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U.S.-China Economic and Security Review Commission

Monthly Summary of U.S.-China Trade Data **January 08, 2014**

Highlights of this month's edition

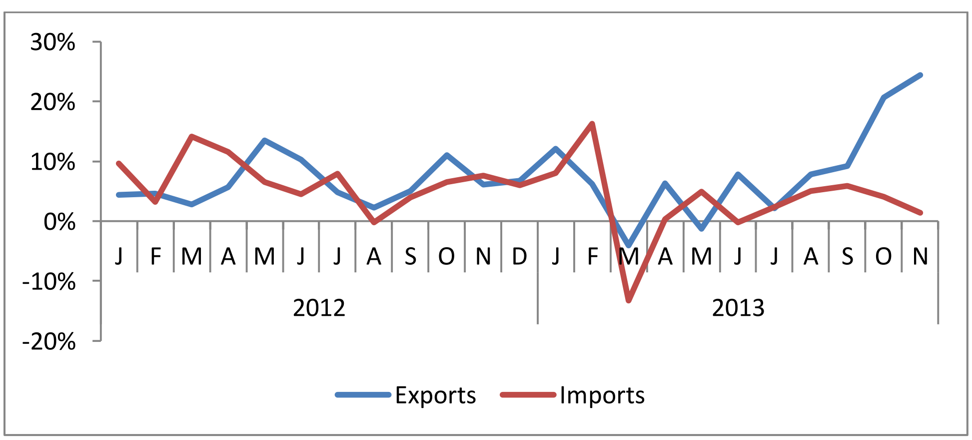
- **Bilateral trade:** U.S. exports to China set record; trade deficit on pace for new annual high but imbalances reduced; manufactures and ATP exports perform well
- **Bilateral policy issues:** Tensions flare in Northeast Asia; Baucus to become next U.S. ambassador to China; Chinese companies top CFIUS list; Volcker rule may harm operations of Chinese banks and funds in the United States
- **JCCT special:** China makes new commitments on pharmaceuticals patents, beef access, trade secrets, and procurement
- **Sector spotlight:** Natural gas gaining prominence in China's energy mix, energy imports, and negotiations with US; potential for imports from US
- **China's economy:** 2013 GDP growth forecasts see at least 7.5 percent; growth achieved despite weak output, sales, and exports; another credit crunch; incipient financial reform

Strong Increase in U.S. Exports

U.S. exports to China reached $13.2 billion in November 2013, a record. The exports rose by 24.4 percent year-on-year, sustaining a sudden uptick that began in October. China's share of U.S. exports to the world edged up to 10 percent, about three percentage points higher than the average of recent years, making it an important driver of U.S. exports. Imports from China rose by just 1.4 percent (see figure 1).

The latest data indicates a modest correction in the trade imbalance. At $293 billion through the first eleven months, the cumulative U.S. trade deficit with China is on pace to surpass the 2012 record of $315 billion. But the cumulative U.S. deficit with China has expanded by just $3.3 billion so far in 2013 (pending December data). That compares with deficit growth of $43.7 billion, $19.9 billion, and $18.3 billion over the same period in 2010-2012.

Figure 1: Growth of U.S. Trade with China through November 2013
(monthly, year-on-year, %)



Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, December 2013). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Top Exports and Imports

The fall harvest played an important role in boosting U.S. exports to China, as agricultural products topped the list of goods shipments (see figure 2). But after hitting a record $25 billion in 2012, agricultural exports are likely to decline this year for the first time in a decade. Instead, manufacturing industries are featured more prominently. Transport equipment has been the leading export to China in 2013, accounting for 19 percent of the total, compared with 14 percent in 2012. Computer and electronics, chemicals, and machinery accounted for a third of the exports. A welcome absentee from the top-five export list is waste and scrap, which for years ranked ahead of manufactures as a top U.S. shipment to China.

Figure 2: Top Exports and Imports through November 2013
(in US$ millions)

U.S. Top-Five Exports to China

	Exports	Share of total (%)	Change over Nov'12 (%)
Monthly (November 2013)			
Agricultural Products	4,192.3	31.8%	24.3%
Transportation Equipment	2,000.1	15.2%	44.0%
Chemicals	1,313.6	10.0%	34.1%
Computer and Electronic Products	1,275.1	9.7%	20.8%
Machinery, Except Electrical	820.0	6.2%	7.1%
Other	3,577.7	27.1%	
Total	**13,178.9**	**100.0%**	
Year-to-date (thru November 2013)			
Transportation Equipment	20,738.2	19.0%	
Agricultural Products	16,234.4	14.9%	
Computer and Electronic Products	14,571.0	13.4%	
Chemicals	12,309.5	11.3%	
Machinery, Except Electrical	9,027.8	8.3%	
Other	36,052.6	33.1%	
Total	**108,933.4**	**100.0%**	

U.S. Top-Five Imports from China

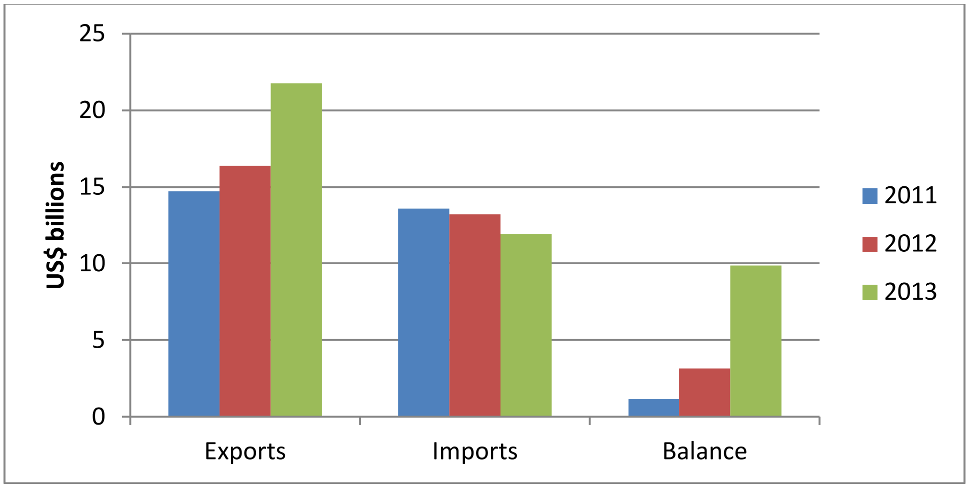
	Imports	Share of total (%)	Change over Nov'12 (%)
Monthly (November 2013)			
Computer and Electronic Products	17,325.4	43.2%	-1.3%
Miscellaneous Manufactured Commodities	3,775.4	9.4%	-2.8%
Electrical Equipment, Appliances, and Component	2,817.7	7.0%	6.1%
Apparel and Accessories	2,470.2	6.2%	5.2%
Machinery, Except Electrical	1,879.4	4.7%	10.3%
Other	11,841.6	29.5%	
Total	**40,109.6**	**100.0%**	
Year-to-date (thru November 2013)			
Computer and Electronic Products	147,867.2	36.7%	
Miscellaneous Manufactured Commodities	33,667.8	8.4%	
Electrical Equipment, Appliances, and Component	30,959.0	7.7%	
Apparel and Accessories	30,557.9	7.6%	
Leather and Allied Products	22,871.1	5.7%	
Other	136,953.6	34.0%	
Total	**402,876.6**	**100.0%**	

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, December 2013). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Advanced Technology Products

Excluding information & communications, which accounts for 88 percent of the United States' advanced technology imports from China, the U.S. ATP trade surplus with China has increased substantially in 2013. This is owing to both a rise in exports and a decline in imports (see figure 3). Although this is cause for optimism, much of the improvement in ATP trade is attributable to aerospace, which increased its exports by 51 percent and its trade surplus by 55 percent year-on-year through November (see figure 4). At the December talks of the U.S.-China Joint Committee on Commerce and Trade, IAE Aero Engines signed an agreement with ICBC Financial Leasing Co. Ltd to sell V2500 engines to power 17 firm and three option A320 aircraft, a deal worth $311 million.[1]

Figure 3: U.S.-China Trade in Advanced Technology Products, 2011-2013
Excluding Information and Communications
(YTD November, in US$ billions)



Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, December 2013). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Figure 4: U.S.-China Trade in Advanced Technology Products
(in US$ millions)

	Monthly			Cumulative year-to-date			
	Exports	Imports	Balance Nov'13	Exports	Imports	YTD Balance Nov'13	YTD Balance Nov'12
TOTAL	**2,322**	**15,608**	**-13,286**	**25,917**	**132,246**	**-106,329**	**-108,757**
(01) Biotechnology	36	5	31	362	69	293	192
(02) Life Science	246	158	88	2,699	1,845	854	626
(03) Opto-Electronics	58	567	-509	326	4,774	-4,448	-6,286
(04) Information & Communications	415	14,394	-13,979	4,167	120,345	-116,178	-111,872
(05) Electronics	393	293	100	4,445	3,108	1,337	801
(06) Flexible Manufacturing	173	89	84	2,278	868	1,410	1,080
(07) Advanced Materials	10	19	-9	168	221	-53	75
(08) Aerospace	987	64	923	11,235	726	10,509	6,790
(09) Weapons	0	20	-20	2	151	-149	-152
(10) Nuclear Technology	4	0	4	236	140	96	-10

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, December 2013). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Bilateral Policy Issues

Security Tensions in Northeast Asia

The past month saw an escalation of security tensions in Northeast Asia, raising concerns about the region's economic and political stability. In late November, China established an air defense identification zone (ADIZ) that raised tensions with the United States and its allies Japan and Korea. According to China's ADIZ regulations, both military and civilian aircraft are required to report their flight plan to, maintain radio contact with, and reply promptly to identification inquiries from Chinese authorities, even if they are not planning to enter Chinese airspace. The zone includes the Diaoyu/Senkaku Islands area that is subject to competing territorial claims by China and Japan, as well as Socotra Rock/Ieodo/Suyan Rock in waters contested between China and Korea. The White House called the ADIZ "dangerous and provocative", and the Pentagon joined with Japan and Korea to disregard the ADIZ jurisdiction for its military aircraft. However, the approach to civilian aircraft has not been uniform – the United States has asked private carriers to comply, while Japan has urged its own carriers not to do so.[*]

Actions by the Japanese government in late December suggested that relations between Japan and China, Asia's two largest economies, will remain tense for the foreseeable future. On December 26, Japan's Prime Minister Shinzo Abe paid a visit to the Yasukuni Shrine, where 14 class-A war criminals are enshrined among 2.5 million Japanese war dead. It was the first visit to Yasukuni by a serving prime minister since Junichiro Koizumi went in 2006. The visit infuriated the Chinese government, which viewed it as evidence that Japan still denies its war crimes.[2] Separately, Japan and the United States edged closer to prolonging the U.S. military presence at Okinawa, after the local governor approved construction of a new base on a remote coast of the island. Some suggest that the agreement, impeded by local opposition for many years, was made possible by Prime Minister Abe, who has lobbied for a stronger U.S. military presence in the region.[3]

A political purge by Kim Jong-un, North Korea's young dictator, also illustrated the risks that North Korea still poses to stability in Northeast Asia. On December 13, Kim ordered the execution of his uncle, Jang Song Thaek, seen by Beijing as the most pro-China and pro-business figure in the North Korean leadership. According to the *Wall Street Journal*, Chinese leaders are "likely to be particularly concerned by the accusation in North Korean state media that Mr. Jang sold coal and other resources 'at random,' and granted an unnamed foreign country a 50-year land lease in the port of Rason." Both of these accusations indirectly implicate China. China is the main buyer of Korean coal. Rason, on North Korea's border with China, is one of several special economic zones North Korea established to try to attract foreign investment, and several Chinese companies have built infrastructure there.[4] Seemingly undaunted by these political developments, China in early January declared that it would open a high-speed rail line to the North Korean border in 2014, a tangible commitment to boosting trade and economic ties.[5]

Baucus to Become Next U.S. Ambassador to China

Senator Max Baucus, the veteran Montana Democrat who has served in the Senate since 1978, was nominated by the White House to serve as the next U.S. ambassador to China, following the surprise announcement that Gary Locke, the current ambassador, will leave his post in early 2014. Sen. Baucus is Chairman of the Senate Committee on Finance, Vice Chairman of the Joint Committee on Taxation, and a member of the Senate Committee on Agriculture, Nutrition and Forestry. He is also a member of the Senate Committee on Environment and Public Works and chairs its Subcommittee on Transportation and Infrastructure.

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[*] On December 5, the same day the U.S. issued public statements condemning the ADIZ, vessels from the United States and China came close to colliding in the South China Sea, when a Chinese warship cut across the bow of an American cruiser, the USS Cowpens. According to Defense Secretary Chuck Hagel, the two ships came within 100 yards of each other, and Pentagon officials disclosed that the USS Cowpens had to carry out emergency maneuvers to avoid hitting the Chinese vessel. Secretary Hagel on December 19 called the Chinese Navy's actions "irresponsible." Thom Shanker, "Hagel Criticizes Chinese Navy, Citing Near Miss," New York Times, December 19, 2013. *http://www.nytimes.com/2013/12/20/world/asia/hagel-criticizes-chinese-navy-citing-near-miss.html?_r=1&.*

Sen. Baucus's China credentials were established in the 1990s, when he was a crucial proponent of China's entry into the World Trade Organization. In announcing the nomination, President Obama stressed Sen. Baucus's work over two decades on economic agreements with China that "have created millions of American jobs and added billions of dollars to our economy."[6] As chairman of the Senate Finance Committee, Sen. Baucus voted for several bills to punish China for undervaluing its currency, though the legislation never became law. He has also criticized China for shutting out U.S. beef imports (see note in this bulletin on JCCT outcomes on related issue). Nonetheless, Sen. Baucus has remained a strong advocate of expanding trade, most recently backing the restarting of stalled Bilateral Investment Treaty negotiations with China, announced at the latest Strategic & Economic Dialogue. His expertise in the security arena—particularly important in the face of China's current tensions with its neighbors over territorial claims—is less well known.

Volcker Rule May Affect China's Banks and Sovereign Wealth Fund

In early December, five U.S. government agencies jointly released the Volcker Rule, an essential component of the Dodd-Frank Act's regulatory overhaul prompted by the 2009 financial crisis. The rule restricts banks from engaging in proprietary trading, a form of trading in which banks invest their own capital instead of bank deposits. Initially proposed in 2011, Volcker took over two years to complete, owing to a litany of legal challenges from banks. In anticipation of the rule, many banks shut their proprietary trading desks or broke off standalone groups that traded separately from units that serve clients.[7] Some financial experts with close ties to the Chinese government – such as Liu Dongmin from the Chinese Academy of Social Sciences, Li Wenhong of the China Banking Regulatory Commission, and Wang Yong from the People's Bank of China's (PBOC) Zhengzhou Training Institute – agreed that the regulations herald a new era of tougher regulation that will reduce risk and moral hazard, ultimately creating a more stable environment for China's economy as well.[8]

However, there is also concern about the Volcker Rule's impact on Chinese financial institutions. The National Association of Financial Market Institutional Investors (NAFMII), a self-regulating organization founded in 2007 under the PBOC, held a meeting in October 2012 to publicly debate the impact of the Volcker Rule and other U.S. and European financial regulation on China. China's main commercial banks are members of NAFMII's governing council, as are many leading state-owned enterprises. At the 2012 event, NAFMII issued a report criticizing the "extra-jurisdictional" impact of US financial reform. The U.S. regulations will "not only affect the operations of Chinese banks in Europe and the United States, but also their cross-border and domestic business." For example, Chinese banks that have banking operations in the United States may find it difficult to engage in proprietary trading in other jurisdictions.[9]

An institution that could be more immediately affected by the Volcker Rule is China Investment Corp. (CIC), China's flagship sovereign wealth fund. According to *Hedge Fund Alert*, a niche financial publication, CIC may have to divest billions of dollars from the United States. As a bank holding company that owns controlling stakes in large Chinese banks, it is subject to Volcker Rule provisions barring banks from investing in hedge funds and private equity vehicles run by unaffiliated managers.[10] CIC has invested heavily in U.S. private equity vehicles in recent years, part of an effort to generate higher returns after incurring losses during its initial years of operation.[†]

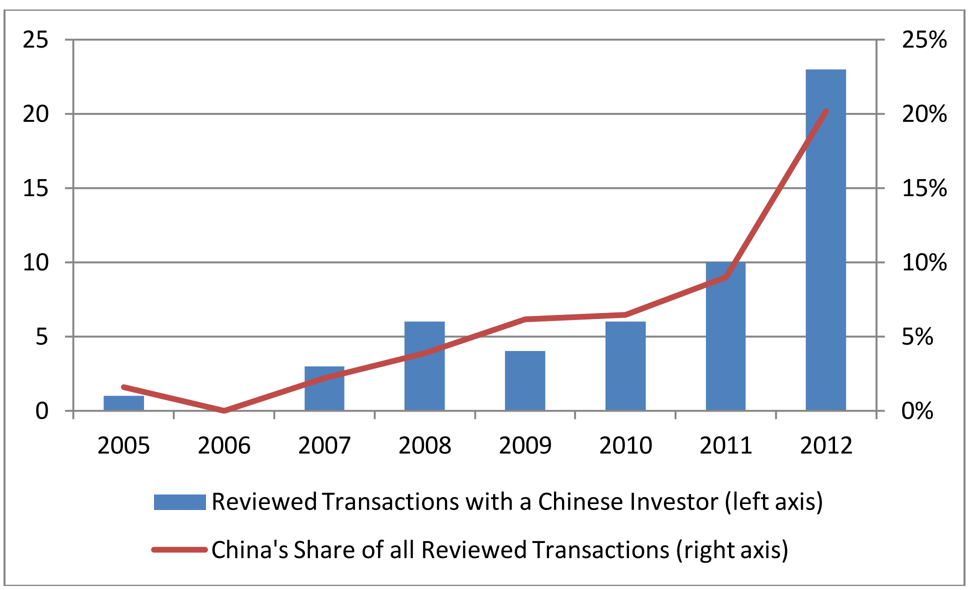
[†] For more information, see the June 2013 USCC staff report "China Investment Corporation: Recent Developments in Performance, Strategy, and Governance". *http://origin.www.uscc.gov/sites/default/files/Research/China%20Investment%20Corporation_Staff%20Report_0.pdf*.

Under Volcker, covered institutions face a July 21, 2015, deadline to largely exit their positions in alternative-investment vehicles run by outside managers. If CIC is indeed implicated under the Rule, it has three principal options. One would be to divest its U.S. holdings, which is unlikely on a large scale, given the financial interests at stake. A more realistic option might be to exploit Volcker loopholes, such as the right of banks to invest with outside managers via separate accounts, as long as the investments are longer term.[11] A final option would be to fundamentally alter CIC's relationship with Central Huijin, the bank holding company that has been its subsidiary since 2007. CIC came under new leadership in 2013, and already faces other structural challenges, such as limited access to central bank funding. From a regulatory standpoint, CIC's bank holding function has complicated its efforts to own equity in non-financial institutions, and made it more difficult for its subsidiary banks to expand abroad. The Volcker Rule could give renewed impetus to reforming CIC, a process that would likely involve negotiations among the central bank, the Ministry of Finance, CBRC, and the Politburo's Leading Small Group for financial matters.

CFIUS Annual Report to Congress

The Committee on Foreign Investment in the United States (CFIUS) is charged with reviewing mergers and acquisitions where an investment by a foreign entity might pose a threat to national security. According to the December 2013 CFIUS unclassified report to Congress (which covers transactions reviewed in 2012), there were 114 reviews in 2012, compared to 111 reviews in 2011. CFIUS received 23 notifications of covered transactions related to China, a twofold increase from the notifications in 2011. In 2012, China overtook the historic leader, the United Kingdom (17 transactions). Canada (13 transactions), Japan (9), and France (8) rounded off the top 5 for 2012.[12] The growth of Chinese investment is particularly striking: In 2012, China submitted for review more transactions than the combined total for submissions between 2005 and 2010 (see figure 5).

Figure 5: Chinese Transactions Covered by CFIUS, 2005-2012



Source: CFIUS, *Annual Report to Congress* (Washington, DC: various years).

The trend suggests that despite heightened national security concerns, Chinese interest in investing in the United States continues undeterred. In 2012, President Obama formally blocked a transaction, only the second time presidential action was formally required against any country.[‡] That transaction involved the acquisition by Ralls, Corp.[§] of wind-farm assets on property in Oregon within the restricted airspace of a U.S. Navy training range for unmanned aircraft. The Chinese investors initiated litigation challenging the decision but failed to prevail. They are currently appealing.

While manufacturing accounted for 42 percent of all notices filed in from 2010 to 2012, 20 out of 39 transactions from Chinese investors were in that sector. Mining, utilities and construction accounted for 16 percent of all notices filed in 2010-2012, but accounted for 31 percent (12 of 39) of notices from Chinese acquirers.[13] In 2010-2012, Chinese investment in finance, information, and services accounted for 18 percent (7 out of 39), although it accounted for 34 percent of all notices.

In 2012, CFIUS reported that the U.S. intelligence community had "moderate confidence" that there was likely a coordinated strategy among one or more foreign governments or companies to acquire U.S. companies involved in research, development, or production of critical technologies. In its December 2013 report to Congress, CFIUS reported that the intelligence community "judged it unlikely" that such a coordinated strategy existed.[14] Nonetheless, consistent with its previous reports, CFIUS said in the 2013 report that the U.S. intelligence community "judges that foreign governments are extremely likely to continue to use a range of collection methods to obtain critical U.S. technologies."[15] This finding is in line with general reports of espionage by foreign governments that could lead to acquisition of U.S. critical technologies.

JCCT Outcomes

On December 19-20, 2013, China and the United States held the 24th meeting of the Joint Commission on Commerce and Trade (JCCT). Unlike the S&ED, which is split between an economic and strategic track, the JCCT is focused on high-level technical discussion of bilateral trade issues. The 2013 JCCT marked an important turning point: on the Chinese side, longtime chief negotiator Wang Qishan was replaced by Vice-Premier Wang Yang; on the U.S. side, the top negotiators, Commerce Secretary Penny Pritzker and U.S. Trade Representative Michael Froman were new. U.S. Ambassador Gary Locke, a longtime participant, attended his last JCCT meetings before stepping down.

The 2013 JCCT saw a reduction in commitments and did less to raise issues like indigenous innovation that shaped the 2011 and 2012 talks. Some business groups have expressed frustration over the 2013 JCCT's failure to tackle several important issues, such as new restrictions proposed by the Chinese government on telecommunications and business services, and anti-monopoly cases targeting foreign companies.[16] Nonetheless, the commitments made were in many respects more concrete and enforceable than at past meetings. This may signal a new negotiating strategy by the U.S. government. The important commitments are summarized below.

Government Procurement

China's failure to join the WTO's plurilateral Government Procurement Agreement (GPA) has been frustrating U.S. negotiators for years. When it joined the WTO in 2001, China pledged to join the GPA as soon as possible, and tabled an initial offer in January 2008, followed by

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§ Ralls is a Delaware-registered company owned by executives of China-based Sany Group Co, parent company of Sany Heavy Industry Co., China's largest machinery maker. For more details on this deal, see U.S.-China Economic and Security Review Commission, *2012 Annual Report to Congress* (Washington, DC: November 2012), p. 99. http://origin.www.uscc.gov/sites/default/files/annual_reports/2012-Report-to-Congress.pdf.

revised offers circulated in July 2010, November 2011, and November 2012. Although each revised offer broadened the number and kind of Chinese government entities that would be covered by the GPA, the United States, EU and other parties rejected each Chinese offer in turn for being insufficient. The latest offer, tabled on December 31, 2013 comes after China made a commitment at the 2013 JCCT to make another submission in 2014.

China's latest submission offers to open procurement of six additional provinces (Liaoning, Chongqing, Hebei, Hubei, Hunan and Henan) to foreign bids.[17] Under the staged approach outlined in the new offer, four of the new provinces (Hebei, Hubei, Hunan, and Henan) would be covered three years after the other provinces and municipalities. China's previous offer covered eight provinces and municipalities (the three municipalities of Beijing, Tianjin, and Shanghai plus the provinces of Jiangsu, Zhejiang, Fujian, Shandong, and Guangdong).[18] Despite the broadened coverage, the new offer will likely fall short of U.S. and EU demands. First, the revised offer still fails to cover state-owned enterprises (SOEs); and second, it maintains several broad exclusions:

- Beijing reserves the right to deviate from the national treatment principle in specific procurements for "important" public policy objectives;
- China would have the right to impose requirements for technology transfer and the use of domestic content in connection with procurements; and
- The opening of procurement carried out by central government entities would be limited only to their offices in the capital of Beijing, excluding field offices located in other parts of China.

The new offer also lowers the threshold above which procurement by sub-central entities of construction services would be opened up to foreign bidders. Under the new offer, the threshold would begin the five-year phase-in period at 60 million Special Drawing Rights (SDRs)[**] (down from the 100 million SDRs in the previous offer), and end up at 20 million SDRs after the phase-in period (down from 30 million SDRs in the previous offer). [19]

U.S.-China Energy Cooperation

The U.S. Trade and Development Agency (USTDA) and China's National Energy Administration (NEA) signed a memorandum of understanding (MOU) in support of the U.S.-China Energy Cooperation Program. The two agencies are set to establish a work plan covering a broad range of energy activities. According to the U.S. fact sheet, subjects of joint interest under the MOU "may include, but are not limited to: clean transportation (clean fuels), decentralized energy and combined cooling, heat and power, industrial energy efficiency, shale gas, renewable energy, smart grid and micro-grid, and other fields as mutually determined." There were also several commercial signings in the energy sector, including:

- An MOU on green data center standards development;
- An MOU on the clean air industrial emission reduction technical assistance program, accelerating the deployment of U.S. best-in-class energy efficiency and emission reduction technologies in China;
- A partnership between Honeywell and Shanghai New Changning Group to deploy electricity demand side management technologies in the Changning District of Shanghai;

[**] One SDR, a standard of value used by the International Monetary Fund and based on a basket of major currencies, was valued at approximately $1.53 on January 7, 2014.

- An agreement between OSIsoft and China Southern Grid to collaborate on a smart grid technology pilot project showcasing capabilities, data integration and data management; and
- A contract between Lockheed Martin and the Reignwood Group to provide the business framework for the future development of Ocean Thermal Energy Conversion technology (OTEC), leading to the building of the world's first 100 MW OTEC utility-scale production plant in China.

These latest energy agreements are the byproduct of the U.S.-China Ten-Year Framework for Cooperation on Energy and the Environment, established in June 2008, which includes action plans for cooperation on energy efficiency, electricity, transportation, air, water, wetlands, nature reserves, and protected areas.

Market Access for U.S. Beef

In December 2003, China imposed a ban on U.S. live cattle, beef, and beef products due to the detection of a BSE-positive[††] animal in the United States in 2003. Since that time, the United States has repeatedly provided China with extensive technical information on all aspects of U.S. BSE-related surveillance and mitigation measures. But China continues to maintain barriers to U.S. beef and beef product exports that are inconsistent with international standards of the World Animal Health Organization (OIE).[‡‡] At the 2013 JCCT, both sides agreed to "strive for the resumption of U.S. beef access by July 2014 on the basis of mutually agreed conditions," but the statement failed to elaborate or provide any specifics. The USDA spokeswoman said that U.S. and Chinese regulatory agencies will "continue to cooperate on beef access," but that no meetings have been scheduled.[20]

Market access for U.S. meat exports is not new to JCCT talks. In 2011, the two countries already agreed to resume talks on beef. Nonetheless, by placing a specific date on beef access, the 2013 commitment is significant. In 2009, China agreed to reopen its market for U.S. pork, and promptly enforced it. The question is whether access will be maintained in the long run; in the case of pork, China subsequently introduced new market barriers.

Trade Secret Protection

China's National Leading Group on Combating IPR Infringement and the Manufacture and Sales of Counterfeit and Substandard Goods committed, as a priority item in its 2014 action plan, to adopt and publish a program to combat trade secret theft.

The action plan is expected to include "concrete enforcement actions; improvements of public awareness about the importance of not infringing trade secrets and the penalties for infringement; and requirements for strict compliance with all laws, regulations and measures on trade secret protection and enforcement by all enterprises and individuals," according to the fact sheet.[21]

China also committed to provide the U.S. with updates on this plan, and to "give serious consideration to U.S. legislative reform proposals," according to the fact sheet.

Patent Processing for Pharmaceutical Products

[††] Bovine spongiform encephalopathy, commonly known as the "mad-cow disease."
[‡‡] For more information, please refer to Chapter 1.4 of the *USCC 2014 Annual Report.*

China "re-affirm[ed] that the Chinese Patent Guidelines permit patent applicants to file additional data after filing their patent applications," according to the JCCT fact sheet. This is potentially a significant development, because Chinese regulators have been holding up or invalidating U.S. pharmaceutical patents by charging that the application contains insufficient information, without allowing companies to supplement information after the initial filing. [22]

The United States has lobbied actively for pharmaceuticals at past JCCT meetings but secured less specific commitments. In 2012, China agreed to "define new chemical entities in a manner consistent with international research and development practices in order to ensure regulatory data of pharmaceutical products are protected against unfair commercial use and unauthorized disclosure." In 2010, China agreed to "actively protect undisclosed pharmaceutical data required for marketing approval from unfair commercial use as well as to study the concrete measures for improving implementation thereof."[§§]

Sector Spotlight: Natural Gas

Natural gas is becoming a prominent feature of cooperation between the United States and China. A White House statement released on December 5, 2013 pointed to three areas in which the two countries will cooperate in this sector:

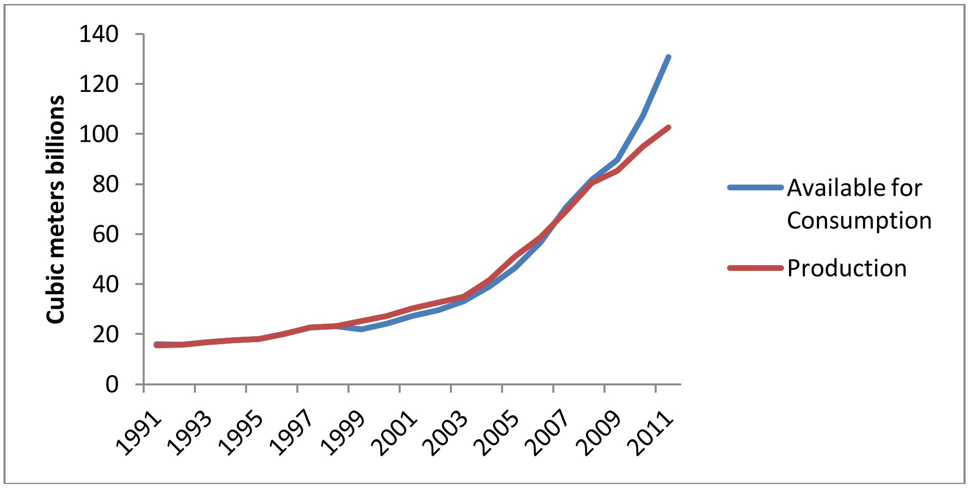
- *Unconventional gas development in China:* The United States voiced support for China's shale gas development, and China stated that it welcomes the participation of international private businesses and investors in this sector. The United States committed to engage with China on technological innovation, environmental supervision, and resource regulation in the shale gas sector, in the interest of energy security and energy market stability.
- *U.S. oil and gas technology exports*: The United States committed to "actively encourage" the export of technologies and equipment related to oil and gas exploration and development to China. Some deep-water oil and gas and shale gas exploration and development-related technology and equipment for civilian end users and civilian end uses in the United States are subject to export controls. The U.S. government committed to ensure that China's "specific requests" for such technology receive "all necessary information required under the Export Administration Regulations."
- *U.S. liquefied natural gas (LNG) exports*: In a sign that China is interested in importing more LNG from the United States, the U.S. government said it "commits to inform China about the statutory process required by the Natural Gas Act (NGA) which governs the evaluation of liquefied natural gas (LNG) export applications, to FTA countries and to non-FTA countries such as China." To date, only one final and four conditional license approvals have been granted to export LNG to non-FTA countries. The U.S. Department of Energy (DOE), which evaluates pending applications on a case-by-case basis, pledged to "keep the National Energy Administration of China informed of the status of the process."[23]

Since the mid-2000s, China has exhibited a strong interest in natural gas. Both production and consumption have seen steep increases, albeit from a low base (see figure 6). Since 2009, consumption has outstripped production, leading to a rapid rise in imports (see figure

[§§] "Fact Sheet: 23rd U.S.-China Joint Commission on Commerce and Trade Fact Sheet" (Washington, DC: U.S. Department of Commerce, December 19, 2012). *http://www.commerce.gov/news/fact-sheets/2012/12/19/fact-sheet-23rd-us-china-joint-commission-commerce-and-trade*; [§§] "Fact Sheet: 21st U.S.-China Joint Commission on Commerce and Trade Fact Sheet" (Washington, DC: U.S. Department of Commerce, December 15, 2010). *http://www.commerce.gov/news/fact-sheets/2010/12/15/fact-sheet-21st-us-china-joint-commission-commerce-and-trade*.

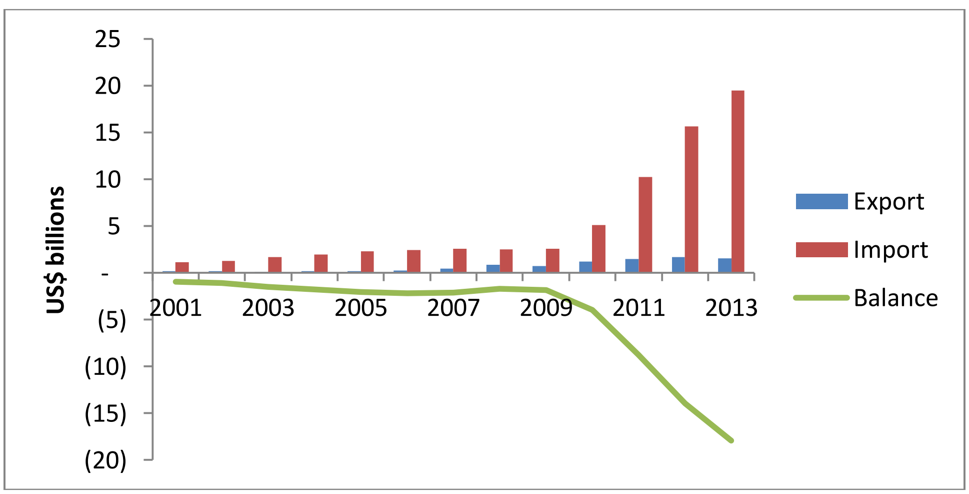
7). In the first ten months of 2013, natural gas accounted for 8 percent of China's energy imports, up from just 2 percent in 2006. The increase in import share is remarkable, considering the rapid increase in China's petroleum and coal imports during the same period.

Figure 6: Natural Gas Production and Consumption, October 2001-2011
(cubic meters billions)



Source: National Bureau of Statistics, via CEIC data.

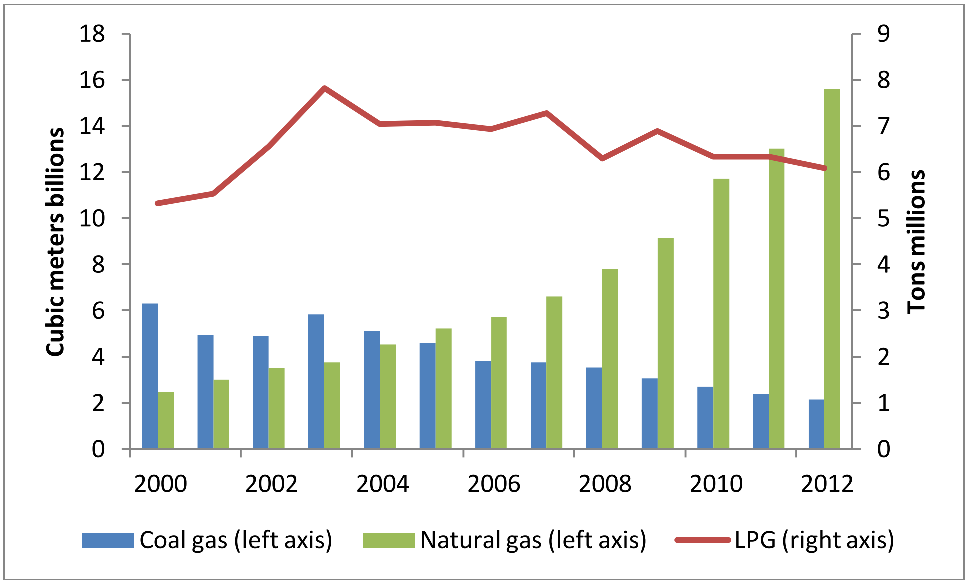
Figure 7: China's Natural Gas Trade, October 2001-2013
(YTD, in US$ billions)



Source: China General Administration of Customs, via CEIC data.

Natural gas is poised to figure prominently in three areas of China's energy mix: residential, transportation, and power generation. So far, it has made only a small dent on the power generation side, accounting for less than five percent of the total. As in most countries, gas still plays only a minor role in transportation. However, in terms of residential gas consumption in China, natural gas is already displacing coal gas and liquefied petroleum gas (see figure 8).

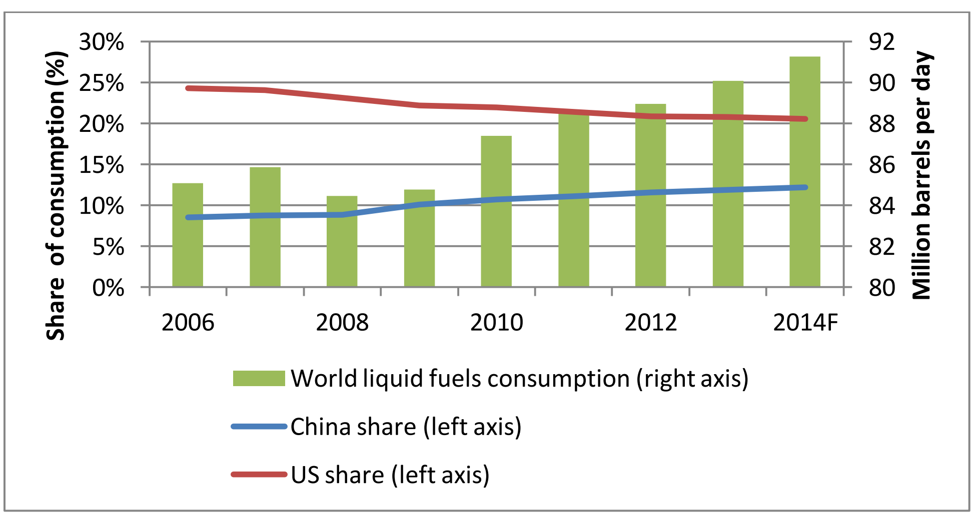
Figure 8: Urban Residential Gas Consumption in China, 2001-2012



Source: National Bureau of Statistics, via CEIC data.

China's suboptimal energy mix has been a key incentive to promote natural gas. Despite being the third-largest non-OPEC oil producer, China relies on imports for over half of its oil consumption. China is now the world's top importer of oil, ahead of the United States, and it is also closing in on the United States as the top oil consumer (see figure 9). Reliance on oil imports presents risks not only to China's energy security and price stability, but also has ramifications for its outbound investments and overseas lending. The death of Hugo Chavez in Venezuela last spring raised questions about the long-term viability of China's oil-for-loans strategy. The recent threat of civil war in Sudan and Iraq, and the uneasy relations between Iran and the United States, illustrate the diplomatic complications of importing oil. China is making substantial efforts to import more oil via pipelines, but in the medium term, this is unlikely to resolve the strategic dilemma of shipping Middle Eastern oil through the Malacca Straits.

Figure 9: China and U.S. Share of World Liquid Fuels Consumption



Source: U.S. Energy Information Administration.

China's domestic energy resources also present difficulties. Coal, which accounts for about four-fifths of China's energy mix, is the country's primary source of pollution and CO2 emissions. Efforts to mitigate this pollution through clean coal technologies will take time and demand substantial investment. The build-out of hydropower dams, begun in the 1990s, is proceeding at a rapid pace, but is incurring opposition from neighboring states as well as environmental groups. China is leading the world in installed wind and solar power, but misguided policies have led to industrial overcapacity, poor site selection, and a lack of grid connectivity.

Two questions are of strategic interest to the United States. One is whether China's gas consumption will come mainly from imports, or from domestic production. Many policymakers in China are keen to copy the U.S. model of developing domestic unconventional gas through public-private partnerships, pointing to the Department of Energy's (DOE) prudent decision to fund research in the 1970s, when the U.S. economy was hit by oil shocks. But others realize that China faces many constraints in copying this model, including a lack of water for fracking; more challenging geological formations; and major institutional constraints, such as the dominance of state-owned enterprises in oil and gas prospecting and drilling.

If China opts instead for more imports, it may eventually turn to the United States. The value of U.S. oil and gas exports increased at a 16.8 percent annualized rate in 2000-2012, an indication that the United States is becoming an energy exporter; and yet, less than one percent of these exports go to China. For now, China imports most of its gas via pipelines from Turkmenistan and Russia.

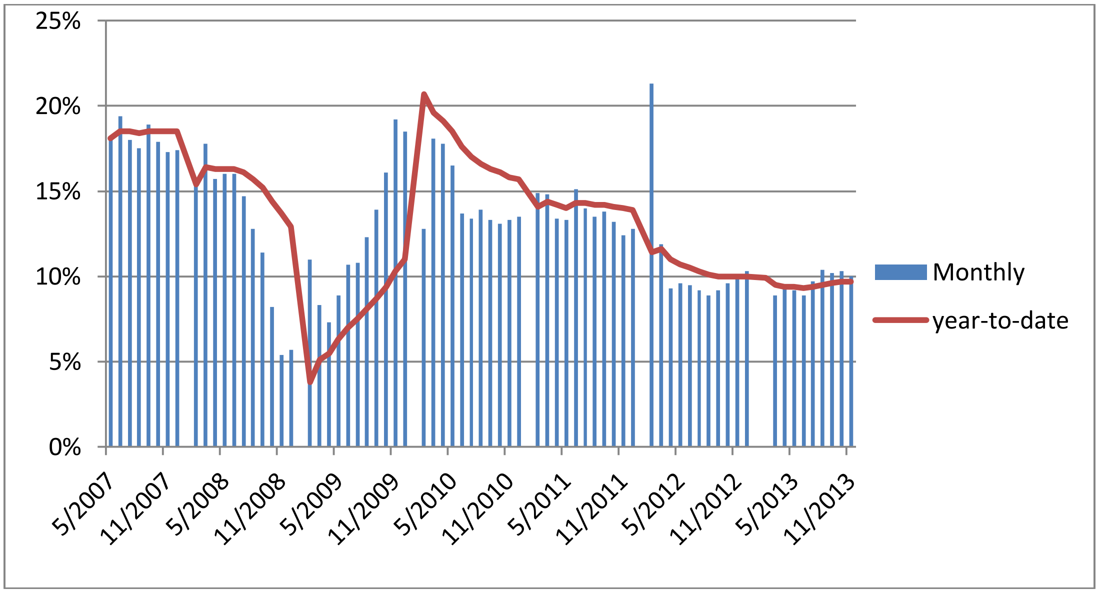
China's Economy

High GDP Growth Expected Despite Sluggish Activity

As China prepares to publish its GDP figures for the fourth quarter of 2013, forecasts have been bullish. Twenty-four analysts polled by Reuters in early January predicted 7.8 percent expansion.[24] That would prolong the rebound that began in the third quarter, when GDP grew by 7.8 percent, defying a slowdown in the first half of the year.[25] On an annual basis, China is poised to meet or exceed the 7.5 percent target set for 2013. A report by China's cabinet, released by the state-run news agency Xinhua in late December, forecasts 7.6 percent GDP growth for the year, in between the government's target of 7.5 percent and the 7.7 percent recorded in 2012.[26] *The Economist* predicts 7.7 percent growth, up 0.2 percentage points from its earlier estimates.[27] All indications are that the Communist Party will maintain the same growth target of 7.5 percent for 2014.[28]

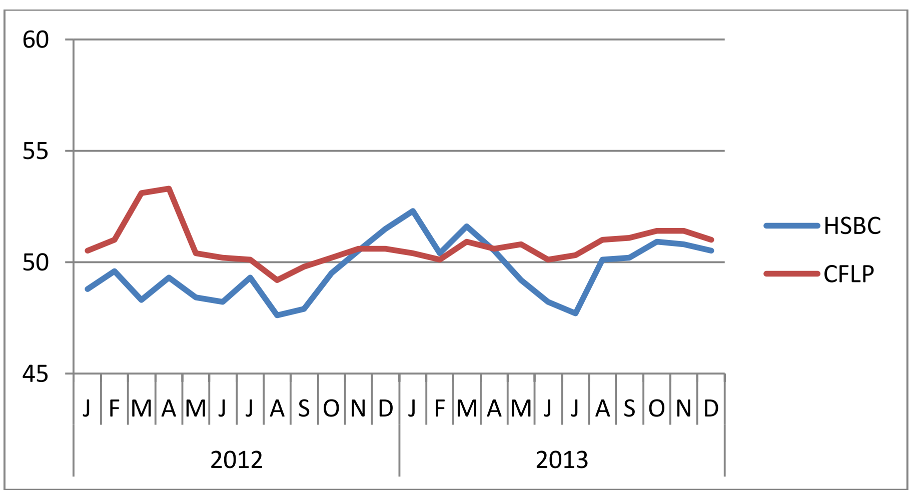
China's ability to sustain high growth is somewhat surprising, given the fickle performance of key indicators. Industrial output data, available to November, shows some pickup in factory activity in the fourth quarter of 2013, but viewed year-to-date, it has been weak (see figure 10). The latest Purchasing Managers' Index (PMI) suggests reduced confidence among manufacturers (see figure 11).

Figure 10: Industrial Output in China through November 2013



Source: National Bureau of Statistics, via CEIC data.

Figure 11: Purchasing Managers' Index through December 2014: HSBC and CFLP PMI compared
(<50 = contraction, >50 = expansion)

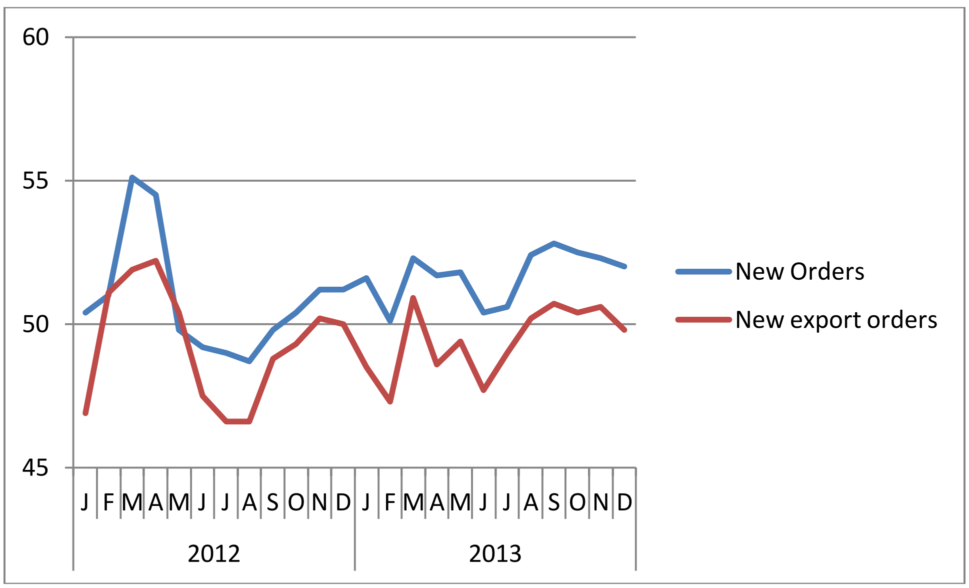


Source: China's National Bureau of Statistics, via CEIC data; HSBC Purchasing Managers' Index. http://www.hsbc.com/1/2/emerging-markets/em-index/purchasing-managers-index.

Export growth jumped in November to 12.7 percent, up from 5.6 percent in October and negative 0.4 percent in September. In absolute terms, China in fact recorded the largest trade surplus in more than four years. That increase topped projections from 41 of 42 analysts surveyed by Bloomberg News.[29] However, there has been speculation that, just as in 2012, China's year-end customs data is flawed. Many companies use over-invoicing of export receipts in order to circumvent China's strict capital controls, which restrict the amount of money that can be freely transferred in and outside the country. China's State Administration of Foreign Exchange (SAFE) issued tough measures to crack down on this practice last spring, but was forced to issue another notice on December 7 to "boost scrutiny" of trade financing and tell banks to prevent companies from getting financing based on fabricated trade.[30]

Other gauges of export activity also cast doubt on the customs figures. Zhang Zhiwei, chief China economist at Nomura Holdings Inc., noted that industrial-production figures showed goods for export advancing only 5.8 percent in November.[31] Producer surveys tell a similar story. The HSBC survey's sub-index for new export orders hit a four-month low of 49.1 in December, the first time since August that it dropped below 50 points. Similarly, the official PMI showed new export orders contracted for the first time since July (see figure 12).[32] Xu Shaoshi, the head of the National Development and Reform Commission, China's top economic planning body, told lawmakers in a December briefing that uncertainties remained in the global economic recovery, as the international market had failed to produce strong demand.[33]

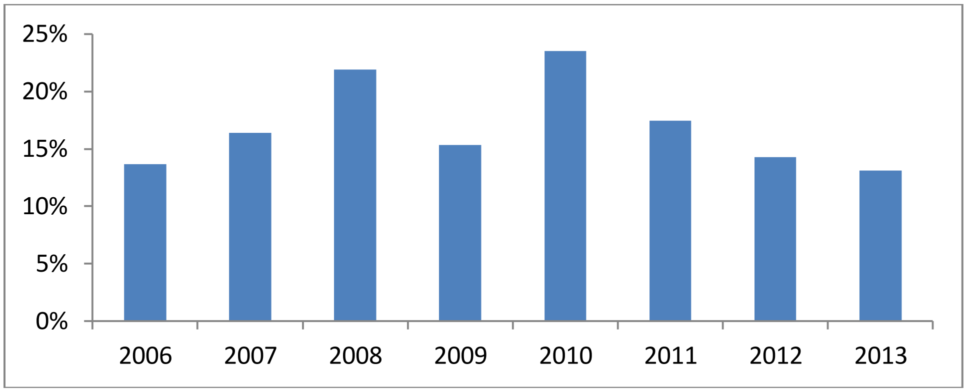
Figure 12: CFLP Purchasing Managers' Index through December 2014: New Orders and New Export Orders
(<50 = contraction, >50 = expansion)



Source: China's National Bureau of Statistics, via CEIC data; HSBC Purchasing Managers' Index. http://www.hsbc.com/1/2/emerging-markets/em-index/purchasing-managers-index.

Domestically, retail sales have shown signs of picking up at the end of the year. China's passenger vehicle sales rose 16 percent in November, according to the state-backed China Association of Automobile Manufacturers.[34] Online shopping discounts associated with "Singles' Day" on Nov. 11 helped fuel retail sales.[35] However, cumulative retail sales growth in 2013 has been 13.1 percent, down from 14.3 percent in 2012 and 17.4 percent in 2011 (see figure 13).

Figure 13: Retail Sales Growth in China, 2006-2013
(YTD November, year-on-year %)

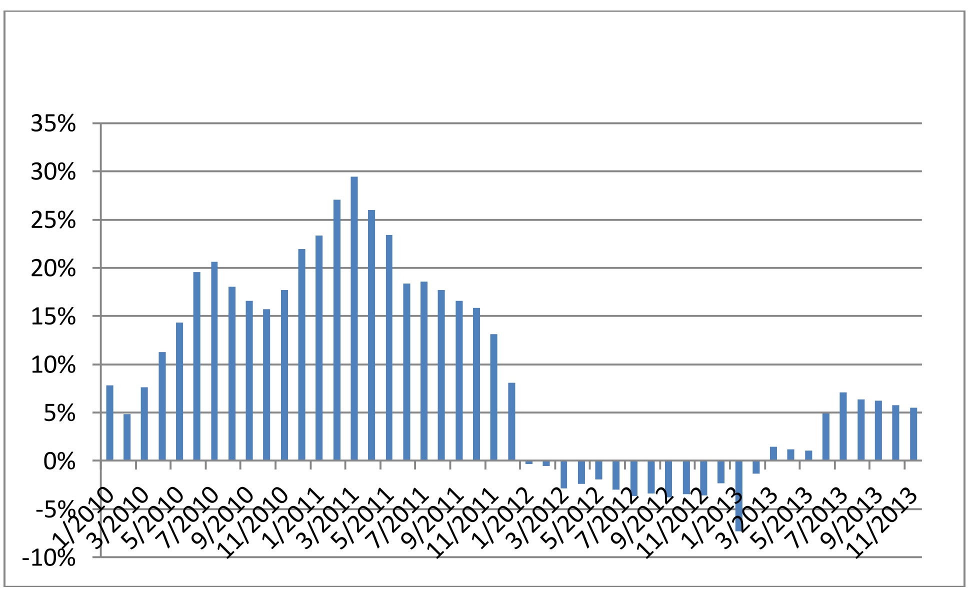


Source: National Bureau of Statistics, via CEIC data.

Fixed asset investment, consistently the principal driver of China's economic growth, grew by 19.9 percent in the first 11 months of the year. Although this was a high growth figure, it was largely attributable to state-owned enterprises (SOEs). SOE investment was likely spurred by a mini-stimulus to prop up a slowing economy, as the government unveiled new efforts to build subways and other infrastructure projects. By contrast, fixed investment by foreign-funded ventures grew by just 4.7 percent, compared to 14.5 percent in 2012.[36] Inward foreign direct investment (FDI) has grown above 5 percent throughout the second half of 2013, a clear turnaround from 2012. Still, FDI growth has decelerated each month since July, and remains well below the 2010-2011 figures (see figure 14).

According to analysts, foreign companies are concerned about China's rising labor costs; the effect of the slowing economy on the middle class's demand for goods; and how the many market reform guidelines released by the Chinese Communist Party's top leaders at the Third Plenum in November will play out.[37]

Figure 14: Foreign Direct Investment in China
(monthly, year-on-year, %)



Source: China Ministry of Commerce, via CEIC data.

Central Bank between Austerity and Stimulus

In the financial sector, events over the past month illustrated the ambivalence among Chinese policymakers about how to tackle the country's rising debt burden. On December 20, the seven-day bond repurchase rate, a key gauge of short-term liquidity, averaged 7.6 per cent – the highest since the crunch that hit China in late June.[38] The rate hike sent renewed shockwaves through China's banking sector. According to many bankers, the problem was of the government's own making. China's banks were scrambling for short-term cash to meet year-end regulatory requirements, under which outstanding loans can total no more than 75 percent of deposits. Chinese companies and local government financing vehicles, also strapped for cash, sought to borrow from banks to meet year-end payments of their own.[39] But the central bank, in an effort to discipline the banks and rein in China's debt, refused to add liquidity to the market in early December. The move echoed similar measures used in June during the previous credit crunch; at the time, the economy emerged relatively unscathed, with the central bank guiding money market rates to levels roughly 150 basis points higher than before the crunch.[40]

But the central bank's policies in December led to a hike in borrowing rates that was higher than expected. The central bank was forced to conduct a "short-term liquidity operation (SLO)" on December 20, a highly unusual measure. According to the central bank's own rules, it is meant to announce SLOs one month after their implementation, but on this occasion it broke the rule. Even this injection was not effective initially, as interest rates continued to surge on the next day of trading.[41] A day later, the central bank was forced to inject fresh money into the markets, a move that finally brought interest rates back to stable levels.[42] Chinese Premier Li Keqiang also sought to reassure the public, stating during a speech in Tianjin that the government will keep liquidity at an appropriate level in 2014.[43]

Some analysts interpreted the PBOC's actions as a positive sign that the government is getting serious about the country's debt. Goldman Sachs forecasted last month that bad loans at China's biggest banks could nearly double by 2015, to more than RMB 1 trillion ($164 billion).[44] A new report by China's National Audit Office has stated that debt and guarantees issued by local governments rocketed 67 percent to RMB 17.9 trillion ($2.95 trillion) in mid-year 2013 since the last tally at the end of 2010. Nearly half of that debt comes due by the end of 2014 – Standard Chartered economist Stephen Green sees a better-than-50 percent chance that a local-government bond will default in 2014. According to Fitch Ratings, China's domestic debt, including local governments, state-owned enterprises, real-estate developers and individuals, now stands at 216 percent of GDP, up from 128 percent in 2008, and could climb to 271 percent by 2017 if not corrected.[45]

Nonetheless, others questioned whether the central bank's austerity measures were the right way to go. According to Lu Ting, an economist with Bank of America Merrill Lynch, the central bank's refusal to inject liquidity shows that the institution is "confused" and "is much more likely than before to make [operational] mistakes."[46] Precisely because more money is now deposited outside of traditional bank accounts, particularly in "wealth management products" and online money market funds, banks have been forced to take greater risks in order to compete for deposits, while still meeting the central bank's rigid loan-to-deposit ratios at year's end.[47] In a sign of more of the same, the central bank in December issued "Document No.9", which suggests lowering the loan-to-deposit ratio from 75 percent to 50 percent. The *Financial Times* predicted that this rigid measure will only make things worse, as banks will seek new loopholes, such as disguising loans behind exotic financial instruments.[48]

Financial Reform in the Wake of the Third Plenum

While the central bank measures in December were poorly calculated, the November Third Plenum has provided momentum for more meaningful financial reform. In an important step toward interest rate liberalization, the central bank in early December announced the launch of certificates of deposit, financial instruments that will allow banks to trade deposits between each other at market-determined interest rates.[49] This was the first decisive move to liberalize interest rates since the central bank eliminated the floor on lending rates in July. The rates determined in the interbank market could lay the groundwork for a market-determined benchmark interest rate.

Concurrently, China's State Council announced that it would allow all qualified small and medium-sized enterprises to raise capital in the over-the-counter (OTC) market. The OTC market focuses on facilitating private placements in smaller Chinese firms, which have had difficulty borrowing from state-owned banks and listing on China's stock exchanges. The reform follows announcements that regulators will allow China's IPO market to restart in early 2014.[50]

China has also decided to allow local governments to issue bonds as a way of rolling over their debt to avoid defaults. Not all local governments are permitted to issue bonds, and the new measure does not go that far. Instead, the National Development and Reform Commission, which issued the measure, is looking for ways to relieve local government debt that is coming due.[51]

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