U.S.-China Economic and Security Review Commission

Economics and Trade Bulletin

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Highlights of This Month's Edition

- **Bilateral trade:** U.S. exports to China reached $8.6 billion in April 2020, the first year-on-year increase since January 2020.
- **Bilateral policy issues:** On May 28, the National People's Congress approved a plan to impose a national security law on Hong Kong, sparking protests in the territory; the Trump Administration declared its intention to begin revoking Hong Kong's special status in U.S. law; two final rules from the Department of Commerce's Bureau of Industry and Security (BIS) add to the Entity List Chinese entities involved in human rights abuses and facilitating military use of U.S. technology; BIS also strengthens controls over semiconductor exports to Huawei; Chinese companies look to other capital markets as the United States tightens scrutiny on Chinese securities.
- **In Focus – Two Sessions 2020:** Convening in Beijing to set national-level priorities, China's top leaders abandoned the country's GDP growth target in favor of measures supporting employment and social stability, unveiled large-scale economic stimulus policies, and announced an ambitious legislative agenda.

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Bilateral Trade

U.S. Goods Exports to China Up in April 2020, but Outlook Uncertain

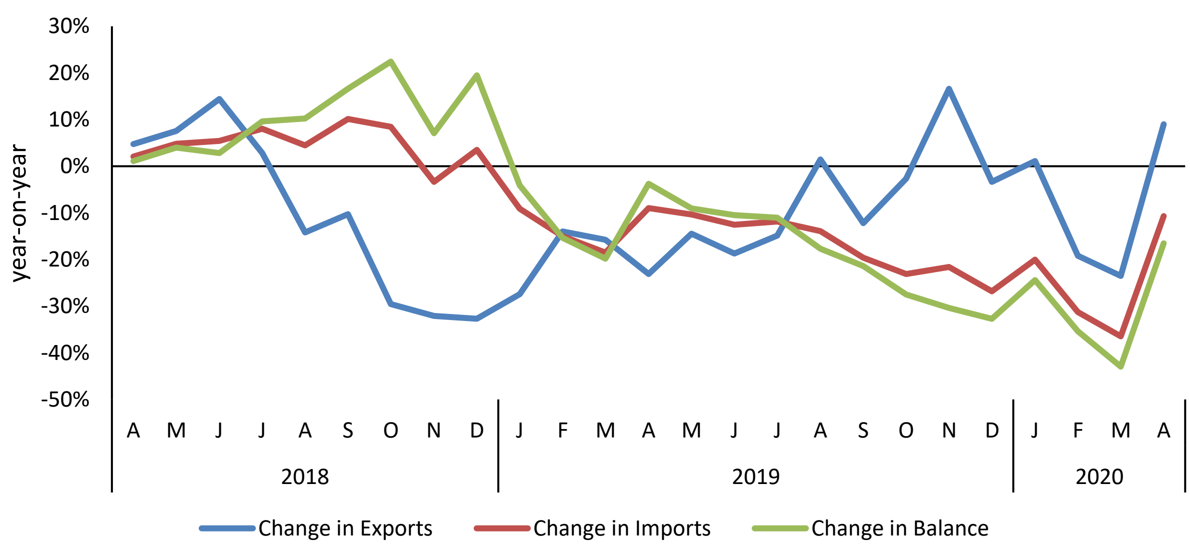
In April 2020, U.S. exports to China reached $8.6 billion, an 8.97 percent increase over $7.9 billion in April 2019 (see Figure 1).[1] China's global imports decreased 14.2 percent from April 2019, according to data from the General Administration of Customs.[2] U.S. goods imports from China in April were valued at $31.1 billion, down 10.7 percent over April 2019.[3] This year-on-year decrease came even as China's global exports in April rose by 3.5 percent from 2019, according to the General Administration of Customs, partially driven by exports of medical supplies.[4] Handling volumes at China's ten largest ports increased by 7 percent over last year.[5]

U.S. goods trade deficit with China in April 2020 was $22.5 billion, down 16.5 percent from $26.9 billion in April 2019. In the first four months of 2020, the deficit was $42.1 billion, down 29 percent from $59.2 billion in 2019, with the narrowing driven primarily by a year-on-year decrease in imports from China in 2020.[6]

Year-to-date, U.S. exports to China are lower than in 2019, with $30.6 billion in goods exported in the first four months of 2020, $3.9 billion less than the same period in 2019 and $8.6 billion less than 2017 levels.[7] The United States imported $107 billion from China in January – April 2020, down $33.8 billion year-on-year.

The falling volume of U.S.-China trade is prompting concerns that China would be unable to meet its Phase One trade deal obligations. Under the terms of that agreement, in 2020–2021 China's government would increase its purchases of U.S. products by $200 billion over 2017 levels (China's purchases in 2017 were $134.2 billion in sectors covered by the agreement), with $76.7 billion of the increase occurring in 2020.[8] Research by global trade data company Panjiva estimates China was $21.2 billion behind on purchases in the first quarter of 2020. Panjiva's research director Chris Rogers noted, "with challenges including weak commodity prices and industrial closures in the U.S. as well as logistics disruptions it may prove challenging for China to get back on track this year."[9]

Figure 1: U.S. Exports, Imports, and the Trade Deficit with China, April 2018–April 2020



Source: U.S. Census Bureau, *Trade in Goods with China*, June 4, 2020. *https://www.census.gov/foreign-trade/balance/c5700.html.*

Bilateral Policy Issues

National Security Law Upends "One Country, Two Systems," Provokes U.S. Response

On May 28, China's National People's Congress (NPC) approved a plan to impose a national security law on Hong Kong, sparking an outcry both in the territory and internationally. Beijing state media outlet Xinhua stated this law would "prevent, stop, and punish any act" in Hong Kong to "split the country," subvert state power, organize "terrorist activities," and "other behaviors that seriously endanger national security."[*] [10] In passing the national security law through China's National People's Congress, Beijing bypassed Hong Kong's own city government and legislative council, generating immediate opposition.[†] The move violates Beijing's promise to preserve Hong Kong's autonomy, as written in the "one country, two systems" policy adopted after the 1997 transfer of Hong Kong from Great Britain to the People's Republic of China.

Democratic Party founder Martin Lee called Beijing's actions "a breach of the [Sino-British Joint Declaration] agreement," and 2014 Occupy Central (or Umbrella) Movement leader Nathan Law said it represented the "end of [Hong Kong]'s freedom."[11] The Hong Kong Bar Association said no guarantee was made that the national security law would comply with the International Covenant on Civil and Political Rights which Hong Kong's Basic Law pledged to support, including the protection of freedoms of conscience, expression, association, and peaceful assembly.[12] Mr. Law concurred, noting the law's ambiguity could allow "any criticism or political action that threatens the [Chinese Communist Party] or the central government" to be considered unlawful, silencing opposition, revoking Hong Kong's freedom of expression, and debilitating its independent court system.[13]

In response, on May 29 President Donald Trump said his administration would begin the process of removing policy exemptions underpinning Hong Kong's special status in U.S. law.[14] This announcement followed an earlier statement on May 27 by Secretary of State Michael Pompeo, who certified to Congress, "No reasonable person can assert today that Hong Kong maintains a high degree of autonomy from China."[15] While details remain forthcoming, President Trump's withdrawal of special treatment could affect "the full range of agreements" between the United States and Hong Kong.[16] Areas where Hong Kong receives special treatment under the 1992 United States-Hong Kong Policy Act include but are not limited to:

- Recognition of Hong Kong as a separate customs territory;[‡]
- Separate treatment for Hong Kong in economic and trade matters, including import quotas and the negotiation of bilateral economic agreements;[§]
- Greater access to U.S. exports of controlled sensitive technologies relative to the Mainland for as long as the United States "is satisfied that such technologies are protected from improper use or export."[17]

In addition to these areas, President Trump said the United States would take "necessary steps" to impose sanctions on officials in mainland China and Hong Kong "directly or indirectly involved in eroding Hong Kong's autonomy,"

[*] It also called for the Hong Kong government to implement its own national security legislation under Article 23 of the Basic Law, Hong Kong's mini constitution. Article 23 would ban secession and subversion against Beijing. The Hong Kong government attempted to implement Article 23 in 2003, provoking protests of about 500,000 people in the territory. Further attempts were abandoned. Alice Woodhouse and Nicolle Liu, "Top Hong Kong Official Backs Call for Controversial Security Law," *Financial Times*, January 21, 2020. *https://www.ft.com/content/3c2bb6d4-3c17-11ea-b232-000f4477fbca*; *Xinhua*, "China Focus: Draft Decision on Hong Kong National Security Legislation Submitted to NPC," May 22, 2020. *http://www.xinhuanet.com/english/2020-05/22/c_139078396.htm*.

[†] According to Hong Kong's Basic Law, Hong Kong's Legislative Council retains the power to introduce, enact, amend, or repeal laws in the territory. Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, Article 73-Article 74. *https://www.basiclaw.gov.hk/en/basiclawtext/images/basiclaw_full_text_en.pdf*.

[‡] For instance, U.S. Section 301 tariffs in place on U.S. imports from China do not currently apply to U.S. imports from Hong Kong. Takeshi Kihara, "Hong Kong's Tariff Loophole Flourishes in U.S.-China Trade War," *Nikkei Asian Review*, March 4, 2019. *https://asia.nikkei.com/Economy/Trade-war/Hong-Kong-s-tariff-loophole-flourishes-in-US-China-trade-war*.

[§] No trade or investment agreement currently exists between the United States and Hong Kong.

which may draw on authorities specified in the 2019 Hong Kong Human Rights and Democracy Act.[18] The Administration could also consider changes to bilateral treaties between the United States and Hong Kong.[*]

The United States has a sizeable business presence in Hong Kong. U.S. companies have established over 1,300 offices in the territory, including nearly 300 regional headquarters.[19] Approximately 85,000 U.S. citizens reside in Hong Kong.[20] Even before the national security law was announced, U.S. companies already felt on edge due to the outbreak of the novel coronavirus, COVID-19, and continuing unrest sparked by the Hong Kong government's extradition bill proposed in 2019.[†] In early March, American Chamber of Commerce (AmCham) Hong Kong President Tara Joseph said U.S. businesses were "desperate" for a "proactive strategy to restore Hong Kong's battered image and economy" as living in Hong Kong had become a "riskier undertaking."[21] The national security law only exacerbated these fears. In a June 2020 AmCham Hong Kong survey, 53 percent of respondents said they felt "very concerned" and 30 percent of respondents felt "moderately concerned" about the national security law.[22] To that end, on May 29 President Trump announced the Department of State's travel advisory status for Hong Kong would be revised "to reflect the increased danger of surveillance and punishment" by Chinese state security.[23]

U.S. Department of Commerce Tightens Chinese Entities' Access to Technology

Two final rules issued in May by the U.S. Department of Commerce's Bureau of Industry and Security (BIS) add 33 new firms to the Entity List,[‡] while an interim final rule strengthens existing Export Administration Regulations (EAR) controls on Chinese firm Huawei, largely aimed at Huawei's efforts to establish capabilities in semiconductor production.[24] The interim final rule follows the addition of Huawei and many of its international affiliates to the Entity List in May 2020, and responds to reports that Huawei was still able to access controlled U.S. technology and items produced with that technology due to limits in the scope of U.S. export controls.[25]

BIS Adds 33 Entities for Human Rights Violations, Military Ties

On May 22, 2020, BIS issued two separate final rules adding a total of 33 more Chinese entities to the Entity List. The first added nine entities for human rights violations associated with China's mass detention and repression of the Uyghur Muslim minority in China's Northwest Xinjiang Province.[26] The nine entities include China's Ministry of Public Security's China's Institute of Forensic Science and Aksu Huafu Textiles Co.,[§] as well as seven firms providing surveillance technologies used in Xinjiang.[**] This action follows a similar final rule BIS issued in October 2019, which added 29 entities—including camera maker Hikvision and Hong Kong-based facial recognition startup SenseTime—to the Entity List for human rights violations in Xinjiang.[27]

[*] Such agreements include but are not limited to a mutual legal assistance agreement (i.e., enabling administrative cooperation in connection to criminal offenses); a mutual extradition treaty (i.e., a party may surrender fugitive offenders wanted for serious crimes, such as murder, rape, and human trafficking); and a transfer of sentenced persons (i.e., a party may surrender a person sentenced to jail for at least a one-year term). An incomplete list of bilateral agreements with Hong Kong is available at the Hong Kong Department of Justice, *Treaties and International Agreements*. *https://www.doj.gov.hk/eng/laws/treaties.html*.

[†] For more information on the Hong Kong extradition bill, see U.S.-China Economic and Security Review Commission, *2019 Annual Report to Congress*, November 2019, 483. *https://www.uscc.gov/sites/default/files/2019-11/Chapter%205%20-%20Hong%20Kong.pdf*.

[‡] 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. U.S. Department of Commerce, Bureau of Industry and Security, "Addition of Entities to the Entity List," *Federal Register* 84:98 (May 21, 2019).

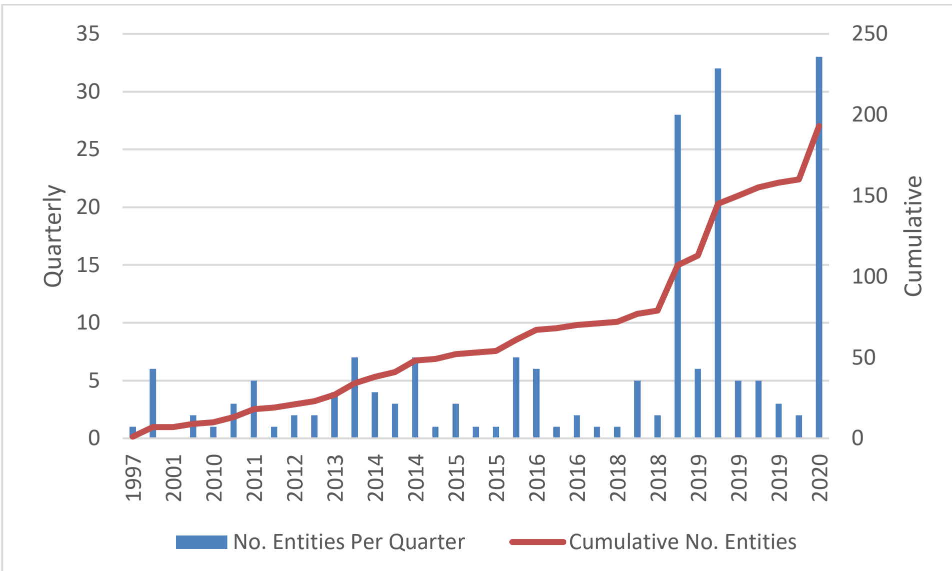
[§] BIS did not specify how Aksu Huafu Textiles was involved in human rights violations, though analysis from the *Kharon Brief* links the firm and its parent company, Huafu Fashion Co., to an industrial park where detained Uighurs are forced to participate in what the CCP claims is "vocational training." Edmund Xu and Samuel Rubenfeld, "Industrial Parks in Xinjiang Supplying Global Retailers Prompt Human Rights Concerns," *Kharon Brief*, May 28, 2020. *https://brief.kharon.com/updates/industrial-parks-in-xinjiang-supplying-global-retailers-prompt-human-rights-concerns/*.

[**] These include CloudWalk Technology, FiberHome Technologies Group and its subsidiary Nanjing FiberHome Starrysky Communication Development, NetPosa and its subsidiary SenseNets, Intellifusion, and IS'Vision. CloudWalk is an artificial intelligence startup with backing from Japanese conglomerate SoftBank that has also supplied facial recognition technology to state security services in Zimbabwe. David Shepardson and Karen Freifield, "Dozens of Chinese Companies Added to U.S. Blacklist in Latest Beijing Rebuke," *Reuters*, May 22, 2020. *https://www.reuters.com/article/us-usa-china-blacklist/dozens-of-chinese-companies-added-to-us-blacklist-in-latest-beijing-rebuke-idUSKBN22Y2QR*; Steven Feldstein, "How Artificial Intelligence Is Reshaping Repression," *Journal of Democracy* 30 (January 2019), 40–52, 40–41. *https://carnegieendowment.org/files/201901-Feldstein-JournalOfDemocracy.pdf*; Crunchbase, "Cloudwalk Technology." *https://www.crunchbase.com/organization/cloudwalk-technology#section-overview*.

BIS's second rule added 24 companies involved in supporting Chinese military end-use procurement.* Ten of the 24 entities are affiliated with the Chinese Academy of Engineering Physics (CAEP), a technology complex that conducts research, development, and testing of nuclear weapons.[28] The new entries also include Qihoo 360, a cybersecurity firm with a global footprint, and Harbin Institute of Technology, a known supporter for military research.[29] The final rule indicated that Harbin Institute of Technology had sought U.S. technology to support Chinese missile programs.[30]

The Entity List now contains nearly 200 entries for a destination† of mainland China, over half of which were added in the past 18 months (see Figure 2).[31] BIS' changes to the definition of military end-use specifically addressing China's military-civil fusion program‡ in April 2020 could further increase the rate at which new Chinese firms, institutes, government agencies, and individuals are added.§

Figure 2: Entries for Mainland Chinese Entities on BIS's Entity List, 1997–2020



Note: An individual entry may list numerous subsidiaries, aliases, and/or addresses for the same entity and may be updated multiple times.
Source: Department of Commerce, Bureau of Industry and Security, *Export Administration Regulations Supplement No. 4 § 744 Entity List*.

BIS Restricts Huawei's Access to Semiconductors and Semiconductor Manufacturing Equipment

* The full list includes Beijing Cloudmind Technology Co., Ltd., Beijing Computational Science Research Center, Beijing Jincheng Huanyu Electronics Co., Ltd., Center for High Pressure Science and Technology Advanced Research, Chengdu Fine Optical Engineering Research Center, China Jiuyuan Trading Corporation, Cloudminds (Hong Kong) Limited, Cloudminds Inc., Harbin Chuangyue Technology Co., Ltd., Harbin Engineering University, Harbin Institute of Technology, Harbin Yun Li Da Technology and Development Co., Ltd., JCN (HK) Technology Co. Ltd., K Logistics (China) Limited, Kunhai (Yanjiao) Innovation Research Institute, Peac Institute of Multiscale Science, Qihoo 360 Technology Co. Ltd., Qihoo 360 Technology Company, Shanghai Nova Instruments Co., Ltd., Sichuan Dingcheng Material Trade Co., Ltd., Sichuan Haitian New Technology Group Co. Ltd., Sichuan Zhonghe Import and Export Trade Co., Ltd, and Skyeye Laser Technology Limited, Zhu Jiejin. U.S. Department of Commerce, Bureau of Industry and Security, "Addition of Entities to the Entity List, Revision of Certain Entries on the Entity List," *Federal Register* 85:109 (June 5, 2020).

† The Entity List is arranged by destination country according to U.S. customs territories, so affiliates of the same corporation may be treated as separate entities. For instance, Huawei's subsidiary in Vietnam has its own entry on the Entity List. Department of Commerce, Bureau of Industry and Security, *Export Administration Regulations Supplement No. 4 § 744 Entity List*.

‡ 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.

§ The *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* broadens the definition of "military end use" for the specified countries to include technologies supporting any stage of a product lifecycle, where before only application to the entirety of the life-cycle constituted military end use. For more details on the Final Rule, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, May 6, 2020.

On May 19, 2020, BIS published an interim final rule establishing a much broader scope for application of the EAR to certain technology and software exports and applying this new rule to Huawei and its 114 affiliates included on the Entity List.[32] In particular, the rule targets semiconductor production for Huawei by non-U.S. firms using equipment or software exported from the United States. The rule adds a footnote modifying part of the EAR called the "Direct Product Rule," which establishes the basis for applying export controls to products made from controlled U.S. technology or software.[33] While the current update only targets Huawei and its affiliates, the new category, called "footnote one," could be applied to other designed entities in the future.[34] The interim rule went into effect on May 15, but BIS is accepting comments submitted through July 14, 2020.[35]

Prior to revision of the Direct Product Rule, specified U.S. technology and software[*] were only subject to the EAR when: (1) not only the technology or software itself, but also products made using them were subject to national security controls; and (2) these products were going to specific destinations (including China, but not including many countries where Huawei subsidiaries operate). In other words, a civilian application of a dual-use technology or software would not have required a license. Under the new rules, any product intended for export to a designated entity and made from a factory or process dependent on specified U.S. technologies and software would also be subject to the EAR.[36] BIS's definition of "production" is broad, encompassing all stages from design and manufacturing to testing and quality control; therefore, footnote one potentially applies to non-U.S. semiconductor foundries dependent on U.S. technology for any stage of the production process.[37] The revision also extends to possessing knowledge that a product will go to a designated entity.[38]

The impact of the final rule could have substantial ramifications for certain suppliers to Huawei, the world's second-largest handset maker behind Samsung and one of the largest consumers of semiconductors.[39] China is the second-largest importer of U.S. semiconductor manufacturing equipment, and many U.S. producers will have to intensify due diligence of their customers and possibly sever ties to mainland Chinese foundries that may be producing for Huawei.[40] Semiconductor foundry Taiwan Semiconductor Manufacturing Co. (TSMC)—the world's largest foundry, with 52 percent market share—drew $5.1 billion or 14 percent of its annual revenue from contract work for Huawei in 2019.[†] TSMC announced it stopped taking orders from Huawei the day the final rule went into effect.[41] Although Huawei began developing alternative supply chains after chip designers Qualcomm and Intel stopped selling to Huawei following its inclusion on the Entity List last year,[42] Chinese foundries have lagged behind the capabilities of international producers. For now, Taiwan, the United States, Japan, and South Korea lead the world in cutting-edge chip production, but China's government has invested tens of billions of dollars attempting to close the gap.[43] In a separate final rule on May 15, BIS extended the Temporary General License exempting certain transactions with Huawei until August 13, 2020, marking the fifth extension since Huawei was added to the Entity List in May 2019.[44] BIS officials indicated they do not intend to renew the license after it expires in August.[45]

China Threatens Retaliation with an Unreliable Entities List

So far, China's government has sidestepped addressing BIS's latest actions against Huawei and the 33 additions to the Entity List, though state-run media outlets have lambasted the decision. Hu Xijin, editor-in-chief of state-run tabloid *Global Times*, suggested on Twitter that China invoke an "unreliable entity list" against U.S. technology giants Apple, Qualcomm, and Cisco.[46] China's government supposedly began developing an "unreliable entity list" that would impose restrictions on U.S. firms in response to Huawei's inclusion on the Entity List in May 2019, but it has yet to enact such a list.[47]

According to analysis from law firm DLA Piper, the retaliatory list may be close to completion.[48] The list would be administered by China's Ministry of Commerce and would apply to entities that met four criteria: (1) discriminating against Chinese firms; (2) engaging in noncommercial behavior and neglecting contractual obligations; (3) causing material damage to Chinese firms; and (4) potentially threatening China's national security.[49] China's legislature is

[*] Under the revision, specified technology and software include items covered by 16 export control classification numbers (ECCNs) for semiconductors, computing, and telecommunications: 3D001, 3D991, 3E001, 3E002, 3E003, 3E991, 4D993, 4D994, 4E001, 4E992, 4E993, 5E001, 4D001, 5D001, 5D991 and 5E991. Regan Alberta et al., "US Government Hurls Another Export Control Grenade at Huawei," *JDSupra*, May 19, 2020. *https://www.jdsupra.com/legalnews/us-government-hurls-another-export-55194/*.

[†] TSMC drew $8.2 billion of 23 percent of its revenue from Apple, its largest customer in 2019. Argam Artashyan, "Huawei Contributed $5.1 Billion in Revenue to TSMC in 2019," *GizChina*, April 28, 2020. *https://www.gizchina.com/2020/04/28/huawei-contributed-5-1-billion-in-revenue-to-tsmc-in-2019/*.

also reviewing the second draft of an Export Control Law that includes provisions allowing China to take retaliatory actions for countries that implement export controls on China.[50]

U.S. Steps Up Scrutiny of Chinese Securities

The Trump Administration and Congress took steps in May to curtail the flow of U.S. investment dollars to Chinese entities whose operations threaten U.S. policy interests as well as resolve loopholes in the regulation and oversight of U.S.-listed Chinese companies. Scrutiny is expected to tighten further in the months ahead, with President Trump on June 4 directing the Presidential Working Group on Financial Markets[*] to recommend actions to protect U.S. investors from the poor accounting standards of U.S.-listed Chinese companies within 60 days.[51]

On May 12, the Trump Administration directed the Federal Retirement Thrift Investment Board (FRTIB) to "immediately halt" steps to benchmark the Thrift Savings Program's (TSP)[†] international fund ("I Fund") to the MSCI All Country World Index (ACWI), which includes Chinese securities.[‡] [52] In a letter to Labor Secretary Eugene Scalia, who oversees the TSP, the Administration expressed concern that the TSP's proposed benchmarking of the I Fund to MSCI ACWI would channel federal employees' savings to companies that present national security and humanitarian concerns.[53] For example, the MSCI ACWI includes A-shares[§] of several subsidiaries of Chinese state-owned defense conglomerate Aviation Industry Corporation of China, which supports China's military-civil fusion strategy.[**] [54] Other companies included in the index have supplied surveillance technology deployed in Beijing's repressive campaign of mass detention and surveillance of Muslim minority groups in Xinjiang.[55] As the U.S. Department of Commerce has placed such companies on its Entity List,[††] their financial performance could be eroded, thereby diminishing the returns U.S. federal government employees receive.

While the Administration's directive will address these concerns vis-à-vis U.S. federal employees' retirement accounts, U.S. investment dollars will continue flowing into Chinese assets through other avenues. An array of U.S. private companies' and federal government contractors' retirement plans, for example, currently track the MSCI ACWI.[56] However, experts estimate that all U.S. investors may hold just 2 percent of Chinese stock markets' total market capitalization.[57] Therefore, the restriction of U.S. portfolio investment flows to Chinese companies, whether through public or private sector pension plans, may not meaningfully impact these companies' overall financial position or alter their conduct. Additionally, only a handful of Chinese companies are cross listed on both the MSCI ACWI and Commerce Department's Entity List; if U.S. sanctions weaken the profitability of such companies, it would likely have limited impact on U.S. federal employees' MSCI ACWI-tracked investment returns.

Separately, Congress is advancing legislation that would close loopholes in the regulation and oversight of U.S.-listed Chinese companies. On May 20, 2020, the Senate unanimously passed the S. 945 Holding Foreign Companies

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[*] The Presidential Working Group on Financial Markets was originally established by an Executive Order issued by President Ronald Reagan with the mandate of investigating the causes of the 1987 stock market crash. It is composed of the Treasury Secretary; Chairman of the Board of Governors of the Federal Reserve System; Chairman of the SEC; Chairman of the Commodity Futures Trading Commission; or their designees. National Archives, *Executive Order 12631—Working Group on Financial Markets*, March 18, 1988. *https://www.archives.gov/federal-register/codification/executive-order/12631.html*.

[†] The TSP is a retirement savings and investment plan for U.S. federal government employees and members of the uniformed services.

[‡] The TSP I Fund currently invests in a stock index fund that replicates the MSCI EAFE (Europe, Australasia, Far East) Index. In November 2017, the Federal Retirement Thrift Investment Board (FRTIB), which administers the TSP, decided to replace the MSCI EAFE Index benchmark with the MSCI ACWI Index benchmark at a future date.

[§] A-shares are RMB-denominated securities of companies incorporated in China that trade on either the Shanghai or Shenzhen stock exchanges. A-share trading is restricted to Chinese residents, and foreigners can only access the A-shares market through special investment programs such as the Qualified Foreign Institutional Investor program and the Stock Connect programs. A-shares are distinct from other Chinese share classes such as H-shares (shares in Chinese incorporated companies listed on the Hong Kong Stock Exchange), trading of which is not restricted to Chinese residents. FTSE Russell, "Guide to Chinese Share Classes," May 2019. *https://research.ftserussell.com/products/downloads/Guide_to_Chinese_Share_Classes.pdf*.

[**] For more on the Chinese government's military-civil fusion strategy, 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 to Congress*, November 2019, 205–247.

[††] For example, in October 2019, iFlytek, Zhejiang Dahua, and Hikvision Technology were added to the Department's Entity List due to their role in the repression of Muslim minority groups in Xinjiang. U.S. Department of Commerce, Bureau of Industry and Security, "Addition of Entities of Certain Entities to the Entity List, *Federal Register*, 84:196 (October 9, 2019). *https://www.govinfo.gov/content/pkg/FR-2019-10-09/pdf/2019-22210.pdf*.

Accountable Act.[58] The bill would require foreign companies to be delisted from U.S. stock exchanges if the Public Company Accounting Oversight Board (PCAOB) has been unable to review their audit work papers for three consecutive years.[59] The bill would also require these companies to disclose whether they are owned or controlled by a foreign government[*] and makes an explicit reference to Chinese Communist Party (CCP) influence.[60] Specifically, U.S.-listed Chinese companies would be required to disclose the CCP affiliations of any company executives as well as whether their articles of incorporation contain any charter of the CCP.[61] U.S. Securities and Exchange Commission (SEC) Chairman Jay Clayton described the bill as a sensible solution to a longstanding problem, adding that the PCAOB's continued inability to inspect the audit work papers of U.S.-listed Chinese companies creates an "unlevel playing field."[62]

The bill's passage in the Senate comes as Nasdaq similarly toughens oversight of U.S.-listed Chinese companies following revelations of accounting fraud at Luckin Coffee in April.[63] For example, the exchange is reportedly considering tightening initial public offering (IPO) restrictions by requiring companies to raise $25 million in their IPO or at least 25 percent of their post-listing market capitalization.[64] In a separate filing with the SEC on June 2, Nasdaq also proposed changing its listing rules to apply more stringent criteria to an applicant for listing or a listed company based on the qualifications of the company's auditor.[65]

If adopted into law, the bill would put Beijing on a three-year timeline to remove its obstruction on the review of audits conducted by accounting firms in China.[†] However, the Chinese government's adoption of its updated Securities Law in March 2020 suggests Beijing will remain inflexible on this point. Article 177 of the updated law, for example, stipulates that overseas audit regulators are not allowed to conduct investigations within China.[66] Rhetoric from Chinese officials and state media suggest Beijing is prepared to withstand continued U.S. scrutiny. A China Securities Regulatory Commission (CSRC) spokesperson slammed the bill, claiming it would "weaken the confidence of global investors in U.S. capital markets" and adding that "global investors will make their own wise choices."[67] CCP tabloid *Global Times* also invoked a "financial war," alleging the U.S. economy would suffer most if Washington moved to delist U.S.-listed Chinese companies and asserting the development of China's financial sector into a "complete system" enables it to defend itself from U.S. actions.[68]

Despite rhetorical bluster, the Chinese government and companies have already begun planning for contingencies. On May 1, the CSRC lowered the market value threshold for Chinese companies listed overseas to issue shares at home from renminbi (RMB) 200 billion ($28.1 billion) to RMB 20 billion ($2.8 billion).[69] Previously, only Alibaba, Baidu, JD.com, NetEase, and Tencent met the criteria.[70] The Chinese government is also encouraging Chinese companies seeking to raise capital abroad to consider markets besides the United States. In mid-May 2020, Reuters cited anonymous sources in reporting that the Chinese government is pushing domestic companies to list in London through the Shanghai London Stock Connect program.[71] The Shanghai Stock Exchange has resumed vetting

[*] Concerns regarding opaque ownership are further heightened by some Chinese companies' use of a complex legal structure, the variable interest entity (VIE), to list in the United States. Since the Chinese government restricts foreign investment in industries it defines as sensitive—such as the internet, media, and telecommunications—many Chinese companies use VIEs to list in the United States. VIEs create foreign ownership of the company though a mix of legal contracts and equity ownership while still loosely complying with Chinese foreign ownership laws. However, investors' attempts to enforce contractual arrangements or seek redress often fail for two primary reasons: (1) U.S. regulators lack jurisdiction over the locations where Chinese companies utilizing a VIE structure tend to be domiciled; and (2) Chinese regulators do not recognize the legality of the structure. For more, see U.S.-China Economic and Security Review Commission, Chapter 3, Section 1, "U.S.-China Commercial Relations," in *2019 Annual Report to Congress*, November 2019, 175–179.

[†] In 2011, the SEC, PCAOB, China's Ministry of Finance, and the CSRC began to discuss joint inspections of accountancies undertaking audits for U.S.-listed Chinese companies, resulting in a Memorandum of Understanding on enforcement cooperation in 2013. However, the PCAOB maintains that Chinese audit regulators' cooperation remains insufficient for the agency to obtain timely access to relevant documents and testimony necessary to inspect the audit papers of U.S.-listed Chinese firms. *Reuters*, "Timeline: U.S., HK Regulators Struggle to Get China Audit Papers," December 20, 2017. *https://www.reuters.com/article/china-audit-timeline/timeline-u-s-hk-regulators-struggle-to-get-china-audit-papers-idUSKBN1EE0HT*; Public Company Accounting Oversight Board, "China-Related Access Challenges." *https://pcaobus.org/International/Pages/China-Related-Access-Challenges.aspx*.

applications of companies seeking to sell global depositary receipts (GDRs) there.[*] [72] U.S.-listed Chinese companies are also increasingly looking to issue secondary listings in Hong Kong to lessen risks and broaden their investor base,[73] a trend first set by Alibaba when it launched a secondary listing in Hong Kong in November 2019.[74] For example, Baidu, NetEase, and JD.com, all currently listed in the United States, made moves to list in Hong Kong in early June.[75]

In Focus: At the Two Sessions, Beijing Overhauls Economic, Health, and Banking Policies

From May 22 to May 28, China's NPC and the People's Political Consultative Conference (CPPCC) convened in Beijing after more than two months' delay due to the COVID-19 pandemic. The so-called "Two Sessions" saw Beijing abandon its gross domestic product (GDP) growth target for the first time in decades, unveil fiscal stimulus policies on par with those deployed during the 2008–2009 global financial crisis and announce an unusually ambitious legislative agenda.[76]

"Six Stabilities" and "Six Ensures" Indicate Beijing's Emphasis on Employment

In his government work report, Premier Li Keqiang attributed the NPC's decision to abandon an economic growth target to global economic uncertainty due to COVID-19, which led to a historic 6.8 percent contraction in China's GDP growth during the first quarter of 2020.[77] While a government official involved in drafting the work report said the target may return next year, the decision is significant as the growth target has traditionally anchored China's macroeconomic policy.[78] Casting it aside this year also signifies an implicit recognition that General Secretary of the CCP Xi Jinping's goal of doubling the size of China's economy from 2010 levels by the end of 2020 will not be met.[79] Premier Li said not setting a GDP growth target allowed policymakers instead "to concentrate energy on realizing the 'six stabilities' and 'six ensures,'" two distinct but related economic frameworks.[80]

The "six stabilities," first mentioned during a Politburo meeting in 2018, promotes achieving stability of employment, financial markets, trade, investment, foreign investment, and market expectations.[81] When it was introduced, "six stabilities" marked a rhetorical shift by Chinese policymakers away from balanced growth toward higher topline growth. In December 2017, the Central Economic Work Conference (CEWC), which sets China's national economic agenda, had set a policy of deleveraging and "de-risking" in the economy.[†] While Beijing's subsequent measures made highly uneven progress toward this goal, its designation as policy at the CEWC was nevertheless an important signal from Chinese policymakers. By contrast, at the December 2018 CEWC, amid slowing domestic growth and trade tensions with the United States, policymakers set the expansionary "six stabilities" policy, accompanied by greater fiscal and monetary stimulus measures.[82] At a May 2020 State Council meeting, Premier Li reiterated that the government would use "a combination of fiscal, monetary, social insurance, and pro-employment policies" to ensure the six stabilities.[83]

The "six ensures" policy[‡] was first mentioned at a Politburo meeting in April 2020 and refers to guaranteeing employment, basic livelihood of people, the survival of market players, food and energy security, the stability of supply chains, and local government operations.[84] According to an interview with economist Zheng Gongcheng

[*] Only one Chinese company (Huatai Securities) has made use of the London Stock Connect Program so far to issue U.S.- dollar denominated GDRs. A Shanghai Stock Exchange official unexpectedly announced in January 2020 that the program would be suspended. Analysts surmised the Chinese government may have moved to close the program due to London's condemnation of the Chinese government's treatment of a former official at Britain's Hong Kong consulate as prodemocracy protests rocked the city in 2019. Zhang Shidong and Daniel Ren, "China to Revive IPOs in London to Hedge against Wall Street's Growing Hostility, amid Options Aplenty for Capital Hungry Firms," *South China Morning Post*, May 19, 2020. *https://www.scmp.com/business/markets/article/3085086/china-revive-ipos-london-hedge-against-wall-sts-growing-hostility*; Xie Yu, "China Pauses U.K. Listing Project," *Wall Street Journal*, January 2, 2020. *https://www.wsj.com/articles/china-pauses-u-k-listings-project-11577974419*; Wenxin Fan, "Former U.K. Consulate Employee Says Chinese Secret Police Tortured Him," *Wall Street Journal*, November 21, 2019. *https://www.wsj.com/articles/former-u-k-consulate-employee-says-chinese-secret-police-tortured-him-11574229602?mod=article_inline*.

[†] Deleveraging refers to reducing debt in China's financial system. "De-risking" refers to reducing overall risk in lending practices, such as shadow banking.

[‡] This policy is also known as the "six guarantees" in some sources, due to translation variance of the Chinese term "*liubao*."

released by China's Central Commission for Discipline Inspection, the "six ensures" policy is intended to both coexist with and supplement the "six stabilities."[85] In his government work report at the NPC, Premier Li referred to the "six ensures" policy as the "focal point" of this year's "six stabilities" work.[86]

Taken together, the "six stabilities" and "six ensures" policies suggest the top priority of the CCP this year is protecting employment, which the CCP views as crucial to upholding its legitimacy and maintaining social stability.[87] "Employment" is the only concept common to both the "six stabilities" and "six ensures," and the first economic goal Premier Li discussed in his work report was "over 9 million new urban jobs, a surveyed urban unemployment rate of around 6 percent, and a registered urban unemployment rate of around 5.5 percent."[*] [88] In his report Premier Li paid particular attention to small enterprises and the private sector, which provide the majority of jobs in China, mentioning the growing employment difficulties in micro, small, and medium businesses and stressing the need to create an "enabling environment" for the private sector.[89]

The stimulus measures announced at this year's Two Sessions reflect the importance of small firms and the private sector to China's employment and include a set of measures aimed toward supporting them (see below for an in-depth discussion). Nevertheless, Beijing's stimulus efforts have traditionally favored Chinese state-owned enterprises, and stimulus plans this year have included announcements of additional infrastructure building and modernization projects, placing private firms—which often lack the capacity to compete for such projects—at a distinct disadvantage. Contrary to Beijing's policy pronouncements at the Two Sessions, therefore, its stimulus programs this year may cause greater retrenchment of China's private sector.[90]

New Stimulus Policies

During the Two Sessions, Premier Li announced a sweeping set of stimulus policies aimed at providing relief to small businesses, which continue to have difficulty accessing bank loans and are particularly vulnerable to the negative economic fallout of the COVID-19 pandemic.[91] However, the stimulus measures also include a large dose of traditional fiscal policy antidotes, such as infrastructure spending, which will likely further strain local government finances. Moreover, deficit financing of infrastructure to support economic growth is a recurring theme in China's macroeconomic policy and belies the government's rhetoric about transitioning toward a greater focus on consumption.[92] Notable new stimulus measures include:

- *Budget deficit increase:* The Chinese government set a budget deficit target of 3.6 percent of GDP for 2020, which represents a $140.5 billion (RMB 1 trillion) increase over the 2019 deficit and exceeds a longstanding informal cap of 3 percent.[93] In his government work report, Premier Li announced that the Ministry of Finance would issue a further $140.5 billion (RMB 1 trillion) in special treasury bonds.[94] He also said the combined $281 billion would be provided directly to local governments through a "special transfer mechanism" to help ensure it goes "directly to the city and county level and directly benefits companies and people"—an implicit admission that the normal intragovernment fiscal transfer system is not working as intended.[95] It remains unclear whether the special treasury bonds will be monetized through purchases by the People's Bank of China (PBOC). Prior to the beginning of the Two Sessions, tensions emerged publicly between the two agencies about whether monetization of the fiscal deficit is an appropriate policy response to China's current economic challenges.[†] [96]

- *Business costs cut:* In addition to ramping up government spending, Beijing indicated it would provide another $560 billion (RMB 4 trillion) in economic support through a combination of cuts to taxes and fees, utility cost reductions, lower interest rates, and using the balance of unemployment insurance.[97] In his government work report, Premier Li also suggested the PBOC would significantly increase the money

[*] China's surveyed unemployment rate was introduced in 2018 to account for undercounting in China's registered unemployment rate, which only records urban residents with a local *hukou* permit. Allen Feng, Logan Wright, and Vincent Zhu, "China's Labor Market after COVID-19," *Rhodium Group*, June 2, 2020.

[†] Debt monetization involves direct—as opposed to secondary market—purchases of government bonds by the central bank. Debt monetization is considered a way of "printing money" to fund a fiscal deficit, and such a policy can carry significant inflation risks. PBOC opponents of debt monetization argue that direct central bank purchases of government bonds will erode fiscal discipline and central bank independence. Proponents of the policy contend that without monetization, large-scale government bond issuances will push up interest rates. See Yu Hairong, Zhang Yuzhe, and Denise Jia, "Should China's Central Bank Buy Treasury Bonds?" *Caixin Global*, May 25, 2020. *https://www.caixinglobal.com/2020-05-25/in-depth-should-chinas-central-bank-buy-treasury-bonds-101558347.html.*

supply to supplement these efforts, though he did not give any details.[98] In nominal terms, the size of the nonbudgetary stimulus package is the same as the fiscal component of the massive stimulus Beijing deployed during the global financial crisis.[99] However, policymakers are clearly trying to avoid some of the bloat and waste that occurred as a byproduct of previous stimulus efforts by focusing on cost reductions for businesses. The tradeoff is that such cost cutting will further erode local governments' revenue base, which has already deteriorated amid tax cuts in 2019 and business shutdowns in the first quarter of 2020.[100]

- *More special purpose bonds:* In addition to providing local governments with direct fiscal assistance, Beijing also increased the 2020 quota for so-called special purpose bonds (SPBs)* to $528 billion (RMB 3.75 trillion), $230 billion (RMB 1.6 trillion) more than the quota for 2019.[101] Premier Li said local governments would be permitted to use SPB proceeds for a greater proportion of project capital.[102] Project capital used to designate the portion of local government investment projects that must be financed from revenue rather than debt.[103] However, in June 2019 the State Council changed SPB rules to allow local governments to count SPB proceeds toward project capital, thereby reducing the initial capital outlay for local infrastructure projects.[104] This further reduction to the amount of initial capital local governments must contribute to infrastructure projects reflects the erosion of local governments' fiscal position in 2019 amid large-scale cuts to taxes and fees.[105]
- *Additional small and micro enterprise (SME) support:* The Chinese government announced a raft of new measures to support SMEs and help them through the economic shock caused by COVID-19. Continuing a policy first tested in 2019, Beijing stipulated that the six largest commercial banks must increase lending to SMEs by 40 percent in 2020. More surprising, however, was Premier Li's announcement that loan forbearance for SMEs—initially scheduled to expire at the end of June 2020—will be extended to the end of March 2021. He also indicated the government's intention to require banks to extend loans to SMEs for which the principal need never be repaid.[106] These measures are likely motivated by two factors. First, they are an economic lifeline to small companies that have struggled to survive amid COVID-19. Second, policymakers are wary of rising nonperforming loan (NPL) levels, which threaten bank balance sheets. In a press conference on May 26, PBOC Governor Yi Gang admitted that banks could face a "large increase" in their NPL ratios and elevated "disposal pressure."[107] By extending the repayment period for risky borrowers, the government has effectively declared a moratorium on NPL recognition and given small businesses time to recover.

An Ambitious Legislative Agenda

The NPC also outlined a remarkably ambitious legislative agenda for 2020. According to NPC Chairman Li Zhanshu's work report, the NPC will aim to draft ten new laws and amend 15 existing laws—a significantly busier schedule than in 2019, when it drafted and amended a combined 14 laws.[108] Several of the proposed changes seek to address weaknesses in the public health system exposed by the COVID-19 pandemic. For example, the NPC plans to amend the Law on the Prevention and Control of Infectious Diseases, the Frontier Health and Quarantine Law, and the Emergency Response Law, and is considering establishing a unified command system with a direct, automatically triggered reporting mechanism for public health emergencies.[109] The NPC will also amend the Wildlife Protection Law, likely to incorporate a permanent ban on wildlife trade instituted in February 2020 and a new list of animals approved for use as livestock that the Ministry of Agriculture and Rural Affairs issued in April 2020.[110]

The COVID-19 pandemic has also spurred the NPC to fast-track a new law on biosecurity, which aims to strengthen the Chinese government's ability to respond to infectious disease outbreaks and bioterrorism and increase its oversight of biotech research and development, laboratory security, and the management of human genetic and other biological resources.[111] China already has a patchwork of laws that address certain aspects of biosecurity, but the broad nature of the proposed legislation will create a legal framework for a mechanism to coordinate resources

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* SPBs are local government bonds backed by a specific government fund or project revenues. SPB issuances may be linked to either an individual project or a group of projects. See China State Council, *Ministry of Finance Issues Notice on the Management of Local Government Special Purpose Bonds* (财政部关于印发《地方政府专项债券发行管理暂行办法》的通知), 2015. Translation. *http://www.gov.cn/gongbao/content/2015/content_2883246.htm*.

and responses across multiple agencies.[112] However, some experts are concerned that a provision prohibiting the dissemination false biosecurity information could deter medical professionals from raising the alarm in the event of a public health emergency, especially in light of China's suppression of whistleblowers during the early stage of the COVID-19 pandemic.[113]

Revisions to the Law of the People's Bank of China and the Commercial Banking Law are also on the NPC's agenda for 2020. Although few details have been revealed about what an overhaul of the central bank's mandate might contain, it will likely update the law—last revised in 2003—to reflect the actual scope of the PBOC's activities.[114] The PBOC law designates currency stability as the bank's key monetary policy objective, but in practice the PBOC pursues several high-level goals simultaneously. These include maintaining price stability, supporting economic growth, ensuring employment, maintaining stability in China's balance of payments, and promoting financial reform and financial market development.[115] Chinese media have also suggested the revisions could include updates that reflect the PBOC's role in managing systemic financial risks.[116] The Commercial Banking Law is similarly in need of update as it has not been substantially revised since 2003. NPC delegates suggested that revisions could include sections of the law that address banks' classification and business scope, the penalty system, and a more market-based mechanism for firms to exit the market.[117]

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