CHAPTER 1
2019 IN REVIEW
SECTION 1: YEAR IN REVIEW:
ECONOMICS AND TRADE

Key Findings

• On-and-off trade negotiations between the United States and China to resolve a years-long trade dispute have failed to produce a comprehensive agreement. The impasse in negotiations underscores, in part, China’s commitment to preserving the government’s dominant role in determining economic outcomes.

• The United States is confronting China in response to decades of unfair Chinese economic policies and trade-distorting practices. The Chinese Communist Party (CCP) increasingly perceives U.S. actions as an attack on its vision for China’s national development. China’s government has intensified nationalist rhetoric criticizing the United States, applied pressure on U.S. companies, and targeted key U.S. export sectors with tariffs in response.

• U.S. measures to address illegal activities by Chinese technology companies are leading China’s government to push harder on technological self-reliance. The reinvigoration of the state-driven approach to innovation will pose a sustained threat to U.S. global economic competitiveness and national security.

• A range of domestic factors and trade tensions with the United States have slowed China’s economic growth. In response, China’s government has deployed infrastructure spending, tax cuts, and targeted monetary stimulus. While the stimulus enabled a modest recovery during the first half of 2019, China’s rate of growth continues to slow.

• China’s government continues to falsify official economic statistics, obscuring the true extent of its current economic slowdown. Independent observers estimate that China’s true growth rate is at least 0.5 percentage points—and possibly as much as 3 percentage points—lower than Beijing’s published figures.

• Beijing’s deleveraging campaign has succeeded in containing China’s corporate debt growth, but local governments continue to borrow. Expanding household debt and a rapid increase in the value of nonperforming loans also pose significant risks to
China’s financial system and are a major challenge for Chinese policymakers.

- China’s state sector is strengthening and private companies are struggling. The deleveraging campaign and related crackdown on shadow banking had the unintended effect of cutting off credit to the private sector, which traditionally relies on informal finance.

- China’s government has taken limited market opening steps, including incremental liberalization of China’s foreign investment regime and financial system. However, these measures have been pursued in terms favorable to the Chinese government as opposed to the market, underscoring that any changes in China’s economic practices will continue to be controlled by the state.

**Introduction**

Historic patterns in the U.S.-China economic relationship are being disrupted as bilateral trade frictions take deeper hold. While the U.S. deficit in goods trade with China reached a record $419.5 billion in 2018, the trade imbalance narrowed in 2019 as bilateral tariff actions impacted imports and exports and reconfigured trading patterns and relationships. The Chinese government’s commitment to preserving its dominant role in determining economic outcomes has made reaching a comprehensive agreement increasingly difficult.

Trade tensions exacerbated a slowdown in China’s economy in 2019, with gross domestic product (GDP) growth falling to nearly three-decade lows. The Chinese government deployed moderate stimulus measures in response, approving $184.1 billion in new infrastructure spending, rolling out tax cuts for businesses, and encouraging banks to lend more to the private sector. While these efforts contributed to a modest recovery in the first half of 2019, they have not stopped China’s broader economic slowdown, and key indicators point to continued challenges ahead.

This section examines key developments in U.S.-China bilateral trade and economic tensions, as well as China’s domestic and external economic rebalancing. For analysis of China’s economic vulnerabilities, see Chapter 2, “Beijing’s Internal and External Challenges.” The activities of U.S. companies in China and Chinese companies in the United States are discussed in Chapter 3, Section 1, “U.S.-China Commercial Relations.” For analysis of U.S.-China competition in emerging technologies, see Chapter 3, Section 2, “Emerging Technologies and Military-Civil Fusion: Artificial Intelligence, New Materials, and New Energy.” U.S.-China links in health and medical products are discussed in Chapter 3, Section 3, “Growing U.S. Reliance on China’s Biotech and Pharmaceutical Products.”

**U.S.-China Trade**

The United States has pursued and supported China’s greater economic opening since relations were normalized in 1979. However, the Chinese government chose to retain or even strengthen many
of the features of the command economy. U.S. efforts to address the Chinese government's market-distorting practices have intensified since 2018, with the United States imposing 15–25 percent tariffs covering $362 billion worth of imports from China, and China responding with 5–25 percent tariffs covering $139 billion worth of U.S. exports as of October 2019.¹ Reciprocal tariff actions narrowed the U.S. goods trade deficit with China to $231.6 billion in the first eight months of 2019, an 11.4 percent decline year-on-year (see Figure 1).²

**Figure 1: U.S. Goods Trade Deficit with China, Quarterly, 2017–Q2 2019**

![Graph showing U.S. goods trade deficit with China, quarterly, 2017–Q2 2019.](image)

Source: U.S. Census Bureau, *Trade in Goods with China*.

The fall in the U.S.-China goods trade in 2019 reflects deeper shifts in bilateral trading patterns as tariffs take hold. Both the United States and China are stepping up engagement with other trading partners and U.S. and Chinese firms are beginning to recalibrate supply chains to circumvent reciprocal tariff actions, albeit in limited ways.³ U.S. imports of Chinese computer and electronic products, a top import category, fell 19.4 percent year-on-year to $70.7 billion through the first six months of 2019 as a result of U.S. tariff actions, with U.S. importers upping purchases from Vietnam, South Korea, and Taiwan.⁴ Because foreign-invested enterprises operating in China produced 87 percent of China’s exports of computer and electronic products in 2018, U.S. tariffs are driving some of these enterprises to consider shifting production away from China.⁵

Retaliatory Chinese tariffs have surgically targeted top U.S. exports to China, including transportation equipment and agricultural products (see Table 1). U.S. exports of transportation equipment—the top U.S. export to China in 2018—fell 22 percent year-on-year in the first six months of 2019, and are expected to fall further.⁶
U.S. exports of agricultural products* were also hard hit by Chinese retaliatory tariffs, declining by 21 percent year-on-year in the first six months of 2019 as China pushed to bolster domestic soybean cultivation and increased imports of the good from South American trading partners.7

Table 1: U.S. Trade with China, Top Five Exports and Imports, January–June 2019

<table>
<thead>
<tr>
<th>Top Five U.S. Exports to China</th>
<th>Top Five U.S. Imports from China</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Exports (US$ billions)</strong></td>
<td><strong>Change over H1 2018</strong></td>
</tr>
<tr>
<td>Transportation Equipment</td>
<td>9.7</td>
</tr>
<tr>
<td>Computers and Electronic Products</td>
<td>9.4</td>
</tr>
<tr>
<td>Chemicals</td>
<td>8</td>
</tr>
<tr>
<td>Nonelectrical Machinery</td>
<td>5.3</td>
</tr>
<tr>
<td>Agricultural Products</td>
<td>3.9</td>
</tr>
<tr>
<td>Other</td>
<td>15.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>52</strong></td>
</tr>
</tbody>
</table>


Impact of the African Swine Fever Outbreak

In August 2018, hogs in China’s Liaoning Province tested positive for African swine fever. The disease is not harmful to humans but is highly contagious and deadly to pigs. As of August 2019, African swine fever has been identified in all of China’s provinces and significantly reduced the country’s hog population by 38.7 percent.8 The shortage also increased the price of pork in China almost 50 percent year-on-year in August.9

The epidemic is decreasing Chinese demand for animal feed products such as soybeans and sorghum and increasing Chinese demand for pork. U.S. exports of both product categories are sub-

*Punitive Chinese tariffs on U.S. agricultural exports exacerbate other unfair Chinese trade practices, including the opaque application of tariff-rate quotas (TRQs). TRQs are tiered tariffs, with a set volume of imports taxed at a lower level while subsequent imports are charged a higher rate. While China’s World Trade Organization commitments call for these quotas to serve as a transparent way for foreign farmers to access China’s market, China’s uneven application and underutilization of them restricts access for U.S. farmers, protects domestic farm interests, and serves as a trade barrier. For more on U.S.-China agricultural trade, see U.S.-China Economic and Security Review Commission, Chapter 1, Section 3, “China’s Agricultural Policies: Trade, Investment, Safety, and Innovation,” in 2018 Annual Report to Congress, November 2018.
The United States continues to run a trade surplus with China in services,* but the pace of growth in U.S. services exports is slowing. In 2018, the United States posted a record $38.8 billion services trade surplus with China, up less than 1 percent from $38.5 billion in 2017 (see Figure 2). The United States posted a record $38.8 billion services trade surplus with China, up less than 1 percent from $38.5 billion in 2017 (see Figure 2). In 2018, services exports to China grew to $57 billion and imports reached $18.3 billion, a modest 2 percent and 5.1 percent increase, respectively, relative to higher growth rates seen in 2017. The deceleration in U.S. services exports growth to China is caused by a fall in Chinese tourism to the United States, a top U.S. services export.† In 2018, 2.9 million Chinese travelers visited the United States, a 6 percent year-on-year decline that reversed a 24 percent average annual growth rate in tourism over the prior decade. The Chinese government’s inflammatory rhetoric associated with the trade dispute, including travel advisories issued by the Ministry of Culture and Tourism warning Chinese travelers of potential harassment by U.S. authorities, as well as a slowing Chinese economy, contributed to the decline.20

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The United States’ trade deficit in advanced technology products with China narrowed by 26.6 percent year-on-year to $46.7 billion in the first six months of 2019. U.S. imports of Chinese information and communication technology products—the largest import product category for U.S.-China advanced technology products trade—fell 21.2 percent in the first six months of 2019 as U.S. tariffs targeting Chinese information and communication technology products took effect. A nearly 50 percent uptick in U.S. exports of electronics to China in the first six months of 2019 further narrowed the deficit in advanced technology products, as U.S. exporters rushed to complete sales prior to tightened U.S. export controls on select technology goods.

Bilateral Economic Tensions

After the Office of the U.S. Trade Representative (USTR) published in March 2018 its Section 301 report concerning China's unfair trade practices related to technology transfer, intellectual property (IP), and innovation, it has pursued related tariff actions. Since then, the United States and China have held 13 rounds of high-level negotiations as of October 2019. However, a resolution of U.S.-China trade tensions remains uncertain. The United States wants China to correct a range of market-distorting policies, and

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*Advanced technology products (ATP) are a broad range of high-technology goods, including advanced elements of the computer and electronic parts industry, biotechnology, aerospace, and nuclear technology. U.S. Census Bureau, “Trade Definitions.” [https://www.census.gov/foreign-trade/reference/definitions/index.html](https://www.census.gov/foreign-trade/reference/definitions/index.html).

†The Chinese government deploys a range of market-distorting and anticompetitive trade practices that contravene the commitments it made when it acceded to the World Trade Organization. These include subsidies, industrial espionage, tariffs and local content requirements, restrictions on foreign ownership, forced technology transfers, technical standards that promote Chinese technology usage and licensing, and data transfer restrictions, among others. For further discussion of Chinese trade distortions, see U.S.-China Economic and Security Review Commission, Chapter 1,
has pushed Beijing to codify commitments to structural economic reforms that strengthen IP protection, prohibit forced technology transfer, and eliminate subsidies. Chinese negotiators demand that any agreement eliminate tariffs imposed by the Trump Administration, refrain from imposing future duties, ensure a deficit-reducing list of Chinese purchases of U.S. goods is in line with real demand in the Chinese economy, and, nebulously, respect China’s “[national] dignity.” In May 2019, U.S. negotiators accused China of reneging on commitments made in a draft deal. The resulting impasse triggered a range of policy actions, including: the United States increasing tariffs covering $200 billion in U.S. imports from China from 10 percent to 25 percent; President Donald Trump directing the USTR to identify an additional $300 billion in U.S. imports from China to be subject to 25 percent tariffs; and China raising tariff rates on $60 billion worth of Chinese imports from the United States to a maximum of 25 percent.

Tensions escalated further in August 2019 amid charges from the Trump Administration that China failed to follow through on promises to make large purchases of U.S. agricultural goods and curb fentanyl flows to the United States. The United States subsequently announced new 10 percent tariffs on an additional $272 billion worth of imports from China, with tariffs on a first list of $112 billion worth of imports implemented in September 2019 and tariffs on a second list covering $160 billion to be implemented in December 2019. The Trump Administration increased these new tariffs to 15 percent, and also threatened to hike current 25 percent tariffs on $250 billion worth of imports from China to 30 percent on October 1, 2019, following retaliatory tariff actions from the Chinese government. This tariff hike was delayed after select tariff exemptions by the Chinese government ahead of high-level trade talks to be held in mid-October (see Figure 3).

U.S. Companies Respond to Tariffs’ Supply Chain Impact

The trade dispute between the United States and China has affected a wide range of multinational businesses with operations in both countries. Though U.S. tariffs on Chinese imports have endeavored to target products in sectors determined by the USTR to unfairly benefit from Chinese industrial policies, they have also disrupted the supply chains of U.S. firms that import intermediate inputs from China. Amid uncertainty concerning the trajectory of bilateral trade negotiations, a growing number of U.S. firms are considering or implementing adjustments of their supply chains to relocate production out of China to other emerging markets. This dynamic is especially true for U.S. technology firms, with Apple moving some of its production to India and Vietnam, and Dell and Hewlett-Packard considering moving production to Taiwan, Vietnam, or the Philippines. Other companies have also considered a “China plus one” strategy in which they relocate portions of production to Southeast Asia while continuing to manufacture in China for the Chinese and non-U.S. markets.

Figure 3: Timeline of U.S.-China Trade Tensions, 2019

Source: Created by Commission staff.
The disruptive effects of U.S. tariffs on imports from China are underscored in a 2019 survey conducted by the American Chamber of Commerce in Shanghai.* According to the survey, less than half (47.1 percent) of U.S. companies expect to increase their investments in China—versus 61.6 percent in 2018—as a result of trade frictions.36 Separately, 26.5 percent of U.S. firms have redirected investments originally planned for China to other regions, an increase of 6.9 percentage points from 2018, citing a need to guard supply chains against further degradations in U.S.-China trade relations and related tariffs.37 (For further discussion of U.S. companies’ operations in China, see Chapter 3, Section 1, “U.S.-China Commercial Relations.”)

China’s Response to U.S. Trade Actions

Because China cannot match U.S. tariffs dollar for dollar, it has also adopted informal measures to target the United States. Beijing stepped up the intensity of its nationalist rhetoric and threats toward the United States and deployed a range of informal barriers to trade, some of which are highlighted below.

Amplification of Nationalist Rhetoric

Prior to the May 2019 collapse of trade talks, Chinese officials and state-controlled media outlets avoided direct criticism of the United States in pursuit of a negotiated agreement. Following U.S. accusations that Chinese negotiators reneged on promises recorded in a draft agreement, the tone of Chinese reporting changed and hardened. For example, a May 25 editorial in state-run news outlet Xinhua argued that U.S. demands for China to curb subsidies for state-owned enterprises (SOEs) violated its economic sovereignty under the 1974 UN Charter of Economic Rights and Duties of States † by forcing China to make injurious changes to its fundamental economic system.38 General Secretary of the CCP Xi Jinping has further framed the breakdown in negotiations as a national hardship, invoking Mao-era imagery of a “new long march” and referring to “unfavorable factors at home and abroad.”39 Minister of Commerce Zhong Shan echoed General Secretary Xi in describing negotiations as a “national struggle” against U.S. “unilateralism and protectionism.”40 Read together, these rhetorical shifts underscore a tougher bottom line for Chinese officials in trade negotiations with the United States, and signal a willingness to prolong tensions until their demands are met.41

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*This survey of business membership was conducted from June 27 to July 25, 2019, and received 333 responses. By sector, 52.3 percent of respondents worked in manufacturing; 30.6 percent worked in services, and 17.1 percent worked in retail and distribution. American Chamber of Commerce in Shanghai, “2019 China Business Report,” September 11, 2019, 3.

†The charter does not codify, or even use the term, “economic sovereignty.” It does indicate states must ensure prices of goods traded internationally are equitable, stable, and remunerative (i.e., not subsidized to be sold below costs of production and dumped on world markets). UN Charter of Economic Rights and Duties of States, General Assembly Resolution 3281 (XXIX), 1974.
Reduction of Tariffs on Non-U.S. Goods

China has matched its increased tariffs on U.S. exports with reduced tariffs on imports from other countries, making U.S. products comparatively more expensive and exacerbating preexisting market access barriers. Analysis by the Peterson Institute for International Economics shows the average Chinese tariff rate on U.S. products has reached 21.8 percent as of September 2019 and will jump to 25.9 percent by year-end. In contrast, the Chinese government has lowered tariff rates on competing products from other World Trade Organization (WTO) member countries from 8 percent to 6.7 percent in the same period (see Figure 4).42

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Average Tariff Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 2018</td>
<td>8.0</td>
<td>United States</td>
</tr>
<tr>
<td>April 2, 2018</td>
<td>Retaliation to U.S. Section 232 tariffs</td>
<td>8.4</td>
</tr>
<tr>
<td>July 6, 2018</td>
<td>Retaliation to U.S. Section 301 tariffs (516 billion)</td>
<td>10.1</td>
</tr>
<tr>
<td>August 23, 2018</td>
<td>Retaliation to U.S. Section 301 tariffs against U.S. autos and parts</td>
<td>14.4</td>
</tr>
<tr>
<td>September 24, 2018</td>
<td>Retaliation to U.S. Section 301 tariffs (560 billion)</td>
<td>18.3</td>
</tr>
<tr>
<td>June 1, 2019</td>
<td>Tariff increase on some U.S. products (subset of $60 billion)</td>
<td>20.7</td>
</tr>
<tr>
<td>Sept 1, 2019</td>
<td>Tariff increase on some U.S. products (subset of $75 billion)</td>
<td>21.8</td>
</tr>
<tr>
<td>Dec 15, 2019</td>
<td>Tariff increase on some U.S. products (subset of $75 billion)</td>
<td>25.9</td>
</tr>
</tbody>
</table>

8.0 8.0 6.9 6.9 6.9 6.7 6.7 6.7 6.7

United States Other Exporters


Due to this strategic adjustment of duty rates, it is 12.7 percent less expensive in China to buy something imported from Canada, Japan, Brazil, or Europe than it is to buy something imported from the United States.43 In some cases, tariffs on U.S. products alone sufficed to redirect Chinese purchases, regardless of a reduction in tariffs on imports from other countries. Chinese soybean imports have shifted away from the United States toward Brazil and Argentina, for example, without any reduction of an existing 3 percent tariff rate on soybeans from those countries.44

Coercion against U.S. Companies

China often leverages its economic heft to apply coercive measures in moments of diplomatic stress, ranging from formal barriers to trade such as tariffs and investment restrictions to more informal tactics such as popular boycotts and pressure on specific multinational companies.45 Harassment of U.S. companies can include unwarranted tax investigations, slowed visa approval processes for foreign nationals working for U.S. firms in China, unannounced site inspections, uneven regulatory enforcement, and delayed customs
inspection procedures for U.S. goods arriving in Chinese ports. While public data on such disruptions are sparse, a 2019 U.S.-China Business Council survey found that 33 percent of U.S. businesses have reported increased scrutiny from Chinese regulators as a result of rising trade frictions, up from 28 percent in 2018. For example, following the U.S. Department of Commerce’s addition of Huawei to its Entity List, Chinese authorities opened an inquiry into U.S. international courier FedEx for allegedly harming “the legitimate rights and interests of customers” and violating “relevant laws and regulations of China’s delivery industry.”

Separately, officials from the National Development and Reform Commission (NDRC, China’s economic planning agency), Ministry of Commerce, and Ministry of Industry and Information Technology summoned representatives from major U.S. technology companies, including Microsoft and Dell, to warn they could face “dire consequences” if they limited their sales to Chinese companies.

### China Suspends WTO Case over Market Economy Status

In May 2019, China suspended a dispute it brought to the WTO in 2016 against the EU over China’s status as a nonmarket economy. China brought a nearly identical case against the United States, which remains open. In both cases, Beijing’s dispute claimed that under the terms of its 2001 WTO accession, China should have automatically qualified as a market economy effective in 2016. With the dispute suspended, the EU and the United States can continue to use proxy measures to calculate duties on dumped Chinese exports. Under WTO rules, the case may be taken up again anytime within the next 12 months, after which time the WTO’s authority to review the case will lapse.

The Chinese government did not publicly explain why it decided to suspend the case. That China’s decision came after the WTO reportedly ruled against it suggests it may have been driven by a desire to limit public disclosure of the WTO’s findings that Europe can continue treating China as a nonmarket economy. According to one unnamed trade official close to the case, China “lost so much that they didn’t even want the world to see the panel’s reasoning.” Public release of the WTO’s report would

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† Under U.S. antidumping law in the Tariff Act of 1930 (19 U.S.C. § 1677 [18]), the U.S. Department of Commerce determines whether a country is a nonmarket economy based on six criteria: (1) the extent to which the currency of the foreign country is convertible into the currency of other countries; (2) the extent to which wage rates in the foreign country are determined by free bargaining between labor and management; (3) the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country; (4) the extent of government ownership or control of the means of production; (5) the extent of government control over the allocation of resources and over the price and output decisions of enterprises; and (6) such other factors the administering authority considers appropriate. Tariff Act of 1930, Pub. L. No. 103–465, 1930, codified at 19 U.S.C. §1677 (18).

have validated the arguments by the EU, the United States, and other critics that China is a nonmarket economy at a moment when Beijing is already fielding extensive international scrutiny of its economic policies. Contrastingly, the associate dean of the School of WTO Research and Education at the Shanghai University of International Business and Economics suggested the decision served as a negotiation tactic in the ongoing trade dispute with the United States.56 (Ongoing U.S.-China WTO litigation is summarized in “Addendum I: WTO Cases.”)

Chinese Government Allows the Currency to Weaken against the Dollar

U.S.-China trade tensions, along with slowing growth in the Chinese economy and attendant monetary stimulus, have applied downward pressure on the renminbi (RMB). As a result, the currency depreciated significantly between March 2018—when the USTR published its Section 301 report—and August 2019 (see Figure 5).57

**Figure 5: RMB to U.S. Dollar Exchange Rate, 2018–August 2019**

![Graph showing the RMB to USD exchange rate from January 2018 to August 2019. The rate decreases from approximately 6.8 to 7.2 during this period.]

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

In August 2019, the People’s Bank of China (PBOC) allowed the RMB to weaken* past the psychologically important threshold of 7

*China maintains a “managed float” in which the government plays a fundamental role in setting the exchange rate. Specifically, the PBOC establishes a daily trading midpoint, and permits the RMB to fluctuate within a 2 percent intraday band from that point. The midpoint, or central parity rate, is determined based on a combination of the previous day’s close value and assessments of market fundamentals provided by major banks. The PBOC can also leverage its $3 trillion in foreign exchange reserves to manage the RMB’s value by, for example, selling its U.S. dollar holdings to prop up the value of the RMB. For a detailed discussion of how China’s
RMB to the U.S. dollar for the first time since 2008. The August depreciation of the RMB amplified U.S. concerns that the Chinese government may be deliberately allowing its currency to slide to make its exports more competitive and thereby offset the effects of U.S. tariffs, leading the U.S. Department of the Treasury to label China a currency manipulator for the first time since 1994.

In testimony before the Commission, expert on the Chinese economy Victor Shih observed that the PBOC “weaponized” the RMB in response to trade frictions. Separately, senior China economist at Capital Economics Julian Evans-Pritchard noted that the PBOC’s decision to let the RMB weaken suggests the Chinese government has abandoned hopes for a trade agreement with the United States.

Existing U.S. laws governing designation of currency manipulation offer inconsistent definitions of its practice and corresponding solutions, including bilateral negotiations—a step the United States has already taken in its ongoing trade dispute with China. In May 2019, the International Trade Administration of the Department of Commerce issued a proposal for currency manipulation to be considered a countervailable subsidy if Treasury determined a country was devaluing its currency. Some analysts note, however, that difficulties in measuring a currency’s deviation from its equilibrium value would complicate the calculation of related countervailing duties.

While a weakened RMB can provide China relief from U.S. tariffs, it also presents a range of possible negative consequences for China’s economy, including:

- **Potential for capital flight:** As the RMB weakens, wealthier households in China may be motivated to move their money out of China to protect their wealth, accelerating capital outflows and putting pressure on China's foreign exchange reserves.

- **Depressed consumption:** Imports from abroad, particularly commodities such as agricultural and energy goods—which are mostly priced in U.S. dollars—become more expensive as the RMB declines in value, placing downward pressure on consumption activity.

- **Difficulty paying foreign debt:** A weaker RMB makes it more difficult for Chinese companies that borrowed in dollars to repay their debts. Though economists debate the magnitude of China’s external debt, some estimate that Chinese firms and financial institutions owe nearly $3 trillion in dollar-denominat-
ed debt, approximately $215 billion of which will mature over the next two years.65

Chinese policymakers understand the risks of an extensive deprecation, and are trying to mitigate them. In August, the PBOC took steps to control RMB weakness by, for example, selling $4.2 billion worth of short-term RMB-denominated securities* in Hong Kong and attempting to set a stronger daily trading midpoint for the RMB in the days after it weakened past 7 RMB to the dollar.66 PBOC Vice Governor Pan Gongsheng issued signals to this effect in an op-ed, writing that while he sees more currency weakness on the horizon due to “external shocks such as trade friction,” the currency will stabilize “after a short period of turbulence,” hinting at Chinese preparedness for prolonged trade tensions and the potential for the RMB to depreciate further to prop up exports.67

Technological Conflict and Competition

The Chinese government has a long-term strategy aimed at establishing China as a global leader in a range of next-generation technologies, using a state-directed approach that limits opportunities for foreign firms in China and impacts U.S. technological leadership and economic competitiveness.† Chinese government policies raise a number of concerns among U.S. observers and policymakers, including unfair industrial policies that promote and protect Chinese “national champions” in key industries, the close relationships the CCP maintains with Chinese companies, and Chinese legal requirements that organizations and businesses support, assist, and cooperate with intelligence work.68

U.S. Targets Illegal Activities by Chinese Technology Companies

In 2018–2019, the United States advanced a series of measures, including criminal indictments and bans on exports of sensitive U.S. technology, to address trade-distorting and illegal behavior by Chinese technology companies (see Figure 6).

U.S. actions have focused on Chinese telecommunications firm Huawei out of concern about the firm’s close links with the Chinese government and evasion of Iran sanctions. In January 2019, the U.S. Department of Justice indicted Huawei Chief Financial Officer Meng Wanzhou for misleading banks into clearing business transactions conducted by Skycom, an Iran-based subsidiary of Huawei, in violation of U.S. sanctions.69 The Department of Commerce’s Bureau of Industry and Security (BIS) subsequently added Huawei and 114 international affiliates to the Entity List.‡70

* Unless noted otherwise, this section uses the following exchange rate throughout: $1 = RMB 7.06.
† For more on China’s development of 5G and the Internet of Things, see U.S.-China Economic and Security Review Commission, Chapter 4, Section 1, “Next Generation Connectivity,” in 2018 Annual Report to Congress, November 2018, 441–468.
‡ The Entity List (Supplement No. 4 to part 744) identifies entities reasonably believed to be involved, or pose a significant risk of being or becoming involved, in activities contrary to the national security or foreign policy interests of the United States. Placement on the Entity List is not limited to technology firms. Huawei was first placed on the Commerce Department’s Entity List in May 2019 but shortly after was granted a 90-day grace period that allowed some U.S. sales to Huawei to continue temporarily. This temporary reprieve was extended in August 2019 simultaneous to the addition of a further 46 Huawei subsidiaries and affiliates to the Entity List. U.S. Department of Commerce, Department of Commerce Adds Dozens of New Huawei Affiliates
Figure 6: Timeline of U.S.-China Technology Tensions, April 2018–September 2019

Source: Created by Commission staff.
Following a meeting with General Secretary Xi in June 2019 at the G20 Summit, President Trump directed the Department of Commerce to allow licensed sales to Huawei that do not pose a threat to U.S. national security. However, BIS’ separate addition of Chinese supercomputer developers* to the Entity List underscores far-reaching U.S. concerns regarding China’s state support for technological development and the threat it poses to U.S. technological leadership and national security.†

Observers warn that export restrictions will only accelerate China’s efforts to produce sophisticated chips domestically, although some experts assess that China’s hurdles to developing comparable technology are nearly insurmountable. China’s semiconductor industry is still heavily reliant on foundational technology dominated by U.S. firms at critical points in the supply chain, from the basic architecture in chip design to advanced manufacturing equipment used in semiconductor foundries.‡

Chinese Responses to U.S. Technology Actions

U.S. measures to defend against adverse actions taken by China’s technology companies have put Beijing on the defensive, with General Secretary Xi calling for self-reliance in “core technologies” and describing the economy’s limited innovation capabilities as its “Achilles’ heel.” Chinese policymakers appear to be following his directive, with China’s Ministry of Finance granting income tax relief to Chinese chipmakers and software developers over a five-year period following the addition of Huawei to the Entity List.† China is also taking steps to retaliate against the U.S. technology sector, including:

• Establishing an “unreliable entities” list: China’s Ministry of Commerce indicated it would soon publish an “unreliable entities” list, apparently modeled on the U.S. Entity List. The list could include foreign companies, organizations, and individuals who had “taken discriminatory measures on Chinese entities, caused actual damage to Chinese firms and related industries,

* Specific entities added included Sugon, the Wuxi Jiangnan Institute of Computing Technology, Higon, Chengdu Haiguang Integrated Circuit, and Chengdu Haiguang Microelectronics Technology. According to a notice published by the Bureau of Industry and Security at the Department of Commerce, these five entities, and the numerous aliases they used, were added to the Entity List due to growing concerns about the military applications of the supercomputers they are developing. For example, the Wuxi Jiangnan Institute of Computing Technology is affiliated with the People’s Liberation Army (PLA).

† For instance, although Huawei’s chip manufacturing arm HiSilicon is often cited as an example of Chinese parity in chip design, the firm licenses its chips’ basic architecture, or the set of instructions that determines how a processor handles comments, from British designer ARM. Because ARM in turn uses technology of U.S. origin, it canceled existing contracts with Huawei in late May to comply with Huawei’s inclusion on the Entity List.

‡ In line with a State Council directive in early May 2019, the Ministry of Finance announced that companies in integrated circuit design and software industries will receive eased income tax rates over a five-year period. Firms that became profitable before the end of 2018 will be exempt from paying any income taxes for two years, and will have the existing 25 percent corporate income tax rate cut in half to 12.5 percent for the subsequent three years. China’s Ministry of Finance, Announcement on Corporate Income Tax Policy for Integrated Circuit Design and Software Industries (关于集成电路设计和软件产业企业所得税政策的公告), May 17, 2019. Translation. http://szs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201905/t20190521_3261938.html.
and posed actual or potential threats to China’s state security.” The announcement of the list was followed by a white paper that blamed Washington for the breakdown in trade negotiations.

- **Threatening to ban rare earths exports:** On May 28, the NDRC released a question-and-answer document suggesting China could cut rare earths exports to the United States as a retaliatory measure. The NDRC has continued to fuel speculation that it could follow through with the threat, organizing an industry symposium in June in which academics advised that supervision of the industry should increase, which later led to the announcement of a planned survey of China’s rare earths supply. State-run rare earths industry associations have also voiced broader support for “counter measures against U.S. import tariffs on Chinese products.” Rare earths supplies are critical to U.S. national security, with China accounting for 80 percent of the U.S. supply from 2004 to 2017.

- **Diversifying supply chains:** As Andrew Polk, co-founder of macroeconomic research and advisory firm Trivium China, noted in testimony before the Commission that the Chinese government aspires to technologically de-couple from the United States amid concerns about overreliance on the United States for core technologies. Trade frictions with the United States have accelerated de-coupling efforts, leading China’s NDRC, Ministry of Industry and Information Technology, and Ministry of Commerce to undertake an interagency study of Chinese technology firms’ reliance on U.S. suppliers. Separately, Chinese technology firms have taken steps to protect their supply chains from U.S. sanctions in 2019, with Huawei increasing purchases of integrated circuits from Japanese suppliers and other Chinese firms looking for technology investment opportunities outside of the United States.

### China’s Internal and External Economic Management

The rate of China’s economic growth has continued to slow over the last year as Beijing’s deleveraging campaign limited investment and trade tensions with the United States hurt business operations. In March 2019, Beijing lowered its annual GDP growth target for 2019 to between 6 and 6.5 percent. This range is

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*Rare earth elements are a collection of 17 elements that are critical to the development of both high-technology consumer products, including smartphones and electric vehicle motors, and military applications, including jet engines and satellites. China mined 70.6 percent of the world’s supply in 2018, and holds 36.7 percent of global rare earths reserves, leading the U.S. Department of Defense to highlight U.S. reliance on Chinese supplies of the resource as a national security risk. While China may dominate global processing and production of rare earth elements, the resource is otherwise relatively abundant around the world, and China’s dominance of the industry is due, in part, to its willingness to accept high environmental and capital costs. U.S. Department of Defense, *Assessing and Strengthening the Manufacturing and Defense Industrial Base and Supply Chain Resiliency of the United States*, September 2018, 96; Lee Levkowitz and Nathan Beauchamp-Mustafaga, “China’s Rare Earths Industry and Its Role in the International Market,” *U.S.-China Economic and Security Review Commission*, November 3, 2010, 1–3; U.S. Geological Survey, *Rare Earths Statistics and Information*. [https://www.usgs.gov/centers/nmicanon/](https://www.usgs.gov/centers/nmicanon/rare-earths-statistics-and-information).*
lower than the previous year’s target of “about 6.5 percent,” and reflects the government’s uncertainty about economic growth. The CCP treats national GDP figures as highly politically sensitive and observers have increasingly questioned the veracity of official statistics. Foreign economists have offered a range of alternative estimates, some of which draw on data they believe are harder for Beijing to manipulate, while others use less conventional methods such as satellite imagery to assess industrial activity. Some independent estimates show China’s actual GDP growth rate could be 3 percentage points lower than the official number, while others propose a half percentage point difference. However, all of the credible alternative estimates show a similar trend of decelerating growth.

In late 2018 and early 2019, the government deployed measures to mitigate the slowdown, including $184.1 billion (RMB 1.3 trillion) in new infrastructure spending, $283.3 billion (RMB 2 trillion) in cuts to taxes and fees for businesses, and targeted monetary stimulus.* However, growth rates have continued to decline and the government is now taking additional steps to stimulate the economy. (For an in-depth assessment of China’s economic, political, and security challenges, see Chapter 2, “Beijing’s Internal and External Challenges.”)

China’s policymakers also pursued incremental market opening measures over the course of 2018 and 2019, including limited easing of restrictions on foreign investment, financial opening, and expansion of free-trade zones (FTZs). However, these narrow measures are not market-driven, and instead reflect efforts by the Chinese government to mitigate trade frictions with the United States and attract foreign investment to strategic sectors, underscoring the state’s dominant role in managing economic outcomes.

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**Growing Censorship of Economic News**

The Chinese government has long censored media coverage of issues deemed politically sensitive. Whereas government censors traditionally targeted subjects like human rights abuses or social unrest, slowing growth has seen their mandate extend to economic and business journalism. In the past year, Beijing has directed media outlets to avoid stories on declining consumer confidence, local government debt risks, and other unwelcome economic news. Internet regulators, meanwhile, have sought to acquire government stakes in independent business media companies like wallstreet.cn.

Heightened censorship of economic news casts further doubt on the accuracy of official Chinese data, the reliability of which has long been questionable. As economic growth slows and reporting on the economy becomes increasingly politicized, officials may feel more tempted to falsify official data releases. While this section necessarily makes reference to official figures when discussing China’s domestic economy, these numbers should be viewed critically, and, when possible, are supplemented with U.S. government or independently collected statistics.

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*Monetary stimulus refers to a variety of methods central banks use to increase the money supply in the economy such as lowering interest rates or lowering banks’ reserve requirements.
China’s Domestic Economic Slowdown

In the first half of 2019, China posted an official GDP growth rate of 6.3 percent, marking the slowest growth recorded in nearly 30 years (see Figure 7). Although slower growth is typical as a country transitions from an emerging to advanced economy, China’s economy is now growing slower than it did in the first quarter of 2009 when its exports and imports collapsed amid the global financial crisis. Moreover, China’s GDP per capita remains far behind that of other advanced East Asian economies such as Japan, South Korea, and Taiwan, when their respective periods of high-speed growth ended.

China’s slowing growth rate is the result of both long-term structural trends and recent policy decisions. The old engines of China’s economy—such as state-led infrastructure investment and rapid urbanization—no longer deliver the same pace of growth they did in the past. Demographic trends are no longer favorable and returns on investments are diminishing. While these factors represent longstanding threats to China’s growth prospects, China’s immediate economic difficulties mainly stem from Beijing’s decision in late 2016 to aggressively crack down on the financial sector and risky lending. China’s corporations and local governments are saddled with large amounts of debt, but the government’s policy response has been uneven, largely focusing on curbing corporate debt buildup while encouraging local governments to borrow more to prop up growth. Trade tensions with the United States and slowing global demand are also compounding the problem.

Figure 7: China’s Official GDP Growth, 2009–Q2 2019
(year-on-year)

Note: In 2016, the target was set at a range of 6.5–7.0 percent GDP growth. In 2019, the target is set at a range of 6.0–6.5 percent.
Source: China’s National Bureau of Statistics via CEIC database.
China’s slowdown is also visible across several other major indicators (see Figure 8):

- **Fixed asset investment**: A measure of investment in physical assets such as buildings, machinery, and equipment, fixed asset investment (FAI) has historically been a major driver of China’s economic growth, but has slowed significantly in recent years as the structure of China’s economy shifted and regulators tightened control over lending. In the first eight months of 2019, fixed asset investment growth fell to 5.5 percent year-on-year, down from 5.9 percent growth in all of 2018.98

- **Industrial production**: The growth rate for industrial production has fallen significantly since the fourth quarter of 2018, despite the government’s efforts to stimulate production by ramping up infrastructure spending. Weak internal demand and intensifying trade tensions with the United States have contributed to the slowdown.99 In July and August 2019, industrial output growth fell to consecutive 17-year lows of 4.8 and 4.4 percent, respectively—down from 6 and 6.1 percent in growth during the same months in 2018.100

- **Retail sales**: China’s economic slowdown has prompted consumers to postpone or refrain from larger purchases such as automobiles and home appliances, cutting into retail sales. Monthly retail sales growth reached a 16-year low of 7.2 percent in April this year and continues to remain suppressed in comparison with 2018 figures.101

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**Figure 8: China’s Key Economic Indicators, 2014–August 2019**

(year-on-year)

![Graph of China's Key Economic Indicators](source:
China’s National Bureau of Statistics via CEIC database.)
Unofficial estimates of China’s manufacturing and services purchasing managers’ indexes (PMI) published by Chinese financial media firm Caixin are also closely watched because they provide an indication of the prevailing direction of economic trends.* The Caixin Manufacturing PMI has remained weak throughout much of 2019, hovering around a reading of 50, which indicates no change, and slipping into contractionary territory several times (see Figure 9).102 This reflects weak internal demand and stronger trade headwinds and suggests a worrying outlook for the manufacturing sector absent further stimulus.103 The services sector—which accounts for more than half of China’s GDP—performed better but still showed significant volatility over the last year.104

Figure 9: Caixin Manufacturing and Services PMI, 2016–Q2 2019

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*Caixin’s PMI is a survey-based index that measures production level, new orders, inventories, supplier deliveries, and employment level at both manufacturing and services firms to gauge economic activity. A reading above 50 indicates expansion; a reading below 50 indicates contraction.

Debt and Deleveraging

A major driver of China’s economic slowdown is General Secretary Xi’s campaign over the past three years to curb debt growth and reduce financial risks.105 This deleveraging campaign has two main components: reducing the use of monetary stimulus and curtailing shadow banking. Both of these components are aimed at slowing growth of credit and cleaning up the financial system rather than cutting the overall debt stock.106 The deleveraging campaign has been fairly successful at controlling the rate of debt growth, which has slowed considerably. However, the risks it seeks to address are far from eliminated, and the campaign has had unintended negative consequences for the overall economy. According to the Bank for International Settlements, in the first
quarter of 2019 (the latest data available) China’s total outstanding debt accumulated by non-financial corporations, households, and the government reached $35.4 trillion, or 259.4 percent of GDP, up from 138 percent at the end of 2008 (see Figure 10).* This is relatively high compared to emerging markets, and is more comparable to debt levels observed in advanced economies like the United States.107

![Figure 10: China’s Debt-to-GDP Ratio, 2008–Q1 2019](image)

* In comparison, in the first quarter of 2019 the United States’ total debt reached $51.8 trillion (249.3 percent of GDP), Japan’s total debt reached $18.8 trillion (378.4 percent of GDP), and India’s total debt reached $3.4 trillion (125 percent of GDP). Bank for International Settlements, “Credit to the Non-Financial Sector,” September 22, 2019.

Although China’s overall debt stock is high, it is the speed at which it has grown that raises risks for the economy. Before the deleveraging campaign, China’s debt was expanding faster than any other country’s in modern times.108 The speed of the buildup means that credit is created faster than it could be productively deployed, greatly increasing the amount of waste in the financial system.109 This is visible in the exponential increase in the value of nonperforming loans over the last several years. Even when the deleveraging campaign was in full swing, nonperforming loans continued to climb, expanding 18.7 percent in 2018, up from 12.8 percent in 2017 (see Figure 11).110
Crackdown on Corporate Debt Hits the Private Sector, but SOEs are Unscathed

Corporations hold the largest category of debt, comprising nearly two-thirds of China’s debt. SOEs are responsible for the majority of corporate debt. Not only do they have easier access to credit, but they also tend to be less efficient and profitable than private companies. This has allowed many SOEs to survive on credit past the point when they have much hope of repaying their loans—increasing overall corporate debt levels in the process. To address this problem, Beijing undertook a deleveraging campaign focused on reducing excessive corporate borrowing. In 2016, the PBOC began reducing the money supply, and in early 2017 regulators strengthened oversight of the financial sector, cracking down on risky, off-balance-sheet lending. These measures succeeded in halting corporate debt growth, but had the unintended consequence of depriving small, private sector companies of credit they badly needed. This loss of access to credit by private companies is a key driver of the ongoing slowdown. Meanwhile, officials have been slow to address the problem of lossmaking SOEs, frequently intervening in bankruptcy proceedings to help them restructure instead of allowing them to exit the market, thus perpetuating China’s debt problems.

*While the Chinese government does not publish an official breakdown, the International Monetary Fund estimated that SOEs held 57 percent of China’s corporate debt in 2016. Raphael Lam et al., “Resolving China’s Zombies: Tackling Debt and Raising Productivity,” International Monetary Fund, November 2017.
SOEs Strengthen, Private Enterprises Struggle

SOEs receive preferential treatment from the Chinese government, including public subsidies, regulatory exemptions, and access to loans. Even though SOEs are more heavily indebted than private sector companies, they still enjoy preferential access to credit because banks believe they are implicitly guaranteed by the government. Efforts to deleverage the corporate sector and crack down on risky lending have therefore disproportionately hurt private companies (especially small and medium enterprises), which are more reliant on shadow banking channels. Additionally, since 2016, “supply-side reform” policies have encouraged consolidation of SOEs and pushed private enterprises in industries with excess capacity to shut down, effectively hollowing out private sector competition while strengthening SOEs without addressing their overall inefficiency. These dynamics have enabled SOEs to weather China’s economic slowdown better than small private companies.

As the shadow banking crackdown took hold in 2017 and 2018, private listed companies began pledging their own shares as collateral in order to access credit. By late 2018, more than $600 billion worth of shares trading on Chinese exchanges were pledged as loan collateral. This practice developed into a crisis in October and November 2018 amid a major stock market downturn. In 2018, 136 listed firms changed ownership—compared to 85 ownership changes in 2017—with 41 changes occurring in October and November alone. The government responded by organizing bailout funds through local State-Owned Assets Supervision and Administration Commissions and encouraging state owned insurers and securities companies to buy up stocks. According to the China Securities Regulatory Commission, by March 2019 local governments and SOEs mobilized $99.2 billion (RMB 700 billion) to bailout private companies. While these measures have succeeded in calming markets for now—the pace of ownership turnover of China’s listed companies has slowed—structural incentives that favor SOEs remain largely in place.

External Debt Risks Loom

Estimates of China’s foreign debt vary widely. According to official figures published by the State Administration of Foreign Exchange, China’s external debt was equivalent to $1.97 trillion in March 2019, of which $726 billion is denominated in U.S. dollars. However, some analysts claim China’s foreign debt could be as much as $3 trillion, roughly equal to its foreign exchange reserves. The discrepancy is usually attributed to the fact that government data omit debt accumulated by Chinese companies’ foreign subsidiaries based in Hong Kong and other locations abroad. In August 2019, Bloomberg estimated that Chinese companies have accumulated another $650 billion in debt through their overseas subsidiaries.

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If these higher estimates are correct, the recent devaluation of the RMB would make repayment of external debt more expensive (as foreign currencies rise in value relative to the RMB). In testimony before the Commission, expert on the Chinese economy Victor Shih argued that one reason Chinese companies borrow such large sums through Hong Kong is because banks “lend to both their Hong Kong based subsidiaries and to the headquarters in Beijing.” 128 In other words, Hong Kong’s treatment as a separate customs area enables banks to “lend even more money than prudential, internal rules would allow.” According to Dr. Shih, banks do this because “Chinese companies will pay higher interest.” 129 However, there are some factors that help mitigate China’s external debt risks. For example, roughly 35 percent of China’s foreign debt is denominated in RMB and Chinese banks hold significant foreign-currency-denominated assets.130 (For further discussion of Hong Kong’s special status, see Chapter 6, “Hong Kong.”)

**Household Debt Is on the Rise**

While China’s deleveraging campaign has focused on curbing corporate debt buildup, household borrowing has been on the rise. Growing household debt could suppress consumption and lower long-term growth. Recent scholarship on the relationship between household debt and economic growth reveals that while a rapid increase in household borrowing can boost consumption and growth in the short term, it usually leads to reduced GDP growth in the longer term as households adjust their consumption to meet debt obligations.131

At 53.6 percent of GDP in March 2019, China’s household debt remains below the international average of 60.3 percent,* and most observers agree it is manageable at current levels. But household debt has grown quickly since the 2008 financial crisis.132 Between December 2008 and December 2018, China’s household debt accumulated faster than any of the other 44 economies tracked by the Bank for International Settlements.133 Moreover it grew roughly twice as fast as urban disposable income over the last decade, an indication that a growing number of Chinese families may need to reduce their consumption to pay off debt.134

Continued buildup of China’s household debt could also pose risks for financial stability.135 Because home mortgages account for about two thirds of China’s household debt, there is some risk that a financial shock that forces households to quickly deleverage could cause a downturn in the property market, which analysts generally regard as overheated. This would have wide-ranging consequences since the housing market is a key engine of China’s economic growth and real estate is a form of collateral local governments and corporations have used to secure bank loans.136

**Stimulus Pushes Local Government Debt Higher**

China’s local government debt has risen consistently since the 1990s but expanded especially rapidly after the global financial crisis.137 The persistence of local government liabilities stems from a

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*This figure is the average household debt to GDP ratio of 44 countries on which the Bank for International Settlements publishes regular credit statistics. Bank for International Settlements, “Credit to the Non-Financial Sector,” September 22, 2019.
structural imbalance in the fiscal relationship between local governments and Beijing. Local governments shoulder the majority of expenditure obligations but receive less than half of all tax revenue. Theoretically, this gap is later closed with fiscal transfers from the central government, but in practice these transfers rarely cover local government expenses, resulting in a de facto unfunded mandate.  

In 2014, the National People’s Congress adopted a revision to China’s Budget Law, which permitted local governments to run a deficit. Prior to this, local officials got around the deficit prohibition by establishing shell companies called local government financing vehicles (LGFVs) to borrow on their behalf, often using land as collateral.  

While LGFVs continue to exist, local governments now have other ways of raising money. The revision to the Budget Law gave local governments permission to issue debt with the approval of—and within limits set by—the State Council. Beijing also set up a debt swap program for local governments to convert debt accumulated through LGFVs to bonds. Official figures indicate that as of July 2019, total outstanding local government bonds were equal to $2.98 trillion, but the true scale of local government debt is unknown as much of it is hidden through LGFVs and other shadow banking activity.  

In December 2018, the State Council began approving local government bonds for 2019 three months earlier than usual as a way to encourage local officials to ramp up infrastructure spending and stimulate the economy. Chinese Premier Li Keqiang subsequently announced a $113 billion increase to the annual local government bond quota in March 2019. Combined with $283.3 billion in cuts to business taxes and fees that were rolled out simultaneously, this policy strategy has had a corrosive effect on local government budgets in 2019. In the first half of the year, every province except Shanghai expanded its budget deficit compared to the same period in 2018, and many experienced severe revenue contractions or decelerations. But in September 2019, as local government bond issuance approached annual quotas for the year, the State Council once again signaled its intention to begin early approvals for 2020 bonds.  

Trading Fiscal for Monetary Stimulus: Still Risky  

Historically, Beijing has used monetary policy as one of its main tools for stimulating growth. In the aftermath of the global financial crisis, and to a lesser extent in 2015 during a major stock market crash in China, the PBOC pumped vast sums of money into the economy. However, excessive monetary stimulus is one of the reasons for China’s corporate credit buildup over the last decade. Therefore, as the current economic slowdown has unfolded, policymakers have consciously sought to refrain from returning to heavy monetary stimulus. Instead, they have emphasized fiscal stimulus and measures to improve the business environment. At the annual session of China’s legislature in March 2019, for example, Premier

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*Annual bond quotas for local governments are typically set during the dual meeting of the National People's Congress and the People's Political Consultative Conference in March each year.
†Fiscal stimulus refers to government spending designed to prevent or alleviate an economic recession. This is distinct from monetary stimulus, which refers to measures taken by the central bank to increase the money supply.
Li promised that the government would refrain from unleashing “a deluge of stimulus” to prop up economic growth and would keep the growth of money supply in line with GDP. Policymakers have so far maintained this commitment, instead resorting to fiscal stimulus to shore up growth. However, ramped up fiscal spending swapped increased corporate leverage for higher public debt and thus amounts to a qualitative decision about what kind of debt is preferable. It does not prevent overall debt levels from continuing to rise.

**Current Account Surplus Narrows**

China has long maintained a current account surplus and continued to do so in 2018 and the first half of 2019. However, the current account surplus has trended downward over the past decade, and in the first quarter of 2018 China registered its first quarterly current account deficit in nearly 17 years (see Figure 12).

![Figure 12: China’s Current Account, Quarterly, 2008–Q2 2019](image)

While the overall downward trend has led some observers to predict that China’s current account will turn negative sometime in the near future, debate about the extent, causes, and implications of the decline in China’s current account remains ongoing. In the first half of 2019, analysis in the *Economist* argued that higher outbound tourism and a declining savings rate will soon lead China to run a current account deficit, increasing pressure on its foreign exchange reserves and forcing Beijing to liberalize its foreign investment regime. This is in line with an assessment published by the International Monetary Fund (IMF) in August 2019 asserting that the changing current account represents a “normalization” of China’s economy.

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*The current account balance refers to the balance of trade plus net (investment) income from abroad and net transfer payments. The current account is one half of the balance of payments; the other half is the capital account. Economists often refer to the current account as the difference between savings and investment because this is arithmetically equivalent.*
domestic savings rate as the country’s population ages and people naturally save less in their retirement years.150

Other observers contend that the extent of the decline in China’s current account is overstated and is partly the result of government policy rather than structural factors. Brad Setser and Barry Eichen-green, economists at the Council on Foreign Relations and University of California, Berkeley, respectively, have recently claimed that China’s savings rate remains very high and its current account surplus will only disappear if China maintains its current levels of investment, which are a largely the result of policy-driven stimulus.151 The impact of a sustained current account deficit on China’s economy remains unclear as it is unprecedented in the country’s recent history. However, one likely outcome would be an increase in exchange-rate volatility as downward pressure on the RMB could prompt heavy-handed government intervention in currency markets. It is also possible the declining current account surplus could put pressure on Beijing to further liberalize the financial sector in order to attract foreign capital to finance continued growth.152

The Baoshang Bank Takeover

On May 24, 2019, Inner Mongolia commercial lender Baoshang Bank ("Baoshang") was taken over by the China Banking and Insurance Regulatory Commission (CBIRC), China’s primary banking and insurance sector regulator.153 While the PBOC fully guaranteed deposits and interbank liabilities up to $7.1 million (RMB 50 million), it forced Baoshang’s larger creditors to accept losses of up to 30 percent.154 This protected the bank’s retail customers but passed on some of the cost of its failure to large commercial lenders.

Baoshang is a medium-size regional lender classified by the CBIRC as a city commercial bank. There are 134 city commercial banks in China that, together with 1,427 smaller rural commercial banks, are often collectively referred to as “regional banks.”155 Although a handful of national state-owned banks dominate China’s commercial banking sector, these regional banks play an important role as intermediary lenders, borrowing funds from larger banks and making loans to local governments, property developers, and other nonbank financial actors.156 Additionally, since regional banks are not permitted to operate outside of their local area, they rely on local enterprises for business and consequently tend to engage in riskier lending behavior than their national counterparts.157

The Baoshang takeover was highly unusual: the Chinese government has not seized a private bank in 20 years.158 Instead, in 2015 and 2016, China’s financial regulators dealt with weak financial institutions by recapitalizing lenders and writing off or transferring troubled assets.159 Because of this, and because analysts have identified several other regional banks as having similar risk profiles, Baoshang is more than just locally significant for China’s financial system.160 The takeover caused large national bank lenders to reassess their customers’ credit risk, pushing up the costs of short-term borrowing and reducing regional banks’
access to interbank financing. In the immediate aftermath of the takeover, the PBOC pumped $63.7 billion (RMB 450 billion) into the banking system and regulators pressured lenders to support smaller banks in order to ease the credit shortfall.

In shoring up Baoshang, the PBOC had two contradictory targets: reducing the problem of financial actors taking too much risk, and sustaining growth by keeping interbank credit channels open to minimize the likelihood of a financial shock. The risk aversion affecting interbank markets and decreasing credit to small and regional banks could lead to slower credit expansion—a problem because policymakers need to maintain economic growth. Since small and regional banks and nonbank financial institutions are risk-takers in the Chinese economy, reducing their access to financing could threaten China’s economic recovery.

It remains unclear exactly why the PBOC decided to seize Baoshang rather than recapitalize or restructure its loans. To explain the abrupt takeover, the PBOC stated that Baoshang had “serious credit risk,” and that by assuming its banking operations for a year, the government would “protect the lawful interest of depositors and other clients.” The PBOC also emphasized that the Baoshang seizure was connected to embezzlement by its former controlling shareholder, the financial conglomerate Tomorrow Group formerly managed by detained tycoon Xiao Jianhua.*

While the PBOC characterized Baoshang’s takeover as a one-off, problems have subsequently emerged at two other regional banks. On July 29, 2019, three state-owned asset managers, operating under PBOC guidance, made strategic investments to shore up the struggling Bank of Jinzhou. Unlike with Baoshang, however, creditors and corporate depositors reportedly suffered no losses in this process. On August 9, 2019, a unit of China’s sovereign wealth fund acquired a stake in Hengfeng Bank after the CBIRC had earlier tried to calm markets by saying the bank’s liquidity risks were manageable.

Observers believe the different approach to resolving the Bank of Jinzhou crisis demonstrates regulators’ concern about the market reaction to Baoshang investors’ losses. Michael Pettis, senior associate at the Carnegie Endowment for International Peace, stated the interbank reaction demonstrated Chinese investors found the takeover “very significant,” given the “surge in interbank interest rates” and quick measures by the PBOC to shore up the interbank market and continue the flow of credit.  

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* Xiao Jianhua was abducted from a luxury Hong Kong hotel in January 2017 amid China’s crackdown on risky financial behavior that also ensnared chairman of Anbang Insurance Wu Xiaohui and CEFC China Energy chairman Ye Jianming. But analysts have speculated that Xiao may also have been targeted for political reasons. Xiao previously helped General Secretary Xi’s family members divest assets during the early stages of the Xi’s anticorruption campaign, and in 2014 he divulged details of the family’s wealth to the New York Times. Xiao is currently still detained in China, where he is reportedly cooperating with the government to unwind Tomorrow Group’s assets. Don Weinland and Lucy Hornby, “Tycoon Abducted by China Works with Authorities to Sell Assets,” Financial Times, June 10, 2018; Michael Forsythe, “Billionaire Is Reported Seized from Hong Kong Hotel and Taken into China,” New York Times, January 31, 2017; Michael Forsythe, “As China’s Leader Fights Graft, His Relatives Shed Assets,” New York Times, June 17, 2014.
China’s External Economic Opening

Trade frictions with the United States and a slowing domestic economy have pushed the Chinese government to implement limited market opening measures over the course of 2019, including the liberalization of foreign investment, financial opening, and the establishment of new FTZs. While these measures narrowly open the Chinese economy on the margins, they also demonstrate that the Chinese government continues to coordinate economic activity in a manner favorable to the state.

New Foreign Investment Law Rehashes Old Promises

China’s National People’s Congress passed a new Foreign Investment Law in March 2019, combining three separate laws governing joint ventures established by contract, joint ventures established with equity investment, and wholly foreign-owned enterprises. The passage of the law aims to address U.S. and international concerns about China’s treatment of IP and comes as China seeks to attract more foreign capital to bolster its domestic economy. While the law consolidates previously disparate foreign investment regulations and effectively simplifies China’s foreign investment regime, its purported protections for foreign-invested firms may prove unenforceable or be selectively enforced absent more substantive changes that promote genuine rule of law in China’s legal system.

Chinese officials have indicated that swift passage of the law—the first draft was only introduced in late December 2018—was intended to facilitate ongoing U.S.-China trade negotiations. The law includes articles that appear to respond directly to a number of complaints raised in the USTR’s Section 301 report concerning China’s unfair trade practices related to technology transfer, IP, and innovation. Some of these provisions include penalizing government officials for sharing foreign firms’ trade secrets with their domestic competitors, forbidding use of administrative means to force technology transfers, treating foreign investors the same as domestic investors, and creating a complaint mechanism and channel for foreign firms to sue government agencies.

Both Chinese and international legal experts have noted that the Foreign Investment Law is vaguely worded and the most substantial provisions are not new. For instance, technology transfers are already expressly banned under China’s WTO accession protocol, yet numerous testimonies before the USTR detail a pattern of market access being preconditioned on the transfer of technology. Foreign firms’ trade secrets are also protected under China’s Administrative Law, but the Section 301 report documents instances of Chinese regulators requiring excessive disclosure of trade secrets as a precondition to obtain licenses, and then providing this information to domestic competitors. Since Chinese officials deny that Chinese companies or government agencies have violated these laws in the first place, additional legal mechanisms may be useless in addressing a violation if the government is unwilling to acknowledge the violation occurred.

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*On average, new legislation between 1993 and 2017 took 4.7 years to pass, and amended legislation took 2.9 years to pass, with 73 percent of introduced (both new and amended) legislation passing. Yang Mingyu, “Does China Have a Legislative Backlog?” (中国也有“立法堵塞”?) CNPolitics.org, August 1, 2018. Translation.
**Negative List Revised in Line with National Development Ambitions**

Since 2016, China has managed foreign direct investment through the use of a so-called “negative list,” which classifies investment into certain sectors as prohibited, restricted, and encouraged. Sectors not specified are presumed to be open to foreign investment but are sometimes subject to separate regulations.\(^{180}\) In June 2019, the NDRC and Ministry of Commerce published a revised version of the national negative list, reducing the number of prohibited and restricted sectors from 48 to 40.\(^ {181}\) The changes from the previous year’s list are:\(^ {182}\)

- Removal of prohibitions on foreign investment in molybdenum, tin, antimony, and fluorite mining; calligraphy paper and brush production; and development of wildlife and plant products protected by the investor’s origin country;
- Removal of the requirement for majority Chinese ownership of shipping agencies, performance companies, movie theaters, and the construction of gas and steam pipelines in cities with a population over 500,000;
- Removal of joint venture requirements and foreign equity caps for oil and gas exploration and value-added telecommunications services.

While some of these adjustments to the list—such as the removal of equity caps on multiparty telecommunications, e-storage, forwarding, and call centers—are likely welcome news to foreign companies, the changes do not amount to a significant liberalization of China’s foreign investment regime. Restrictions that affect major U.S. corporate interests, such as the 50 percent foreign equity cap on automobile production, remained in place—albeit with promises for eventual removal.\(^ {183}\)

The NDRC and Ministry of Commerce simultaneously published an expanded list of encouraged investment areas. Unsurprisingly, most of the new additions—including semiconductors, information and communication technology, new energy vehicles, and new materials—are in high-technology areas that align with Beijing’s industrial policy goals.\(^ {184}\) (China’s efforts to develop emerging technologies are analyzed in Chapter 3, Section 2, “Emerging Technologies and Military-Civil Fusion: Artificial Intelligence, New Materials, and New Energy.”)

**Financial Opening: Too Little, Too Late**

Though the Chinese government has limited foreign companies’ access to its financial markets for many years, Beijing accelerated financial opening in 2018 and 2019 (see Figure 13). At the April 2018 Boao Forum for Asia, General Secretary Xi and PBOC Governor Yi Gang announced the Chinese government would deliver on longstanding pledges to open up China’s financial sector to foreign competition.\(^ {185}\) Since then, Beijing has taken several steps to (1) increase market access in the banking, securities, and insurance industries; (2) grant foreign institutions equal treatment in credit and payment sectors; and (3) open up the domestic bond market to foreign investors.\(^ {186}\)
Figure 13: Timeline of China's Financial Opening, April 2018–September 2019

Source: Created by Commission staff.
The most significant opening came in June 2018, when regulators raised foreign equity caps on banking, securities, and insurance joint ventures to 51 percent, and promised to remove them entirely by 2021, a timeline that was later shortened to 2020. These changes have enabled several major foreign companies to establish new businesses in China or take controlling stakes in existing joint ventures, and reflect a “pragmatic market opening streak” as the Chinese government endeavors to internationalize its financial markets and push domestic financial services firms to become more competitive.*

While Beijing has touted these measures, there remains skepticism that foreign companies’ market access in China will significantly improve. For example, though American Express received approval to clear RMB payments, other foreign card service providers’ applications remain in limbo. Executives of Mastercard and Visa, which applied at the same time as American Express, say Chinese regulators have informally pressured them to form joint ventures to gain regulatory approval. Although Chinese law requires regulators to respond within 90 days of an application submission, the PBOC has stalled their applications for nearly three years.

In June 2019, China also launched the long-awaited Shanghai-London Stock Connect, which, like the Shanghai-Hong Kong Stock Connect, allows Chinese companies to raise capital abroad without needing to list on foreign stock exchanges. The connect also gives foreign investors—typically not permitted to purchase shares of Chinese companies—access to China’s onshore equities market. Separately, the State Administration of Foreign Exchange (SAFE) scrapped the qualified foreign institutional investor (QFII)† scheme (which had a ceiling of $300 billion on total asset purchases) in September 2019, allowing qualified foreign institutional investors unrestricted access to China’s stock and bond markets. (For further discussion of the Hong Kong stock and bond connects, see Chapter 6, “Hong Kong.”)

The steady opening of China’s stock and bond markets in 2019 provides the Chinese government with additional conduits for drawing foreign capital and channels for bolstering its balance of payments in the face of a slowing economy and trade headwinds. However, the impact of the measures may be small. In the case of the stock connect, a number of unresolved compatibility issues, such as mismatched daily trading volume limits between the two exchanges,

*A range of U.S. and multinational banking, securities, and insurance firms have taken advantage of increased liberalization of China’s financial sector. American Express won approval to clear payments in RMB through a joint venture operation in November 2018, and Standard and Poor’s became the first foreign company to operate a credit rating agency in China’s domestic bond markets in July 2019. However, though China committed to a five-year phase-in for banking services by foreign firms as part of its accession to the WTO, the Chinese government has instead protected the financial services industry from foreign competition, resulting in a market dominated by unfairly state-supported Chinese firms. For more on U.S. access to the Chinese market, see Chapter 3, Section 1, “U.S.-China Commercial Relations.” Doug Palmer and Frank Tang, “China Slow-Walks Opening Country to U.S. Credit Card Companies,” Politico, April 2, 2019; U.S. Trade Representative, 2018 Report to Congress on China’s WTO Compliance, February 2019, 147.

† Launched in 2002, the QFII program grants foreign investors with relevant qualifications access to Chinese stock and bond markets. An RMB-denominated cap applied to a parallel “RQFII” program was initiated in 2011. The SAFE announcement scraps quotas on both foreign investment schemes, which have become increasingly overshadowed by the Stock Connect and Bond Connect schemes. Reuters, “China to Scrap Quotas on QFII, RQFII Foreign Investment Schemes,” September 10, 2019.
will make it illiquid in the beginning.* Furthermore, listings are subject to minimum market capitalization requirements, limiting the number of potential participants. The removal of investment quotas is also mostly symbolic; despite a doubling of the QFII quota to $300 billion in January 2019, only $111.4 billion of the limit had been used by foreign investors by the end of August. 193

**Internal and External Pressures Prompt FTZ Expansion and Reform**

The Chinese government took steps to expand its FTZ program to underdeveloped provinces in 2019, as well as marginally ease business registration and licensing procedures in China’s pilot FTZs.† In establishing new FTZs, Beijing seeks to deepen trade ties with neighboring countries and bolster economic development in China’s poorer inland regions. The cutting of red tape in already established FTZs aims to counteract downward economic pressure by improving the business environment.

Against the backdrop of trade frictions with the United States, the expansion of pilot FTZs into border regions and underdeveloped provinces underscores efforts by the Chinese government to strengthen trade ties with other countries and boost economic growth. Newly established FTZs in the relatively underdeveloped Yunnan and Guangxi provinces, for example, aim to promote greater economic integration between China and Southeast Asia as well as draw foreign investment. In a press conference announcing the establishment of the new FTZs, Vice Minister of Commerce Wang Shouwen noted that the Guangxi FTZ will also “form an important gateway” to the Association of Southeast Asian Nations in advancing the Belt and Road Initiative.

Separately, in August 2019, Premier Li announced steps to simplify business registration and permit requirements for foreign companies in China’s FTZs. Foreign companies in China require a range of permits—in addition to a business license—to operate, effectively heightening market entry thresholds. Beginning in December 2019, permit requirements for 81 items will be abolished, simplified, or replaced by precommitments of compliance. While the move is intended to make it easier for foreign companies to start operations as quickly as possible, it only applies to China’s FTZs and does not address broader market access issues in the Chinese economy. Additionally, permit requirements for 442 other items remain in force.

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*The Shanghai Stock Exchange enforces a 10 percent daily trading limit, while the London Stock Exchange has no such restriction, in theory making Chinese securities purchased through the connect less liquid than other securities traded on the London stock market. Tom Hancock et al., “London-Shanghai Stock Link Hailed as Groundbreaking,” Financial Times, June 16, 2019.
†An FTZ is a type of special economic zone. It is a designated geographic area where economic transactions are conducted under terms and regulations different from the general conditions administered outside the FTZ. China’s government has used FTZs to test economic reform measures promoting financial liberalization, simplifying the foreign investment management system, and easing international trade. Customs clearances procedures are relatively streamlined in China’s FTZs (e.g., goods imported into them can be stored, handled, and re-exported to other overseas destinations or routed into the Chinese market at reduced duty rates). The Chinese government established China’s first FTZ in Shanghai in 2013, and has since expanded the FTZ program to a total of 18 zones as of September 2019, with more zones increasingly being located in China’s underdeveloped interior. Shen Fan and Han Wei, “China Expands FTZ Pilot Program to Promote Trade and Reforms,” Caixin, August 27, 2019.
## Addendum I: WTO Cases

### Ongoing WTO Cases Brought by the United States against China

<table>
<thead>
<tr>
<th>No.</th>
<th>Title</th>
<th>Request for Consultation</th>
<th>Panel Report</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>DS508</td>
<td>Export Duties on Certain Raw Materials</td>
<td>July 13, 2016</td>
<td>Panel established November 2016, but not yet composed as of September 2019</td>
<td>The United States requested consultations with China over China’s export duties on nine raw materials.*</td>
</tr>
<tr>
<td>DS511</td>
<td>Domestic Support for Agricultural Producers</td>
<td>September 13, 2016</td>
<td>Panel report circulated February 28, 2019</td>
<td>The dispute settlement panel found China’s agricultural subsidies exceeded its allowed amount in three of the four crops for which the United States claimed Beijing was breaching its commitments.</td>
</tr>
<tr>
<td>DS517</td>
<td>Tariff Rate Quotas for Certain Agricultural Products</td>
<td>December 15, 2016</td>
<td>Panel report circulated April 18, 2019</td>
<td>The United States argued China’s tariff rate quota (TRQ) treatment for rice, wheat, and corn is non-transparent and violates China’s WTO commitments. The panel found the administration of China’s TRQ is not transparent, predictable, or fair.</td>
</tr>
<tr>
<td>DS519</td>
<td>Subsidies to Producers of Primary Aluminum</td>
<td>January 12, 2017</td>
<td>In consultations; panel not yet formed as of September 2019</td>
<td>The United States argues China provides certain producers of primary aluminum with subsidies, including artificially cheap loans and artificially low-priced inputs for production, such as coal, electricity, and alumina.</td>
</tr>
<tr>
<td>DS558</td>
<td>Additional Duties on Certain Products from the United States</td>
<td>July 16, 2018</td>
<td>Panel composed January 2019</td>
<td>The United States requested consultations with China concerning the imposition by China of additional duties with respect to certain products originating in the United States.</td>
</tr>
</tbody>
</table>

*Source: World Trade Organization, Disputes by Member.*

*The materials are antimony, cobalt, copper, graphite, lead, magnesia, talc, tantalum, and tin.*
## Addendum I: WTO Cases—Continued

### Ongoing WTO Cases Brought by China against the United States

<table>
<thead>
<tr>
<th>No.</th>
<th>Title</th>
<th>Request for Consultations</th>
<th>Panel Report</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>DS437</td>
<td>Countervailing Duty Measures on Certain Products from China — Recourse to Article 21.5 of the Dispute Settlement Understanding By China</td>
<td>May 25, 2012</td>
<td>Original panel report circulated July 14, 2014; Second Recourse to Article 21.5 Appellate Body Report circulated July 16, 2019</td>
<td>The dispute settlement panel found select U.S. tariffs on Chinese goods do not comply with its rules, providing China the option to respond with retaliatory measures against the United States if Chinese pricing is not accepted.</td>
</tr>
<tr>
<td>DS515</td>
<td>Measures Related to Price Comparison Methodologies</td>
<td>December 12, 2016</td>
<td>In consultations; panel not yet established as of September 2019</td>
<td>China’s complaint alleges the United States has failed to treat China’s as a market economy for the purposes of calculating antidumping duties.*</td>
</tr>
<tr>
<td>DS543</td>
<td>Tariff Measures on Certain Goods from China</td>
<td>April 4, 2018</td>
<td>Panel composed June 2019</td>
<td>China requested consultations with the United States concerning certain tariff measures on Chinese goods which would allegedly be implemented through Section 301–310 of the U.S. Trade Act of 1974.</td>
</tr>
<tr>
<td>DS544</td>
<td>Certain Measures on Steel and Aluminum Products</td>
<td>April 5, 2018</td>
<td>Panel composed January 2019</td>
<td>China requested consultations with the United States concerning certain duties that the United States had imposed on imports of steel and aluminum products.</td>
</tr>
<tr>
<td>DS562</td>
<td>Safeguard Measure on Imports of Crystalline Silicon Photovoltaic Products</td>
<td>August 14, 2018</td>
<td>In consultations; dispute Settlement Body deferred establishment of a Panel in July 2019</td>
<td>China requested consultations with the United States concerning the definitive safeguard measure imposed by the United States on imports of certain crystalline silicon photovoltaic products.</td>
</tr>
</tbody>
</table>

*The case is related to the expiration on December 11, 2016 of a provision in China’s WTO accession protocol that allowed its trade partners to automatically treat China as a non-market economy when calculating dumping margins. China argues it is now automatically entitled to be treated as a market economy, while the United States says there is no automaticity. China filed a similar case against the European Union.
### Addendum I: WTO Cases—Continued

**Ongoing WTO Cases Brought by China against the United States—Continued**

<table>
<thead>
<tr>
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<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>DS563</td>
<td>Certain Measures Related to Renewable Energy</td>
<td>August 14, 2018</td>
<td>In consultations; panel not yet formed as of September 2019</td>
<td>China requested consultations with the United States concerning certain measures allegedly adopted and maintained by the governments of certain U.S. states and municipalities in relation to alleged subsidies or alleged domestic content requirements in the energy sector.</td>
</tr>
<tr>
<td>DS565</td>
<td>Tariff Measures on Certain Goods from China II</td>
<td>August 23, 2018</td>
<td>In consultations; panel not yet formed as of September 2019</td>
<td>China requested consultations with the United States concerning certain tariff measures allegedly imposed by the United States on certain goods from China.</td>
</tr>
<tr>
<td>DS587</td>
<td>Tariff Measures on Certain Goods from China III</td>
<td>September 2, 2019</td>
<td>In consultations; panel not yet formed as of September 2019</td>
<td>China requested consultations with the United States regarding tariff measures imposed by the United States on certain goods originating from China.</td>
</tr>
</tbody>
</table>

*Source: World Trade Organization, *Disputes by Member*. 

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69
2. U.S. Census Bureau, Trade in Goods with China.


80. Eric Ng, “China’s Rare Earth Producers Say They Are Ready to Weaponize Their Supply Stranglehold, Pass Any Tariff as Cost to U.S. Customers,” South China Morning Post, August 8, 2019.


Foreign Investment Law Designed to Level Domestic Playing Field for Overseas Investors,” South China Morning Post, March 15, 2019.


185. He Huifeng, “Xi Jinping Promises to Open China’s Door Wider for Foreign Investors,” South China Morning Post, April 10, 2018; Kevin Yao, “China Pledges to Allow More Foreign Investment in Financial Sector by Year-End,” Reuters, April 10, 2018.


196. State Council of the People’s Republic of China, “Li Keqiang Presided over the State Council Executive Meeting and Announced ‘License Decoupling’ Reform in Free Trade Zones” (李克强主持召开国务院常务会议 决定在自由贸易试验区开展“证照分离”改
