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U.S.-China Economic and Security Review Commission

Monthly Analysis of U.S.-China Trade Data **August 6, 2014**

Highlights of this month's edition[i]

- **Bilateral trade:** The U.S. June trade deficit in goods was the highest yet this year; although the U.S. surplus in services increased in the first quarter of 2014, the overall U.S. deficit is headed for another record.
- **Bilateral policy issues:** Latest S&ED sets a timeline for BIT negotiations, few other outcomes; WTO issues a mixed ruling in China's challenge to U.S. countervailing duties; Ralls wins a limited legal victory in battle with CFIUS; Chinese investment in U.S. real estate jumps; Microsoft under investigation by Chinese antitrust authorities.
- **Quarterly review of China's economy:** Momentum sustained despite housing slump; surge in exports and PMI; lack of rebalancing; corporate bond boom and new private banks; Beijing deepens ties with Latin America and co-establishes BRICS bank.
- **Sector spotlight China's meat industry:** U.S. companies under fire in meat safety scandal; questions about China's food safety and discrimination against foreign companies.

Bilateral Goods Trade

The U.S. trade deficit in goods with China was $30.1 billion in June, the highest monthly deficit so far this year, and $3.4 billion higher than a year ago (see Table 1). The cumulative bilateral deficit through the first six months reached $155.3 billion, an increase of $7 billion over the same point last year. The bilateral trade deficit is on track for a new annual record.

U.S. goods exports to China grew by 1.4 percent month-on-month, and 1.5 percent year-on-year. Exports thus lost the momentum they gained in May. Worse still, U.S. goods imports from China outpaced exports substantially, expanding by 3.7 percent month-on-month and 9 percent year-on-year.

Table 1: U.S. Trade in Goods with China, January-June, 2014
(US$ billions; growth %)

	Jan	Feb	Mar	Apr	May	Jun
US$ billions						
Exports	10.4	9.9	10.8	9	9.2	9.4
Imports	38.2	30.7	31.2	36.3	38	39.4
Balance	(27.8)	(20.9)	(20.4)	(27.3)	(28.8)	(30.1)
Total	48.6	40.6	42.1	45.3	47.2	48.8
Balance YTD (US $billions)						
2013	(27.8)	(51.4)	(69.2)	(93.4)	(121.2)	(147.9)
2014	(27.8)	(48.7)	(69.1)	(96.4)	(125.2)	(155.3)
yoy growth %						
Exports	10.4%	8.2%	13.6%	0.9%	5.4%	1.4%
Imports	2.7%	-6.1%	14.4%	9.6%	3.7%	1.6%

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, August 2014). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

[i] Note: This bulletin was reposted on August 8. The original version contained incorrect growth figures in Table 2A.

Transport equipment led U.S. exports to China once again in June. At $2.2 billion, these shipments accounted for nearly one quarter of total exports, but declined by 2.8 percent year-on-year. Most other top exports to China remained fairly steady (see Table 2). The notable exception was exports of agricultural products, which were down 43.5 percent year-on-year. That was attributable mainly to the unusually high volume of wheat exports to China in June 2013.

Table 2A: Top U.S. Goods Exports to China in June, 2013-2014
(US$ millions)

		Value (US$ mn)		Yoy growth
		2014	2013	(%)
1	Transportation Equipment	2,167.9	2,230.7	-2.8%
2	Computer and Electronic Products	1,501.7	1,561.7	-3.8%
3	Chemicals	1,286.8	1,244.3	3.3%
4	Machinery, Except Electrical	951.3	859.6	9.6%
5	Waste and Scrap	590.9	689.5	-14.3%
6	Food and Kindred Products	372.4	398.4	-6.5%
7	Agricultural Products	170.9	302.5	-43.5%

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, August 2014). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

The top categories of U.S. imports from China all grew, some by double digits.

Table 2B: Top U.S. Goods Imports from China in June, 2013-2014
(US$ millions)

		Value (US$mn)		Yoy growth
		2014	2013	(%)
1	Computer and Electronic Products	14,069.6	13,386	5%
2	Electronic Equipment, Appliances and Components	3,329.9	2,695.7	19.1%
3	Apparel & Accessories	2,794.1	2,633.1	5.8%
4	Miscellaneous Manufactured	2,588.5	2,376.8	8.2%
5	Machinery, Except Electrical	2,583.5	1,991.2	23%
6	Leather & Allied Products	2,143.2	2,133.2	0.5%
7	Fabricated Metal Products	1,778.8	1,576.6	11.4%

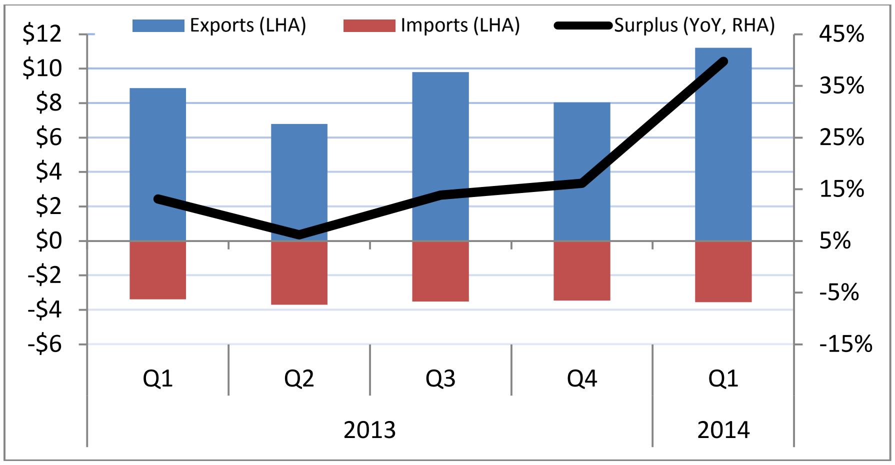
Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, August 2014). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Excluding information & communications products (ICT) and optoelectronics, U.S. advanced technology product trade with China continues to improve this year. While ICT products and optoelectronics have registered a combined deficit of $62.2 billion, all other advanced technology products achieved a $7.7 billion surplus, up from $6.7 billion at the same point last year. Aerospace alone accounts for more than half of all U.S. advanced technology product exports to China.

Trade in Services

The U.S. trade surplus in services with China increased 40 percent year-on-year in the first quarter of 2014 (see Figure 1). The quarterly trade surplus was $7.7 billion, which combined with the previous three quarters, totaled $21.6 billion, an increase of 21 percent year-on-year. U.S. service exports, which increased 26 percent year-on-year in the first quarter, fueled the surplus expansion; while imports of Chinese services increased only five percent.

Figure 1: U.S.-China Trade in Services
(LHA in US$ billions)



Source: U.S. Bureau of Economic Analysis, International Transactions Data (U.S. Department of Commerce, August 2014). *http://www.bea.gov/iTable/index_ita.cfm*.

The biggest change in U.S. service exports was in travel-related services, which increased 71 percent year-on-year. This large increase is likely due to a classification change by the U.S. Bureau of Economic Analysis (BEA) that re-categorized health and education-related travel as "travel services."[1] However, the reclassification of health and education-related travel as "travel services" does not change the overall value of service exports and imports, and therefore, it does not explain the 40 percent year-on-year increase in the bilateral services surplus or the 26 percent year-on-year increase in U.S. service exports to China. Meanwhile, intellectual property imports from China (measured by royalties and license fees) dropped a sharp 68 percent in the first quarter of 2014.

Bilateral Policy Issues

Sixth Strategic and Economic Dialogue (S&ED) Talks Yield Little Progress

The sixth round of the S&ED talks, held July 9–10, 2014, in Beijing, produced a timeline for conducting the Bilateral Investment Treaty (BIT) negotiations, but yielded few other concrete results. The two sides committed to reach agreement on the core text of the BIT by the end of 2014 and to start discussions on their respective negative lists[ii] early in 2015.[2] After nine rounds of technical discussions, the United States and China announced "substantive" BIT negotiations at last year's S&ED, but progress has been slow. Uncertainty remains about what China's negative list for the BIT will look like. U.S.-China Business Council Vice President Erin Ennis said that getting China to commit to a "commercially significant negative list could be a battle," citing Chinese government actions in the Shanghai Free Trade Zone (FTZ).[3]

[ii] A negative list means all sectors are presumed open for investment unless specifically excluded.

The Chinese government last year touted the Shanghai FTZ as a significant step toward a liberalized investment regime, and observers hoped it would open sectors in the Chinese economy to foreign investment that were previously off-limits—especially service industries—since the FTZ would use the negative list approach. However, the initial negative list covered so many industries, including finance and real estate, that even state media criticized the Shanghai government for being too conservative.[4] The government published a new list—reducing the number of restricted sectors from 190 to 139—in July 2014, a week before the start of the S&ED talks. The change was largely cosmetic since it did not reduce major barriers.[5]

The S&ED talks failed to yield a predicted breakthrough in the stalled efforts to conclude a revised Information Technology Agreement (ITA) in the World Trade Organization (WTO). U.S. Trade Representative Michael Froman stressed progress on the ITA talks as one of the priorities for this year's S&ED in the run-up to the July meeting, but the published outcomes of the talks merely mentioned "constructive discussions," with no concrete progress.[6] Originally slated for conclusion last year, the ITA negotiations have stalled due to China's unwillingness to include key products such as multicomponent integrated circuits (MCOs) and flat-panel displays. China insisted on lengthy tariff phase-out periods for other products.[7]

WTO's Muddled Decision in China's Challenge of U.S. Countervailing Duties (CVD)

On July 14, 2014, the WTO Dispute Settlement Panel issued a mixed ruling in China's challenge of various aspects of 17 separate CVD investigations[iii] conducted by the U.S. Department of Commerce (DoC) (DS437).[8] In this case, China argued the United States acted inconsistently with the WTO Agreement on Subsidies and Countervailing Measures Agreement (SCM Agreement). The Chinese claims rejected by the Panel involved challenges to the use of facts available, the use of out-of-country benchmarks, and the analysis used to determine whether a subsidy is "specific." China prevailed in claims that mostly involved issues on which the United States lost in earlier cases.[9] Panel rulings on key claims are summarized below.

- *Facts available*: The Panel rejected China's challenge of DoC's use of "adverse facts available" when making findings in cases of noncooperation by respondent companies or China. At issue is DoC's practice of using or making adverse inferences to carry out investigations despite refusal of companies to supply data by replacing missing information with the facts available. This is a major win for the United States, as it enables DoC to conduct investigations if foreign companies or foreign governments refuse to cooperate.

- *Public bodies*: The Panel faulted the United States for a "rebuttable presumption" that a state-owned enterprise (SOE) is a public body if there is majority ownership by the government. Majority government ownership by itself, the Panel found, does not make an SOE a public body. Rather, the SOE must possess "government authority" and perform a "government function." The WTO made a similar ruling in China's earlier challenge of other U.S. CVD orders (DS379).[10]

- *Regional Specificity*: China challenged seven CVD determinations that certain subsidies were regionally specific under the SCM Agreement. The Panel agreed on six of the investigations, finding that the presence of companies in an industrial park or economic development zone was not sufficient to prove they received specific

[iii] The Chinese products affected by these investigations consist of solar panels, wind towers, thermal paper, coated paper, tow-behind lawn groomers, kitchen shelving, steel sinks, citric acid, magnesia carbon bricks, pressure pipe, line pipe, seamless pipe, steel cylinders, drill pipe, oil country tubular goods, wire strand, and aluminum extrusions.

subsidies. A very similar issue was considered by the Panel in DS379 (the Panel faulted the United States).[11]

The United States and China have 60 days to appeal the Panel's findings.

Chinese Company Scores Limited Legal Victory in Battle with CFIUS

Ralls Corporation, a U.S.-domiciled subsidiary of Chinese corporate giant Sany—made headlines in late 2012 when it mounted legal challenges to the United States' national security review process for investments. On July 15, the U.S. Court of Appeals for the District of Columbia reversed a 2013 district court ruling and found that President Obama's 2012 executive order forcing Ralls to divest its interest in an Oregon wind farm had deprived the company of a constitutionally protected property interest without due process. The victory does not mean Ralls will be able to move forward with its investment, but it does have potential implications for foreign investors and the United States' investment review process.

In 2012, the Committee on Foreign Investment in the United States (CFIUS) determined that Ralls' investment posed a potential national security risk, and issued temporary mitigation orders restricting the company's access to an Oregon wind farm property, halting further construction there. CFIUS is an interagency executive branch committee established by section 721 of the Defense Production Act of 1950 to review the national security implications of transactions that could result in foreign control of a U.S. entity, and to make recommendations to the president based on its findings. In the case of Ralls' Oregon project, proximity to sensitive U.S. Navy training sites is believed to have been a major factor in CFIUS' determination that the investment posed a national security threat. In September 2012, the president issued an executive order permanently prohibiting the Ralls investment and compelling Ralls to divest the wind farm assets it had already purchased. The order specified that Ralls remove equipment and assets from the business site, and it also barred Ralls' operational access to the site while the divestiture proceeded. In October 2012, Ralls took the unusual step of challenging the divestiture order, arguing that the provisions were arbitrary, violated the equal protections afforded by the Constitution and amounted to an unconstitutional taking of property, violated Ralls' constitutional rights under the due process clause of the Fifth Amendment, and overstepped CFIUS' and the president's legal authority.

In April 2013, the U.S. District Court for the District of Columbia dismissed Ralls' arguments on the merits of the president's order, noting that section 721 of the Defense Production Act of 1950, as amended, provides "[t]he actions of the President … and the finding of the President [as part of the CFIUS review process] … shall not be subject to judicial review."[12,13] The court also dismissed the equal protection claim since it would require "determining whether the alleged differential treatment was rationally related to a legitimate government purpose," which in turn would necessitate that the court review the particulars of the president's actions, a review that the court held section 721 does not permit.[14] Ralls also argued that the due process clause of the Constitution entitles the company to hear the reasons for the president's executive order, and that the U.S. government provided neither this explanation nor sufficient notice and the opportunity for Ralls to be heard before the president's decision was made.[15] But again, the court dismissed Ralls' claim. Ralls appealed this decision to the U.S. Court of Appeals for the District of Columbia.[16],[17]

In its July 2014 ruling, the Court of Appeals held that although section 721 prohibits judicial review of the president's national security determinations, it does not prohibit the judiciary from reviewing the CFIUS process to ensure its legality and constitutionality. The court further held that Ralls' property interests were constitutionally protected, and that Ralls therefore had a due process right to adequate notice of CFIUS' findings, as well as a right to access any unclassified information that had contributed to CFIUS' determination and to rebut the evidence. Finally, the Court of Appeals remanded to the district court the question of CFIUS exceeding its authority by issuing an interim order. Whether or not CFIUS is found to have exceeded its authority, the Ralls legal battle may result in expanded due process for companies subject to CFIUS reviews.

Chinese Are Biggest Foreign Buyers of U.S. Homes

Chinese buyers[iv] now rank as the largest foreign purchasers of U.S. real estate by dollar value, according to the National Association of Realtors (NAR).[18] Chinese buyers also constitute the fastest growing segment of foreign buyers.[19] In the first three months of 2014, Chinese buyers spent $22 billion on U.S. homes (a 72 percent increase year-on-year), more than any other nationality.[20] Over 75 percent of buyers from China pay cash for U.S. homes, and the median home price among Chinese buyers was $523,148, more than twice the median price of existing home sales.[21] About half of Chinese buyers reported they plan to use their U.S. home for fewer than six months per year.[22] Canada remains the top foreign source of U.S. homebuyers by number of transactions, according to the NAR; but the median value of Canadian-bought U.S. homes is about half that of Chinese buyers.[23]

California and New York are two of the top U.S. property markets for Chinese buyers. In California, Chinese bought 32 percent of the homes sold to foreign buyers.[24] In some suburbs of the Los Angeles area, prices have been increasing rapidly as wealthy Chinese purchase expensive homes with cash. For example, in Arcadia, a suburb in Southern California popular among Chinese buyers, prices increased 18.5 percent year-on-year in May as Chinese buyers dominated the local real estate market.[25] In New York City, according to a survey by Reuters, Chinese buyers ranked first in both volume and value of home purchases.[26] One New York City real estate broker reported that her sales for Chinese buyers increased 28.5 percent year-on-year in the first quarter of 2014.[27]

Chinese buyers have many reasons for purchasing U.S. real estate. Some real estate experts say that property market trends in China and the United States are leading factors. In major Chinese cities, property prices have skyrocketed, while housing costs in U.S. cities are considered to be relatively low.[28] Chinese buyers also view purchasing U.S. homes as a cheap but reliable investment with strong rent potential.[29] In addition, the U.S. property market is a convenient way for wealthy Chinese to store money overseas anonymously if the purchases are made as a limited liability corporation (LLC) or through other "creative corporate structuring."[30] Chinese buyers also purchase U.S. homes to be near their children, who study in the United States, or to establish local residency for easier admission to U.S. universities. One survey of wealthy Chinese shows that 85 percent want to send their children overseas for school.[31] Real estate brokers report that Chinese buyers prefer property near major educational institutions. One New York broker said that many Chinese clients purchase property in Manhattan in hopes of sending their children to Columbia or New York University.[32]

Although their motivations for buying U.S. homes are largely innocuous, the methods Chinese buyers use to acquire property in the United States raise questions of legality and transparency. Because China imposes a per-person limit of $50,000 that can be taken out of China annually, Chinese buyers making all-cash offers on U.S. homes in excess of that amount must wire or physically carry the money into the country.[33] University of California,

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[iv] The NAR includes buyers from Taiwan and Hong Kong in their classification of "Chinese." However, the NAR confirmed that only about 1 percent of "Chinese buyers" surveyed were from Taiwan or Hong Kong, with the remaining 99 percent reportedly from mainland China.

Los Angeles, economist William Yu says that wealthy Chinese find creative ways to circumvent the restriction, including laundering money through Macau casinos and "cooking the books" of import-export firms.[34]

The Chinese government's anticorruption campaign has started to reveal the extent of corrupt officials' investment in U.S. real estate.[35] For example, the 2011 investigation of former Chinese Minister of Railways Zhang Shuguang revealed that he purchased an $860,000 home in a suburb of Los Angeles in 2002 while his government salary was less than $400 per month.[36] Weeks prior to the start of the investigation, Zhang transferred full ownership of the property to his wife. The investigation is reportedly still ongoing, and some analysts predict that the property may be seized as President Xi Jinping's anticorruption drive begins to target the overseas assets of corrupt officials.[37]

Antitrust Complications Increase for Foreign Firms

China continues to ramp up investigations of prominent foreign firms for violating its opaque antimonopoly laws. The latest salvo came on July 28, when Chinese regulators dispatched around 100 investigators to offices of Microsoft Corp. (Microsoft).[38] According to China's State Administration for Industry and Commerce, Microsoft had not disclosed certain information about security features in its software products.[39] Earlier this year, the Chinese government ordered government agencies, including SOEs, not to use Microsoft's Windows 8 operating system, citing "energy efficiency" concerns. The ban is seen as a response to Microsoft ending support for Windows XP (widely pirated in China), which would have forced SOEs to upgrade to legally purchased Windows 8 software.[40] In November 2013, San Diego-based chipmaker Qualcomm Inc. (Qualcomm) disclosed that it was under investigation for breaching China's antimonopoly law, in regards to abuse of its market position in mobile phone chip pricing. That case is ongoing.[41] These antitrust actions have occurred in the face of rising bilateral tensions regarding cyber theft and digital surveillance.

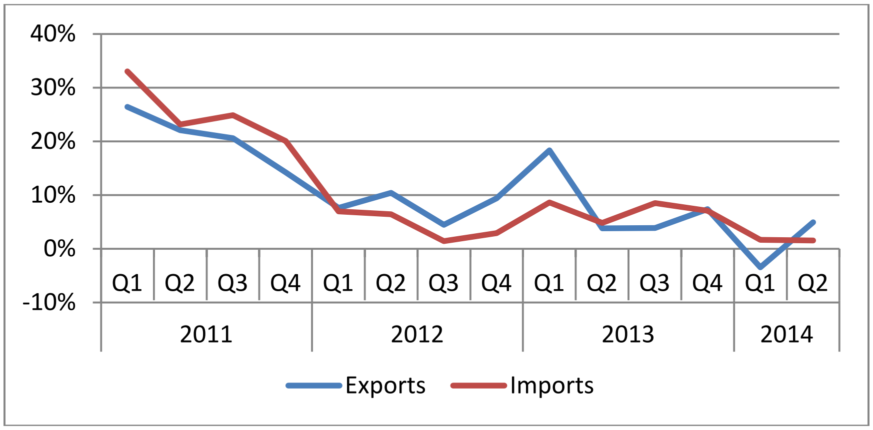
China's antitrust actions against foreign companies go beyond the tech industry. The auto industry has recently come under attack. The National Development and Reform Commission (NDRC), an agency with authority over industrial policy and price regulation, is investigating foreign premium carmakers for overcharging Chinese customers on products and spare parts. NDRC alleges these companies are abusing their dominant market positions to set prices.[42] Offices of Daimler AG's Mercedes-Benz were raided on August 4, and the German automaker confirmed they were "assisting the authorities" in the investigation, without specifying the details.[43] Although no formal verdict has been issued, several foreign auto brands—including Volkswagen AG's Audi, Jaguar's Land Rover, and Daimler—have started cutting spare part and service charges by as much as 20 percent.[44]

Quarterly Review of China's Economy

Manufacturing, Trade, and External Accounts

In the second quarter of 2014, China's economy grew by 7.5 percent, up from 7.4 percent in January to March. Despite weakness in some sectors of the economy, Beijing so far has been able to meet its targets and avoid a destabilizing slowdown. Exports were the highlight of China's second-quarter growth, rebounding to 5 percent year-on-year, after contracting in the first quarter (see Figure 2). The purchasing managers' index (PMI) for manufacturing, a gauge of business confidence, also surged in the second quarter according to data from official and private sources. New orders, including new export orders, are expanding as well (see Figure 3).

Figure 2: Growth in China's Exports and Imports
(quarterly, year-on-year, %)

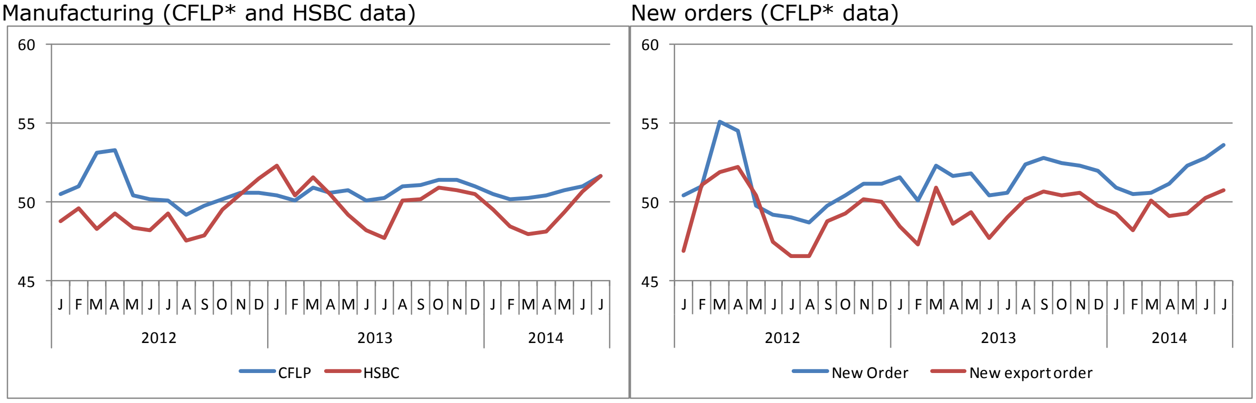


Source: China Administration of Customs, via CEIC data.

Figure 3: Purchasing Managers' Index
(>50 = expansion; <50 = contraction)

Manufacturing (CFLP* and HSBC data)

New orders (CFLP* data)

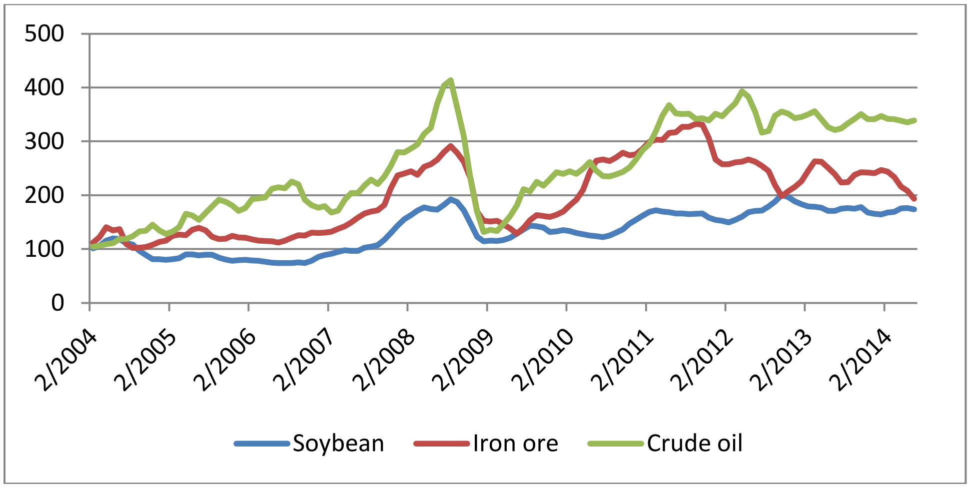


*CFLP refers to the China Federation of Logistics and Purchasing.
Source: China Federation of Logistics and Purchasing, via CEIC data; HSBC.

China's export statistics may be inflated, however. Chinese customs data do not match that of some trading partners. According to Bloomberg, "China recorded $1.31 of exports to Hong Kong in June for every $1 in imports Hong Kong tallied from China, for a $6.4 billion difference." [45] This suggests Chinese businesses continue to over-invoice export receipts to evade capital controls and funnel money in and out of the country. The State Administration of Foreign Exchange repeatedly cracked down on these illicit activities last year, but appears to have had limited success.

Reinforcing this suspicion is the anemic growth of China's imports, which usually correlate with manufactures exports. China's imports consist primarily of industrial inputs and commodities. Given the soft commodity prices on the world market (see Figure 4), the weak imports suggest a lack of underlying demand in Chinese factories.

Figure 4: Unit Value of China's Key Commodity Imports
(January 2004 = 100)



Source: China Administration of Customs, via CEIC data.

The combination of high exports and low imports also led China to register its highest current account surplus ($72 billion) since the third quarter of 2012. China's total foreign exchange reserves are fast approaching $4 trillion, suggesting major external imbalances. Efforts to address this problem, such as loosening up currency controls earlier this year, have yet to alter the status quo.

The only external rebalancing in the second quarter occurred in China's capital accounts. According to preliminary data, net capital flows were around zero, and foreign direct investment inflows declined by 0.9 percent year-on-year.[v] Changes in U.S. monetary policy could shape this trend in the coming months. The U.S. economy registered 4 percent growth in real gross domestic product (GDP) in the second quarter, a strong turnaround from the negative 2.1 percent growth in the first quarter. The Federal Reserve responded by slightly scaling back its quantitative easing program.[46] Faced with a higher cost of borrowing and improved business conditions in the world's largest economy, some portfolio investors could lose appetite for assets in China, resulting in further outflows and divestments.

Investment, Consumption, and Internal Rebalancing

Fixed investment, the largest component of China's economy, continued its slide from the end of last year. The slowing housing market appeared to contribute to this trend. Residential buildings accounted for 15.1 percent of China's total fixed investment through June, the lowest level in over a decade. Building activity—both newly started and under construction—increased, but at a much slower rate than a year ago (see Figure 5).[vi]

Despite a slowdown in investment, the domestic economy is not significantly rebalancing. China's share of global consumption is certainly on the rise—retail sales, the best gauge of consumption, improved slightly in the second quarter—but consumption growth still lags well behind investment (see Figure 6).

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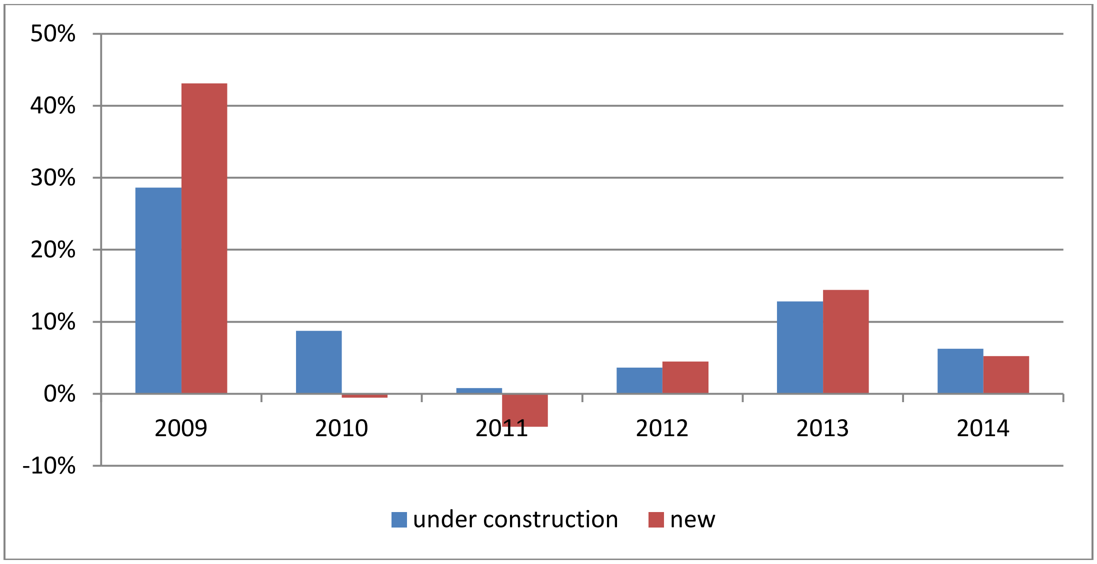
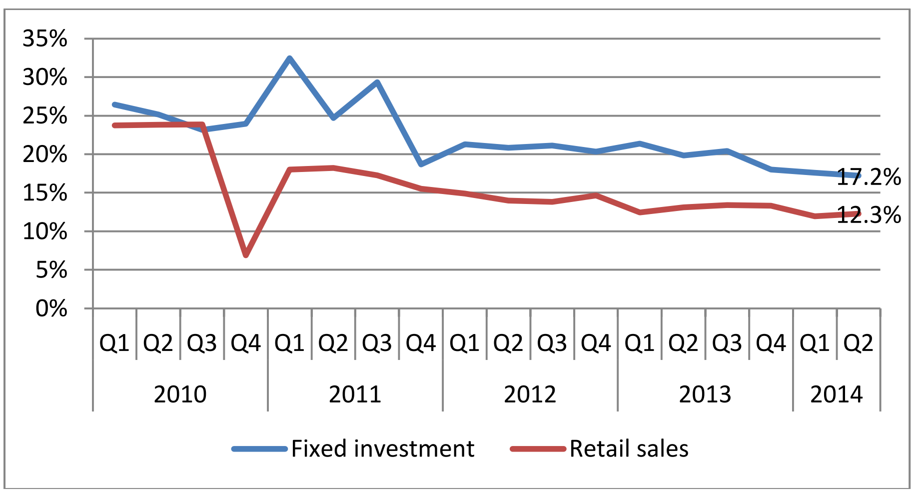
[v] China publishes two separate sets of statistics on its external accounts: (1) balance of payments and (2) international investment position. The former is published faster but is less accurate than the latter. At the time of this publication, only balance of payments data were available for the second quarter of 2014.
[vi] For more information on the housing sector, see the July 2014 edition of the USCC trade bulletin. *http://origin.www.uscc.gov/sites/default/files/Research/July%202014%20Trade%20Bulletin.pdf*.

Figure 5: Growth in China's Building Activity, January–June
(YTD, year-on-year, %)



Source: National Bureau of Statistics, via CEIC data.

Figure 6: Growth in Investment and Consumption
(quarterly, year-on-year, %)



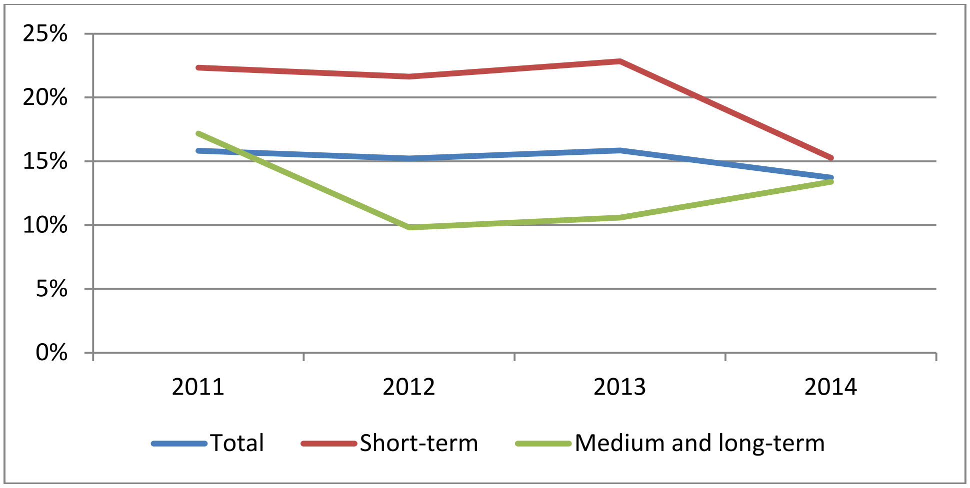
Source: National Bureau of Statistics, via CEIC data.

Stability and Reform in the Financial Sector

In 2013, China's financial sector was quite volatile, with spikes in interbank lending rates in June and December. This year has been comparatively stable. In the six months leading to June, the narrow money supply (M1) increased by 5.6 percent, less than half the rate during the same period in 2013. The broad money supply (M2) rose by 13.3 percent year-on-year, the lowest rate since 2005. In theory, slower liquidity growth should discourage excessive lending. Indeed, short-term lending—the riskiest kind—expanded by 14.7 percent in the January–June period, nearly seven percentage points less than the year before (see

Figure 7). China's official nonperforming loans, though rising since 2012, remain low as a share of outstanding credit.

Figure 7: Growth in China's Bank Loans, January–June
(YTD, year-on-year, %)



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

Nonetheless, many risks remain in China's "shadow banking" sector, where the full extent of losses and mutual obligations is not well understood. "Total social financing," which measures aggregate credit beyond traditional bank lending, increased by 23.7 percent year-on-year in the second quarter of 2014, the highest increase since the first quarter of 2013. This credit expansion is occurring in the face of a downturn in the housing market, where a big chunk of shadow credit is invested.

The government cannot realistically rein in shadow banking, since it provides an important outlet for borrowers and lenders who are frustrated with the state-controlled banking system. One of the partial solutions has been to develop the country's bond markets. Between the fourth quarter of 2013 and the second quarter of this year, corporate bond financing rose from 8.4 percent to 18.4 percent of China's aggregate credit. Over the same period, two of the riskiest shadow banking tools—trust loans and entrusted loans—declined from 30 percent to 16.4 percent of aggregate credit.

Recent evidence suggests that developing the bond market will not be easy. As China's economic growth slows, small and medium-sized enterprises (SMEs) are facing increased challenges. In March 2014, Shanghai Chaori Solar Energy Science & Technology Co. (Shanghai Chaori) registered China's first corporate bond default.[47] In April, construction materials manufacturer Xuzhou Zhongsen Tonghao New Board Company missed a $2.9 million interest payment on its $29 million in bonds because of a "liquidity problem."[48]

Chinese regulators are struggling to balance the risk of letting weak companies fail—an imperative of corporate governance reform—with preserving the stability of the $4.2 trillion bond market.[49] On one hand, investors in privately held companies have grown more conscious of the risk that the government might remove its implicit bailout guarantee. Bond financing for riskier privately held corporate borrowers has become increasingly challenging.[50] On the other hand, influential backers in the government can still prevent defaults on a whim. That was evident on June 16, when China's interbank bond market[vii]

[vii] China's interbank bond market represents 94 percent of its entire $4.2 trillion bond market. Wynne Wang, "China Traders Jittery Over Huatong Bond Default Warning," *Wall Street Journal*, July 17, 2014. *http://online.wsj.com/articles/chinese-construction-company-huatong-warns-on-bond-default-1405580900*; David

nearly experienced its first public default. Shanxi-based construction company Huatong Road & Bridge Group Co., Ltd. (Huatong) announced that it might be unable to honor both the principal and interest payments on a $64.5 million bond.[51] At the last minute, Huatong was reportedly able to avert default with the help of the Shanxi provincial government.[52] The company's bailout is a blow to Beijing's market-oriented financial reform agenda. Such near misses are not without impact, however. According to China Money, a bond market information website backed by China's central bank, at least four companies either delayed or cancelled planned bond offerings in the wake of Huatong's near default.[53]

The government's support of small private banks is a more encouraging sign of financial reform. On July 25, the China Banking Regulatory Commission approved the establishment of three private banks that are to provide local lending targeted at small firms and individuals.[54] One of these, Webank, is cofounded by Internet conglomerate Tencent Holdings Ltd. (Tencent), and will be based in Shenzhen; the other two will be based in Tianjin and Wenzhou.[55] The private banks were chosen among several others that applied to participate in a private banking pilot program, including one bank jointly backed by the financial services affiliate of Alibaba Group Holding Ltd. (Alibaba) and partner Wanxiang Group, China's largest auto parts company.[56] The involvement of tech giants Tencent and Alibaba may reflect a growing commitment to opening the banking sector to competition.

Still, the impact three private banks can make in China's state-dominated financial sector may be limited. China's major commercial banks, which comprise state-owned commercial banks and state-controlled joint stock commercial banks, hold 42.2 percent of the total assets of China's banking institutions.[57] The survival of private banks is also threatened by the delayed implementation of universal deposit insurance legislation, which would discourage banks from lending overwhelmingly to SOEs that seem certain to repay.[58]

China Strengthening Ties with Latin America

In July, President Xi made his second trip to Latin America since assuming office. He traveled to Brazil to attend the 6th BRICS (Brazil, Russia, India, China, and South Africa) Summit, met with Community of American States and the Caribbean (CELAC) leaders,[viii] and paid state visits to Brazil, Argentina, Venezuela, and Cuba.[59] Along with the usual announcement of trade and infrastructure deals, this trip included the official launch of a new "BRICS bank," and the establishment of the China-CELAC Forum.

At the 6th BRICS Summit, Brazil, Russia, India, China, and South Africa announced the creation of the New Development Bank (NDB). The bank will be headquartered in Shanghai with an initial subscribed capital of $50 billion, which will later be increased to $100 billion. The creation of the NDB elevates the BRICS meetings from a talk shop into actual coordinated policy. Notably, the summit also led to the creation of a $100 billion emergency swap fund.

NDB funds are to be directed toward "infrastructure and sustainable development projects in BRICS and other emerging and developing countries." As such, they could fill an estimated $1 trillion infrastructure gap in low- and middle-income countries.[60] However, reactions from international observers have been mixed. Bhaskar Chakravorti, senior associate dean at The Fletcher School at Tufts University, questioned the credibility of the new bank as a globally responsible lender, and criticized the structural inequity of its members' contributions, roles, and economic weight.[61] In contrast, Raj M. Desai and James

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Yong et al., "China Averts Second Corporate Default as Huatong Pays Bonds," Bloomberg, July 23, 2014. *http://www.bloomberg.com/news/2014-07-23/china-averts-second-corporate-default-as-huatong-pays-bonds-1-.html.*

[viii] CELAC was created in December 2011 and consists of 33 countries in the Western Hemisphere, but excludes Canada and the United States.

Vreeland, associate professors at Georgetown University, welcomed the bank's creation, arguing that the NDB will exert much-needed pressure on the World Bank and International Monetary Fund to reform their quota system and accord a larger role to emerging economies.[62]

Following the BRICS summit, President Xi met with leaders of CELAC[ix] to establish the China-CELAC Forum and prepare for the first summit meeting in the fall. At the meeting, President Xi proposed a $20 billion infrastructure development fund, a $10 billion credit line, and $5 billion in initial funding for the China-Latin America Cooperation Fund.[63] Dr. Evan Ellis, a China-Latin American scholar at the Center for Hemispheric Defense Studies, argues that this forum accelerates China's commercial presence in the region. It also demonstrates China's new assertiveness in creating multilateral institutions that do not include the United States.[64]

President Xi also paid visits to countries in the region that are of strategic importance to Beijing. The focus was on expanding infrastructure and energy development and deepening existing trade ties:[65]

- *Brazil*: China and Brazil signed 59 cooperative agreements focused on energy, finance, and industry to include exploration of Brazil's oil fields, the purchase of 60 passenger jets from Brazilian airplane manufacturer Embraer, and cooperation on new railways from Brazilian agricultural and mining areas to the Atlantic coast, which would cut China's shipping costs and time.[66]

- *Argentina*: China and Argentina upgraded their bilateral relationship to "comprehensive strategic partnership" and signed 20 agreements to include an $11 billion currency swap, a $1.2 billion loan for the purchase of railway equipment, and a $4.7 billion loan for the construction of hydroelectric dams in Argentina.[67]

- *Venezuela*: China and Venezuela also upgraded their bilateral relationship to a "comprehensive strategic partnership" and signed 38 agreements focused on providing additional support for Venezuela's mining and petroleum sector. That support includes $4 billion in oil-backed loans and $691 million for a gold and copper extraction project.[68] This will add to the $50 billion in oil-backed loans from China that Venezuela accumulated since 2007.[69]

- *Cuba*: China and Cuba signed 29 agreements to include loans to cover the construction of a port terminal, installation of digital television using Chinese technology, and contracts on the purchase of Cuban nickel and its derivatives.[70] In addition, the two countries established cooperation development zones dedicated to agriculture, digital television, port development, and a special economic zone.[71]

Sector Focus – China's Meat Industry

In July, a meat safety scandal hit several U.S. food companies in China. Shanghai Husi Food Co. (Shanghai Husi), the Shanghai-based subsidiary of Illinois-based OSI Group (OSI), was accused by the Chinese government of selling expired poultry and beef. Chinese officials announced on July 14 that they had suspended Shanghai Husi's operations, detained five Husi employees, and launched a further investigation. OSI Group is a meat supplier to numerous U.S. fast food companies, notably Yum! Brands Inc. (Yum!), the owner of KFC and Pizza Hut, and McDonald's Corp. (McDonald's). These chains operate thousands of

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[ix] CELAC leaders at the meeting included representatives from Costa Rica, Cuba, Ecuador, and St. Vincent and the Grenadines.

outlets across China and, through OSI, source extensively from the Shanghai Husi facilities.[72]

The scandal places U.S. food companies in a difficult bind. On one hand, Yum! and McDonald's must mitigate damage to their brands. The safety lapses initially came to light on a Chinese national television program that featured lurid footage of shoddy conditions at Shanghai Husi's facilities, including meat being picked up off the floor and reused.[73] Yum! already saw its sales in China fall last year, when Chinese state media alleged that KFC's smaller chicken suppliers used high levels of antibiotics. At McDonald's, the scandal has also added to existing woes. The company is faring poorly in the U.S. market, and sales at its Chinese outlets (open 12 months or more) declined by 3.6 percent last year. The alleged "rotten meat" from Husi is estimated to affect about 500 out of 2,000 McDonald's outlets in China, as well as outlets in Japan and Hong Kong. [74]

On the other hand, finding a supplier that can substitute for OSI in terms of production scale and quality is difficult. OSI has been a reliable partner for years, with state-of-the-art facilities that are superior to most Chinese meat processors. OSI opened its ninth and tenth plants in China in 2014—part of a $750 million investment to become one of China's biggest poultry producers—capable of processing more than 300 million chickens per year. Its integrated, "farm-to-plate" supply chain model is being adopted by other U.S. companies entering the Chinese meat industry, such as Tyson and Cargill. [75]

Yum! and McDonald's are taking divergent approaches. Yum! announced on July 22 that it will drop OSI as a supplier not only in China, but also in the United States and Australia. McDonald's has been much more lenient. On July 24, it stated that it would continue to work with OSI Group and, moreover, would continue to source from Shanghai Husi facilities located in other parts of China.[76]

The Shanghai Husi scandal has broader implications both for product safety in China and for the treatment of foreign companies by the Chinese government. Food safety is a perpetual concern in China's rapidly growing economy.[x] The U.S. Food and Drug Administration (FDA) has several times halted shipments of Chinese food products, including melamine-tainted pet food, into the United States. Unlike the United States, where the food industry is dominated by several large companies, food production in China is fragmented among thousands of small producers, both at the farm and the processing level. The imperative for local governments to secure rural livelihoods and create manufacturing jobs stands in the way of meaningful consolidation. In the meat sector, this problem is magnified by scale. China is the world's largest pork producer and second-largest poultry producer, breeding vast amounts of livestock—often under unhygienic conditions.

Vast and fragmented production is compounded by poor regulation. China's food safety regulators primarily operate at the provincial and municipal level. They depend on local governments for funding, and the governments in turn often prioritize industrial output over product safety. Regulation is also fragmented across agencies. The government established a consolidated food and drug administration last year, but oversight of "primary" food production, including livestock slaughter, remains with the Ministry of Agriculture. Until recently, meat processing oversight was under the jurisdiction of a special quarantine agency and local bureaus of industry and commerce.[77]

The Chinese government has worked with various stakeholders, including U.S. companies, industry associations, and officials, to improve its food safety controls. A new food safety law was issued in 2009, with significant input from the U.S. FDA. Ironically, Shanghai Municipality, the site of the current meat scandal, prides itself on having one of the best

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[x] For more detailed analysis, see Chapter 1, Section 4 of the *2013 USCC Annual Report*. *http://www.uscc.gov/Annual_Reports/2013-annual-report-congress*.

local food and drug regulators in the country. A positive interpretation of the recent scandal is that China's media and officials are becoming more vigilant, and are therefore holding foreign companies like OSI to higher standards.

However, there may also be ulterior motives behind the recent allegations against OSI. U.S. food companies have been repeatedly targeted by the state media, even though their operations tend to be superior to those of local firms. It appears that, as foreign companies push to enter China's promising consumer markets, they are increasingly liable to being blamed by the government for poor service quality or legal infringements. This problem is not unique to the food industry. Pharmaceutical, software, and automotive companies, for example, have recently been accused of price fixing under China's antitrust law. Foreign companies can serve as scapegoats for problems that have more to do with the Chinese market than the particular company in question. By weakening powerful foreign companies, the government may try to reserve the markets for China's domestic firms, which have struggled to produce competitive, brand-name consumer goods.

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