# U.S.-China Economic and Security Review Commission

Economics and Trade Bulletin

**May 6, 2020**

## Highlights of This Month's Edition

- **Bilateral trade:** In Q1 2020, U.S. goods trade deficit with China decreased to $53.9 billion as the COVID-19 outbreak led to dramatic reductions in Chinese production and U.S. consumer spending; for full year 2019, the U.S. services trade surplus with China was $37.9 billion, a 2.3 percent fall from 2018.
- **Bilateral policy issues:** Two new final rules from the Department of Commerce's Bureau of Industry and Security strengthen controls over and scrutiny of technology exports to China that may support military applications; a joint letter by the SEC and PCAOB warns of disclosure and financial risks associated with investments in emerging markets, particularly China.
- **Quarterly review of China's economy:** China's economy shrank 6.8 percent in Q1 2020; the Chinese government moves to shore up small- and medium-sized enterprises, while households struggle; the official unemployment rate reaches a record 6.2 percent, but unofficial estimates place it at 20 percent or higher.
- **Policy trends in China's economy:** Bank of Gansu becomes the seventh distressed bank in the past year to receive government assistance; China's new plans to protect intellectual property restate familiar commitments and remain ambiguous on implementation.

## Contents



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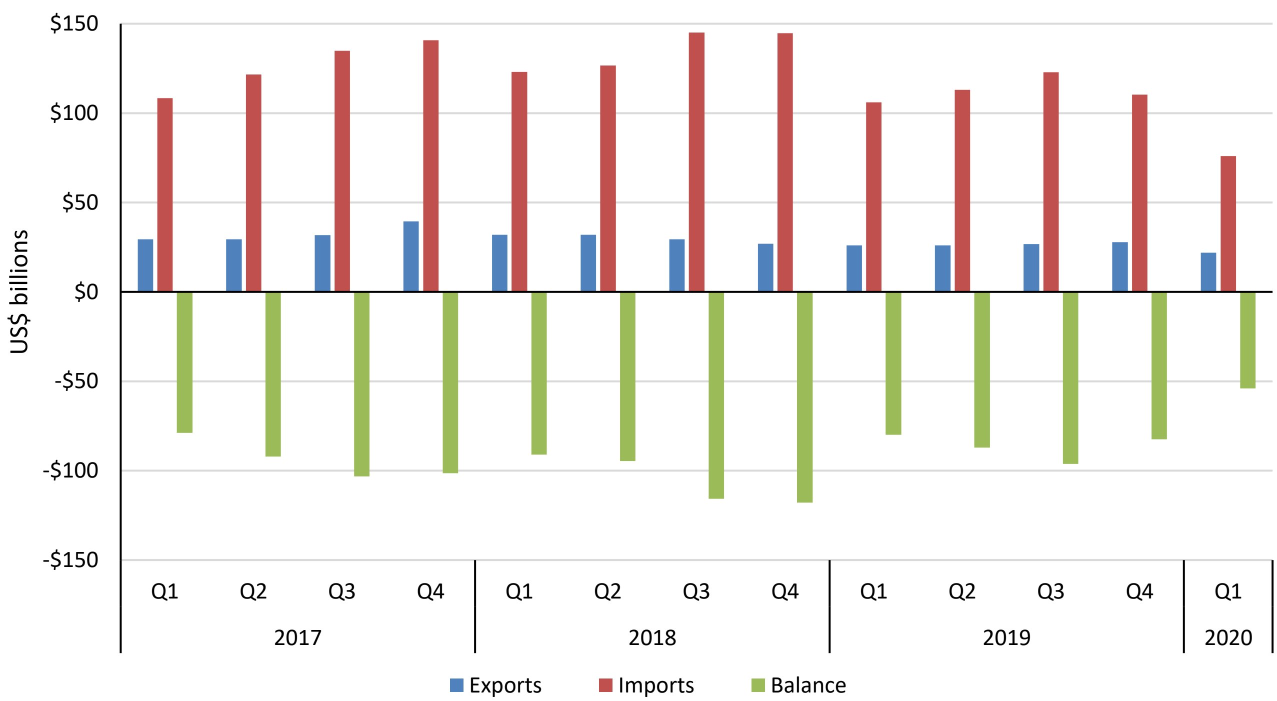
# Bilateral Trade

## U.S. Imports from China Sink in Q1 2020 as COVID-19 Takes Economic Toll

In addition to COVID-19's extensive human toll, the outbreak and response to it continue to affect U.S.-China trade. In Q1 2020, the U.S. trade deficit with China was $53.9 billion, its lowest quarterly level since 2014 (see Figure 1).[1] In February and March 2020, U.S. imports from China fell to $22.8 billion (down 31.3 percent year-on-year) and $19.8 billion (down 36.5 percent year-on-year) respectively—a downward trend that started in 2019.[2]

As the Chinese government imposed strict restrictions on movement to halt the spread of illness, migrant workers remained stranded in their hometowns after the Lunar New Year, rather than journeying back to work in urban metropolises. This caused stoppages in production and logistics in China, delaying Chinese exports to the United States and causing disarray in global shipping routes.[*] These disruptions to U.S. supply chains could be seen in U.S. ports in February, when container volumes from China to California's three largest marine ports fell by 35.2 percent.[3] The Chinese government slowly began to loosen restrictions on movement, culminating in the lifting of the quarantine in Wuhan on April 8, by which point many U.S. states and cities had entered their own lockdown period. U.S. consumer spending suffered a record collapse of 7.5 percent month-on-month in March,[4] which ricocheted back to China in the form of a drop in U.S. demand for Chinese exports.

**Figure 1: U.S. Exports, Imports, and the Trade Balance with China, Q1 2017–Q1 2020**




*Source:* U.S. Census Bureau, *Trade in Goods with China*, May 5, 2020. *https://www.census.gov/foreign-trade/balance/c5700.html.*

## Dramatic Drop in U.S. Imports from China across Key Sectors

In Q1 2020, U.S. imports from China fell by about 28.4 percent over the same period in 2019. Shocks to Chinese production and U.S. domestic demand led to a slump in nearly all types of U.S. goods imports. This slump ranged from a relatively light decline on various kinds of food products (-3.1 percent year-on-year) to a heavy impact on transportation equipment (-22.6 percent year-on-year) to deep reductions in petroleum and coal products (-89.5

[*] For more information about the economic impact of COVID-19 as it occurred in China, see Kaj Malden and Suzanna Stephens, "Cascading Economic Impacts of the COVID-19 Outbreak in China," *U.S.-China Economic and Security Review Commission*, April 21, 2020. *https://www.uscc.gov/sites/default/files/2020-04/Cascading_Economic_Impacts_of_the_Novel_Coronavirus_April_21_2020.pdf*.

percent year-on-year) (see Table 1).[5] Of all sectors, however, U.S. demand for computers and electronics suffered the deepest deterioration by volume, from $31.8 billion in Q1 2019 to $22.3 billion in Q1 2020.[6] Computers and electronics accounted for nearly a third of U.S. imports from China overall in 2019,[*] three times greater than any other import category. All other types of goods accounted for less than 10 percent of total U.S. imports in 2019.[7]

**Table 1: U.S. Trade with China Top Five Exports and Imports, Q1 2020**

**U.S. Top-Five Exports to China**

| | Exports (in US$ millions) | Share of total (%) | Change over Q1'19 (%) |
|---|---|---|---|
| *Quarter 1 (Jan-Mar' 2020)* | | | |
| Computer & Electronic Products | $4,634 | 21.1% | -2.6% |
| Chemicals | $3,575 | 16.2% | -14.9% |
| Transportation Equipment | $2,726 | 12.4% | -51.7% |
| Machinery, Except Electrical | $2,296 | 10.4% | 7.1% |
| Agricultural Products | $1,668 | 7.6% | -19.4% |
| Other | $7,104 | 32.3% | |
| **Total** | $22,002 | **100%** | |

**U.S. Top-Five Imports from China**

| | Imports (in US$ millions) | Share of total (%) | Change over Q1'19 (%) |
|---|---|---|---|
| *Quarter 1 (Jan-Mar'2020)* | | | |
| Computer & Electronic Products | $22,267 | 29.3% | -30.0% |
| Electrical Equipment, Appliances & Components | $7,490 | 9.9% | -26.1% |
| Machinery, Except Electrical | $6,439 | 8.5% | -25.6% |
| Miscellaneous Manufactured Commodities | $6,119 | 8.1% | -28.0% |
| Fabricated Metal Products, Nesoi | $4,224 | 5.6% | -26.4% |
| Other | $29,359 | 38.7% | |
| **Total** | $75,899 | **100%** | |

*Source:* U.S. Census Bureau, *USA Trade Online*, May 5, 2020. *https://usatrade.census.gov/*.

## U.S. Imports of Advanced Technology Products from China Decrease

U.S. imports of advanced technologies from China fell across nearly all sectors in the first quarter of 2019,[8] with an average decline of 14 percent.[†9] By category, the drop varied from a 12.4 percent decrease in aerospace imports to a 57 percent decrease in opto-electronics. These trends mirrored the fall in U.S. imports from China broadly.

**Table 2: U.S.-China ATP Trade, Q1 2020**
(US$ millions)

| | Exports | Imports | Balance Q1'2020 | Balance Q1'2019 | Balance YOY |
|---|---|---|---|---|---|
| **TOTAL** | **$6,570** | **$21,179** | **-$14,609** | **-$20,219** | **-27.7%** |
| (01) Biotechnology | $190 | $79 | $111 | $865 | -87.2% |
| (02) Life Science | $905 | $551 | $354 | $250 | 41.6% |
| (03) Opto-Electronics | $104 | $513 | -$409 | -$1,069 | -61.7% |
| (04) Information & Communications | $676 | $18,723 | -$18,047 | -$25,193 | -28.4% |
| (05) Electronics | $2,507 | $841 | $1,666 | $1,573 | 5.9% |
| (06) Flexible Manufacturing | $1,012 | $173 | $839 | $386 | 117.4% |
| (07) Advanced Materials | $67 | $41 | $26 | -$16 | -262.5% |
| (08) Aerospace | $1,083 | $241 | $842 | $2,983 | -71.8% |
| (09) Weapons | $0 | $16 | -$16 | -$22 | -27.3% |
| (10) Nuclear Technology | $26 | $1 | $25 | $24 | 4.2% |

*Source*: U.S. Census Bureau, *U.S. Trade with China in Advanced Technology Products*, May 5, 2020. *https://www.census.gov/foreign-trade/statistics/product/atp/2019/12/ctryatp/atp5700.html*.

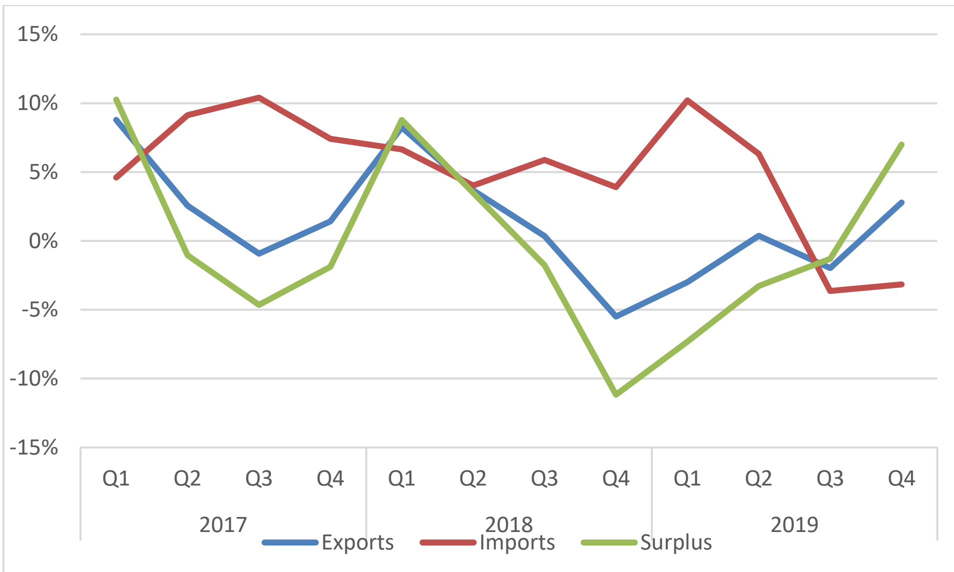
[*] U.S. imports of computers and electronics made up 32.4 percent of total U.S. imports from China in 2019. U.S. Census Bureau, *USA Trade Online*, May 5, 2020. *https://usatrade.census.gov/*.

[†] Advanced technology imports of electronics did not fall relative to the first quarter of 2019. These imports increased slightly, to 1.7 percent. U.S. Census Bureau, *U.S. Trade with China in Advanced Technology Products*, May 5, 2020. *https://www.census.gov/foreign-trade/statistics/product/atp/2019/12/ctryatp/atp5700.html.*

## U.S. Services Surplus with China Falls in 2019

In Q4 2019, the United States maintained a trade surplus in services of $7.2 billion, the first year-on-year increase since Q2 2018 (see Figure 2). U.S. services exports to China were $11.8 billion, 2.8 percent higher than during Q4 2018.[10] Notably, travel—the most significant U.S. service export to China—declined year-on-year, a trend certain to continue amid ongoing travel restrictions due to the COVID-19 pandemic. Imports of services totaled $4.6 billion, a 3.2 percent decrease compared to last year.[11] For full year 2019, the U.S. services trade surplus with China was $37.9 billion, a 2.3 percent fall from 2018. The United States exported $56.7 billion in services to China over 2019, a 0.8 percent decrease from the previous year.[12]

**Figure 2: U.S.-China Trade in Services, Q1 2017–Q4 2019**
(year-on-year)




*Source:* U.S. Department of Commerce – Bureau of Economic Analysis, *U.S. Trade in Goods and Services by Selected Countries and Areas, 1999-Present,* U.S. Department of Commerce, Foreign Trade Division, March 19, 2020.

Among the top services exports from the United States to China, charges for intellectual property (IP) usage totaled $2.2 billion in Q4 2019, an 11.7 percent increase year-on-year. Financial services exports reached $1.1 billion, a 5 percent increase year-on-year. Travel ($5.2 billion) and transportation ($1.2 billion) saw decreases of 3.8 and 1.9 percent, respectively. [13] Together, these sectors accounted for 83.4 percent of U.S. services exports to China, with travel accounting for 44.7 percent—its lowest share of U.S. services exports to China since 2013. [14] Among the top U.S. imports from China, miscellaneous business services expanded 3.3 percent to $1.5 billion. Transportation ($1.2 billion) and travel ($1.1 billion) saw year-on-year falls of 7.7 and 2.9 percent, respectively. [15] These three sectors accounted for 82.2 percent of U.S. services imports from China.[16]

# Bilateral Policy Issues

## Bureau of Industry and Security Strengthens Technology Export Controls

Two final rules issued by the U.S. Department of Commerce's (DOC) Bureau of Industry and Security (BIS) on April 28, 2020, tighten controls on technology exports to China, among other countries. A proposed rule issued the same day would require exporters based in a number of U.S. ally and partner countries,[*] as well as in Hong Kong, to obtain authorization to reexport to China certain technologies imported from the United States.[17] DOC indicated all three rules aim to reduce potential military uses of ostensibly civilian technology—a heightened concern given the opacity of ties between China's defense and commercial sectors under its program of military-civilian fusion.[†18]

The first rule, *Expansion of Export, Reexport, and Transfer (in-Country) Controls for Military End Use or Military End Users in the People's Republic of China, Russia, or Venezuela*, expands restrictions on technology exports for military users and increases scrutiny on controlled technologies exported for reported civilian use.[19] It also broadens the definition of "military end use" specifically for exports to China, Russia, and Venezuela. Where the Export Administration Regulations define "military end use" as encompassing the entire product lifecycle—"operation, installation (including on-site installation), maintenance (checking), repair, overhaul and refurbishing"—of military items, under the broadened definition any one of these functions constitutes military end use.[20] The second rule, *Elimination of License Exception Civil End Users (CIV),* ends an exemption allowing exports of 541 controlled technologies[‡] to civilian users in a number of countries[§] without a license.[21]

The immediate commercial impact of the two final rules, which go into effect June 29, 2020,[**] is difficult to assess, as it depends on how readily DOC grants export licenses for covered items.[22] Of 15 new technology areas that now require licensing for sale to military end users in China, legal analyses have identified several mass market technologies as being particularly broad in scope.[23] These include encryption software used in handsets and personal computers, consumer electronic devices such as smart phones and their components, and components used in commercial aircraft.[24] Other controls on specialized semiconductor manufacturing and testing equipment could hamper the Chinese government's costly effort to establish a wholly domestic semiconductor supply chain.[25]

Legal analysts have also observed that the new restrictions place added due diligence requirements on U.S. exporters regarding the business activities of their customers.[26] U.S. firms that export controlled technologies to civilian manufacturers may need to obtain a license if the customer has any business relationship with China's military.[27] Nonetheless, based on an analysis of current exports volumes, BIS indicated that it anticipates the new rules will have a limited impact, based on an analysis of current exports volumes.[28] The agency further noted that the typical four-year validity of export licenses should minimize ongoing compliance requirements for affected exporters.[29]

The new regulations come as BIS pursues broader restrictions on transactions with Chinese technology firms, particularly those with ties to the Chinese military or public security apparatus. In May 2019, BIS added Chinese telecommunications equipment and handset maker Huawei to the Entity List.[††] Although it has repeatedly extended

[*] The full list of countries includes Argentina, Australia, Austria, Belgium, Bulgaria, Canada, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Ireland, Italy, Japan, Latvia, Lithuania, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Turkey, and the United Kingdom. U.S. Department of Commerce, Bureau of Industry and Security, *Export Administration Regulations Supplement No. 1 § 740 "Country Groups." https://www.bis.doc.gov/index.php/documents/regulation-docs/2255-supplement-no-1-to-part-740-country-groups-1/file*.

[†] China's policy of military-civil fusion aims to facilitate transfers between the defense and civilian sectors to improve the sophistication of China's military technology. It also aims to drive economic innovation and growth and prepare for societal mobilization to support military objectives. For more on the policy background and implications for the United States, see U.S.-China Economic and Security Review Commission, Chapter 3, Section 2, "Emerging Technologies and Military-Civil Fusion: Artificial Intelligence, New Materials, and New Energy," in *2019 Annual Report*, November 2019. *https://www.uscc.gov/sites/default/files/2019-11/Chapter%203%20Section%202%20-%20Emerging%20Technologies%20and%20Military-Civil%20Fusion%20-%20Artificial%20Intelligence,%20New%20Materials,%20and%20New%20Energy.pdf*.

[‡] For a full list of items in question, see Kay C. Georgi et al., "RIP CIV! BIS to Remove License Exception CIV from the EAR," Arent Fox, April 29, 2020. *https://www.arentfox.com/perspectives/alerts/rip-civ-bis-remove-license-exception-civ-the-ear*; Export Administration Regulations § 744 Supplement No. 1 "Commerce Control List." *https://www.govinfo.gov/content/pkg/CFR-2012-title15-vol2/pdf/CFR-2012-title15-vol2-part774-appNo-.pdf*.

[§] In addition to China, these countries include Armenia, Azerbaijan, Belarus, Burma, Cambodia, Georgia, Iraq, Kazakhstan, Kyrgyzstan, Laos, Libya, Macau, Moldova, Mongolia, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan, Venezuela, Vietnam, and Yemen. U.S. Department of Commerce, Bureau of Industry and Security, *Export Administration Regulations Supplement No. 1 § 740 "Country Groups." https://www.bis.doc.gov/index.php/documents/regulation-docs/2255-supplement-no-1-to-part-740-country-groups-1/file*.

[**] Comments are due for the proposed rule on June 29, 2020, but there is no indication of when it may be implemented.

[††] The Entity List (Supplement No. 4 to part 744) identifies entities reasonably believed to be involved—or that pose a significant risk of being or becoming involved—in activities contrary to the national security or foreign policy interests of the United States. U.S. Department of Commerce, Bureau of Industry and Security, "Addition of Entities to the Entity List," *Federal Register* 84:98 (May 21, 2019).

a temporary general waiver that allows many U.S. firms to continue doing business with Huawei, in March 2020 BIS solicited feedback on whether it should continue extending the license.[*] [30] In 2019, BIS also added to the Entity List several firms and academic institutions supporting the People's Liberation Army's ability to develop super computers, as well as companies involved in supplying surveillance technologies used in mass detention and racial profiling of Uyghurs, a predominantly Muslim minority from China's northwestern Xinjiang Province.[31]

## SEC and PCAOB Warn of Disclosure Risks Associated with Chinese Firms

On April 21, 2020, the U.S. Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) issued a joint letter on disclosure and financial reporting risks associated with emerging market investments, with a particular focus on China. These risks include varying quality of financial information, the limited ability of U.S. authorities to bring actions in emerging markets, and limited rights for shareholders. In addition to noting barriers to information and redress, the 2020 letter also emphasizes the fiduciary duty of financial investors to convey to their clients the risks of emerging market investments. The letter notes that boilerplate warnings on investments are no longer sufficient to convey risks to clients and urges advisors to "conduct a reasonable investigation into the investment."[32]

A key issue of concern is the PCAOB's inability to review audits conducted by the PCAOB-registered audit agencies in China and Hong Kong due to laws limiting the transfer of business books, records, and the auditors' documentation of work abroad. The recent revelations of fraud by U.S.-listed Chinese firms, including Luckin Coffee, highlight the risks to U.S. investors from the deficiencies outlined in the joint letter. While the SEC and PCAOB can take action against firms that fail to cooperate with investigations, they have not yet done so.

The SEC and PCAOB had previously issued a joint letter in 2018 highlighting similar concerns. Since then, 37 Chinese companies have entered the U.S. stock market,[33] and the number of U.S.-listed companies that are clients of audit firms to which the PCAOB was denied access has increased from 241 issuers in 2018 to 276 issuers in 2020.[34] The majority of these issuers are based in China and Hong Kong, but the PCAOB also did not have access in 2020 to 9 Belgian issuers and 22 French issuers.[†] [35]

The 2020 letter may have been prompted by an April 2 announcement by Chinese-headquartered Luckin Coffee that an internal investigation found the chief operating officer fabricated roughly $310 million in sales in 2019, resulting in a loss of 74 percent in the company's stock value.[36] The company was viewed as a strong competitor to Starbucks in the Chinese market, and was the first company since 2000 to achieve a $3 billion public valuation within two years of its launch.[37]

The China Securities Regulation Commission has condemned the Luckin Coffee fraud and expressed interest in cooperating with the SEC. Zhu Ning, professor of finance at Tsinghua University, suggests the desire to be seen taking action on this case may have been prompted by concerns among Chinese regulators about reputational harms to China and prospects for the listing of Chinese companies in New York.[38] It is unclear if such statements will change the agency's relationship with the SEC. In 2018, the SEC and PCAOB noted that they had attempted to increase cooperation with their Chinese counterparts for several years without tangible progress.[39] Last month, TAL Education also reported suspected revenue inflation, and Wolfpack Research alleged that iQiyi (a video streaming company in which Chinese search giant Baidu has a majority share) had inflated revenue by $1–2 billion.[40]

[*] The comment window closed on April 22, 2020, but BIS has not published a final decision as of May 6, 2020. U.S. Department of Commerce, Bureau of Industry and Security, *Request for Comments on Future Extensions of Temporary General License (TGL)*, March 27, 2020. *https://www.regulations.gov/docket?D=BIS-2020-0001*.

[†] Access to French auditors was impeded by the lapse of a cooperative agreement with the French audit authority in December 2019. The PCAOB currently lacks a bilateral agreement to conduct inspections in Belgium, but negotiations to reach one are nearing completion.

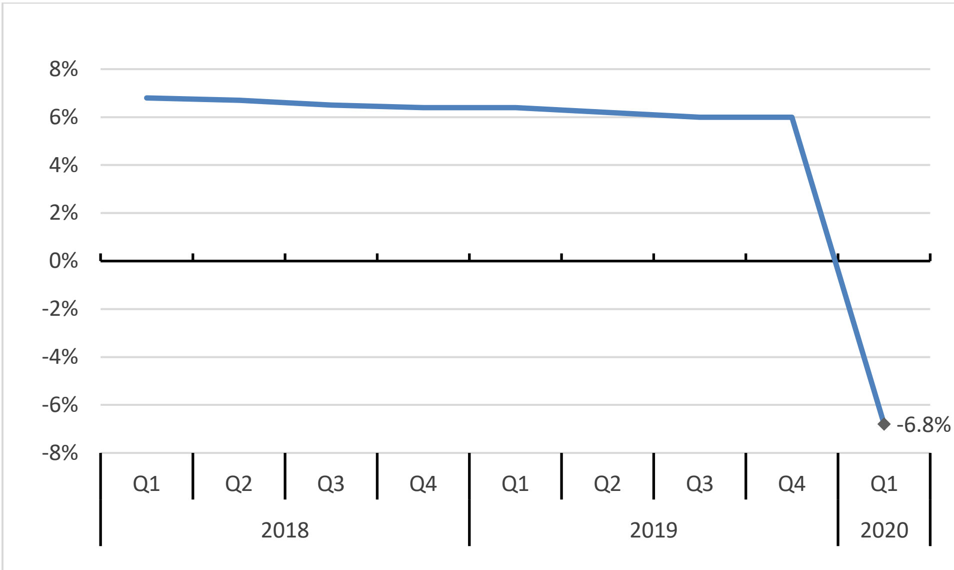
# Quarterly Review of China's Economy

## China's Economy Contracts for the First Time in Decades

China's official gross domestic product (GDP) growth contracted 6.8 percent year-on-year in Q1 2020—the worst quarterly performance since 1992* and the first year-on-year contraction since the Mao era† (see Figure 3).[41] The historic plunge in growth threatens the Chinese Communist Party's (CCP) goal of doubling GDP by 2020.[42] Though key economic indicators suggest a tentative rebound in the second quarter of the year, recovery will be fragile as the coronavirus outbreak shuts down economies worldwide and arrests external demand for China's exports.

**Figure 3: China's Official GDP Growth, 2018–Q1 2020**

(year-on-year)




*Source:* China's National Bureau of Statistics via CEIC database.

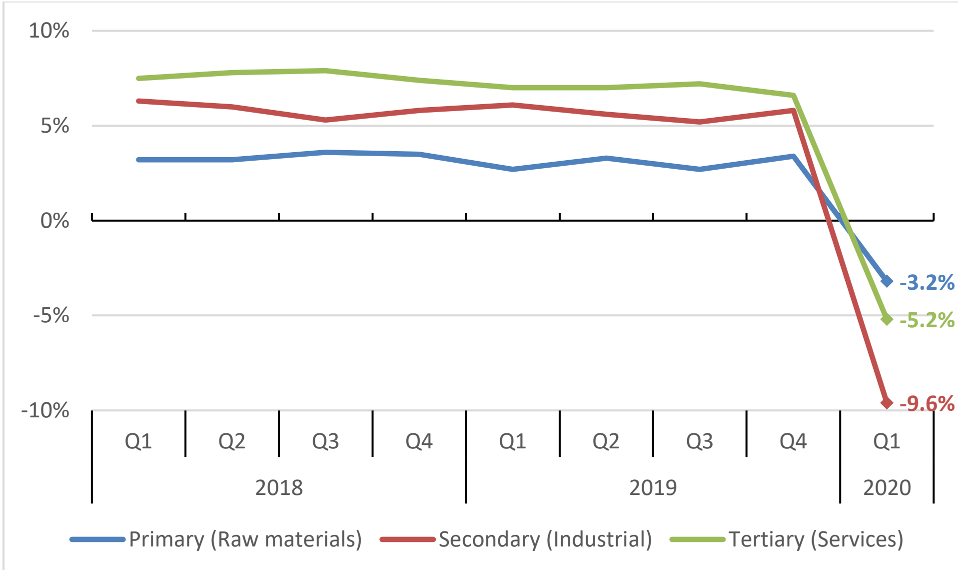
Extensive factory shutdowns in February, followed by slow and uneven reopening in March, drove China's economic contraction in Q1 2020. Growth in China's secondary sector—including manufacturing, construction, and utilities—declined 9.6 percent year-on-year. China's tertiary sector (services) did comparatively better, contracting only 5.2 percent year-on-year (see Figure 4).[43] Contraction in China's primary sector—including industries such as agriculture and animal husbandry—was comparatively mild, declining by a modest 3.2 percent year-on-year in the first quarter as demand for food products remained resilient.‡

* The Chinese government began releasing official estimates of quarterly GDP growth in 1992. *Bloomberg*, "China Suffers Historic Economic Slump with Hard Recovery Ahead," April 16, 2020. *https://www.bloomberg.com/news/articles/2020-04-17/china-s-economy-contracts-for-first-time-since-at-least-1992?sref=FlHD1WjR*.

† According to data from the World Bank, the last time China registered a year-on-year fall in economic output was in 1976, when growth contracted 1.6 percent as the Chinese economy reeled from the Tangshan earthquake as well as the social and economic tumult arising from CCP founder Mao Zedong's death. Keith Bradsher, "Coronavirus Could End China's Decades-Long Economic Growth Streak," *New York Times*, March 16, 2020. *https://www.nytimes.com/2020/03/16/business/coronavirus-china-economy.html*; World Bank, "GDP Growth (annual %) - China." *https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=CN*.

‡ Agricultural production grew 3.5 percent in the first quarter of 2020 as Chinese consumers bought more groceries and stockpiled foodstuffs amid lockdowns, restaurant closures, and fear of eating food prepared by others. Food sales grew 9.7 percent year-on-year in January–February 2020 and surged 19.2 percent year-on-year in March. China's National Bureau of Statistics, *Overall Prevention and Control of the Epidemic and Economic and Social Development Achieved Significant Results in March* (统筹疫情防控和经济社会发展成效显著 3 月份主要经济指标降幅明显收窄), April 17, 2020. Translation. *http://www.stats.gov.cn/tjsj/zxfb/202004/t20200417_1739327.html*; China's National Bureau of Statistics via CEIC database.

**Figure 4: GDP Growth by Sector, 2018–Q1 2020**
(year-on-year)

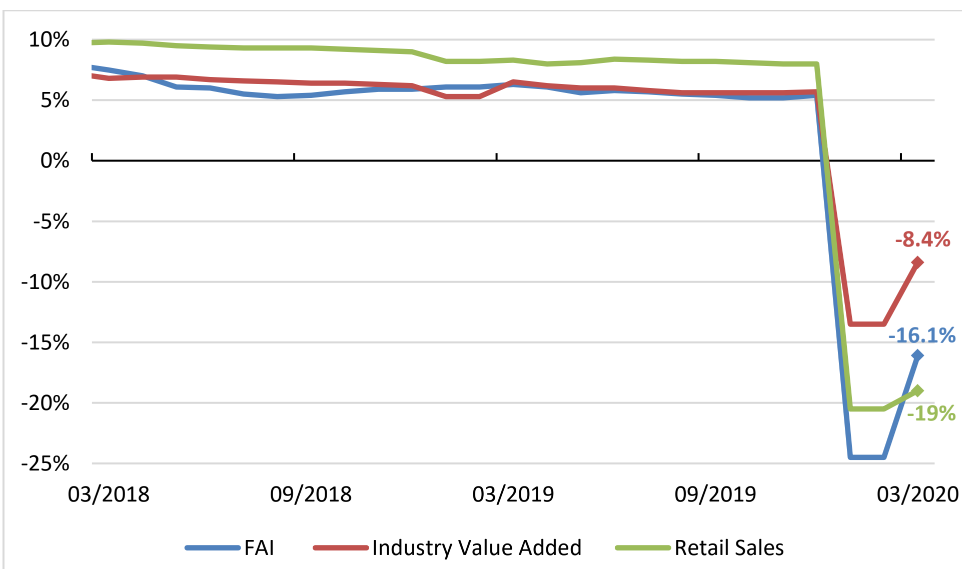



*Source:* China's National Bureau of Statistics via CEIC database.

## Key Drivers of China's Economy Plummet, Consumption Hardest Hit

Key drivers of China's economy—including fixed asset investment (FAI), industrial output, and retail sales—registered severe year-on-year contractions in Q1 2020, despite a mild recovery in March (see Figure 5). The divergent recovery of retail sales from FAI and industrial output also underscores that the Chinese government's policy responses to COVID-19 to date have focused on shoring up businesses rather than restoring household and consumer sentiment, which remains subdued amid fears of contracting the virus and anxiety about job security. One joint survey by Southwestern University of Finance and Economics and Ant Financial, for example, revealed that 50.2 percent of Chinese households increased savings and cut back on spending in the first quarter.[44] (For more, see "Rising Unemployment and Household Debt Dampen Consumption" later in this bulletin.)

**Figure 5: Key Indicators of China's Economy, 2018–Q1 2020**
(year-on-year)




*Source:* China's National Bureau of Statistics via CEIC database.

FAI—a traditional driver of China's growth that measures investment in physical assets such as buildings, machinery, and equipment—shrank 16.1 percent year-on-year in the first quarter of 2020, a moderation from the steep 24.5 percent year-on-year fall in the first two months of the year.[45] Analysts at Capital Economics attributed this recovery to the Chinese government's fiscal stimulus measures,[46] with investment rising 6.1 percent month-on-month in March.[47]

The contraction in China's value-added industrial output, which measures production at factories, mines, and utilities, narrowed to 1.1 percent year-on-year in March from the 13.5 percent year-on-year decline observed in January–February[48] as the government moved to provide tax and credit relief for struggling firms.[49] Still, growth in industrial output remained negative for the quarter, measuring at -8.4 percent.[50]

Retail sales growth declined 19 percent in Q1 2020,[51] the deepest contraction of all indicators, as consumers stayed at home in accordance with stringent quarantine measures. Recovery in retail sales is markedly sluggish compared to other indicators, with the contraction narrowing just 4.7 percentage points in March from the 20.5 percent year-on-year plunge in January–February.[52] Prospects of layoffs and pay cuts are also weakening consumer sentiment as households worry about job and income security.[53]

## Corporates Struggle as Government Steps Up Support

Despite a slight recovery in China' official manufacturing Purchasing Managers' Index (PMI)[*] in March, data from April showed the manufacturing index experiencing only very slight expansion, with trade indicators still in contraction (see Figure 6).[54] New export orders, a measure of demand for Chinese exports from abroad, contracted further as the COVID-19 outbreak hit global economies. In response, the Chinese government moved to provide support to small- and medium-sized enterprises (SMEs) most vulnerable to shutdowns as well as those involved in epidemic control efforts. The People's Bank of China (PBOC) launched a special-purpose relending program, which by late February had issued $114.8 billion in discounted financing to specific banks to relend to eligible companies of their choice.[55] The China Banking and Insurance Regulatory Commission, a powerful financial regulatory agency, also encouraged banks to tolerate late payments from companies affected by the virus, though details regarding this guidance were not provided.[56] The PBOC also pumped more money into the banking system in March through reduced reserve requirement ratios[†] and medium-term lending facility[‡] rate cuts.[57]

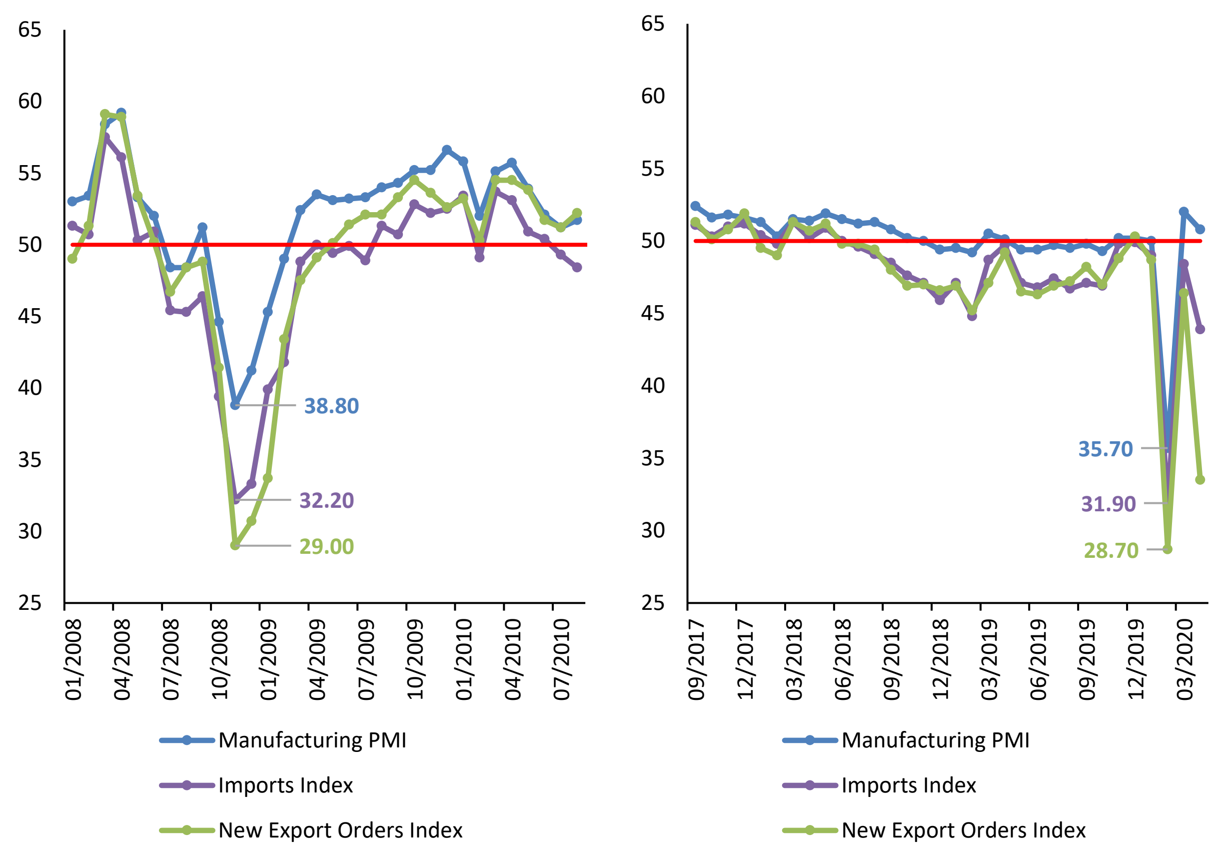
[*] The PMI is a month-on-month indicator showing trends in the manufacturing sector compiled from a monthly survey of enterprise purchasing managers. An index above 50 indicates an expansion, normally with higher volumes of new orders and output. An index below 50 indicates a contraction. According to Tom Orlik, senior economist at Bloomberg, the China Federation of Logistics and Purchasing's PMI is the largest sample and most comprehensively available public data. Tom Orlik, *Understanding China's Economic Indicators*, FT Press Science, 2012, 41–42.

[†] The reserve requirement ratio is the minimum amount capital banks must hold against outstanding loans.

[‡] The medium-term lending facility is a monetary policy tool the PBOC uses to increase liquidity in the banking system by providing funds with longer maturities (between three months and one year). *Bloomberg*, "China's Evolving Toolkit to Manage Monetary Policy," June 14, 2018. *https://www.bloomberg.com/news/articles/2018-06-14/china-s-evolving-toolkit-to-manage-monetary-policy-quicktake?sref=FlHD1WjR*.

**Figure 6: Manufacturing PMI and Export and Import Indices**

*January 2008–August 2010* *September 2017–April 2020*




*Note:* An index above 50 indicates an expansion, normally with higher volumes of new orders and output; an index below 50 indicates a contraction.
*Source:* China Federation of Logistics and Purchasing and National Bureau of Statistics via CEIC.

## Rising Unemployment and Household Debt Dampen Consumption

As Chinese companies struggle to resume work amid a global demand crunch and fears of reinfection, unemployment has risen dramatically, leaving households vulnerable without much direct governmental support. The China National Bureau of Statistics' official unemployment rate, widely viewed as inaccurate given its political sensitivity,[*] reached a record 6.2 percent in February 2020.[58] In late April, Chinese brokerage firm Zhongtai Securities estimated unemployed workers "may have already exceeded 70 million,"[†] a jobless rate of about 20.5 percent.[59] Unemployment and underemployment have placed many households under great pressure. According to a March survey of 120,000 households conducted by the China Household Finance Survey and Research Center,

[*] Though many of China's official statistics are viewed with suspicion, the unemployment rate is understood to be the least informative of all key economic indicators for which Beijing publishes data. One 2017 study found that China's official unemployment rate fluctuated in a narrow range between 4 and 4.3 percent in 2002–2010 and stayed fixed at 4.1 percent since the third quarter of 2010. The official rate's apparent imperviousness to major fluctuations in China's economy—such as the global financial crisis—suggest it is tightly controlled by the government. See Shuaizhang Feng, Yingyao Hu, and Robert Moffitt, "Long Run Trends in Unemployment and Labor Force Participation in Urban China," *Journal of Comparative Economics* 45 (2017): 304–324.

[†] As a testament to the continuing political salience of unemployment figures, on May 1 *Caixin* business magazine reported that Zhongtai Securities removed its research chief from his post—though he remains the brokerage's chief economist--after this analysis was published and then scrubbed by online censors. Zhongtai Securities has subsequently said the personnel change had been decided prior to the analysis' publication and were unrelated to the unemployment analysis. *Caixin*, "Zhongtai Securities Removes Research Chief after Controversial Report," May 1, 2020. *https://www.caixinglobal.com/2020-05-01/zhongtai-securities-removes-research-chief-after-controversial-report-101549484.html*.

about 20 percent of households can only withstand slightly more than two months with no income, while 40 percent cannot withstand more than three months.[60] The situation is particularly perilous because many Chinese households had rapidly taken on a large amount of debt before the COVID-19 outbreak, primarily in the form of mortgages. Logan Wright and Allen Feng of Rhodium Group reported household debt rose by about $4.6 trillion between 2015 and 2019,[*] currently standing at about 128 percent of household income, a level comparable to U.S. household debt-to-income levels ahead of the 2008 Financial Crisis.[61] While no specific debt-to-income level is inherently dangerous for households, higher debt-to-income levels put households at risk if their incomes decline to the extent that it can no longer afford monthly payments.

Despite households' vulnerability, Chinese government authorities provide little direct support to them. In a mid-March interview, Li Gan, the director of the China Household Finance Survey and Research Center at the Southwestern University of Finance and Economics, noted that social support measures in China continue to remain low at 3 percent of GDP, relative to 12 percent of GDP across advanced economies.[62] Even newer policy measures may not suffice. In an April 21 meeting, China's State Council called for an expansion of "both minimum subsistence allowances and unemployment insurance to cover all eligible families in urban and rural areas," including to unemployed migrant workers.[63] Migrant workers traditionally are ineligible for urban unemployment benefits: as nonresidents, they are barred from receiving local social programs and services. Despite the State Council's expansion, however, Geoffrey Crothall, China Labour Bulletin Communications Director, stated these benefits are low and challenging to access.[64] The State Council did not specify how long income support measures would last.[65] In addition, as these types of social expenditures typically occur at the local level, the extent to which the central government could step in to support nonresidents is uncertain.

Consequently, households have responded by increasing savings at a time when the Chinese government is encouraging them to spend. In the first quarter of 2020, the PBOC reported that household savings rose $913.4 billion (renminbi [RMB] 6.47 trillion), an increase of 6.6 percent over the same period in 2019.[66] This trend, mirrored in the March retail sales contraction of 19.0 percent over the prior year (see Figure 5),[67] runs counter to government hopes. More than 30 province and city local governments have reportedly issued "digital coupons" for dining, shopping, and travel on platforms like Alipay and WeChat Pay.[68] Some retail areas have succeeded by moving into online sales. Online sales of food and consumer goods, for example, increased 26.4 percent year-on-year in January–February 2020, while purchases of clothing fell 18.1 percent in the same period.[69] Chinese platform Taobao's online sessions doubled in February as retail brands relied on e-commerce and livestreaming for customers.[70]

# Policy Trends in China's Economy

## State-Owned Shareholders Rescue Bank of Gansu

On April 17, Hong Kong-listed Bank of Gansu announced it would issue new equity to a coalition of four shareholders, all of which are provincial state-owned enterprises (SOEs), making Bank of Gansu the seventh distressed bank in the past year to receive government assistance.[71] Under the plan, Gansu Provincial State-Owned Asset Investment Group, Gansu Provincial Highway Aviation Tourism Investment Group, Jiuquan Iron and Steel Group, and Jinchuan Group will increase their collective stake in the bank from 35 percent to 48.2 percent.[72] Caixin, a Chinese business and financial media company, also reported the PBOC would provide special loans to assist with the bailout, though authorities have not confirmed the report.[73] News that the Gansu provincial government would step in to shore up Bank of Gansu came less than three weeks after the bank released its 2019 annual report, which revealed that its operating revenue shrank 18.5 percent last year, while its net profit fell 85.2 percent and its assets expanded a meager 2 percent.[74] Two days later, the bank's stock price fell 43.5 percent, in part because margin calls[†] on pledged shares forced brokers to liquidate client positions.[75]

[*] By comparison, U.S. households increased household debt by $5.1 trillion between the third quarter of 2003 and the third quarter of 2008. Logan Wright and Allen Feng, "China's Household Debt, Part I: The Last Frontier," *Rhodium Group*, April 16, 2020, 1.

[†] A margin call occurs when the value of assets in an investor's margin account—an account containing securities purchased with funds borrowed from a broker—fall below a preestablished threshold set by the broker. The margin call is the broker's demand that the investor either deposit additional funds in the account or sell the assets in the account.

Bank of Gansu's problems in 2019 were characteristic of the challenges faced by many regional banks. The main drag on its profitability was a significant deterioration in asset quality. Prior to the crackdown on shadow banking that began in 2017, Bank of Gansu extended large volumes of risky off-balance-sheet loans and did not maintain adequate provisioning against potential losses.[76] When strengthened recognition standards for nonperforming loans (NPLs) went into effect in 2019, the bank suddenly had to recognize many off-balance-sheet NPLs as such and was forced to write down $590 million (RMB 4.2 billion) worth of impaired assets in 2019.[*] [77] Without sufficient loan loss provisions, Bank of Gansu had no choice but to divert profits to pay for the write downs. As a result, it recorded $610 million (RMB 4.3 billion) in losses due to asset impairment, a 119 percent increase from 2018.[78]

China's financial regulators believe the way to strengthen weak regional banks like Bank of Gansu is to overhaul their shareholder structure. At a press conference on April 22, Vice Chairman of the Banking and Insurance Regulatory Commission (CBIRC) Cao Yu said the government's priority for reforming small and medium banks was to "optimize shareholder structure, strictly check shareholder qualifications, and regulate shareholder behavior."[79] Beijing has good reason to be concerned about shareholder malfeasance: it has uncovered 3,000 shareholder violations since the beginning of 2018.[80] Moreover, similar to Baoshang Bank, Bank of Jinzhou, and others, many of the problems at Bank of Gansu were linked to unscrupulous private shareholders that also took out loans from the bank.[81]

Government statements notwithstanding, the pattern established by the string of bank rescues over the past year—raising new capital through share issues to SOEs—simply replaces troubled private shareholders with state-owned ones, some of which have their own financial problems.[82] Such swaps do not resolve the fundamental problem that the government is on the hook when the bank's loans go bad. On April 10, with its bailout secured, Bank of Gansu pledged $4.3 billion (RMB 30 billion) in new loans to provincial SOEs, apparently partly in an attempt to calm depositor nerves after a run on one of its branches.[83] Less than two months earlier, S&P affirmed the BBB rating of Bank of Gansu's largest shareholder and bailout coalition member, Gansu Provincial Highway Aviation Tourism Investment Group, on the basis of "an almost certain likelihood of extraordinary government support if needed."[84] This begs the question of whether regulators are trading private risk-takers betting on a government bailout for state-owned ones that will do the same. Even so, Beijing may ultimately prefer the devil it knows—unlike rogue private shareholders, SOEs are reliably within the fold.

## New Plans to Protect Intellectual Property Light on Details

Recent policy plans alleging to improve IP protection in China instead restate prior commitments, maintain ambiguity on implementation, and indicate that improvements in China's IP regime will serve state rather than market interests. On April 20, China's National Intellectual Property Administration (CNIPA) released the *2020–2021 Implementation Plan for the "Opinions on Strengthening the Protection of Intellectual Property"* (the Plan), a roadmap outlining 133 measures to execute the *Opinions on Strengthening the Protection of Intellectual Property*.[†] [85] While some measures in the Plan appear to suggest progress on key areas negotiated as part of the U.S.-China

[*] Asset impairment occurs when a company recognizes that the market value of an asset or group of assets on its balance sheet is lower than the recorded book value. Once impairment is recognized, the value of the asset must be "written down" on the company's balance sheet to reflect its new market value, which in turn requires the company to raise new capital to meet loss-provisioning requirements.

[†] The CCP Central Committee and State Council released the *Opinions on Strengthening Intellectual Property Rights Protection* on November 24, 2019. While the document directly addressed U.S. concerns about IP theft, particularly around improved coordination between administrative and criminal enforcement, its vague pronouncements suggest its primary aim was to foster momentum toward the Phase One agreement. Mark Cohen, "New CPC and State Council Opinions on Improving IP Protection," *China IPR*, November 25, 2019. *https://chinaipr.com/2019/11/25/new-cpc-and-state-council-opinions-on-improving-ip-protection/*; State Council of the People's Republic of China, *Central Committee and State Council Release "Opinions on Strengthening Intellectual Property Rights Protection"* (中共中央办公厅 国务院办公厅印发《关于强化知识产权保护的意见》), November 24, 2019. Translation. *http://www.gov.cn/zhengce/2019-11/24/content_5455070.htm*.

Phase One trade agreement,* they offer little detail on how or by which government departments they will be implemented. Elsewhere, the Plan calls for the revision of other laws before its proposed measures can be implemented (e.g., amending the Patent Law to include a punitive compensation system when IP rights are infringed upon)—actions that will take time to work through China's policy process. China legal expert Mark Cohen also observes that the Plan is promulgated at a low level of governmental authority,† raising further questions about implementation.[86] Specifically, CNIPA's low position within the Chinese government bureaucracy makes any plans it issues subject to higher-level approval, raising the possibility that the Plan's proposed measures could be rejected or delayed.

Some measures in the Plan suggest Beijing seeks to expand the international influence of its IP regime. Measure 98, for example, calls for the Chinese government to strengthen cooperation with international organizations such as the World Intellectual Property Organization, WTO, and Asia-Pacific Economic Cooperation to "participate in the formulation and *revision* of international rules on IP rights."[87]

Separately from the CNIPA Plan, on April 21 China's Supreme People's Court issued general guidelines to strengthen IP rights protection in a nod to many of the commitments made by Beijing as part of the Phase One agreement.[88] The *Opinions of the Supreme People's Court on Comprehensively Strengthening Judicial Protection of Intellectual Property Rights* (the Opinions) summarize plans to strengthen IP enforcement, bolster trade secret protection, and impose higher penalties on IP rights violators.[89] Though the Supreme People's Court Vice President Jiang Bixin indicated the Opinions were developed in part to respond to Phase One commitments,[90] language in the document remains high-level and vague, suggesting the Opinions serve more as a framework under which more concrete policy changes will still need to be developed.

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This report is the product of professional research performed by the staff of the U.S.-China Economic and Security Review Commission, and was prepared at the request of the Commission to support its deliberations. Posting of the report to the Commission's website is intended to promote greater public understanding of the issues addressed by the Commission in its ongoing assessment of U.S.-China economic relations and their implications for U.S. security, as mandated by Public Law 106-398 and Public Law 113-291. However, it does not necessarily imply an endorsement by the Commission, any individual Commissioner, or the Commission's other professional staff, of the views or conclusions expressed in this staff research report.

* Measure 8, for example, calls for an early resolution mechanism for pharmaceutical patent disputes to be established by the end of October 2020. The measure seems to respond to Section C, Article 1.11 in the Phase One agreement concerning the development of a patent linkage system for pharmaceuticals. Patent linkage systems protect branded pharmaceuticals from infringement but also allow potential generic competitors to challenge whether a patent holder's claim is valid or applicable to a proposed generic drug. Such systems prevent expensive and time-consuming litigation by requiring pharmaceutical regulators to review claims directly before they go to court. Under the system proposed in the Phase One trade deal, patent holders would be notified and have a chance to respond any time a potential generic competitor claimed they were not infringing on the patent holder's IP. The CNIPA Plan only indicates that a corresponding mechanism will be established by October 2020; it does not provide further detail on what government department will establish and manage the mechanism. China National Intellectual Property Administration, *2020–2021 Implementation Plan for the "Opinions on Strengthening the Protection of Intellectual Property"* (2020—2021 年贯彻落实《关于强化知识产权保护的意见》推进计划), April 20, 2020. Translation. *http://www.cnipa.gov.cn/zscqgz/1147678.htm*; Office of the U.S. Trade Representative and U.S. Department of the Treasury, *2020 Economic and Trade Agreement between the United States of America and the People's Republic of China: Phase One*, January 15, 2019, 1–6.

† CNIPA is a division within the ministry-level State Administration of Market Regulation, making it arguably weaker and less independent than the previously separate State Intellectual Property Organization it replaced as part of the government restructuring enacted at the 2018 National People's Congress. See Mark Cohen, "Is It In There – CNIPA's 'Phase 1' IP Action Plan?" *China IPR*, April 22, 2020. *https://chinaipr.com/2020/04/22/is-it-in-there-cnipas-phase-1-ip-action-plan/*; U.S.-China Business Council, "China National Intellectual Property Administration," August 2018. *https://www.uschina.org/policy/china-national-intellectual-property-administration*.

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