U.S.-China Economic and Security Review Commission

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Highlights of This Month's Edition

- **Bilateral Trade:** U.S. goods imports from China stood at $36.6 billion in May 2020, down 6.6 percent year-on-year; U.S. and global demand for Chinese exports likely to remain weak through the summer.
- **Trends in China's Economy:** China's revised negative list aims chiefly to leverage foreign capital for domestic policy goals; China's National Audit Office reported that more than $7.1 billion (RMB 50 billion) of funds raised from special-purpose bonds last year remain unused, adding to concerns that government efforts to stimulate growth through infrastructure spending are losing steam; rising risks in China's $3.1 trillion trust industry, a key shadow banking component, threaten financial instability and draw renewed regulatory scrutiny; China's 6.18 shopping festival generated roughly $155.2 billion in sales this year but growth in online shopping has not been enough to offset an overall drop in retail sales.
- **In Focus – China Stock Market Reforms:** Beijing accelerates pace of stock market reforms to channel funds to firms hard hit by the pandemic and prepare for prospects of reduced access to U.S. capital markets.

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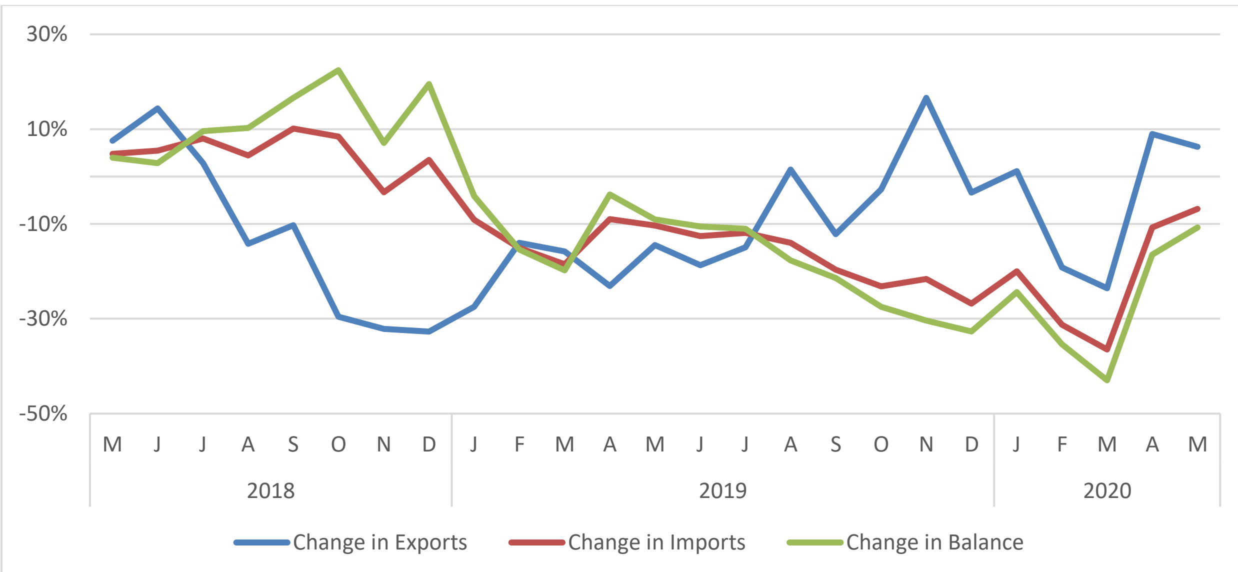
Bilateral Trade

Imports from China Weaken as U.S. Consumer Demand Falls

In May 2020, U.S. imports from China totaled $36.6 billion, down 6.6 percent from $39.2 billion in May 2019 (see Figure 1).[1] Month-to-month, however, U.S. May imports from China showed a gradual recovery from a 10-year low of $20.7 billion in March 2020. Though factory activity in China slowly picked up after local shutdowns began to lift in March and April, imports from China remained 13 percent lower for the first five months of 2020 over 2019.[2] As of May, the U.S. goods trade deficit with China stood at $103.3 billion for 2020, down 24.6 percent year-on-year.[3]

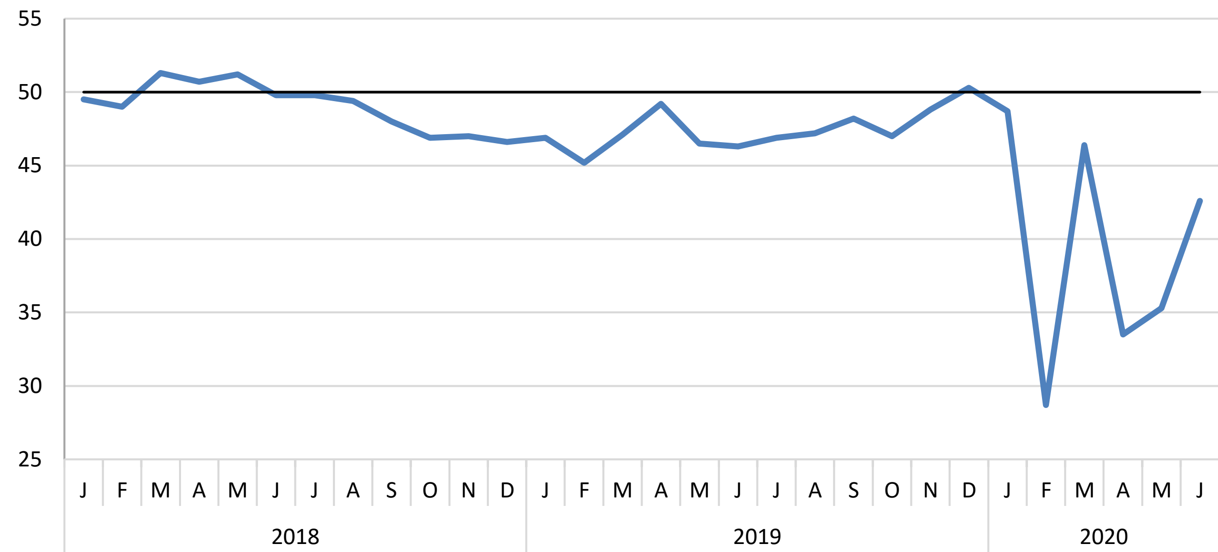
Figure 1: Change in U.S. Exports, Imports, and the Trade Balance with China, May 2018–May 2020
(year-on-year)



Source: U.S. Census Bureau, *Trade in Goods with China*, April 2, 2020. *https://www.census.gov/foreign-trade/balance/c5700.html*.

The slump in Chinese exports will likely continue as the pandemic dampens global demand. For instance, in the United States, household consumption—an estimated 68 percent of U.S. gross domestic product (GDP)[4]—fell by an average 4.9 percent in the first five months of 2020 after increasing steadily through 2019.[5] This persistent weakness has lingered even as production in China has come back online. A manufacturing indicator for new export orders showed a contraction in exports persisting through June (see Figure 2).

Figure 2: China's Manufacturing New Export Orders Index, January 2018–June 2020
(year-on-year)



Note: Above 50 indicates an expansion, normally with higher volumes of new orders and output; below 50 indicates a contraction.
Source: China Federation of Logistics and Purchasing via CEIC.

Policy Trends in China's Economy

Chinese Agencies Overstate Impact of Revised Negative List, Seek to Channel Foreign Capital toward Domestic Policy Goals

On June 24, China's Ministry of Commerce (MOFCOM) and state economic planner, the National Development and Reform Commission (NDRC), released a revised list of sectors in which foreign investment is restricted or prohibited.[6] The so-called negative list removes restrictions on foreign investment in financial services, commercial vehicle manufacture, urban water management, and a few niche fields.[7] The Chinese government introduced the list with great fanfare, touting it as further evidence of China's commitment to economic liberalization.[8] In fact, half of the restrictions removed from the list have been eliminated previously. Furthermore, in many other cases allowing foreign investment into niche industries aims to address urgent policy problems with foreign capital.

Chinese state-run media claim the negative list opens foreign investment in seven new areas from the 2019 iteration of the list.[9] In reality, the list cuts only six items and simply merges two restrictions on the previous list into one category.[*] Of the six categories removed from the list, three concern restrictions in financial services, which Chinese

[*] Items 15 and 16 on the 2019 revision of the negative list, respectively regarding foreign ownership of "public aviation companies" or fixed-route passenger and cargo air transport, and "general aviation companies" or specialized air transport for industries such as agriculture, forestry, and fishing, are merged into item 13 on the 2020 revision without eliminating any restrictions. National Development and Reform Commission and Ministry of Commerce of the People's Republic of China, *Special Management Measures for Foreign Investment Access (Negative List) (2020 Version)* (外商投资准入特别管理措施 (负面清单)(2019 年版)), June 24, 2020. Translation. *https://www.ndrc.gov.cn/xxgk/zcfb/fzggwl/202006/t20200624_1231938.html*; National Development and Reform Commission and Ministry of Commerce of the People's Republic of China, *Special Management Measures for Foreign Investment Access (Negative List) (2019 Version)* (外商投资准入特别管理措施 (负面清单)(2019 年版)), June 30, 2020. Translation. *http://www.gov.cn/xinwen/2019-06/30/content_5404703.htm*; Artoria Gongla, "What's the Difference between General Aviation and Air Transport (通用航空和运输航空的区别是什么)," *Baidu Zhidao*, July 23, 2017. Translation. *https://zhidao.baidu.com/question/1811681241265214O4.html*.

regulators already began lifting in December 2019.[*] [10] Notably, China had also committed to open these sectors in the January 2020 Phase One trade deal with the United States.[11] Elimination of restrictions on foreign investment in commercial vehicle manufacture was also planned in advance of this year's changes (see Table 1).[12]

Table 1: New Sectors Permitting Foreign Investment on the 2020 Negative List

Eliminated Restrictions *(Green background indicates restrictions were already removed)*	**Estimated Market Size or Proxy** *(Blue background indicates investment in a sector is a domestic policy priority)*
Financial services: Caps on foreign ownership of life insurance companies removed. Previously foreign ownership could not exceed 51 percent.	Life insurance premiums totaled $313 billion in 2018.
Financial services: Caps on foreign ownership of futures companies removed. Previously foreign ownership could not exceed 51 percent.	Total turnover in Chinese futures markets was 3.9 billion lots[†] in 2019.
Financial services: Caps on foreign ownership of securities firms and asset managers removed. Previously foreign ownership could not exceed 51 percent.	There were $2.3 trillion (RMB 16.7 trillion) of assets under management by public fund managers in China at the end of the first quarter of 2020.
Infrastructure: Requirement that a Chinese partner control construction and operation of urban water supply and drainage pipeline networks for cities with a population of greater than 500,000 eliminated.	Everbright Securities estimates there is need for 174,653 miles of new pipeline in Chinese cities, totaling construction costs of $59.8 billion (RMB 423 billion).
Manufacturing: Restrictions on foreign share of commercial vehicle manufacturing removed. [‡] Previously foreign companies could not own greater than 50 percent.	4.3 million units, including trucks and buses, were sold in 2019.
Civil Aviation: Prohibition on foreign investment in air traffic control systems eliminated.	Fixed asset investment in air traffic control systems totaled $330 million (RMB 2.3 billion) in 2017.

[*] Caps on foreign ownership of securities firms were lifted December 1, 2019 and caps on foreign ownership of life insurance companies and futures companies were lifted on January 1, 2020. For caps on foreign ownership of asset managers, Chinese Securities Regulatory Commission initialed lifted the limit to 51 percent in January, and fully removed the limit on April 1, 2020. JP Morgan, Nomura, and UBS established local joint venture asset managers with a controlling share ahead of January 2020. China Banking and Insurance Regulatory Commission, *General Office of the China Banking and Insurance Regulatory Commission Notice on Clarifying the Timeline for Eliminating Foreign Investment Ratio Restrictions in Joint Venture Life Insurance Companies* (中国银保监会办公厅关于明确取消合资寿险公司外资股比限制时点的通知), December 6, 2019. Translation. *https://www.ndrc.gov.cn/fggz/lywzjw/wstz/201912/t20191225_1216160.html*; *Reuters*, "China Securities Regulatory Commission Says it Will Lift Restrictions on Foreign Shares in Futures, Funds and Securities Companies Starting Next January (中国证监会称明年 1 月起先后取消期货、基金和证券公司外资股比限制)," October 11, 2019. Translation. *https://cn.reuters.com/article/china-csrc-fund-securities-foreign-capit-idCNKBS1WQ14W%3Fil%3D0&prev=search&pto=aue*.

[†] A "lot" is a standard number of units in a financial instrument, such as 100 shares of an equity. For futures, a lot represents a standard size for a contract, such as 5,000 bushels of wheat. The China Futures Association reports transaction volume in lot size first, as commissions and margin are calculated by lot. Chinese Futures Account Net, "What Does One Lot of Futures Mean." Translation. *http://www.qihuokaihu.net/html/201901-16/20190116093250.htm*.

[‡] The NDRC and MOCFOM previously indicated these restrictions would be removed in 2020. National Development and Reform Commission and Ministry of Commerce of the People's Republic of China, *Special Management Measures for Foreign Investment Access (Negative List) (2019 Version)* (外商投资准入特别管理措施 (负面清单)(2019 年版)), June 30, 2020. Translation. *http://www.gov.cn/xinwen/2019-06/30/content_5404703.htm*.

Eliminated Restrictions *(Green background indicates restrictions were already removed)*	**Estimated Market Size or Proxy** *(Blue background indicates investment in a sector is a domestic policy priority)*
Manufacturing: Restrictions on foreign ownership of companies smelting and processing radioactive materials and producing nuclear fuel removed. Previously foreign firms could not participate at all, except in Free Trade Zones.	In 2018, the Nuclear Energy Agency and International Atomic Energy Agency projected Chinese uranium demand to be between 10,100 and 12,000 metric tons in 2020.
Agriculture: Requirement that a Chinese partner control selection and breeding of new wheat varieties and production of seeds eliminated. Chinese partners must still hold a share of at least 34 percent.	The market for wheat seeds totaled $3.6 billion (RMB 25.7 billion) in 2018.

Source: Various.[13]

For at least four of the sectors now permitting foreign investment, China's government has struggled to attract domestic investment or adequate expertise to address urgent concerns.[*] Eliminating restrictions thus appears aimed at fulfilling policy priorities rather than genuinely attempting to liberalize investment access. For instance, China's wheat seed research and development capabilities are still in their infancy and the country has increased imports of wheat to meet domestic demand.[14] Among other benefits, cultivating new strains could address falling yields due to ground water overexploitation in China's northern provinces.[15]

For other sectors, decades of market access restrictions have allowed Chinese firms to secure a dominant position, and competing against entrenched local firms with a loyal customer base may prove difficult. In its 2001 WTO accession protocol, China pledged to open financial services to foreign investment fully by 2006.[16] Fourteen years after the sector was initially supposed to remove ownership restrictions, Chinese life insurance firms command a much greater market share than joint ventures between foreign and Chinese partners, particularly through stronger local distribution networks.[17] Likewise, major Chinese automakers Dongfeng, BAIC, SAIC, and Changda hold an established oligopoly in China's commercial vehicle market, accounting for over 52 percent of unit sales in 2019.[†] Moreover, government procurement accounts for a substantial portion of commercial vehicle purchases, and policy explicitly encourages agencies to buy domestically manufactured vehicles.[18] Chinese brands accounted for 65 percent of central government vehicle purchases in 2018.[19]

Audit Report on SPBs Adds to Growing Concerns over Infrastructure-Led Growth

On June 18, China's National Audit Office reported that more than RMB 50 billion ($7.1 billion) raised from special-purpose bonds (SPBs) last year remains unused, primarily due to poor project management and suspension

[*] Chinese financial regulators and government-managed pension funds are also eager to invite foreign-invested asset managers into the country to reverse a trend of low returns on retirement savings as China faces declining labor force participation and likely pension shortfalls, but this policy need is less urgent than those detailed here and highlighted in blue within Table 1. U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, January 11, 2019, 4. *https://www.uscc.gov/sites/default/files/Research/January%202019%20Trade%20Bulletin.pdf*.

[†] Tesla, which built a production facility in Shanghai after the NDRC and MOFCOM removed restrictions on foreign ownership of electrical vehicle manufacturers in 2018, may seem an exception: the luxury automaker sold over 10,000 units in March 2020 as the factory concluded its first full quarter of production. However, the company enjoys benefits normally reserved for state-owned enterprises. Tesla received exceptionally quick approvals from the Chinese government, secured $1.6 billion in financing from Chinese banks to jumpstart its factory, and sells vehicles with the help of a $3,500 consumer subsidy to promote electric vehicle sales. Additionally, Tesla enjoys unique status among Chinese consumers, but conspicuous consumption is unlikely to drive business-to-business sales for utilitarian purchases such as commercial vehicles. Fred Lambert, "*Tesla Made-in-China Model 3 Sales Jump to Record High*," *Eletrek*, June 8, 2020. *https://electrek.co/2020/06/08/tesla-made-in-china-model-3-sales-jump-record-high/*; Daniel Gessner, "Why China Loves Tesla," *Business Insider*, June 4, 2020. *https://www.businessinsider.com/why-china-loves-tesla-elon-musk-2020-5*.

of projects. Other economic analysts have suggested the money may be going unspent due to a lack of suitable infrastructure projects.[20] The findings of the report, which was based on records from 18 provincial-level governments and 36 cities and counties in those provinces, throw further doubt on the viability of government-led infrastructure projects to stimulate economic growth. Even amid these signs of diminishing returns, however, the Chinese government is expanding the 2020 SPBs quota to manage the economic slowdown caused by the novel coronavirus (COVID-19) pandemic.[21] Beijing's continued reliance on SPBs reflects the difficult choice China's policymakers face between finding ways to stimulate economic growth and controlling financial risks.

SPBs are a type of government debt instrument for funding revenue-producing infrastructure projects.[*] The central government first introduced SPBs in 2015 to bring greater transparency to local government debt in China by reducing the amount of off-balance-sheet lending by local governments. Typically, SPBs are repaid through revenues generated by the infrastructure projects they fund and, unlike other types of debt issued by local governments, cannot be repaid from the fiscal revenue of the governments that issued them.[22] While SPBs were initially seldom used, their issuance increased significantly in 2017 as Beijing tightened regulations on other types of local government financing.[23] As of November 2019, the SPB market was $1.3 trillion.[24] Economic analysts have credited SPBs with decreasing local governments' reliance on shadow lending.[25]

However, local governments have often used SPBs to fund projects that fall outside their intended scope. According to a 2019 analysis by the *Financial Times*, more than $370 billion has been used for real estate projects rather than public infrastructure projects.[26] While SPB projects theoretically must receive approval from central authorities, Chinese local government officials have reported that authorities in Beijing rarely scrutinize SPB applications, creating a risk that local governments could exaggerate the expected income of proposed projects.[27] One official in Shanxi said that because infrastructure projects so often fail to generate sufficient revenue, local governments often plan to repay SPBs with tax revenues, despite official restrictions on doing so.[28]

The findings of the National Audit Office add to concerns that China is running out of commercially viable infrastructure projects to stimulate economic growth. Even before the COVID pandemic, Chinese local government officials were reporting difficulty finding cash-generating infrastructure projects such as bridges or toll roads, instead facing options such as sewer systems, which may generate no income or even lose money.[29] Liu Shangxi, the president of the Chinese government-affiliated think tank Chinese Academy of Fiscal Sciences, said that not many projects can generate the stable cash flow needed to pay off the SPBs. Mr. Liu said local governments should avoid issuing too many SPBs because they could result in too much local government debt and crowd out private investment.[30]

Nevertheless, the Chinese government has continued to rely on SPBs, particularly as COVID-19 has exacerbated China's economic downturn. Issuance of SPBs in the first two months of 2020 totaled $134 billion (RMB 950 billion), nearly three times the amount issued over the same time last year.[31] In May, the Chinese government set a quota of $526 billion (RMB 3.75 trillion)—nearly 75 percent higher than last year's quota of $300 billion (RMB 2.15 trillion).[32]

The increased issuance of SPBs this year has added to concerns over growing government debt in China. The People's Bank of China has referred to rising debt levels, particularly local government debt, as a "grey rhino" threat to China's economic growth that could affect the country's financial sector.[33] At the Two Sessions in May, the Chinese government set a budget deficit target of 3.6 percent, an increase of $140.5 billion (RMB 1 trillion) over last year's budget deficit and markedly higher than the longstanding informal cap of 3 percent observed by policymakers.[†] However, according to estimates from financial services group Macquarie, after accounting for planned issuance of local and sovereign SPBs, China's broader fiscal deficit is closer to 8.3 percent of GDP.[34] Increased issuance of SPBs has also pushed up borrowing costs as investors have sought higher yields from nongovernment issuers, including corporations and policy banks such as China Development Bank.[35]

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[*] Revenue-producing infrastructure projects refers to projects that generate returns, such as airports or toll roads. By contrast, other types of infrastructure facilities such as water plants typically do not generate income.

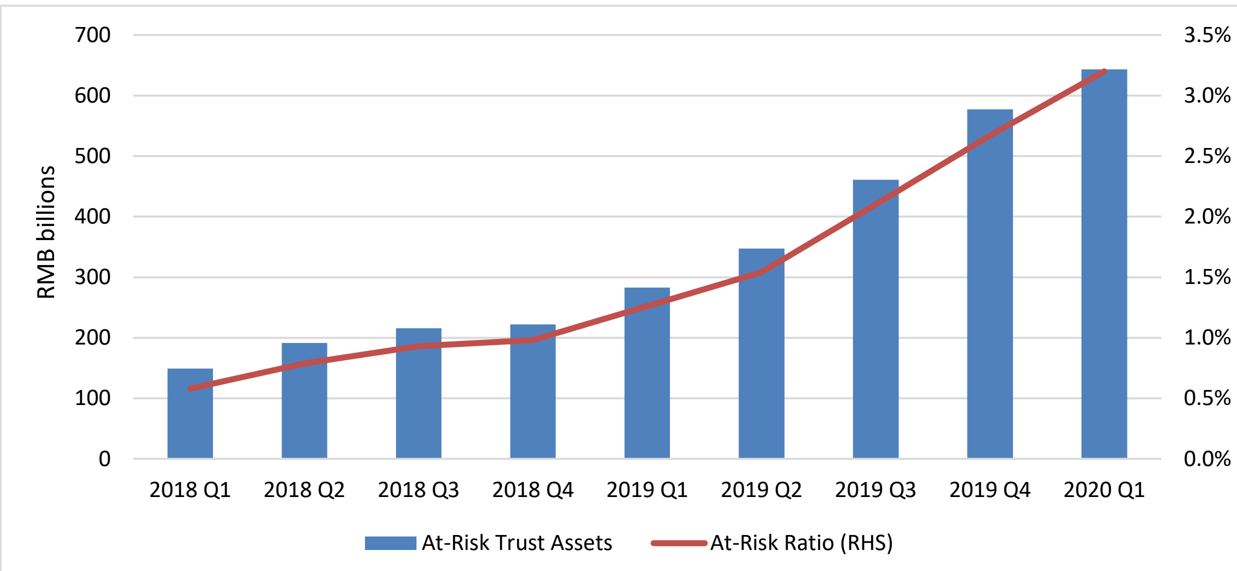
[†] For more on policies announced during this year's Two Sessions, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, June 8, 2020, 9–12. *https://www.uscc.gov/sites/default/files/2020-06/June_2020_Trade_Bulletin.pdf*.

Risks Rise in China's Troubled Trust Industry

China's $3.1 trillion (RMB 21 trillion) trust industry, a linchpin of the country's vast shadow banking sector, is reeling amid heightened repayment risks due to the COVID-19 pandemic and renewed regulatory scrutiny.[36] Trust companies in China function differently from those in the United States and other countries.[*] According to one analyst's description, they are a "hybrid of private equity, asset management, and lending" institutions.[37] They provide a key source of financing to China's underprivileged borrowers but also typically sell pyramid-like products, which use funds raised from new investors to cover losses and repay older investors.[38]

China's trust industry already showed growing signs of strain throughout 2019 before the outbreak of COVID-19. According to statistics published by the China Trustee Association, the value of trust assets with disclosed repayment risks increased 160 percent from $32.5 billion (RMB 222.2 billion) at the end of 2018 to $81.7 billion (RMB 577 billion) a year later (see Figure 3).[39] However, this likely understates the true extent of at-risk assets[†] within the industry. At least six trust companies disclosed nonperforming asset ratios above 20 percent in their 2019 annual reports, and 30 of China's 68 trust companies recorded falling profits last year, with some seeing contractions of 50 percent.[40] However, the economic impact of COVID-19 has accelerated a reckoning for some trust companies as borrowers can no longer repay loans.

Figure 3: China's Trust Assets with Disclosed Repayment Risks, 2018–Q1 2020



Source: Various.[41]

Since March 2020, a growing number of trust companies have defaulted on payments to investors, spurring renewed intervention by banking regulators in an attempt to forestall a crisis.[42] In the most high-profile case, Shanghai-listed

[*] Trust companies in the United States have a wide range of business operations, but their primary purpose is to act as a fiduciary in the administration of assets that belong to a person or corporation. Chinese trust companies also act as trustees, but the bulk of their business is devoted to the provisioning of nonstandard credit (i.e., risky lending to corporate borrowers that prudential rules prevent banks from lending to directly). Moreover, Chinese trust companies have cooperated closely with banks to channel the proceeds of bank-issued wealth management products into trust products, thereby gaining access to retail depositors who could not normally afford to invest in trust products. Chinese trust companies' main function, therefore, is to perform bank-style credit intermediation but with a lower regulatory compliance threshold.

[†] The China Trustee Association provides no definition of what qualifies a particular asset as "at risk" or how this may differ from the more widely used "nonperforming asset" designation. The Association likely only counts assets that have exhibited obvious problems—e.g. they have defaulted. See Allen Feng and Logan Wright, "The Shadow Iceberg," *Rhodium Group China Markets Research*, May 19, 2020, 4.

Anxin Trust defaulted on $3.9 billion (RMB 27.6 billion) in payments to investors and incurred a $2 million (RMB 14 million) fine for explicitly guaranteeing returns to investors, transferring trust assets to shareholders, and failing to appropriately disclose risks and other information.[43] The company's controlling shareholder was detained and trading of its shares suspended for two months.[44] However, the Shanghai bureau of the China Banking and Insurance Regulatory Commission (CBIRC) also held negotiations with Anxin that appear likely to result in a restructuring agreement with a bailout coalition led by state-owned Shanghai Electric Group.[45] Meanwhile, several hundred investors protested outside Anxin's headquarters in April demanding their money back.[46]

Similar problems emerged at Sichuan Trust in May when the company missed payments on several trust products.[47] The proximate cause of the defaults appears to be an April order by local regulators to halt issuance of so-called trust of trust products—trust products invested in other trust products.[48] Although trusts of trusts are technically legal, trust companies treat them as cash-pooling mechanisms that help obscure the details of underlying—and often nonperforming—assets.[49] The halt order precipitated a liquidity crisis at Sichuan Trust, which could no longer use the proceeds of new products to cover losses on old ones.[50] However, the problem ultimately lay with the company's deteriorating asset quality—its nonperforming asset ratio was 22.2 percent at the end of 2019—which was only exacerbated by the pandemic.[51] On June 15, an estimated 600 investors protested outside its Chengdu office to demand their money back.[52] In response to protests by Anxin and Sichuan investors as well as other similar incidents, the CBIRC told trust companies in June to cut their corporate lending, a surprising move given an easing in the deleveraging campaign and government efforts to encourage lending in recent months.[53] However, regulators likely calculate that increased formal bank lending will make up for the loss with less risk for financial stability.

Growing problems in the trust industry have unfolded as Beijing considers new rules that would significantly curtail trust companies' shadow lending business. Draft rules released by the CBIRC in May 2020 would limit trust companies' investments in nonstandard credit assets—loans outside of the formal banking sector and securities markets that typically have low liquidity and transparency—to 50 percent of their total assets.[54] Most trust companies exceed this margin, and according to one estimate nonstandard credit provisioning accounts for 80 percent of their business.[55] The new rules would also require trust companies to match the maturities of products and underlying investments and to structure new products as closed-ended, meaning there is a one-time share issuance to which investors subscribe rather than a cash pool of the proceeds from multiple product issuances.[56] In theory this would eliminate pyramid-style products. The rules also strengthen risk disclosure requirements.[57] Beijing is simultaneously considering whether to loosen restrictions on foreign investment in China's trust sector and appears set to remove a minimum available capital threshold of $1 billion.[58]

In many ways, the trust industry's woes mirror problems in China's banking sector. In fact, the two are closely connected as banks are exposed to trust products through off-balance-sheet lending. Moreover, the CBIRC's efforts to curtail trust sector lending explicitly target the portion of their business that relies on banks investing the proceeds of wealth management products in trust products.[59] Yet, as with similar experiments in the banking sector, regulators' efforts to roll back investor assumptions that their returns are guaranteed may be accelerating the very financial instability they hope to avoid.

6.18 Shopping Festival Shows Online Retail Growing despite Sluggish Economy

China's 6.18 shopping festival, an annual online shopping event that lasts from June 1 to June 18,[*] generated roughly $155.2 billion in sales this year.[†] As global demand for Chinese exports remains sluggish, domestic consumption, which accounts for 38.8 percent of GDP, has become a focus of economic recovery for Chinese policymakers. Online sales, which represent a growing share of overall consumption, were valued at $475.3 billion in the first five months of 2020, up 11.5 percent year-on-year. Nevertheless, this growth was not enough to offset an overall 13.5 percent year-on-year drop in retail sales year-to-date.[60]

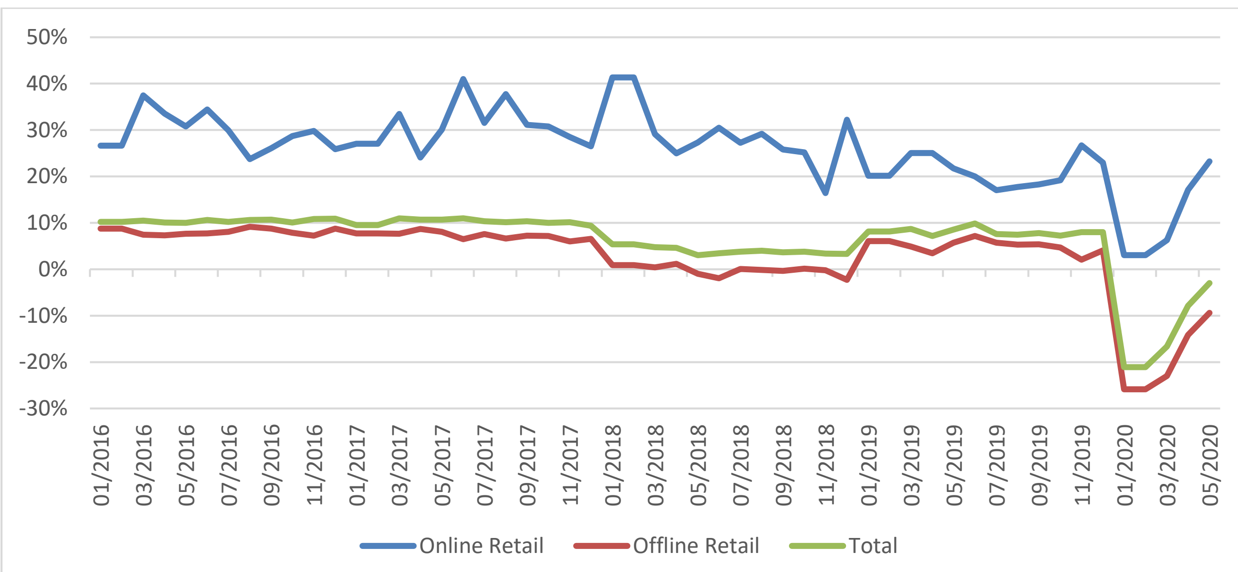
[*] The 6.18 shopping festival was created by JD in 2004 to celebrate its June 18 anniversary, but rival e-commerce platforms, including Alibaba and Pinduoduo, now also offer 6.18 promotions.

[†] Based on the 2020 market share of Alibaba and JD.com, who reported $136.5 billion in sales. Smaller platforms, including Pinduoduo and Suning, did not report sales numbers for the 2020 6.18 festival. Deborah Weinswig, "E-Commerce Is Back and Big on 6.18," *Technode*, June 23, 2020. *https://technode.com/2020/06/23/insider-e-commerce-is-back-and-big-on-6-18/*.

Alibaba and JD.com together generated $136.5 billion in sales during the 18-day event. Alibaba, China's largest e-commerce company with 60 percent of market share, reported $98.2 billion in gross merchandise value, more than double its $38.4 billion in sales for the 2019 Singles' Day shopping festival.* [61] JD.com, China's second-largest e-commerce company with 17 percent of market share, reported $38 billion in transactions, up 30.1 percent from $29.2 billion during last year's 6.18 festival and up 65.2 percent from $23 billion in 2019 Singles' Day sales.[62] JD.com reported a 400 percent increase in luxury purchases, reflecting some "revenge spending" as wealthy customers returned to conspicuous consumption, but food, toiletries, and household appliances were also among the top purchase categories.[63] Across all platforms, online sales of food in the first five months of 2020 were up 36.7 percent from last year, according to China's National Bureau of Statistics, with food purchases on JD.com doubled from last year's 6.18 festival.[64]

The success of 6.18 sales reflects the continued growth in online shopping despite the downturn in overall retail sales (see Figure 4) and a fall in exports as the country struggles to recover from the economic effects of the COVID-19 pandemic. Goods exports were down 3.3 percent year-on-year in May, with stagnant new export orders over the past two months suggesting export demand is likely to remain weak.[65] Domestic consumption, which includes spending on transportation and housing as well as retail purchases, has accounted for more than half of GDP growth since 2018.[66] However, retail purchases represent a shrinking share of overall consumption. In 2019 they accounted for 40.4 percent of consumption, down from 44.1 percent in 2015. Spending on health and housing has accounted for a growing share of consumption since 2013, further cutting into retail sales.[67]

Figure 4: China's Retail Sales of Goods, January 2016–April 2020
(year-on-year)



Note: Monthly sales for January and February are not available and are represented by an average of the first two months of sales.
Source: National Bureau of Statistics via CEIC

E-commerce's market share has jumped since the COVID-19 outbreak, growing from 20.7 percent of retail sales at the end of 2019 to 24.3 percent in May 2020.[68] While online shopping was already quite common among customers under 35, who made up 70.9 percent of all e-commerce app users in China in 2018, the change in shopping patterns triggered by the outbreak may change consumption patterns across all age groups.[69] A survey conducted in April by market research firm Forrester found that 74 percent of respondents in China older than 65 would shop online more in the future.[70] While the spike in online shopping may be partially driven by a temporary shift away from

* Alibaba did not release data for overall sales during the 2019 6.18 shopping festival.

offline businesses due to travel restrictions, Liu Yuan, analyst at UBS Investment Research, expects the e-commerce's share of the retail market to continue to grow, reaching nearly 40 percent in four to five years.[71]

Consumer-to-manufacturer (C2M) services offered by e-commerce platforms saw manufacturers typically serving the export market creating goods customized for the domestic market. Alibaba, JD.com, and Pinduoduo (China's third-largest e-commerce platform, with 7 percent market share)[72] have all committed to expanding their C2M programs, with JD.com launching an "Export to Domestic" initiative in April targeted specifically at manufacturers moving into the domestic market.[73] According to Alibaba, more than 500,000 factories have joined Taobao Deals, its C2M app, since it officially launched in March.[74]

E-commerce platforms saw particular growth among users from lower-tier cities and rural areas this year. McKinsey and other observers have identified these customers, traditionally underserved by conventional retail, as key engines for future consumption growth.[75] While expenditure in urban areas (RMB 28,063 per capita) remained almost twice that of rural expenditure (RMB 13,328 per capita) in 2019, rural expenditure has grown at about 10 percent per year since 2015 compared to 7 percent in urban areas.[76] According to JD.com, 71 percent of new users during the 2020 6.18 festival came from lower-tier cities.[77] Partnerships with livestreaming platforms and influencers may have played a key role in expansion into these markets. On May 27, JD.com announced a partnership with Kuaishou, a livestreaming platform with more than 300 million daily active users popular in small towns and rural areas, allowing Kuaishou users to buy products from JD.com directly within the app.[78] Alibaba reported that overall livestreaming sessions on Taobao Live, its in-house livestreaming platform, increased by 123 percent over last year's festival, with more than 2,000 local officials joining live broadcasts to sell agricultural goods as part of its Spring Thunder Initiative, which aims to digitize concentrated areas of agricultural production and connect agricultural producers directly with consumers.[79]

In Focus: China's Stock Market Reforms

Beijing is accelerating the pace of reforms in China's stock markets to mitigate the economic fallout from COVID-19, enable stock markets to play a larger role in aggregate financing to the real economy, and draw more listings home as U.S. scrutiny of Chinese securities tightens. Beijing has focused on updating initial public offering (IPO) rules to shift from an approval- to a registration-based system and encourage more tech companies to list onshore. However, measures advanced so far in 2020 do not address underlying problems caused by excessive government intervention into the market. China's onshore markets also only allow companies to raise RMB-denominated funds that are difficult to move offshore. Due to these limitations, it is likely Chinese companies will continue to prefer listings overseas or in Hong Kong absent deeper changes to onshore markets, though Hong Kong's attractiveness as a listing destination is threatened by Beijing's tightening grip on the territory.

Overview of China's Stock Market

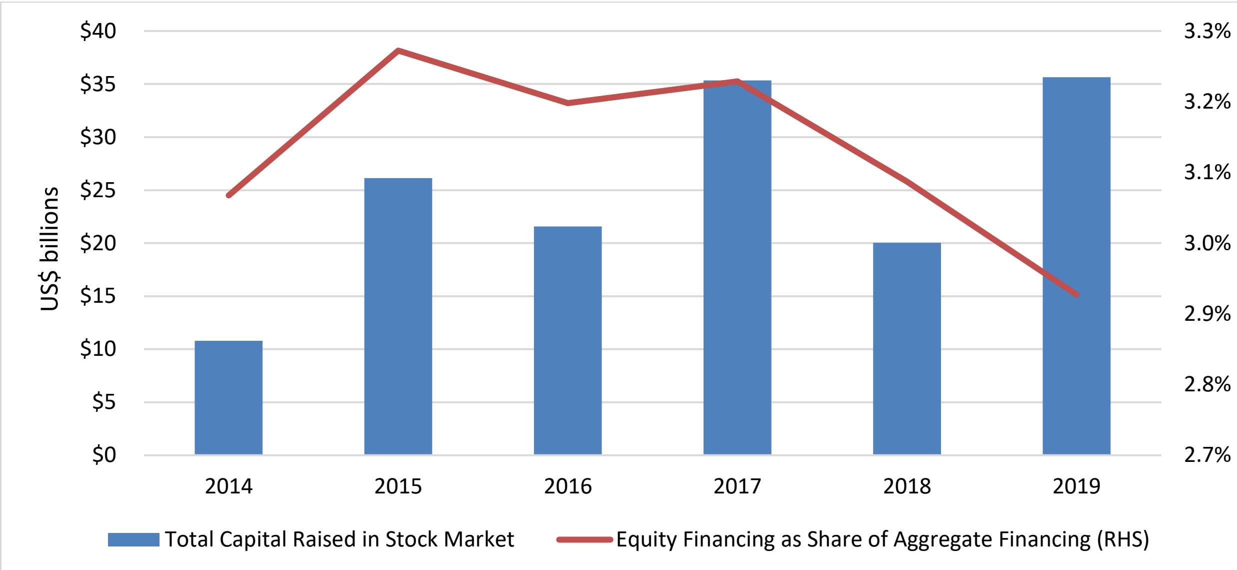
China's stock market[*] is the world's second largest after the United States, with 3,868 companies worth $8.4 trillion listed on the Shanghai and Shenzhen Stock Exchanges as of May 2020.[80] Despite its vast size, China's stock market plays a negligible role in capital allocation in the Chinese economy. In 2019, China's stock market accounted for only 2.9 percent of China's total outstanding credit stock, though Chinese companies raised $35.6 billion in equity through IPOs and secondary offerings[†] that same year, suggesting rising demand for equity financing (see Figure 5).[81] The marginal role of China's stock market in providing financing to the Chinese economy is due to two factors. First, China's banking system dominates capital allocation, with bank loans accounting for 60.3 percent of aggregate

[*] While China has a number of regional exchanges, the Shanghai and Shenzhen stock exchanges, established by the Chinese Securities Regulatory Commission in December 1990, are the primary avenues for Chinese companies to issue stock. Discussion of China's stock market here therefore refers exclusively to these two major exchanges. As of May 2020, the Shanghai Stock Exchange featured 1,627 listed companies with a market capitalization of $4.9 billion, while the Shenzhen stock exchange featured 2,241 listed companies with a market capitalization of $3.5 billion. For an overview of China's stock market, see Grace Xing Hu, Jun Pan, and Jiang Wang, "China's Capital Market: An Empirical Overview," *National Bureau of Economic Research*, February 2018, 3–14.

[†] A secondary offering is the sale of new shares by a company that has already made an IPO to raise additional capital. Secondary offerings typically involve a company making some of its reserve of authorized shares available for sale to the public or making company executives' or institutional investors' shares available for sale. They are sometimes alternatively referred to as follow-on offerings or follow-on public offers. *Speed Trader*, "Understanding Secondary Offerings," 2018. *https://speedtrader.com/understanding-secondary-offerings/*.

financing in 2019.[82] Second, onerous listing requirements[*] have made it difficult for smaller firms to list. State-owned enterprises (SOEs) and other politically connected firms can more easily comply with listing requirements[†] but have little need to raise money on China's stock exchanges because they have privileged access to capital through China's state-controlled banking system.

Figure 5: Total Capital Raised and Equity Financing as Share of Aggregate Financing in China's Stock Market



Note: Total capital raised includes capital raised from IPOs and secondary offerings.
Source: World Federation of Exchanges, "Statistics Portal," updated June 2020. *https://statistics.world-exchanges.org/*; The People's Bank of China via CEIC database.

The Chinese government, as opposed to the market, also continues to influence the decisions of all issuers in China's stock market regardless of ownership. For example, June 2018 listing guidelines issued by the China Securities Regulatory Commission (CSRC) require all publicly traded firms to set up Chinese Communist Party (CCP) cells within their leadership structures.[‡] [83] The Chinese government's control over the stock market is further evidenced

[*] China's stock market has historically featured high thresholds on earnings and cash flow requirements for companies seeking to list. For example, prior to stock market reforms undertaken in 2020, a company needed to demonstrate in its IPO application to the China Securities Regulatory Commission that it had generated positive earnings in the past three consecutive years with accumulated earnings in excess of RMB 30 million. These tight requirements explain why some Chinese companies, particularly in the startup and technology sectors, choose to list in overseas markets such as the United States. According to one study, had JD.com tried to list in China rather than on Nasdaq in May 2014, it would have had to show profits in 2011, 2012, and 2013, and a small loss that occurred in 2012 would have made it impossible to list in China. Franklin Allen et al., "The Development of the Chinese Stock Market," (draft) in Marlene Amstad, Guofeng Sun, and Wei Xiong, *The Handbook of China's Financial System*, forthcoming Princeton University Press, 2020, 18. *https://www.chinafinancialsystem.com/wp-content/uploads/2019/08/Ch11_StockMarket_AllenQianShanZhu_HandbookChinaFinancialSystem_AmstadSunXiong.pdf*.

[†] SOEs and mixed-ownership enterprises, including privatized SOEs and other firms with some government shareholders, account for 65 percent of total market capitalization in China's stock market. Nick Borst, "State-Owned Enterprises and Investing in China," *Seafarer*, November 2019, 1. *https://www.seafarerfunds.com/documents/state-owned-enterprises-and-investing-in-china.pdf*.

[‡] While it has long been presumed that all Chinese companies feature Chinese Communist Party organizations in their leadership structures, the updated listing guidelines issued in 2018 appear to be the first codification of such a requirement with respect to publicly listed companies whose shares are traded on stock exchanges. Specifically, Article 5 of the guidelines state "organizations of the Communist Party of China should be established in a listed company in accordance with the Company Law." The Company Law (last updated in 2013) was ambiguous on this point, and did not indicate that listed companies specifically should feature such organizations, instead stipulating in its Article 19 that "in a company, an organization of the Communist Party of China shall be established to carry out the activities of the party in accordance with the charter of the Communist Party of China." The Company Law's Section 5 on "Special

by the composition of investors. According to China corporate analyst Thomas Gatley, 60 percent of total market capitalization of listed Chinese companies is "locked up" in nontradeable shares held by Chinese government agencies, effectively making more than half of the market's total value out of reach to individual and institutional investors.[84] Expert on China's financial system Carl Walter observes that this limited investability is due to the Chinese government's perennial focus on maintaining control over volatility in China's stock market.[85]

COVID-19, U.S.-China Financial Frictions Accelerate Shifts in Listing Procedures

The Chinese government has unveiled a slew of measures in 2020to accelerate stock market reforms, help firms hurt by the COVID-19 pandemic, and mitigate rising financial frictions with the United States. These efforts focus chiefly on speeding up IPO approval procedures and are modeled on measures first piloted on China's Science and Technology Innovation Board, also known as the STAR Market, in July 2019.[*] [86] While the STAR Market focused narrowly on attracting high-tech companies that align with national development priorities to list onshore, the Chinese government indicated in its updated Securities Law, which went into effect in March 2020, that related provisions would be extended to China's broader stock market in a "step-by-step" fashion.[87]

On June 12, China's State Council announced the CSRC would soon unveil final rules for the extension of the registration-based IPO system[†] to Shenzhen's ChiNext Board, a trading venue for tech startups on the Shenzhen stock exchange, for implementation at an undisclosed date in 2020.[88] Unlike the registration-based IPO system piloted on the STAR Market, however, the changes to the ChiNext Board will apply to secondary offerings and acquisition and merger deals involving a far wider array of companies.[89] The measures could result in a wave of IPOs and secondary offerings on the Shenzhen Stock Exchange, which has featured fewer offerings than the Shanghai Stock Exchange since the STAR Market's debut there, and bring new rivalry to the two exchanges as they pursue listings from Chinese technology startups (see Figure 6). The measures also do away with price limits during the first five trading days of a newly listed stock, after which shares will be allowed to rise or fall up to 20 percent during a trading session, compared with 10 percent previously.[90]

Provisions on the Organizational Structure of Listed Companies" makes no reference to requirements for CCP cells. China Securities Regulatory Commission, "Announcement No. 29 'Government Standards for Listed Companies,'" (第 29 号公告《上市公司治理准则》), September 30, 2018. Translation. *http://www.csrc.gov.cn/pub/zjhpublic/zjh/201809/t20180930_344906.htm*; China Securities Regulatory Commission, "Company Law of the People's Republic of China (Chairman's Order No. 8, as Amended on December 28, 2013)" (中华人民共和国公司法（主席令第 8 号，2013 年 12 月 28 日修正）, December 28, 2013. Translation. *http://www.csrc.gov.cn/pub/shenzhen/xxfw/tzzsyd/ssgs/zh/zhxx/201409/t20140918_260530.htm*

[*] For more on the establishment and key features of the STAR Market, see "New Hi-Tech Board on the Shanghai Stock Exchange" in U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, May 2019. *https://www.uscc.gov/sites/default/files/Research/May%202019%20TB.pdf*.

[†] The IPO application system was historically administration based. A company seeking to list on Chinese stock exchanges first had to have its IPO application reviewed and approved by the CSRC in an often politicized process. For example, in deciding whether to approve an IPO, the CSRC could consult the local government of the province where the applying firm was headquartered. This dynamic explains why SOEs typically had an easier time listing on China's exchanges. It also created incentives for corruption, as companies could try to buy their way to an IPO. In moving to a registration-based system, companies circumvent the CSRC review process altogether and submit their applications directly to the exchange where they seek to list. The listing exchange's review procedure focuses chiefly on financial and operating data disclosure and information transparency, while the CSRC is responsible for registration of the IPO once approved by the exchange. Shiwei Zhang, "Initial Public Offerings 2020 | China," *Global Legal Insights*, June 9, 2020. *https://www.globallegalinsights.com/practice-areas/initial-public-offerings-laws-and-regulations/china*; Franklin Allen et al., "The Development of the Chinese Stock Market," (draft) in Marlene Amstad, Guofeng Sun, and Wei Xiong, *The Handbook of China's Financial System*, forthcoming Princeton University Press, 2020, 8. *https://www.chinafinancialsystem.com/wp-content/uploads/2019/08/Ch11_StockMarket_AllenQianShanZhu_HandbookChinaFinancialSystem_AmstadSunXiong.pdf*; Thomas Gatley, "A User's Guide to the Chinese Stock Market," *Gavekal Dragonomics*, April 2, 2019, 18.

Figure 6: Number of New Listings in China's Stock Market, January 2019–May 2020

Note: Number of new listings includes IPOs and secondary offerings.
Source: World Federation of Exchanges, "Statistics Portal," updated June 2020. *https://statistics.world-exchanges.org/*.

The extension of an IPO registration system to the ChiNext board presents both opportunities and challenges for the development of China's stock markets. Competition between the Shanghai and Shenzhen exchanges for offerings from tech companies and startups could create more dynamic and competitive capital markets. However, variations in listing standards* for IPOs in Shanghai's STAR Market versus IPOs and secondary offerings in Shenzhen's ChiNext Board may lead to inconsistent review and approval procedures. CSRC Vice Chairman Li Chao ambiguously stated that a "mechanism to coordinate the review processes by the two boards" will be needed to resolve this mismatch.[91] Lack of clarity on whether such a mechanism would be established by the CSRC or the exchanges themselves suggests the Chinese government may wait to see how the market reacts to the eased listing provisions on the ChiNext board. The rollout of a registration-based IPO system there may test the Chinese government's tendency to intervene in China's stock markets to manage volatility. As the eased registration-based IPO system applies to all securities and not just new issuers in the ChiNext board, a flurry of listings could inject market volatility and invite familiar intervention from China's regulators. Chinese investors will also need to scrutinize individual securities and offerings more rigorously, an effort the Chinese government appears to be trying to make easier by allowing more foreign ratings agencies to enter the Chinese market in recent months.

Separately, on June 19 the Shanghai Stock Index unveiled changes to its inclusion methodology for the Shanghai Composite Index, a stock market index that tracks all stocks traded in Shanghai.[92] The proposed changes, which will take effect July 22, allow Chinese companies incorporated overseas and listed in Hong Kong as well as high-tech companies listed in Shanghai's STAR Market to be included. Other revisions seek to apply more stringent standards for inclusion. For example, stocks with "special treatment" status, a tag applied to loss-making and other companies with regulatory or financial problems, will be removed.[93] The waiting period for new entrants to join the index will also be prolonged from 11 days currently to three months in a bid to ensure entrants demonstrate strong market performance over a sustained period of time before inclusion.[94] These revisions to the Shanghai Composite

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* For example, for money-losing businesses, ChiNext requires an expected market value of no less than RMB 5 billion and revenue of no less than RMB 300 million in the most recent fiscal year. The STAR Market requires the same minimum revenue but a lower expected market value of at least RMB 3 billion. Liu Caiping and Denise Jia, "In Depth: ChiNext Tests Expanding Registration-Based IPOs to Overall Market," *Caixin*, May 6, 2020. *https://www.caixinglobal.com/2020-05-06/in-depth-chinext-tests-expanding-registration-based-ipos-to-overall-market-101550389.html*.

Index inclusion methodology are notable as the index has not been updated since its introduction in July 1991, leading to excess weighting of securities issued by companies in traditional industries such as banking and energy.[95]

Hong Kong Outcompetes Upgraded Onshore Markets, for Now

Beijing is likely to continue overhauling China's capital markets as U.S. regulatory scrutiny of Chinese securities intensifies and as the Chinese government seeks to keep its innovative tech firms at home. However, many of these companies are likely to gravitate to Hong Kong rather than Shanghai and Shenzhen, as Hong Kong does not place restrictions on companies looking to move funds into or out of the territory and features a wider pool of international investors and capital.[96] Listing onshore also could deprive Chinese companies of dollars needed to fund foreign operations, as the RMB is subject to a number of limits on foreign exchange and wiring.[97] At the end of 2019, roughly a third (1,241) of all Mainland-listed companies (3,777) were also listed in Hong Kong.[98]

Other Chinese companies listed in the United States and not on the Mainland are also more likely to consider Hong Kong before Shanghai or Shenzhen as they consider leaving U.S. exchanges. In recent weeks, Hong Kong has seen a wave of secondary listings from the likes of JD.com and NetEase, and analysts estimate other U.S.-listed Chinese companies could bring $557 billion in new listings to the financial center in the months ahead.[99] Companies outside the e-commerce and technology industries are also eyeing listings in Hong Kong. For example, Yum China, which operates KFC, Pizza Hut, and Taco Bell restaurants in China, is reportedly considering a secondary offering in Hong Kong.[100] Hong Kong's benchmark Hang Seng Index separately announced it would include companies with primary listings abroad and those with dual-class shares in its indices moving forward, with the earliest inclusion occurring in August, further elevating the territory's attractiveness as a listing destination.[101]

However, foreign investors may become discouraged from participating in Hong Kong's capital markets as Beijing tightens its control of the financial hub through its National Security Law, which came into effect June 30.[102] As TS Lombard economist Rory Green observes, "The great attraction of Hong Kong was that it is a play on the Chinese market without the political risks," an assurance that is being called into question as Beijing exerts more control over the territory.[103] The decline of free speech in Hong Kong could also erode its efficiency as a financial market.[104] Investment analysts' notes identifying fraud at Chinese banks, for example, could potentially run afoul of the law given its far-reaching scope.[105] Lastly, as more Chinese companies occupy a greater share of Hong Kong's stock market, Beijing's propensity to intervene in the market may rise, diminishing market independence. For example, when the Hang Seng Index fell 5.6 percent after Beijing announced in May it would move to pass the National Security Law, mainland investors pumped $570 million into the market through the Stock Connect scheme to stand up its value.[106]

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