2012.† Although China's reserve accumulation has slowed significantly since 2011, cumulative reserves are still extremely large, exceeding the combined foreign holdings of Japan, Norway, the

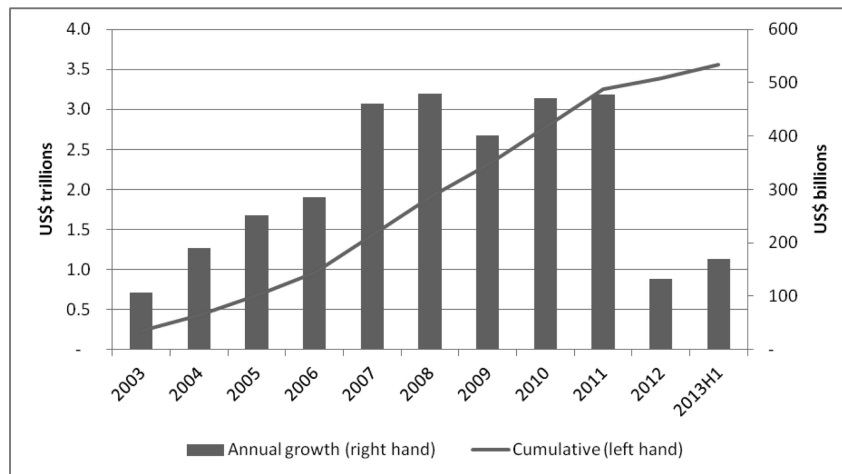
*Data used in calculation exclude the months of January and February. China National Bureau of Statistics, via CEIC database.

†Total "reserve assets" are primarily comprised of foreign exchange. By the end of September 2013, China's foreign exchange reserves reached \$3.66 trillion.

United Arab Emirates, and Saudi Arabia, which rank directly behind China as the top foreign exchange reserve holders (see figure 7).⁸⁶

China's share of U.S. Treasuries in foreign hands increased to 23.2 percent in 2013, cementing its rank as the world's largest holder of U.S. Treasury securities. Other top holders of U.S. Treasuries, such as Japan, Brazil, and Taiwan, all saw their shares decrease over this period.⁸⁷ As of June 2012 (most recent data), China was also the second-largest holder of U.S. agency debt, at \$202 billion.

Figure 7: Growth of China's Reserve Assets, 2003–2013
Cumulative (US\$ trillions); Annual (US\$ billions)



Note: "2013H1" refers to first half of 2013. Numbers for 2003 to 2010 are from China State Administration of Foreign Exchange's balance of payments data. Numbers for 2011 to 2013 are from the State Administration of Foreign Exchange's quarterly report on the international investment position, which are more widely used by economists but are not available for the period before 2011.

Source: China State Administration of Foreign Exchange, via CEIC database.

While maintaining a preference for government securities, China continues to diversify its foreign exchange assets. China's non-financial outbound foreign direct investment (FDI) for the first half of 2013 totaled \$45.6 billion, up 29 percent from the prior year.⁸⁸ One motive behind China's outbound FDI is to acquire resources and enter new markets overseas. In this context, China is increasing its direct ownership of foreign companies. Another motive, which also relates to China's portfolio investments and overseas loans, is to counteract the depreciation of the dollar against the RMB and to earn a higher yield than is provided by U.S. Treasuries.⁸⁹ (For an analysis of China's foreign investment in the United States, see chap. 1, sec. 2, of this Report.)

Rising Competition among China's Sovereign Wealth Funds

China Investment Corp. (CIC),* established in 2007, is the only state-sponsored investment vehicle recognized by the Chinese government as a sovereign wealth fund. But, according to the Sovereign Wealth Fund Institute, an international research body, mainland China currently has three other entities that may qualify as sovereign wealth funds—State Administration of Foreign Exchange (SAFE) Investment Company,† the National Social Security Fund,‡ and the China-Africa Development Fund.§ Each investment fund serves separate interests among branches of the Chinese government and competes with other state-sponsored entities for access to China's foreign exchange reserves.

The Ministry of Finance has been the strongest supporter of CIC and has advocated that the fund act as China's primary outbound investor.⁹⁰ Lou Jiwei, formerly the vice minister of Finance, served as CIC's chairman in 2007–2013.⁹¹ As part of the leadership transition, he was appointed as minister of finance in March 2013.⁹² After some bureaucratic infighting, Mr. Lou was replaced at CIC by another Ministry of Finance official, effectively allowing the ministry to retain its influence over the fund.⁹³ China's central bank, on the other hand, has preferred to invest the country's dollar reserves through other state-sponsored investors. SAFE, the subsidiary of the central bank that manages the bank's foreign exchange, is subject to less external pressure than CIC, because it does not participate in internationally recommended practices on transparency.¶

*CIC is registered as a state-owned enterprise under China's Company Law. Unlike SAFE Investment Company and the National Social Security Fund, it is not a legal subsidiary of any government agency. It reports like a ministry directly to the State Council, China's highest administrative body. Under CIC's Articles of Association, five government agencies—the People's Bank of China, SAFE, the Ministry of Finance, the Ministry of Commerce, and the National Development and Reform Commission—have a seat on the fund's board.

†SAFE Investment Company is a limited company that was registered in Hong Kong prior to the handover of the island to mainland China. It constitutes one of four overseas investment arms of the State Administration of Foreign Exchange. The State Administration of Foreign Exchange is the branch of the People's Bank of China, China's central bank, which exclusively manages China's foreign exchange reserves. SAFE Investment Company's primary objective is to retain the value of China's foreign exchange by making portfolio investments overseas.

‡Established by the State Council, under the auspices of the Ministry of Social Security, the National Social Security Fund is a public pension fund under China's Social Insurance Law. Its objective is to maintain the real value of public pension proceeds as a means to support future social security expenditures. The National Social Security Fund can invest 20 percent of its funds outside China.

§The China-Africa Development Fund is a small fund set up to foster economic ties between China and Africa. It functions as a branch of China Development Bank, China's largest policy bank, though various government ministries are represented on its board. It is worth noting that the China Development Bank is majority owned by Central Huijin, the domestic subsidiary of CIC.

¶CIC is a participant in the International Forum of Sovereign Wealth Funds (IFSWF) and has endorsed the Generally Accepted Principles and Practices, or "Santiago Principles," a set of recommended practices for sovereign wealth funds that calls for increased transparency. SAFE, however, does not participate in the IFSWF.

Rising Competition among China's Sovereign Wealth Funds—Continued

China's sovereign wealth funds rank among the world's largest in terms of assets and have developed substantial portfolios in the United States. CIC has acquired stakes in and loaned capital to major U.S. companies in energy and financial services.⁹⁴ CIC's subsidiary, the bank holding company Central Huijin, also owns shares in China's largest commercial banks, which have opened branches in the United States.⁹⁵ SAFE has become a more aggressive investor and has moved beyond U.S. Treasuries to riskier asset classes.⁹⁶ In 2013, SAFE opened a new branch in New York that will invest in U.S. private equity and real estate.⁹⁷ In addition, China's sovereign wealth funds are contracting U.S. fund managers, such as Blackrock and TPG, to manage large portions of their portfolios.⁹⁸

Foreign exchange is being channeled into overseas lending as well. Among the top lenders is China Development Bank, China's largest policy bank. The bank was established in 1994 to subsidize development projects in China's most backward regions but has vastly expanded its dollar-denominated loan portfolio in recent years. In May, it signed a \$1 billion oil-for-loan deal with India's largest oil company, Essar Oil Ltd. China Development Bank has issued several such loans to energy-rich countries since 2007, notably Venezuela, Russia, and Brazil.⁹⁹

Currency Inflows and the Cash Crunch

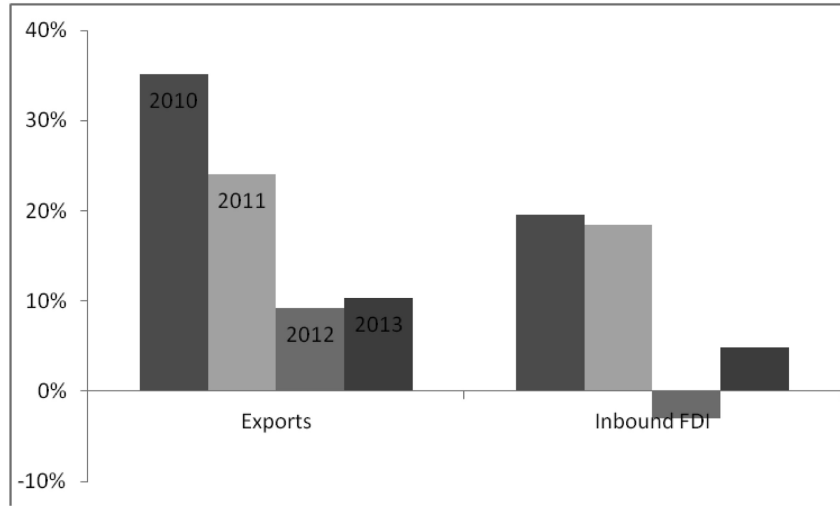
China's foreign currency inflows in the first half of 2013 were large but volatile: reserve accumulation surged in the first quarter, followed by outflows in the second quarter.¹⁰⁰ Volatility in China's external accounts carried over into the domestic financial sector, which encountered a temporary liquidity crisis. The central bank intervened to maintain stability in a slowing economy exposed to high levels of debt.

Export earnings and inbound FDI grew at a slow pace in the first half of 2013, making only a moderate contribution to China's dollar inflows (see figure 8). China's foreign exchange reserves increased by \$128 billion in the first quarter, well above the \$43 billion trade surplus and \$30 billion in foreign investments.¹⁰¹ Other factors, less tied to the health of the economy, played a significant role in attracting capital to the Mainland. One was the reversal of capital flight. According to a February 2013 briefing to the Commission by the U.S. Treasury, many wealthy individuals took money out of the country during China's once-in-a-decade leadership transition in 2012, due in part to concerns about political and economic instability.¹⁰² China's central bank records indicate that some \$79 billion of foreign exchange outflows went unaccounted for. The outflows of capital were so large that China's foreign exchange reserves in 2012 grew by less than the trade surplus—a pattern not seen since China joined the World Trade Organization (WTO). The resumption of currency inflows in early 2013 suggested that some of the flight capital reentered the country.¹⁰³ Due to China's tight

capital controls, a considerable portion of the inflows entered illicitly through over-invoicing of export revenues and other means.¹⁰⁴

Figure 8: Growth of China's Exports and Inbound FDI
(January—June, 2010–2013)

YTD (year-on-year, %)



Source: China General Administration of Customs, China Ministry of Commerce, via CEIC database.

Another factor behind China's surging capital inflows was financial speculation. International investors borrowed U.S. dollars at low rates of interest to purchase assets denominated in RMB, which offered a higher yield and the potential to profit from currency appreciation. Although the RMB did not appreciate much in 2012, the upward pressure on the currency resumed in 2013. This investment pattern was reinforced by the U.S. Federal Reserve's purchases of longer-maturity assets, such as commercial bank bonds, under the stimulus program known as "quantitative easing." First implemented in November 2008, quantitative easing substantially lowers the longer-term cost of borrowing in dollars.¹⁰⁵

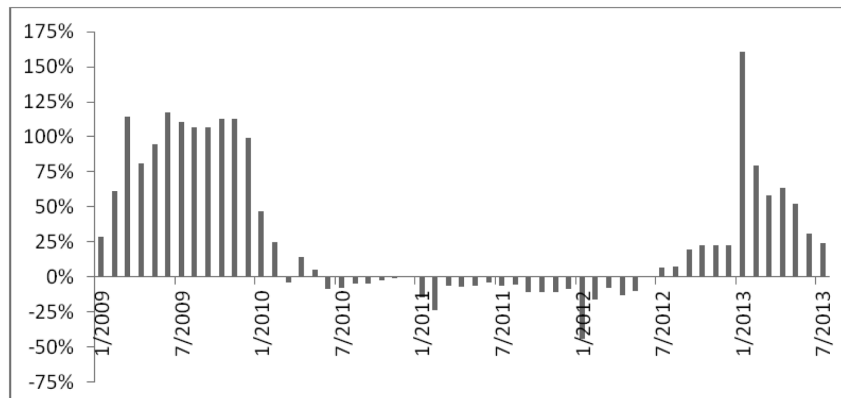
As it has done persistently since 2005, the PBOC counteracted rapid capital inflows by heavy market intervention. The PBOC purchased dollars with RMB in order to support the targeted RMB-dollar exchange rate. That not only added to the PBOC's bulging foreign exchange reserves but also increased China's money supply, raising the risk of inflation. To reduce those risks, the PBOC took additional "sterilization" measures to absorb liquidity out of the economy—essentially issuing RMB-denominated bonds in an effort to remove the money from circulation.¹⁰⁶

Nonetheless, the liquidity buildup contributed to an expansion of lending and debt in China. The broad money supply (M2)* grew by

* Broad money (M2) is a measure of liquid money supply beyond physical currency and demand deposits (also termed narrow money, or M1). M2 includes time-related deposits, savings deposits, and noninstitutional money market funds.

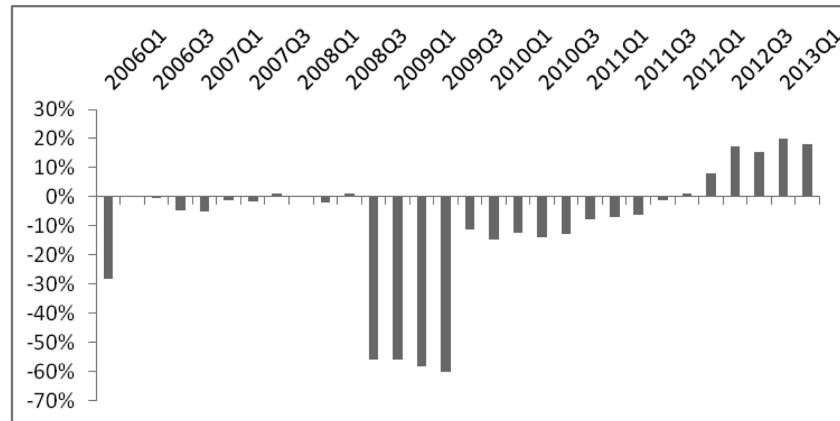
16.1 percent through April, above market forecasts of 15.5 percent.¹⁰⁷ The Chinese government’s measurement of debt, or “total social financing,” rose at its fastest pace since the stimulus in 2009 (see figure 9). Much of this credit expansion was in the “shadow banking” sector, in products such as trust company loans.¹⁰⁸ At the same time, worrying trends appeared in the traditional banking sector. Foreign currency lending increased by 37 percent year-on-year through May—versus 16 percent for RMB-denominated loans—as banks recycled the excess dollars coming into their accounts.¹⁰⁹ Chinese banks are less restricted in terms of the amount of deposits they need to have available when lending in foreign currency, a loose regulation that prompts riskier lending. Nonperforming loans at Chinese banks also grew at their fastest quarterly rate in a decade; an indication that credit was not well allocated (see figure 10).

Figure 9: Aggregate Credit Growth in China, January 2009–July 2013
Monthly (year-on-year, %)



Source: People’s Bank of China, via CEIC database.

Figure 10: Growth of China's Nonperforming Loans, 2006–2013Q1
Quarterly (year-on-year, %)



Source: People's Bank of China, via CEIC database.

Faced with a sudden rise in liquidity, the PBOC in June began to take more drastic measures, such as imposing tougher lending conditions on banks. These policies, which came to be known as the “credit crunch,” were effective in reducing dollar inflows. A concurrent development was the U.S. Federal Reserve’s announcement in May that it might taper quantitative easing, a major policy shift that would raise the cost of borrowing in dollars and reduce the relative yield on RMB-denominated assets. In response to the Federal Reserve’s announcement, international investors rushed to transfer funds out of China and other emerging markets.

However, the credit crunch also destabilized China’s financial sector. The primary effect was to raise interest rates in the interbank lending market to record highs—lending among Chinese banks froze temporarily in late June. Many indebted borrowers worried that they would be unable to refinance their debt.¹¹⁰ The average price-to-earnings ratio for China’s major commercial banks fell sharply on the country’s major stock exchanges, part of a broader decline in China’s capital markets.¹¹¹

Ultimately, the cash crunch did not do much to rein in China’s debt. Once the initial scare of tight liquidity passed, aggregate credit growth continued to rise in June and July. Even as banks have found themselves increasingly strapped for cash, other signs indicate that they may actually be expanding their issuance of risky loans. Shortly after the engineered rate spike that froze interbank lending, nearly every major Chinese bank was selling a short-term wealth management product (a particularly popular vehicle for financing high interest rate, off-balance-sheet loans) that had to be completed by the end of June.¹¹² (For more on shadow banking, see chap. 1, sec. 3, of this Report.)

Capital Account Liberalization

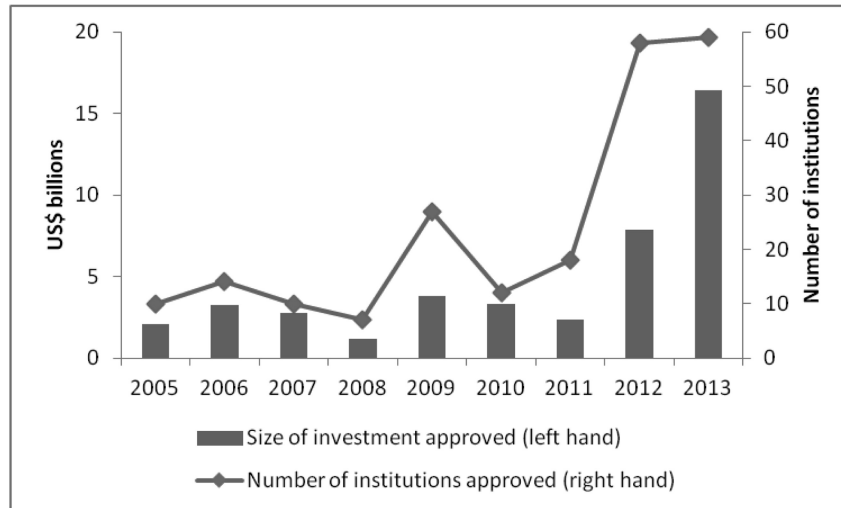
Beijing took moderate steps in 2013 to further open its capital account. The primary motive was to attract foreign investors, an

indirect way to stimulate a sluggish economy. Financial regulators launched the Qualified Foreign Institutional Investor program in 2002 to allow licensed foreign investors to buy and sell shares on China's stock exchanges. China's central bank and securities regulators approve any increase in the number of institutions and the amount of funds that these institutions can invest in China under the scheme. In 2013, the Qualified Foreign Institutional Investor program saw its largest-ever increases in investment approvals (see figure 11). Most of the approvals were given to investors who already held Qualified Foreign Institutional Investor licenses.

In addition to individual approvals, the quota for total investment under the Qualified Foreign Institutional Investor program was increased from \$80 billion to \$150 billion. Raising the quota seemed relatively pointless; with total cumulative funding approvals of \$43 billion over 11 years, even the original \$80 billion quota has yet to be filled. Nonetheless, the policy had its intended effect of generating interest among foreign investors, as several financial services companies quickly applied for a larger quota.*

Figure 11: Increase in Investment Quota under the Qualified Foreign Institutional Investor Program, January-July, 2005-2013

(US\$ billions)



Source: China State Administration of Foreign Exchange, via CEIC database.

The RMB Qualified Foreign Institutional Investor program, first established in December 2011 to complement the Qualified Foreign Institutional Investor program, was also expanded. Whereas the Qualified Foreign Institutional Investor program allows investors to bring U.S. dollars onshore and exchange them into RMB, the

* According to the Qualified Foreign Institutional Investor program, the China Securities Regulatory Commission grants Qualified Foreign Institutional Investor licenses and market access to foreign investors, while the State Administration of Foreign Exchange approves quotas for individual Qualified Foreign Institutional Investor funds. Josh Noble, "China Approves HSBC for Onshore Currency Investing," *Financial Times*, July 26, 2013, via Factiva database.

RMB Qualified Foreign Institutional Investor program allows select institutions to raise RMB offshore as well.¹¹³ RMB Qualified Foreign Institutional Investor funding approvals reached \$20 billion by July 2013, four times higher than the year before, with 34 institutions approved for investment.¹¹⁴ The China Securities Regulatory Commission removed rules on how quotas could be used, so that fund managers could invest in either China's equity or domestic bond markets without requiring separate licenses.¹¹⁵ The China Securities Regulatory Commission also allowed units of Chinese banks and insurers in Hong Kong—as well as other financial institutions based in the city—to apply for RMB Qualified Foreign Institutional Investor quotas. Previously, only the Hong Kong units of Chinese fund management and securities companies were allowed to invest in mainland China via the program.¹¹⁶ In June, the RMB Qualified Foreign Institutional Investor program was then extended beyond Hong Kong to other offshore RMB trading centers, such as London, Singapore, and Taiwan, to the dislike of mainland Chinese fund managers who hoped to monopolize this new market.¹¹⁷

It is questionable, however, whether the Chinese government is making a genuine effort to open the capital account or is merely luring foreign investors into China to stimulate the economy. It has done much less to open up the capital account for Mainland investors looking to send money overseas. Chinese domestic investors are allowed to access foreign equity markets via pilot trustees called Qualified Domestic Institutional Investors, which comprise banks, fund management firms, insurance companies, dealers, and brokers approved by the China Securities Regulatory Commission.¹¹⁸ The amount of investment permitted for Qualified Foreign Institutional Investors barely increased in the first half of 2013.¹¹⁹ The government announced plans in 2012 to introduce a Qualified Domestic Individual Investor program that would permit individuals from the Mainland to trade Hong Kong securities directly. By October 2013, the plan had yet to proceed.¹²⁰ The government in 2013 introduced a less ambitious Qualified Domestic Institutional Investors scheme that would allow firms set up in the new Qianhai special economic zone to invest a certain amount of money in Hong Kong securities or bond markets.¹²¹

Excess Industrial Capacity

The Excess Capacity Crisis

In 2012–2013, China's manufacturers recorded their worst performance since the height of the financial crisis four years ago. Monthly growth in China's industrial production, averaging 13.3 percent in 2010, slowed to 6.1 percent in the first half of 2013. The purchasing managers' index, a monthly survey of manufacturers in China, consistently showed stagnation or decline in production and orders. China's exports were also sluggish, due to weak external demand.¹²² The construction sector, a key source of demand for many industrial materials, recovered slightly in the first half of 2013 from 2012 levels but was still growing at 7 percentage points less than in 2010–2011.¹²³

The economic slump exacerbated the problem of excess capacity in China's heavy industry. The sectors affected extended along the value chain, from suppliers of basic materials, such as metals and cement, to manufacturers of ships, solar panels, and chemical additives. China today is the world's leading producer of most of these goods. According to official estimates, industrial enterprises in many of these sectors were operating at only three-fifths to three-quarters of capacity in 2012, below the Chinese government's target minimum of 80 percent capacity (see table 2).

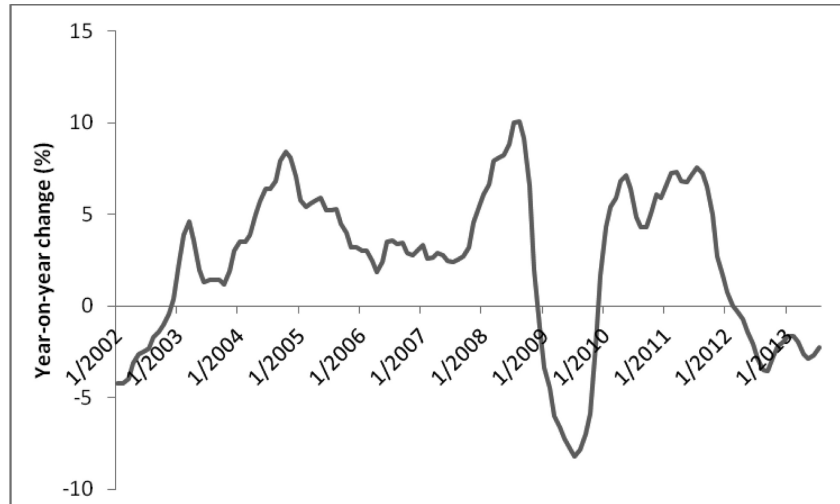
Table 2: Capacity Utilization in Select Chinese Industries, 2012
Capacity utilization (%)

Sector	Capacity utilization (%)
<i>Chinese government target</i>	>80%
Glass	75%
Cement	75%
Aluminum	73%
Wind turbine	70%
Steel	75%
Solar panels	60%

Source: Xinhua News Agency, based on official Chinese government estimates.

Due to excess capacity, business conditions in many industries deteriorated. In order to sell off their inventory and attract new orders, producers slashed prices, leading China's producer price index to contract throughout 2012–2013 (see figure 12). Some enterprises took on more debt in order to offer generous financing terms to their customers. Shipyards, for instance, accepted down payments of just 5 to 10 percent for new orders, versus up to 60 percent at the high mark in 2007.¹²⁴ To some extent, these measures proved effective—the total losses of the industrial sector, and the total number of loss-making industrial enterprises, declined in the first half of 2013, after steep increases in 2012.¹²⁵

Figure 12: Producer Price Index in China, January 2002–July 2013
Monthly (year-on-year change, %)



Source: China National Bureau of Statistics, via CEIC database.

Still, many firms incurred debts that brought them to the brink of insolvency. Among 88 private steel enterprises, the number of companies suffering losses grew from a third to half in 2012–2013.¹²⁶ In the solar sector, China's state-owned banks grew wary of lending to panel makers after product prices fell 66 percent in two years.¹²⁷ Suntech Power, the world's largest solar panel manufacturer, declared bankruptcy in March 2013 after running out of cash and defaulting on a bond payment of more than \$541 million.¹²⁸ In the shipbuilding sector, China Rongsheng Heavy Industries Group Holdings Ltd., a publicly listed company and China's largest private shipyard, sought a bailout in July from the local government in Jiangsu Province.¹²⁹ In its 2012 annual report, Rongsheng acknowledged that it had only \$343 million of cash and cash equivalents to service debts of \$2.7 billion.¹³⁰

Although producers were affected by a slowing economy, structural imbalances and ineffective government policies created the underlying problem. China's industrial sector remains very fragmented. For example, while Japan and South Korea have only a few dozen large-scale shipyards, China has some 1,650 yards of various sizes. Such industrial enterprises have failed to coordinate production or pool resources on a national level, creating cut-throat competition in undifferentiated product lines. They have done so with subsidies from local governments keen on attracting business to grow the economy and raise government revenue. Low-interest-rate loans from state-owned banks, with a bias toward industrial enterprises, created additional capacity without regard for insufficient demand. The 2009 economic stimulus accelerated this pattern. Fixed asset investment in manufacturing grew by an average of 35 percent in 2010–2011.¹³¹ For 35 steel companies listed on the Shanghai and Shenzhen stock exchanges, local government sub-

sidies increased by 128 percent year-on-year in 2010–2011.¹³² One shipbuilder, Rongsheng, received some \$550 million in local government subsidies in 2010–2013, along with two five-year financing deals with Export-Import Bank of China, a Chinese policy bank, and a ten-year agreement with Bank of China, one of China’s “Big Four” commercial banks.¹³³

Reinforcing these patterns was the deliberate expansion of productive capacity in China’s poorer inland regions. In the case of aluminum, more than 90 percent of new capacity has emerged in western areas since 2010. Excess capacity in the cement industry was as high as 30 percent in the Northeast and West of the country, versus 10 to 15 percent in the more developed eastern regions.¹³⁴ Industrial enterprises have relocated to where land and labor are cheaper, urban density is lower, and local governments are less likely to enforce environmental regulations decreed by the central government.¹³⁵

Some of China’s industries have also fallen behind their international competitors, who have performed better in a difficult economic climate. In the aluminum sector, the U.S. firm Alcoa registered profits of \$191 million in 2012, while China’s aluminum giant Chinalco had a loss of \$780 million, its worst since going public in 2007.¹³⁶ In shipbuilding, China in 2012 received orders of \$14.3 billion, its lowest order value since 2004, while its South Korean rivals received \$29.6 billion worth of new orders.¹³⁷

Market forces are unlikely to correct the structural problems of China’s heavy industry. Heavily indebted firms often have an incentive to maintain current output levels, because their loans are contingent upon future output. Due to fierce competition, there is also a concern that distributors will turn to other producers if deliveries are cut. Because many local communities depend on industry for employment, it is difficult to reduce pay or shed jobs. For example, Wuhan Iron and Steel, one of China’s top-five steelmakers, supports a workers’ town of 300,000 people in Hubei Province.¹³⁸

While such overcapacity is harmful to the affected Chinese industries and individual businesses, as well as any shareholders involved, it also spreads damage beyond China’s borders. Industries within the United States, such as steel and glass, are sometimes forced to match the “China price” even if it is below the cost of production, leading to business losses and unemployment.

Tougher Policy Responses by the New Leadership

Excess capacity in China’s industry is not a new problem. The central government’s restructuring of the country’s state-owned enterprises in the 1990s was partly aimed at reducing overcapacity, particularly in the industrial northeast. The 11th Five-Year Plan (2006–2010) focused on the consolidation of capacity, and in the 12th Five-Year Plan (2011–2015), issued in 2010, the State Council introduced a specific five-year Plan for Industrial Transformation and Upgrading.¹³⁹ An important proponent of consolidation has been the NDRC, the coordinating ministry in charge of China’s industrial policy. In September 2009, it issued Document 35, “On Restraining Excess Capacity and Industrial Redundancy in Certain Industries.” The document identified industries such as steel, ce-

ment, aluminum, and shipbuilding. It placed much of the blame on the lavish subsidies and lax regulation of local governments and warned that unchecked capacity expansion would eventually lead to fierce competition and cost-cutting at the national level, threatening the financial health of enterprises and their creditors; depleting China's resource base; increasing reliance on raw material imports; and worsening industrial pollution near urban centers.¹⁴⁰

However, these efforts by the government did not suffice to check industrial expansion. Instead, industrial capacity continued to increase under the \$586 billion economic stimulus program introduced during the global financial crisis. The EU's Chamber of Commerce in China warned in a 60-page report in 2009 that industries such as steel, cement, and plastics were "still blindly expanding" despite a slump in export demand. Referring to the steel industry, the report noted that China, with annual production capacity of 660 million tons of steel, and with an additional 58 million tons coming online, had sold less than 500 million tons the previous year.¹⁴¹ With 20 million tons of primary aluminum capacity in 2008, China could sell only 13.5 million tons, or just 68 percent of its capacity.¹⁴²

By the spring of 2013, during the National People's Congress's annual meetings, top officials openly acknowledged that excess capacity was untenable, particularly in the steel sector. NDRC head Zhang Ping urged "mergers and acquisitions, eliminating backward production, and encouraging more companies to tap into the overseas market."¹⁴³ In April, the new leadership took its first tentative steps to address the issue. Based on a comprehensive set of criteria, including product quality, environmental sustainability, and resource efficiency, the Ministry of Industry and Information Technology (MIIT) chose 45 out of a pool of 104 enterprises for consolidation of the steel industry under the 12th Five-Year Plan. MIIT announced that those companies that could not meet the criteria would eventually be forced to exit the market, either by legislative fiat or reduced access to capital.¹⁴⁴

From June to August, the government's efforts to reduce capacity intensified. The "credit crunch" in June, widely attributed to China's central bank, helped to clamp down on short-term borrowing, forcing dozens of companies to cancel or delay bond sales, including China Development Bank, a key backer of the shipping industry.¹⁴⁵ Weeks after the credit crunch, the central bank lifted the floor on bank lending rates. According to economist Nicholas Lardy, at the Peterson Institute for International Economics, the leadership used the credit crunch and rate reform to signal that the corporate sector would need to cut costs and improve productivity in order to remain profitable.¹⁴⁶

Beijing followed with more targeted measures aimed directly at heavy industry. The most far-reaching measure came on July 25, when MIIT ordered more than 1,400 companies in 19 industries to permanently retire entire production lines within factories by the end of 2013. In a break from past policy, the government published detailed lists of exactly which plants should reduce capacity and by how much.¹⁴⁷ The lists were downloadable from the MIIT website and included publicly listed companies, some of which saw their share price drop as a result.¹⁴⁸ Although the industries were wide-

ranging, the companies targeted were primarily in metals, cement, and other basic materials.¹⁴⁹ MIIT reinforced these policies with specific documents targeting the aluminum and rare earths sectors.*

On September 17, MIIT released another list for industrial capacity retirement—the third of the year—involving a total of 58 companies operating in 14 sectors. The affected industries were largely the same as before, comprising steel, coking, battery, copper smelting, zinc smelting, cement, and plate glass, among others. Black-listed capacities were to be demolished before the end of the year. MIIT expressly forbid the relocation of production to the hinterland.¹⁵⁰

A Lenient Approach to the Shipbuilding and Solar Photovoltaic Industries

Although the central government took concrete steps to rationalize production, vested interests appeared to impede similar efforts in the shipbuilding and solar photovoltaic sectors. A three-year plan to upgrade the country's shipbuilding industry, released by the State Council on July 31, encouraged local governments to provide subsidies to shipbuilders. It also offered ship-holders incentives to scrap their ships in advance, until the end of 2015, in order to raise demand for new ships. Banks were ordered to extend favorable loans to overseas ship-buyers and provide credit support to domestic ship-builders. Although the plan also called for industry consolidation, the measures were less targeted at individual plants.¹⁵¹

Similarly, in the “Guidance on Promoting the Healthy Development of the Solar Industry,” issued on July 15, the State Council announced new measures to spur solar panel installations. The policy called for raising the capacity target for solar power generation in China to 35 gigawatts (GW) by 2015, a large step up from the 21 gigawatt target set in the 2011–2015 Solar Development Plan issued by the National Energy Administration in 2012.¹⁵²

The Chinese government also supported the solar industry through an aggressive trade policy. China followed through on a probe it launched in 2012 into alleged subsidies for U.S. and South Korean polysilicon producers, applying antidumping duties on these imports in July 2013. Many critics interpreted the move as retaliation for U.S. antidumping duties leveled against Chinese solar panel makers in September 2012. The duties also protect China's domestic polysilicon industry, which is suffering from over-capacity.¹⁵³

*MIIT in July convened several agencies, including the Environment Ministry, Customs, the Ministry of Land and Resources, and the Ministry of Commerce, to deliberate a new wave of crackdowns in the rare earths industry, with a focus on rooting out illegal production through higher fines and the closure of mines and smelting facilities. On July 24, MIIT released new aluminum industry standards: only large alumina projects would be authorized to use imported bauxite; alumina projects using high-aluminum fly ash for production were to locate in a place close to fly ash production, to reduce pollution; and the minimum capital ratio of electrolytic aluminum projects was raised to 40 percent from the previous 35 percent, to ensure less leveraged investments in new capacity. Shanghai Securities News, “Zhengzhi fang'an' lidu kongqian: Xitu jiage fantan huo zhicheng” (“Unprecedented Crackdown’ to Support Price Rebound for Rare Earths”) July 23, 2013, p. 5; Xinhua's China Economic Information Service, “MIIT Rolls Out Policies to Resolve Excess Aluminum Capacity,” July 24, 2013, via Factiva database.

In parallel to its rift with the United States, China engaged in a protracted trade dispute with the European Union, which in May 2013 threatened to apply antidumping duties on Chinese solar panels, similar to those being enforced by the United States.¹⁵⁴ The proposed duties, averaging 47.6 percent, would have been the largest duties that the European Union has applied to China and involved some \$27 billion worth of imports.¹⁵⁵ The Chinese government made extensive efforts to block the duties. In mid-May, the Ministry of Commerce (MOFCOM) warned that imposing duties would “seriously harm” bilateral trade ties between the European Union and China.¹⁵⁶ A statement posted on the Chinese government’s main website on May 30 asserted that EU member states did not all agree on the need for the tariff duties.¹⁵⁷ Premier Li Keqiang used his first trip to Europe to encourage Germany and other major countries to oppose the measures.¹⁵⁸

China’s diplomatic offensive proved effective. On June 4, the European Commission agreed to temporarily lower the new tariffs from the proposed level of 47.6 percent to a mere 11.8 percent, while the two sides attempted to negotiate a solution.¹⁵⁹ In late July, China scored a major victory in the negotiations, as the European Union agreed to scrap its proposed duties in favor of a “price undertaking.” The settlement allows Chinese exporters to sell into the European Union only enough solar panels to generate up to seven GW of capacity each year, at a minimum price of 0.56 euros per watt. Only Chinese firms that do not comply are subject to duties. The outcome effectively permitted China’s subsidized solar panel exports to the European Union to continue unabated, only at a higher sales price. As *The Wall Street Journal* noted, the deal was much like the voluntary export restraints negotiated between the Japanese and U.S. governments in the 1980s.¹⁶⁰

U.S.-China Strategic and Economic Dialogue

The fifth round of the U.S.-China Strategic and Economic Dialogue (S&ED) was held on July 10–11, 2013, in Washington, DC. Prior to the S&ED, the United States and China held the first meeting of the civilian-military Cyber Working Group, where the two sides committed to work together on cooperative activities and hold further discussions on international norms of state behavior in cyberspace, but there were no tangible results.¹⁶¹ Both sides agreed to hold the next meeting before the end of 2013. (For discussion of U.S.-China tensions over cybersecurity, see chap. 2, sec. 2, of this Report.)

On the economic front, the most relevant announcements were (1) resumption of Bilateral Investment Treaty (BIT) talks; (2) the launch of the Shanghai Free Trade Zone; and (3) new measures to liberalize China’s financial sector.

Announcement 1: BIT Talks Resumed

Of the economic outcomes, the most significant development was an agreement to restart the 2008 talks to reach a BIT. Six months before leaving office, the Bush Administration had launched talks for a U.S.-China BIT. In November 2009, President Obama then issued a joint statement with President Hu Jintao, announcing

plans to expedite these negotiations. Until now, little progress has been made.¹⁶²

At the S&ED talks, China agreed to negotiate market access using a “negative list” approach (which means that all sectors are negotiable, except for those specifically exempted). China also agreed to grant U.S. investors national treatment in the “pre-establishment” phase of investment, or before U.S. firms are actually invested in China. This means, for example, that China will not discriminate against U.S. firms while they are trying to obtain a license or treat them differently than a domestic firm.¹⁶³

Treasury Secretary Jacob Lew described this as a “significant breakthrough” that “would work to level the playing field for American workers and businesses by opening markets for fair competition.”¹⁶⁴ U.S. business groups welcomed the development as a possible solution to Chinese opposition to foreign investment in large sectors of the Chinese economy, most notably financial services.

Others have urged caution, however. Dr. Lardy called the BIT “a noble goal but one which will be very difficult to conclude in any reasonable time period and it might well fail.”¹⁶⁵ Derek Scissors, then at the Heritage Foundation, was similarly skeptical, noting, “BITs are primarily about protecting investors from discriminatory government policies. They are not transformative instruments that change the nature of economies, especially not large economies.”¹⁶⁶

A comprehensive BIT with China would be highly controversial and involve protracted Senate debate over details. BITs are treaties rather than executive agreements,* such as the North American Free Trade Agreement, and require a two-thirds vote of the Senate to ratify. A BIT would also potentially curtail the powers of state and local governments to regulate health and safety issues and even zoning, raising sovereignty concerns. Moreover, with the exception of a few failed deals, Chinese firms have had success investing in the United States even without an investment treaty. Similarly, U.S. companies have been investing in China for years, fully cognizant of various restrictions on investment, policies that discriminate against foreign investors in favor of Chinese firms, and rampant intellectual property rights theft. China may not be willing to make major concessions for a deal.

Announcement 2: Shanghai Free Trade Zone

At the S&ED talks, China also agreed to expand access to its financial services sector for foreign investors. The most relevant outcome involves the establishment of a pilot free trade zone in Shanghai, which will guarantee equal access to domestic and foreign enterprises. Led by Premier Li, the State Council approved the plans on July 3, a week prior to the S&ED talks. Unlike China’s existing special economic zones, which were established in the early 1980s to attract foreign investment in manufacturing to boost exports, the Shanghai free trade zone will not simply provide fiscal and other incentives; it will also serve as a platform to test an assortment of controversial market reforms.¹⁶⁷

*Free trade agreements are generally passed under an expedited “fast track” rule that does not allow amendments on the floor and calls for expedited procedures.

China's Ministry of Commerce approved the establishment of the free trade zone in August 2013, touting it as a "new path and a new mode of opening to the outside world."¹⁶⁸ After months of media speculation, on September 27, 2013, the State Council released rules to govern the new free trade zone. Beijing has agreed to allow RMB convertibility and market-based setting of exchange rates and interest rates, the first such steps toward full currency convertibility.¹⁶⁹ Financial institutions in the zone would be allowed more freedom to experiment with new products and services, which may allow foreign firms to increase the quantity and sophistication of financial products. The government also pledged to open up shipping, commerce, specialized services (including legal), and travel. Further details remain vague. No specific timeline was given for implementing any of the reforms, though the State Council announcement said that financial liberalization will proceed "as conditions allowed" and "risks would be controlled," forestalling any suggestion of rapid change.¹⁷⁰

The government announced that unlike other Chinese free trade zones the investment at the Shanghai free trade zone will be governed by a "negative list" approach. The use of the negative list suggested that the ability of Chinese regulators to arbitrarily constrain foreign investors might be curtailed. However, expectations for broad reform were dampened following the publication of this list by Shanghai government officials.¹⁷¹ The list includes restrictions covering 18 sectors, including finance, media, utilities, property, and manufacturing.¹⁷² Analysts and banking officials noted that the wide range of restrictions reflects continued jockeying among Chinese government officials over the speed of liberalization.¹⁷³ The list applies to the remainder of 2013 and will be updated as the government continues testing liberalization policies in the free trade zone.

The *South China Morning Post*, a Hong Kong publication, reported that the government would suspend some Internet controls, granting people inside the Shanghai free trade zone access to websites blocked elsewhere in the country, such as Facebook and Twitter.¹⁷⁴ However, the statement by the State Council did not mention any such change. It did say foreign companies might be allowed to offer "specialized telecommunications services" in the zone, and permission to offer services that break existing Chinese laws might be granted on a case-by-case basis by the State Council.¹⁷⁵

The new pilot zone will take up to ten years to construct and will cover 28 square kilometers within Shanghai's existing Waigaoqiao bonded trade zone and three other special customs supervision zones. If successful, the model may be replicated nationwide. In response to the Shanghai free trade zone, other port cities, including Xiamen and Tianjin, have expressed interest in establishing similar pilot zones.¹⁷⁶

Announcement 3: Financial Sector Liberalization

As in past S&ED talks, China once again promised to move toward a market-determined exchange rate and to submit another proposal to join the WTO's Government Procurement Agreement. After China was admitted to the WTO in 2001, it agreed to sign

the procurement agreement “as soon as possible.” However, its first bid was only submitted in February 2008. Because the terms of accession that China offered did not satisfy other WTO members, China subsequently submitted two more bids, the latest in November 2012. Three bids are generally the maximum required for Government Procurement Agreement applicants; yet several obstacles make China’s imminent accession unlikely, not least its huge public sector and narrow definition of procurement in domestic law. China has resisted U.S. demands to include SOEs as government entities that would be bound by the agreement.

China also hinted at greater market access for U.S. financial firms, particularly in trading government bond futures and underwriting corporate bonds. This form of foreign participation would be conducive to China’s financial sector reform, as the government seeks novel ways to raise funds for companies while reining in credit issued by trust companies, local government financing vehicles, and other nontraditional lenders. China also welcomed participation by foreign banks in RMB settlement of cross-border trade and investment.¹⁷⁷ A day after the adjournment of the S&ED talks, China announced that the Qualified Foreign Institutional Investor program will expand to \$150 billion (the current quota stands at \$80 billion, but only \$43 billion of that has been allocated for use in investment).¹⁷⁸ A similar plan for Hong Kong-based RMB investors will grow to encompass Singapore, London, and other cities.¹⁷⁹

China’s securities regulator also announced at the S&ED talks that it will begin providing certain audit work papers to the U.S. Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board, a first step toward resolving a longstanding impasse on enforcement cooperation related to companies that are listed in the United States. U.S. and Chinese audit regulators also committed to accelerating cooperation for cross-border audit oversight.¹⁸⁰ However, the S&ED joint factsheet makes no mention of a formal mechanism for sharing audit papers, so much work remains to be done on this issue. (For further discussion of the U.S.-China friction over the audit issue, see chap. 1, sec. 3, of this Report.)

The U.S.-China Relationship at the WTO

On August 2, 2013, a WTO panel found that China had violated WTO rules in applying antidumping (AD) and countervailing duties (CVD) on U.S. exports of chicken broiler products.* China’s MOFCOM imposed AD and CVD on these products in August and September 2010, respectively. The AD duties ranged from 50.3 percent to 53.4 percent for the U.S. producers who responded to MOFCOM’s investigation notice, while MOFCOM set an “all others” rate of 105.4 percent. In the CVD investigation, MOFCOM imposed CVDs between 4 percent and 12.5 percent for the participating U.S. producers and an “all others” rate of 30.3 percent. According to the Office of the U.S. Trade Representative, U.S. exports to China of broiler products fell by 80 percent following the applica-

*Broiler products include most chicken products, with the exception of live chickens and a few other products such as cooked and canned chicken.

tion of the duties.¹⁸¹ The United States brought the case in September 2011.

In its report, the WTO dispute settlement panel found in favor of the United States on nearly all U.S. claims, including substantive errors in MOFCOM's calculations and procedural errors.¹⁸² The United States scored a major victory against China's use of the average cost of production methodology in calculating dumping margins (i.e., the difference between the price of poultry products in the U.S. market and the price of the same product in China). In order to estimate the cost of production for a given chicken part, China would estimate the average cost of producing a whole chicken and assign the cost of producing that part depending on its weight. The United States argued that this methodology dramatically overestimated the cost of production for cheap parts of a chicken, such as paws.¹⁸³ Both sides agreed not to appeal the ruling, and it was adopted by the WTO on September 25, 2013.

In addition to the broiler case, there are pending WTO cases between the United States and China, whose status is summarized in tables 3 and 4 below.

Table 3: Active WTO Cases Brought by the United States against China

No.	Title	Request for Consultations	Panel Report	Appellate Body Report	Compliance Status
DS419	Measures concerning wind power equipment	December 22, 2010	In consultations; panel not yet formed		
DS427	Antidumping and Countervailing Duty Measures on Broiler Products from the United States	September 20, 2011	August 2, 2013	N/A	The panel upheld most U.S. claims. The two sides agreed not to appeal the ruling
DS431	Measures Related to the Exportation of Rare Earths, Tungsten, and Molybdenum	March 13, 2012	Panel composed September 24, 2012; report pending		
DS440	Antidumping and Countervailing Duties on Certain Automobiles from the United States	July 5, 2012	Panel composed February 11, 2013; report pending		
DS450	Certain Measures Affecting the Automobile and Automobile-Parts Industries	September 17, 2012	In consultations; panel not yet formed		

Source: WTO Dispute Settlement Gateway. www.wto.org.

Table 4: Active WTO Cases Brought by China against the United States

No.	Title	Request for Consultations	Panel Report	Appellate Body Report	Compliance Status
DS437	Countervailing Duty Measures on Certain Products from China ¹⁸⁴	May 25, 2012	Panel composed November 26, 2012; report pending		
DS449	Countervailing and Antidumping Measures on Certain Products from China ¹⁸⁵	September 17, 2012	Panel composed March 4, 2013; report expected by December 2013		

Source: WTO Dispute Settlement Gateway. www.wto.org.

China's Preferential Trade Agreements

Following its accession to the WTO, China has actively worked to negotiate and implement bilateral and multilateral trade agreements across the globe. As China transforms from a regional player to a global power, it has not only created a growing web of international legal obligations but has also gradually advanced its economic and political influence. As of August 2013, China has signed thirteen preferential trade agreements (PTA),* including two with Iceland and Switzerland this year. The Iceland and Switzerland PTAs were the first signed between China and European countries—both representing a significant milestone in strengthening China's trade relationship with Europe.¹⁸⁶ China is currently in the process of negotiating additional bilateral and multilateral PTAs with neighboring and distant countries, each encompassing particular economic and political motives (see table 5).

Table 5: Preferential Trade Agreements with the PRC

Signed Trade Agreements	Asia-Pacific Trade Agreement (2000) Hong Kong (2003) Macau (2003) ASEAN (2004) Chile (2005) Pakistan (2006) New Zealand (2008) Singapore (2008) Peru (2009) Taiwan (2010) Costa Rica (2010) Switzerland (2013) Iceland (2013)
Under Negotiations	Norway China–Japan–Korea Australia Gulf Cooperation Council (GCC) Regional Comprehensive Economic Partnership (RCEP)
Under Consideration	India Korea Colombia

Notes: Number in parentheses indicates the year initial agreement of PTA was signed. ASEAN=Association of Southeast Asian Nations

Source: Liu Debiao, "Zhongguo Ziyou Maoyi Xieding Gailun" (Introduction to China's Free Trade Agreements) (Beijing, China: China Commerce and Trade Press, June 2012), p. 10; Ministry of Commerce, *China FTA Network* (Beijing, China). <http://fta.mofcom.gov.cn/topic/eniceland.shtml>.

While economic development remains the focus and primary objective of China's national policy, PTAs also serve as an important

* Many PTAs negotiated by China are not comprehensive, meaning provisions on trade in goods, services, and investment are not all included or are signed separately. The 20 bilateral PTAs negotiated by the United States, such as those with Chile, Costa Rica, Singapore, and South Korea, differ markedly from the 11 negotiated by China. U.S. agreements tend to cover more product categories and are negotiated from the start with as comprehensive a list as possible. China's PTAs have a narrower scope with fewer product categories.

diplomatic tool and a means to expand regional influence and secure resources. The recently signed PTA with Iceland, for example, was not exclusively motivated by the reduction of barriers to trade but was likely a strategic move by Beijing to advance its access to Arctic shipping routes between China and Europe.¹⁸⁷ Other PTAs currently under negotiation demonstrate Beijing's desire to secure natural resources, especially oil, which is not abundant domestically. China is strategically advancing its domestic agenda by negotiating trade agreements with oil-rich countries such as Norway and international organizations such as the Gulf Cooperation Council, an economic union of oil-rich Arab nations.¹⁸⁸

On a multilateral level, the United States and China have diverging and competing trade initiatives, each of which excludes the other. The U.S.-led Trans-Pacific Partnership is a free trade agreement among 12 Pacific Rim countries. The Trans-Pacific Partnership is based on the principles of "open regionalism,"¹⁸⁹ meaning that any Asia-Pacific country, including China, is welcome to apply on the condition that other parties to the agreement agree that it made a credible commitment to meet the high standards of the agreement.* The second, the China-supported Regional Comprehensive Economic Partnership, is an initiative to link Association of Southeast Asian Nations (ASEAN) member states and its free trade agreement partners. The Regional Comprehensive Economic Partnership includes China and multiple countries concurrently participating in the U.S.-backed Trans-Pacific Partnership negotiations, such as Australia, Japan, and New Zealand.¹⁹⁰

Negotiations on the Regional Comprehensive Economic Partnership began in early 2013 and are to conclude by the end of 2015.¹⁹¹ If realized, the agreement would create the world's largest group of trading partners, accounting for about half of the global market and about a third of the world's economic output.¹⁹² The Regional Comprehensive Economic Partnership has been seen as a move to counteract the U.S.'s high-profile involvement and promotion of the Trans-Pacific Partnership regional trade agreement, which has been interpreted by the PRC as a strategy to reduce China's economic influence in the Asia-Pacific region.¹⁹³ Furthermore, Beijing is leading its own regional trade agenda in Asia through the China–South Korea, China–Australia, China–India, and the trilateral China–Japan–South Korea negotiations, ultimately seeking to construct a regional web of its own free trade agreements and establish an independent ring of influence.¹⁹⁴

*At the 2011 Asia-Pacific Economic Cooperation (APEC) summit meeting in Honolulu, Hawaii, the leaders of the (then) nine Trans-Pacific Partnership countries agreed to the broad outlines of the agreement. In their statement, they envisaged the Trans-Pacific Partnership as a "living agreement," meaning that it will be open to addressing new issues as they evolve, and permit new members to join if they are willing to sign up to its commitments. See Office of the U.S. Trade Representative, "Trans-Pacific Partnership (TPP) Trade Ministers' Report to Leaders" (Washington, DC: November 12, 2011). <http://www.ustr.gov/about-us/press-office/press-releases/2011/november/trans-pacific-partnership-tpp-trade-ministers%E2%80%99-re>. The process by which new members are added has not been formalized. The aspiring candidates have followed a process agreed to by current members informally, with each aspiring candidate being approved with the consensus of the other parties. In practice, the aspiring participant must not only agree to full trade liberalization but must also demonstrate a genuine willingness to negotiate on issues sensitive to others and to commit to a high-standard agreement overall. See Ian F. Ferguson et al., *The Trans-Pacific Partnership Negotiations and Issues for Congress* (Washington, DC: Congressional Research Service, August 21, 2013).

Doing Business in China—Investment and Antitrust Challenges

Investment

China continues to adopt measures designed to encourage FDI into the country even as FDI into China dropped from a record \$116 billion in 2011 to \$111.7 billion in 2012. In the first half of 2013, FDI into China recovered slightly to \$62 billion.^{195,196} Declining optimism about the returns on investment results from China's slowing growth rate, rising labor costs, and regulatory conflicts. Among the major impediments cited by American-based multinationals operating in China are the government's favoritism toward Chinese SOEs and private domestic firms, restrictions on foreign ownership; a lack of regulatory transparency; inequity in licensing processes; increased pressure to transfer technology; weak intellectual property protection; an unreliable legal system; and corruption on the part of government officials.^{197,198}

FDI has shown signs of recovering in 2013 and was up 4.9 percent to \$62 billion in the first half of the year.^{199,200} Beijing's current, targeted efforts to bolster FDI are consistent with its history of relying on a set of measures, including investment catalogues and tax policy, to guide FDI inflows in accordance with development priorities set by the CCP. China's *12th Five-Year Plan for Foreign Capital Utilization and Overseas Investment* seeks to attract higher-quality foreign investment in designated strategic emerging industries.* The Plan also encourages multinational corporations to establish regional headquarters and centers for research and development, procurement, and financial management in China. It also indicates that China will open a variety of sectors to foreign investors.²⁰¹ In November 2012, Beijing announced plans to simplify procedures for FDI, "including new rules under which investors will not require approval for opening foreign currency accounts or for reinvesting foreign exchange earnings."²⁰² Beijing is also considering suspending FDI-related laws and regulations in newly proposed free-trade zones† in order to encourage investments by foreign companies and joint ventures between foreign and Chinese companies.^{203,204} Nevertheless, concerns persist, particularly amid high-profile Chinese antitrust and corruption investigations, which have implicated a growing list of foreign firms.

China Targets Foreign Firms with its Antimonopoly Law

In July 2008, China enacted its Antimonopoly Law. Three agencies ‡ evaluate effects on competition in the marketplace, as well as national security ramifications of corporate practices, and other issues relevant to China's economic development. MOFCOM is au-

*There are seven strategic emerging industries designated in the 12th Five-Year Plan (2011–2015): (1) energy saving and environmental protection; (2) next-generation information technology; (3) biotechnology; (4) high-end equipment manufacturing; (5) new energy; (6) new materials; and (7) new energy vehicles. Strategic emerging industries benefit from preferential policies and funding.

† On July 3, 2013, the State Council approved the establishment of a free-trade zone in Shanghai, "more akin to a free-market zone subject to less regulation and interference than an area of duty-free trade." Bloomberg, "China to Ease Foreign Investment Rules for New Free Trade Zones," August 17, 2013.

‡ MOFCOM, NDRC, and the State Administration for Industry and Commerce.

thorized to handle merger clearances; NDRC to handle cartels and pricing conduct; and the State Administration for Industry and Commerce (SAIC) has authority over abuse of dominance and other non-price-related, anticompetitive conduct. Until recently, however, only MOFCOM was actively engaged in Anti-Monopoly Law investigation and enforcement activities. In the five years since the law came into effect, MOFCOM has reviewed approximately 650 mergers and acquisitions, while NDRC has concluded about 30 cases, and SAIC has handled only 12.²⁰⁵

In recent months, the NDRC has stepped up investigations of foreign companies suspected of price fixing, particularly the pharmaceutical and milk powder industries. The milk powder investigations culminated with the issuance of record fines totaling \$109 million in August 2013, after companies admitted to entering into contracts with distributors to set a minimum sales price for milk powder.^{206,207} U.S.-based Mead Johnson Nutrition was issued the largest fine, RMB 204 million (\$33 million) or 4 percent of the company's total revenue in 2012.²⁰⁸ The NDRC's antimonopoly bureau chief, Xu Kunlin, told China Central Television in August that the petroleum, telecommunications, banking, and auto industries could be next.²⁰⁹ The State Administration for Industry and Commerce is also stepping up its investigative efforts. As of August 15, it is separately investigating claims of bribery, fraud, and anticompetitive behavior in the pharmaceutical industry.²¹⁰

Although both domestic and foreign firms have been targeted in these investigations, there has been speculation that Beijing is specifically targeting multinationals either in reaction to recent antitrust cases penalizing Chinese companies overseas or as a means of protecting domestic industry.*²¹¹ This speculation was bolstered by revelations that at a July 2013 Antimonopoly Law training session, NDRC officials pressured some 30 foreign firms to confess antitrust violations and advised them against hiring outside counsel to defend them in investigations.²¹²

The broad scope of the new Antimonopoly Law makes it difficult for foreign companies to determine whether they are breaking the law. On July 31, 2013, Maureen Ohlhausen, head of the U.S. Federal Trade Commission, told a Beijing audience that she hoped Chinese competition authorities would move to "promote predictability, fairness and transparency."²¹³

Protecting Business Abroad—Chinese Corporate Litigation in International and Foreign Domestic Courts

Beijing has long encouraged domestic enterprises to learn to defend themselves in foreign markets. Under the Regulations on Responding to Antidumping Suits (2001), the government also authorized the Ministry of Foreign Trade and Economic Cooperation (now a division of the Ministry of Commerce) to coordinate companies' legal activities in order to ensure that individual cases are harmonized with national trade policies and objectives.^{214,215} Over the last decade, China has increasingly initiated cases in international

* In March 2013, for instance, a U.S. federal district court found North China Pharmaceutical Group and its affiliate firm to have violated U.S. antitrust law by colluding to raise prices on vitamin C exports to the United States. The Chinese plaintiffs were fined \$162 million.

courts as a means of pursuing and defending its trade and economic interests and, in recent months, there has also been a surge in Chinese corporate litigation in international and foreign domestic courts, backed by official actions and statements of support.

Bringing legal challenges directly is a means for Chinese companies to assert influence over foreign economic policies and practices in forums not designed for state-vs.-state litigation. The idea that corporate litigation can influence trade and investment relationships is not novel, but Beijing's increasing use of such litigation suggests a strategic policy that will play an important role in China's relations with its trading partners. It also has potentially significant implications for China's use of trade and investment agreements.

In 2012, in concert with Chinese government actions at the WTO, Chinese companies successfully used European courts to challenge and overturn CV and AD duties.* Speaking to the press about the 2012 legal victory of Aokang Shoes in overturning duties levied by the European Union, a spokesman for the Chinese Ministry of Commerce said it "boosted the confidence of Chinese companies in protecting their interests through legal action."²¹⁶ *China Daily* cited the victory in a call for Chinese companies to take "bolder moves to defend themselves through legal means;" and China Central Television featured a panel discussion of how the case could serve as an example for dealing with international economic challenges.²¹⁷ Chinese companies are also employing this strategy in the United States, as exemplified by the GPX Tire cases brought in U.S. federal courts last year, which supplemented Beijing's WTO actions, though less successfully.†

Chinese companies are also beginning to bring investment-related claims, both in foreign domestic courts and at the International Center for the Settlement of Investment Disputes. In foreign domestic courts, these companies are questioning other nations' assertions of what constitutes a national security issue and challenging the legality and constitutionality of other countries' domestic applications of their own laws. Ralls Corporation, for example, launched a precedent-setting challenge to the Committee on Foreign Investment in the United States (CFIUS), constitutional

* In late 2012, Aokang Shoes, the largest private Chinese shoe manufacturer, won a major victory when the European Court of Justice overturned duties that the European Union had levied on imported Chinese leather shoes in 2006. In July 2012, Zhejiang Xinan Chemical Company, a manufacturer of the herbicide glyphosate, also won a landmark victory at the same court on similar grounds. Both companies' cases coincided closely with related WTO challenges brought by the Chinese government.

† In December 2011, the U.S. Court of Appeals for the Federal Circuit ruled that the Department of Commerce had incorrectly applied double remedies against imported tires from China's GPX International Tire Co., because statutory and case law both dictated that countervailing duties could not be applied to nonmarket economy countries. (See 1984, 1988, and 1994 amendments to the United States Tariff Act of 1930. See also *Georgetown Steel Corp. v. United States*, 801 F.2d 1308, Fed. Cir. 1986, where the court concluded that countervailing duties could not be applied to nonmarket economy countries because such duties are applied in response to subsidies; a subsidy is a financial contribution by a government that distorts a market; and there can be no finding of a subsidy where there is not a market to distort). This landmark decision threw a host of open countervailing duty investigations into limbo. Fearing that the ruling had encouraged Chinese challenges of the application of countervailing duties on a host of products, the U.S. Congress adopted a legislative fix in the form of Public Law 112-99. This legislation, signed into law on March 13, 2012, amended the Tariff Act of 1930 such that the Department of Commerce was required to apply countervailing duties to nonmarket economy countries where it found subsidies, and made this requirement retroactively applicable to "all proceedings initiated ... on or after November 20, 2006."

due process claim, in response to President Obama's executive order that it divest its investment in an Oregon wind farm.*

At the International Center for the Settlement of Investment Disputes, Chinese companies are employing novel and more expansive interpretations of the investor protection clauses in their bilateral investment treaties. For example, China's second-largest insurer, Ping An, is currently pursuing a \$2.28 billion claim at the International Court for the Settlement of Investment Disputes against the government of Belgium, arguing that Belgium violated the investor protections in the China-Belgium BIT. Though China is one of the world's most prolific BIT negotiators, historically, its agreements have been geared toward managing foreign investment within China and have provided only narrow investor protections in order to protect Beijing's sovereign authority. However, in both the Ping An case and a prior one, *Tza Yup Shum v. The Republic of Peru* (2011), Chinese companies have asserted broader interpretations of investor protection clauses in existing Chinese BITs in order to protect their investments abroad.†

From Beijing's perspective, these private corporate actions may be a necessary part of a defensive strategy abroad. According to Pu Lingchen, a partner at one of the Chinese law firms that represented Aokang Shoes in its European court cases, "Without effective legal challenges against [foreign countries'] administrative measures, the often erroneously-applied legal articles used to defeat Chinese companies will be taken as precedent in future cases," and this will encourage other foreign markets to follow suit, attacking Chinese products and companies without fear of retaliation.²¹⁸ The upshot of this new trend in Chinese corporate litigation is that it indicates a growing reliance on the rule of law. This is good because, as one *Economist* article succinctly points out, the alternative to reliance on the law "would likely be escalating retaliations unrestrained by rules."²¹⁹ But the trend of Chinese corporate plaintiffs directly litigating disputes with foreign governments also suggests a diminishing willingness to rely on the dispute resolution mechanisms offered by international legal regimes, which is not promising for the navigability of the future international legal landscape.

Implications for the United States

China's failure to rebalance its economy harms the United States in two ways. China's emphasis on fixed investment has created overcapacity in many industries, such as steelmaking, which has depressed world prices and caused unemployment in the United States and other developed countries where subsidies to industry

* Ralls Corporation, a U.S. subsidiary of one of China's largest private enterprises, filed suit in U.S. district court in October 2012, presenting a precedent-setting constitutional challenge to CFIUS and the U.S. president. The suit was filed after the president issued an executive order that halted the company's planned construction of four wind farms in Oregon. The U.S. District Court for the District of Columbia dismissed the last remaining claim in October 2013, but Ralls is appealing the Court's decision. Earlier in 2012, Chinese-owned Shanghai Pengxin won a protracted legal challenge to its efforts to acquire a group of bankrupt New Zealand dairy farms, prevailing over contentions that the acquisition might pose a threat to New Zealand's strategic national resources.

† In *Tza Yup Shum v. The Republic of Peru* (2011), Mr. Tza successfully contended that the Peruvian regulators had violated Peruvian law and the China-Peru Bilateral Investment Treaty in their treatment of his investment.

are few. Privately owned companies cannot compete on a commercial basis against Chinese state-owned and state-subsidized companies exporting goods at below the cost of production. China's resistance to imports and foreign investment in its financial and services sector, and its reliance on exports to fuel economic growth, has helped to create an enormous trade imbalance with the United States. China's share of U.S. exports is rising slowly, benefitting a few industries, such as carmakers and soybean growers. And yet, the world's second-largest economy accounted for just 7 percent of total U.S. exports in 2012, a reflection of China's discriminatory market. The cumulative U.S. trade deficit with China since 1979 has risen to more than \$3 trillion, reducing employment in the United States. This trade surplus represents a claim on the productive assets of the United States.

The ASEAN-led Regional Comprehensive Economic Partnership, supported by China, has been seen as a move to counteract the U.S. promotion of the Trans-Pacific Partnership regional trade agreement. The Trans-Pacific Partnership, in turn, has been interpreted by the PRC as a strategy to reduce China's economic influence in the Asia-Pacific region. Concurrent negotiation of two competing Asia-Pacific trade pacts may lead to disunion among ASEAN member states and serve as a point of contention between the United States and China as both countries seek to establish economic and political influence over the region.

The Chinese government's attitude toward foreign investment creates an uncertain environment for U.S. firms. On the one hand, in light of slowing economic growth, Beijing has undertaken steps to reinvigorate foreign investment flows. On the other, recent government actions appear to unfairly single out foreign companies for scrutiny in bribery and pricing investigations and enforcement of the Anti-Monopoly Law.

In July 2013, Chinese regulators launched a series of antibribery and antimonopoly probes into foreign and domestic firms. The probes began with an NDRC-led antibribery probe into British multinational pharmaceutical firm GlaxoSmithKline.²²⁰ Subsequently, numerous antibribery and antimonopoly investigations were conducted on foreign firms. China fined six manufacturers of baby formula more than \$100 million for price-fixing, among them New Zealand's Fonterra, the world's largest dairy company.²²¹ Critics have argued that targeting foreign companies is merely a convenient scapegoat for the government, which is eager to assuage consumers who are upset about high prices and questionable safety of food and medicine products.²²²

While Chinese BITs have traditionally focused on protecting China from foreign litigants, Chinese companies' increasing reliance on international and foreign domestic courts to pursue and protect investment interests abroad suggests a shift toward a more aggressive use of investment treaties. Chinese corporate litigants can also be expected to directly pursue grievances against U.S. trade policies in U.S. courts with increasing frequency, just as they are doing in other jurisdictions around the world.

Conclusions

- China underwent a once-a-decade leadership change with a new president and premier and several new members of the Politburo and Standing Committee. The leadership indicated that China's overall economic policy goal—to transition from an export and investment-led growth model to a greater reliance on domestic consumption, remained the same. In reality, this change proved difficult to implement by a new government concerned about a slowing economy, real estate speculation, stagnating wages, and unemployment. The incoming government issued statements supporting a large and powerful state-owned sector in the economy, disappointing advocates of a larger private sector.
- The new Chinese leadership introduced initiatives aimed at reducing inequality, cracking down on corruption, and promoting urbanization. There are significant impediments to the government's ability to implement these reforms. For example, corruption is endemic at all levels of government, while local governments oppose urbanization due to fear that they will be overwhelmed by a flood of new migrants.
- China's progress in external rebalancing following the financial crisis was only temporary and largely driven by a weak global demand that reduced the relative size of China's export sector. Trade data for 2012–13 show that Chinese exports are again growing at a higher rate than imports, signaling a continued reliance on exports to fuel economic growth and a reversal in reducing China's massive trade surplus. As a result of failed measures to rebalance its economy, China has continued to expand its already record foreign currency reserves, reaching \$3.66 trillion by the end of September 2013.
- China's trade surplus with the United States in goods in 2012 was \$315 billion, a record. For the first seven months of 2013, China's trade surplus with the United States was \$178 billion, also a record. China continues to manipulate the value of its currency, the RMB, to achieve a competitive advantage with the United States. China also continues to follow mercantilist policies to foster a trade surplus with the United States.
- China has had little success transitioning toward a consumption-led growth model and reducing its reliance on massive infrastructure projects to boost economic growth. Consequently, China's high investment levels have led to overcapacity in multiple industries, including steelmaking, shipbuilding, and solar panel manufacturing. A slowdown in urban household disposable income growth and an increase in the household savings rate have cut into consumer purchasing power and contributed to a decline in total retail sales growth.
- Chinese officials have played down the significance of lower growth, saying the slowdown is partly due to economic rebalancing. However, the government continues to stimulate the economy through a variety of small steps. For example, the State Council, China's cabinet, instituted a temporary tax cut (scrapping all value-added and operating taxes) for more than 6 million

small- and medium-sized enterprises; reduced approval procedures and administrative costs for exporting companies; and provided more investment in railway construction in China's central and western regions. In a similar vein, securities regulators and the central bank issued record amounts of investment approvals to the Qualified Foreign Institutional Investors program.

- Due to its restrictive monetary policy, China's central bank has accumulated the world's largest foreign exchange reserves. The bulk of these reserves are invested in U.S. Treasury securities, so that Chinese ownership accounts for nearly one-quarter of foreign-owned U.S. Treasuries. In addition, China's two largest sovereign wealth funds, China Investment Corporation and SAFE Investment Company, have expanded their equity and real estate investments in the United States.
- The PRC has concluded 13 trade agreements, the latest with Iceland and Switzerland this year—the first signed with European governments. China is in the process of negotiating six additional trade agreements, which include the ASEAN-led Regional Comprehensive Economic Partnership, an initiative to link ASEAN member states and preferential trade agreement partners to form the world's largest trading bloc. The Regional Comprehensive Economic Partnership, which excludes the United States, is competing with the U.S.-led Trans-Pacific Partnership, which excludes China. Formal negotiations of the Regional Comprehensive Economic Partnership began in May 2013 and are scheduled to conclude by the end of 2015.
- China's attempts to keep the value of the RMB artificially low while strictly limiting the flow of RMB from the country, coupled with its efforts to control a large state banking sector, led to a banking crisis. The collapse in liquidity threatened economic growth in China and demonstrated the difficulty of conducting a monetary policy so at odds with its trading partners and international norms.
- The fifth round of the U.S.-China Strategic and Economic dialogue was held on July 10–11, 2013, in Washington, DC. There were no significant achievements in the strategic track. On the economic front, the most relevant announcements were (1) resumption of bilateral investment treaty talks; (2) the launch of the Shanghai Free Trade Zone; and (3) new measures to liberalize China's financial sector. In the multilateral arena, the United States successfully challenged China's improper imposition of antidumping and countervailing duties at the WTO.
- China continues to take incremental steps toward RMB internationalization, but the goal of making the RMB a major international currency remains out of reach as the government continues to maintain strict controls on cross-border capital flows.
- Beijing's efforts to reform the financial system continue to be hampered by risky off-balance-sheet lending by banks and nonbank financial institutions. Beijing has undertaken efforts to curb these risky lending practices, removing the floor on lending rates and imposing a short-term credit crunch in a clumsy effort

to send a strong signal to the financial sector. However, there is little evidence so far that these efforts have succeeded. The ceiling on rates paid to depositors remains low, and some risky lending actually increased during the credit crunch.

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