U.S.-China Economic and Security Review Commission

Economics and Trade Bulletin

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Highlights of This Month's Edition

- **Bilateral trade:** In the first three quarters of 2020, the U.S. goods trade deficit was $223 billion, down 5 percent year-on-year, with agricultural exports to China up 92.8 percent from last year; in Q2 2020, the U.S. services surplus with China reached $11.7 billion, a record low due to the COVID-19 pandemic.

- **Policy trends in China's economy:** At the Fifth Plenum, the CCP stressed economic self-reliance and stronger domestic innovation; China's new Export Control Law has a broad scope that creates the potential for arbitrary restrictions on Chinese exports, extraterritorial reach, and retaliation against foreign exporters and end users; China's government introduced the digital RMB; the new Chengdu-Chongqing regional integration plan reflects a multiyear strategy of fostering economic development centered on innovation and exports.

- **Quarterly review of China's economy:** China reported GDP growth of 4.9 percent year-on-year in Q3, but a sluggish recovery elsewhere in the world and concerns over debt could undermine growth going forward; this year's "Golden Week" saw a return to consumption, though indicators point to worsening income disparities.

- **Financial markets:** Suspension of blockbuster Ant Group IPO underscores the CCP's control over private enterprise in China.

- **In focus – Trends in supply chain realignment:** Preliminary data and anecdotal evidence suggest the complete uprooting of supply chains out of China is unlikely, with gradual diversification emerging as a more prominent trend.

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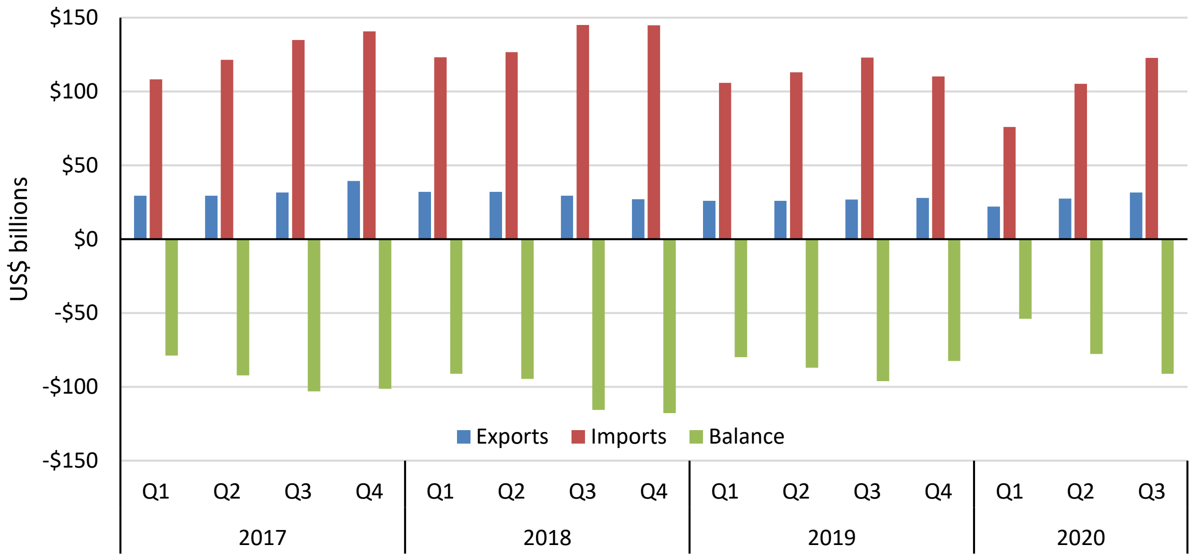
Bilateral Trade

Q3 2020 Sees U.S. Goods Deficit with China Decline Year-on-Year

The U.S. trade deficit in goods with China was $91 billion for Q3 2020, down 5 percent from $96 billion in Q3 2019 (see Figure 1).[1] U.S. exports to China continued to increase, growing 18.1 percent year-on-year to $31.6 billion in Q3 2020 from $26.7 billion in Q3 2019. U.S. imports from China decreased slightly, down 0.2 percent year-on-year to $122.7 billion.[2] The U.S. year-to-date goods deficit increased by 1 percent from $263.2 billion in 2019 to $265.6 billion in 2020, with imports up 1.3 percent to $346.3 billion and exports up 3 percent to $81.1 billion.[3]

Figure 1: U.S. Exports, Imports, and the Trade Deficit with China, Q1 2017–Q3 2020



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

Although Chinese imports of U.S. goods were up from 2019 levels, they continue to fall short of purchases needed to meet targets under the Phase One trade deal. According to analysis by Chad Bown, trade expert at the Peterson Institute for International Economics, China's purchases of covered goods are at 53 percent of year-to-date targets, with $58.8 billion in purchases out of a year-to-date target of $109 billion.[4]

Agriculture Rises to Top Five Export Good but Still Below Phase One Targets

Exports of agricultural products composed a growing share of U.S. exports to China, moving from the sixth-largest category of exports in Q2 to the second-largest category in Q3 (see Table 1). China's purchases of agricultural purchases had plummeted 62.7 percent—from $15.8 billion in 2017 to $5.9 billion in 2018—after the Chinese government imposed retaliatory tariffs of 15 percent or 25 percent on U.S. goods in 2018.[5] Agricultural purchases increased to $10.3 billion in 2019, but remained below 2017 pre-tariff levels.[6] The Chinese government imposed additional tariffs in 2019, taking the total number of tariffs on agricultural goods to 1,053 agricultural goods by September 1, 2019.[7] Agricultural exports grew from $2.4 billion in 2019 to $4.4 billion in 2020—an increase of 92.8 percent year-on-year.[8] Despite this increase, China's purchases of agricultural goods look unlikely to meet Phase One targets, with $12.9 billion in covered purchases representing only 65 percent of the $25 billion year-to-date target based on U.S. export numbers, according to Dr. Bown.[9]

Table 1: U.S. Trade with China Top Five Exports and Imports, Q3 2020

U.S. Top-Five Exports to China	Exports (in US$ millions)	Share of total (%)	Change over Q3'19 (%)	U.S. Top-Five Imports from China	Imports (in US$ millions)	Share of total (%)	Change over Q3'19 (%)
Quarter 3 (Aug-Oct' 2020)				*Quarter 3 (Aug-Oct' 2020)*			
Computer & Electronic Products	$5,364	17.0%	18.23%	Computer & Electronic Products	$37,011	30.2%	0.2%
Agricultural Products	$4,702	14.9%	92.82%	Miscellaneous Manufactured Commodities	$13,094	10.7%	-8.6%
Chemicals	$4,408	13.9%	16.76%	Electrical Equipment, Appliances & Components	$12,384	10.1%	7.0%
Transportation Equipment	$3,364	10.6%	-37.81%	Textile Mill Products	$8,520	6.9%	138.5%
Machinery, Except Electrical	$3,016	9.5%	21.59%	Machinery, Except Electrical	$8,499	6.9%	1.5%
Other	$10,755	34.0%		Other	$43,175	35.2%	
Total	$31,610	**100%**		**Total**	$122,682	**100%**	

Source: U.S. Census Bureau, *USA Trade Online*, November 4, 2020. *https://usatrade.census.gov/*.

Sales of transportation equipment plummeted this quarter, down 37.8 percent from $5.4 billion in Q3 2019 to $3.4 billion in Q3 2020, with declines in purchases of aerospace equipment and railway vehicles driving much of this change.[10] Computer and electronic products, chemicals, and nonelectrical machinery registered moderate-to-high growth, up by 18.2 percent, 16.8 percent, and 21.6 percent, respectively.[11]

Advanced Technology Products

The U.S. trade deficit in advanced technology products (ATP) with China increased by 2.7 percent year-on-year, up from $25.8 billion in Q3 2019 to $26.5 billion in Q3 2020 (see Table 2).[12] Imports of information and communications technology equipment accounted for the majority of this deficit, with $31.3 billion in imports in Q3 2020.[13] Exports of aerospace products fell 71.8 percent year-on-year to $886 million in Q3, while exports of flexible manufacturing products rose 63 percent to $1.5 billion.[14]

Table 2: ATP Trade Q3 2020

(US$ millions)

	Exports	Imports	Balance Q3'2020	Balance Q3'2019	Balance YOY
TOTAL	**$7,944**	**$34,413**	**-$26,469**	**-$25,785**	**2.7%**
(01) Biotechnology	$650	$138	$512	$379	35.1%
(02) Life Science	$1,021	$804	$217	$278	-21.9%
(03) Opto-Electronics	$113	$925	-$812	-$940	-13.6%
(04) Information & Communications	$906	$31,284	-$30,378	-$30,248	0.4%
(05) Electronics	$2,772	$789	$1,983	$1,186	67.2%
(06) Flexible Manufacturing	$1,508	$241	$1,267	$712	77.9%
(07) Advanced Materials	$58	$44	$14	$11	27.3%
(08) Aerospace	$886	$130	$756	$2,847	-73.4%
(09) Weapons	$0	$55	-$55	-$38	44.7%
(10) Nuclear Technology	$30	$3	$27	$28	-3.6%

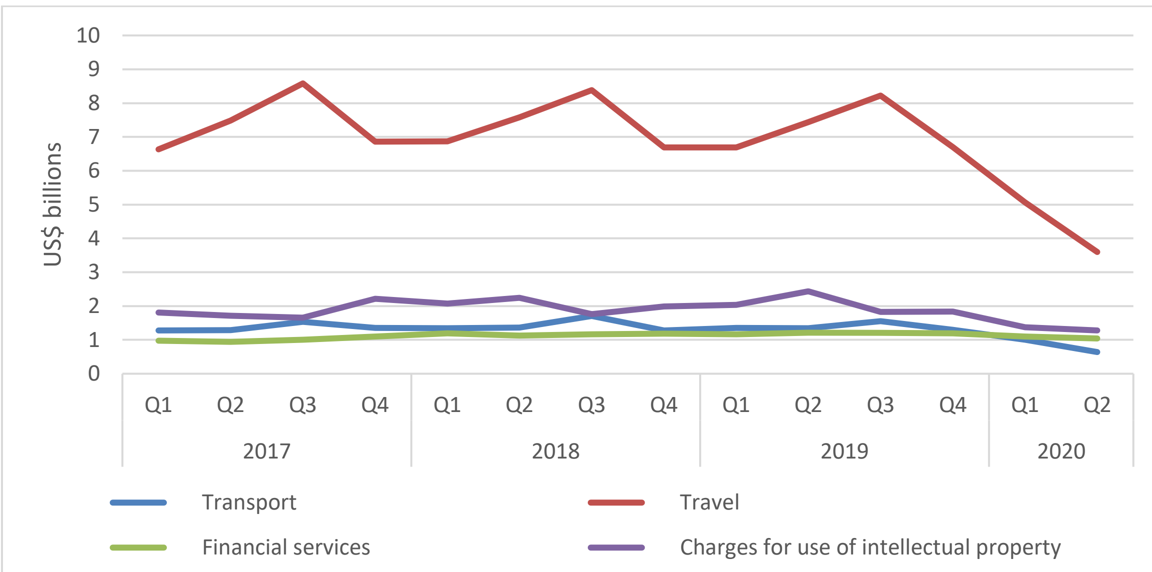
Source: U.S. Census Bureau, *U.S. Trade with China in Advanced Technology Products - Monthly and Cumulative Data (in Millions US $)*, November 2020. *http://www.census.gov/foreign-trade/statistics/product/atp/2016/06/ctryatp/atp5700.html.*

Q2 2020 Sees Dramatic Decline in U.S. Services Trade with China

In the first two quarters of 2020, the U.S. services trade surplus with China reached $11.7 billion, down 35 percent from the same period in 2019.[15] Year-on-year, the U.S. services surplus in the second quarter contracted by 48.3 percent and at $4.7 billion saw the lowest trade surplus value in a single quarter since 2013.[16] The marked decline throughout the first two quarters of 2020 is attributable to the fall in travel due to the novel coronavirus (COVID-19) pandemic.

Border restrictions resulting from COVID-19 remain in place, dramatically reducing normal movement of tourism, business travel, and students across the Pacific. According to the National Trade and Tourism Office under the U.S. Department of Commerce, arrivals of visitors from China saw a year-on-year decline of 84.2 percent, reflecting the downward trend in overseas arrivals from around the globe.[17] In a typical year, nearly 70 percent of arrivals from China are tourists.[18] This loss of traffic is clear from services exports for transportation and travel (including for educational purposes), which plummeted 52.3 percent and 51.6 percent year-on-year, respectively.[19] Other sectors reflected similar declines as charges for the use of intellectual property totaled $2.6 billion in the first two quarters of 2020, a decline of 40.1 percent of exports in the same period the previous year (see Figure 2).[20] Total U.S. services exports to China shrank 43.5 percent year-on-year to reach $8.1 billion in the second quarter of 2020.[21]

Figure 2: Top U.S. Services Exports to China, Q1 2017–Q2 2020



Source: U.S. Department of Commerce – Bureau of Economic Analysis, *U.S. International Transactions*, U.S. Department of Commerce, Foreign Trade Division, September 18, 2020.

Policy Trends in China's Economy

Economic Self-Reliance to Dominate the Forthcoming 14th Five-Year Plan, as Growth Ebbs

On October 26–29, the Chinese Communist Party (CCP) Central Committee (CCPCC)* held the Fifth Plenary Session of the 19th Party Congress (the Fifth Plenum), a conclave to discuss China's forthcoming 14th Five-Year

* Under the CCP's constitution, the CCPCC is the most authoritative body in China's political system, composed of 198 members and 166 alternate members nominally elected by the CCP's quinquennial National Congress. In practice, the seven-member Politburo Standing Committee drives the agenda, and particularly under General Secretary Xi, CCPCC meetings add an illusion of a deliberative process more than serving to formulate policy. For more on the elite politics behind the plenary session, see Jude Blanchette and Scott Kennedy, "China's Fifth Plenum: Reading the Initial Tea Leaves," *Center for Strategic and International Studies*, October 30, 2020. *https://www.csis.org/analysis/chinas-fifth-plenum-reading-initial-tea-leaves*.

Plan that will guide all aspects of policy from 2021 to 2025. The five-year plan outline itself will not be unveiled until March 2021,* but Chinese state media issued a brief communique highlighting key themes from this October's meeting, and the Chinese government published a of broad agenda items for the plan the following week.[22] The official statement, while only a summary, demonstrates an even greater embrace of statist and technonationalist economic policy than the 13th Five-Year Plan (2016–2020). While the summary release does not mention the United States, a strong focus on self-reliance and economic self-sufficiency shows Chinese leaders' preoccupation with technological competition and resilience in the face of further restrictions on China's access to U.S. technology.[23] Subsequent CCP events, such as the Central Economic Work Conference in December, may shed further light into plan's contents ahead of its release next spring.

The communique struck a confident tone on China's economic progress, declaring that the CCP had achieved substantial victories in building a "moderately prosperous society," one of the "Four Comprehensives," CCP political goals first articulated in 2014 by General Secretary of the CCP Xi Jinping.† [24] Having claimed victory, the communique changed this goal to "comprehensively building a modern socialist country."‡ [25] The communique also continued the CCP's rhetorical prioritization of quality economic growth over achieving topline targets; in practice, however, achieving numerical targets has been a centerpiece of the CCP's legitimacy for 40 years. In line with the communique's emphasis on "sustained and healthy economic development," there is no numerical goal for gross domestic product (GDP) growth.[26] A numerical target may still appear in the 14th Five-Year Plan when it is released next year.§ The communique also contained references to improving per capita income and reducing urban-rural and regional economic disparities, as well as addressing societal problems such as an aging population.[27]

Official statements coming out of the Fifth Plenum prioritize attaining self-sufficiency in science and technology. In spite of a triumphalist tone overall, the communique offered a critical assessment of China's current innovative capabilities, stating that they "do not meet the requirements of high-quality development."[28] To address this inadequacy, the document mostly listed high-level aspirations to cultivate domestic talent and improve innovation strategy, without naming specific industries or targets; such targets will follow in the 14th Five-Year Plan when it is released next year.[29] A clear theme, however, is linking improved innovative capacity with concurrent steps to increase deployment of networked technologies and data collection in urban management, manufacturing, and other areas.[30] This furthers a massive long-term effort by the Chinese government to establish leadership in industries dependent on faster connection speeds, greater data processing, and other foundational capabilities provided by digital infrastructure.[31] China's government has increasingly involved large private technology firms in its efforts, a trend that may continue in the 14th Five-Year Plan period.[32]

The communique is also clear that the 14th Five-Year Plan's prescription for addressing China's weak innovative capacity will be an even stronger role for the state in directing the economy. Jude Blanchette and Scott Kennedy, China experts at the Center for Strategic and International Studies, observe that the broader economic vision articulated by the communique and other recent statements by General Secretary Xi place market-oriented development as subservient to the goals of the state.[33] For Chinese policymakers, improving the efficiency of China's domestic economy is a policy tool to bring about other desired outcomes rather than a worthwhile end in itself.[34] Similarly, a call to "stimulate creative vitality" clarifies that technological innovation and scientific

* The plenary session did not approve the 14th Five-Year Plan itself, but rather a series of general recommendations on what the plan should include. Trivium China, "Plenum Power!" *Tip Sheet*, October 30, 2020. *https://mailchi.mp/305f2f8c5c6f/plenum-power?e=e0817d5cde*.

† The other three goals in the "Four Comprehensives" are comprehensively deepening reform, comprehensively governing according to the rule of law, and comprehensively governing the CCP strictly. *Xinhuanet*, "Communique on the 5th Plenum of the 19th Party Congress" (中国共产党第十九届中央委员会第五次全体会议公报), October 29, 2020. Translation. *http://www.xinhuanet.com/politics/2020-10/29/c_1126674147.htm*.

‡ The communique does not define the characteristics of a "modern socialist country," but a CCP report in 2017 defined a modern socialist country as being "prosperous, strong, democratic, culturally advanced, harmonious, and beautiful." *Xinhuanet*, "Resolution of the 19th National Congress of the Communist Party of China on the Report of the 18th Central Committee," October 24, 2017. *http://www.xinhuanet.com/english/2017-10/24/c_136702625.htm*.

§ In a speech made public last week, General Secretary Xi said it is "completely possible" to double China's total economic volume or per capita income by 2035, which would imply annual economic growth of just below 5 percent. *Xinhua*, "Xi Focus: Xi Says China's Economy Has Hope, Potential to Maintain Long-Term Stable Development," November 3, 2020. *http://www.xinhuanet.com/english/2020-11/03/c_139488104.htm*; Bill Bishop, "Sinocism China Newsletter," November 3, 2020.

advances are means to achieve greater national power, reduce China's reliance on other countries, and address other pressing strategic and policy needs.[35]

In addition to fostering self-reliant technological development, achieving self-sufficient domestic economic growth is foundational to Chinese leaders' vision for the next five years. The "dual circulation" economic strategy,[*] which suggests China should redirect its domestic manufacturing capabilities to satisfying domestic demand, also featured in the plenary session communique.[36] Under the dual circulation strategy, China's economic growth would primarily be driven by China's domestic market, with international economic ties viewed as a source of talent, resources, and investment rather than a pillar of China's continued growth as an export-oriented economy.[†] [37] The dual circulation strategy responds both to a collapse in demand for Chinese exports as global recession continues and to geopolitical uncertainty as escalatory tensions with the United States have cost China access to key components vital to its manufacturing sector.[38]

In addition to setting five-year economic goals, the communique also revealed that China's government is setting a 15-year goal of "basically achieving" socialist modernization by 2035, ahead of the CCP's goal of becoming a "modernized socialist country" in 2049, the 100-year anniversary of the founding of the People's Republic of China.[39] The multifaceted goal of "basically achieving" socialist modernization includes, among other economic targets, achieving "major breakthroughs in key core technologies."[40] The communique did not list the core technologies, but past CCP documents have emphasized telecommunications, semiconductors, big data, and artificial intelligence.[41] Analysts of Chinese politics have cited the 15-year timeline as further evidence that General Secretary Xi plans on retaining power well past the expiration of his second term in 2022.[42] Fifteen-year goals are not unprecedented in CCP, last appearing at the Fifth Plenary Session of the 14th Party Congress in 1995.[43]

China Passes Export Control Law

On October 17, China's National People's Congress approved China's first comprehensive Export Control Law,[‡] which will go into effect on December 1, 2020. Over three years of drafting, the law became more expansive in response to U.S. actions and changes to its export control regime.[44] The scope of the law is quite broad with its purpose to protect "national security and interests," though there is no methodology specified for the designation of controlled items.[45] In total, the ill-defined requirements under the law place a significant burden on exporters to identify risks of products and any potential end users for such products. Due to vague guidance, exporters may opt not to export broad categories of sensitive or strategic products to avoid political missteps, which may impact flow of goods to countries China disputes with or seeks to punish.

In addition to controlled items, the law directs exporters to also consult with export control authorities and seek licenses for unlisted items that may still risk national security and interests, be used for weapons of mass destruction, or be employed for terrorism. Controls apply to exports and reexports, but unlike the U.S. foreign direct product

[*] In the late 1980s, Chinese researcher Wang Jiang described China's export-led growth strategy as "great international circulation." The "dual circulation" plays on this description of China's economic model by separating the international economy (external circulation) from China's domestic economy (internal circulation), and proposing to rebalance from prioritizing international economic integration toward domestic economic resilience. "Circulation" (循环) is also translated as "circle" or "cycle." Yu Yongding, "Decoding China's 'Dual Circulation' Strategy," *Project Syndicate*, September 29, 2020. *https://www.project-syndicate.org/commentary/china-dual-circulation-economic-model-by-yu-yongding-2020-09*.

[†] Exports as a share of China's GDP have steadily declined since the mid-2000s, replaced by rapidly expanding investment, particularly after the financial crisis in 2008. The cusp of Chinese firms' technological capabilities is nonetheless in many cases driven by manufacturing for export, often by multinational firms with operations in China. Chengliang Liu and Qingbin Guo, "Technology Spillover in China: The Spatiotemporal Evolution and Its Drivers," *Sustainability* 11 (2019), 2–3, 12; Sharmin Mossavar-Rahmani et al., "Walled In: China's Great Dilemma," *Goldman Sachs Investment Strategy Group*, January 2016, 18–19, 51. *https://www.goldmansachs.com/what-we-do/investment-management/private-wealth-management/intellectual-capital/isg-china-insight-2016.pdf*.

[‡] Prior to this law, China's export control regime was a patchwork of regulations and catalogues. Sofia Baruzzi, "Why Is China Introducing New Export Controls?" October 12, 2020. *https://www.china-briefing.com/news/chinas-new-export-control-law-restrictions-imposed-23-items-technology/*.

and de minimis rules,* China's law contains no additional specifications or minimum thresholds for application, marking an expansion of current controls. The law also introduces a "temporary license" scheme that would give agencies broad authority to prohibit exports for at least two years, regardless of the end user. This temporary license scheme does not include a consultation period or clear requirement for agencies to publicly state the justification for the temporary license, giving agencies broad administrative discretion.

Chinese exporters will not be the only ones contending with the expanded export control rules, as the law has significant extraterritorial reach. It allows Chinese agencies to restrict exports to foreign importers and end users that may pose threats to national security and interests. The law also provides agencies with explicit authorization to retaliate against foreign "abuses" of export control rules. This leaves both exporters and end users outside of China vulnerable to Chinese retaliation. The State Council and the Central Military Commission are responsible for lists of controlled items and restricted end users, license issuance, and enforcement, as well as the creation of a risk management system for export controls. The law states that authorities will maintain a list of restricted end users (individuals and entities) consisting of those who do not meet end user requirements, pose a threat to "national security and interests," or may use controlled items for terrorism. It is possible that the risk management system will provide exporters additional guidance on licensing procedures for listed and unlisted items as well as requirements for management of end users, which are not currently specified in the law.[46]

The definition of controlled items under the law extends to "data such as technical documentation," meant to include source code, algorithms, and similar data. The addition of these elements is in line with China's August 2020 changes to its Catalogue of Technologies Subject to Prohibition and Restriction for Export, which included the addition of several information processing technologies. These changes demonstrate the Chinese government's concerns about protecting sensitive technologies, but the broad authorities under the Export Control Law also clearly provide policy tools to address challenges to trade and increase protectionism.

China's Central Bank Pilots Digital Currency and Releases Draft Legal Framework

China's government pushed ahead in its bid to establish an official digital currency, introducing in October draft legislation defining a regulatory regime for the digital currency and concluding its largest pilot project yet for distributing the fledgling currency to consumers.[47] Now in its sixth year of planning the digital RMB, Chinese government's ambitions to lead the world in a digitized national currency follow its broader financial and technological objectives.[48] China's leaders see the digital RMB as a step toward encouraging global use of the RMB at the expense of the dollar, just as China eases restrictions on its capital account controls. At the same time, the technology and proposed legal framework allow the state to assert greater oversight of China's private sector mobile payments ecosystem and guard against threats to its capital account controls posed by other digital currencies.

China's Draft Law and Digital Currency Lottery

On October 23, 2020, PBOC published a draft amendment to the People's Bank of China Law that would include the digital RMB as part of China's sovereign currency.[49] The draft amendment would make it illegal for any other party to issue digital currencies backed by the RMB, a provision PBOC officials said aimed to protect sovereign currency issuance rights from erosion by cryptocurrencies and stablecoins.† [50] The restrictions follow China's crackdown on cryptocurrency exchanges and prohibition of raising funds via Initial Coin Offerings in 2017.[51]

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* The foreign direct product rule under the Export Administration Regulation (EAR) prohibits exports and reexports of controlled items, including foreign-made products, to certain countries unless the exporter receives license or license exception. The de minimis rule establishes that items with less than 25 percent of U.S.-origin content are not subject to the EAR. U.S. Department of Commerce – Bureau of Industry and Security, *Export Administration Regulations, Part 736 – General Prohibitions*, August 17, 2020, 3. *https://www.bis.doc.gov/index.php/documents/regulation-docs/413-part-736-general-prohibitions/file*.

† Stablecoins are digital currencies designed to minimize price fluctuations by pegging their value to another asset, such as the U.S. dollar or the price of gold. This makes stablecoins a more attractive store of value and medium of exchange than cryptocurrencies such as Bitcoin, which have historically had highly volatile prices. SDF Blog, "Stablecoins: The Future of Money," *Stellar*, September 17, 2020. *https://www.stellar.org/blog/stablecoins-the-future-of-digital-money?locale=en*.

Earlier in October, PBOC also gave away $1.5 million (RMB 10 million) of digital RMB to 50,000 winners* of a lottery in Shenzhen to conduct a trial of the digital RMB's use in retail payments.[52] During the course of the week-long pilot, over 3,000 participating vendors processed 62,788 transactions worth $1.3 million (RMB 8.8 million) in digital RMB.[53] The largest trial of the digital sovereign currency to date, the lottery also served as a public awareness campaign, with 1.9 million registrants for the lottery.[54] PBOC has conducted smaller trials in Shenzhen, as well Suzhou, Chengdu, and Xiongan New Area,† and at venues for the winter 2022 Olympics in Beijing.[55]

How the Digital RMB Works

For the user, the digital RMB functions similarly to mobile payments application like Ant Financial's Alipay, or Tencent's WeChat Pay, that are already prevalent in China.[56] Users download a digital wallet that stores their balance, and can pay for goods and services from this wallet by scanning a QR code.[57] Unlike mobile payments apps, however, which simply log a user's balance like a bank deposit, patenting activity in China suggest the digital RMB is tokenized into units like 100 RMB or 50 RMB notes and includes a traceable transaction history for the life of the unit of currency.[58] Chinese regulators could use this information to track money flows within China's economy, better enabling them to detect and block money laundering or other illicit transactions.[59] Aside from greater visibility into the RMB's circulation, digital currency could also give China far greater control over its money supply. For instance, analysis by *Reuters* notes that PBOC could impose negative interest rates on digital currency in circulation,[60] which could incentivize users to deposit digital RMB into the banking system, increasing banks' capital if they are running short or China's government wants them to offer further loans to a specific sector.

Implications of a Chinese Central Bank Digital Currency

While pilots such as the Shenzhen lottery focus on domestic retail transactions, a widely-available digital RMB may help China increase the currency's use internationally while maintaining control over the capital account, as the country opens its financial markets to greater capital inflows. Chinese leaders have been unequivocal in their ambition to promote the RMB as global currency for decades, driven especially by a desire to unseat the U.S. dollar's near monopoly in international settlement. Aside from increasing China's global financial stature, reducing reliance on international transactions in the U.S. dollar and the Bank of International Settlement's SWIFT network would allow Chinese entities and others who use Chinese systems to circumvent U.S. sanctions.[61] China's leaders have clearly signaled the digital RMB is a tool for achieving greater RMB use internationally.[62] Coupled with China's homegrown challenger to the SWIFT network, the Cross-Border Interbank Payment System (CIPS), Chinese officials believe the increased efficiency and security of cross-border transactions in digital RMB will make it an attractive alternative to existing international payments methods.[63]

Despite former PBOC government Zhou Xiaochuan claiming at an October 2020 forum that the digital RMB was aimed at reducing the dollar's hegemony, China's goal of increased RMB internationalization has seen minimal progress to date.[64] The RMB accounted for 1.7 percent of global reserves at the end the second quarter in 2020, and RMB payments for 1.9 percent of global payments by value, compared to 57.4 percent of reserves and 38.8 percent of payments for the U.S. dollar.[65] The RMB's meager international use relative to China's share of global trade endures in large part because Chinese leaders have been reluctant to allow greater international circulation of RMB at the expense of their ability to control the RMB's exchange value.[66]

Chinese regulators' interest in promoting a digital currency is likely driven by immediate domestic concerns as well as strategic international objectives. The quick rise of mobile payment titans WeChat and Alipay has effectively sidelined China's state-run banks from the country's burgeoning consumer payments market, depriving them of a key potential source of revenue as banks move to a fee-for-service business model.‡ [67] The two payments platforms

* Shenzhen's government indicated 47,573 people actually received the digital renminbi transfers, each totaling $30 (RMB 200). Cissy Zhou, "China Digital Currency: Shenzhen Consumers Spend 8.8 Million Yuan in Largest Trial of Digital Yuan," *South China Morning Post*.

† Xiongan New Area is an economic zone 100 kilometers (62 miles) southwest of Beijing, launched in 2017.

‡ Chinese banks have historically been guaranteed a wide profit margin on the spread between interest rates they charged lenders, and low interests rates they provided depositors. PBOC has slowly liberalized interest rates, which reduces banks' profit margin on lending and has prompted them to seek other sources of revenue. Ligang Song, "Interest Rate Liberalization in China and Implication for Non-State Banking," *Financial Sector Reform in China*, 111-130, 111-113. *https://www.findevgateway.org/sites/default/files/publications/files/mfg-*

accounted for more than 90 percent of the market and processed $27 trillion in mobile transactions in 2018.[68] While both WeChat and Alipay are strictly regulated and subject to political pressure from the CCP, the pace of both innovation and widespread adoption of new technology can far exceed Chinese regulator's ability to respond to systemic threats to financial stability.[*] Introducing a digital currency and supporting framework may allow PBOC more control over the technical evolution of China's digital payments ecosystem. It may also enable China's state-run banking system to carve out more market share in the lucrative consumer payments market, benefiting from a customer base already well accustomed to digital payments, though Chinese officials have denied an intent to compete with the mobile payments apps.[69]

In allowing far greater tracking of individual units of currency, a digital RMB could partially alleviate the concerns of Chinese regulators that rising international circulation of RMB decreases PBOC's ability to control the exchange rate.[†] While it cannot control the market value at which non-Chinese banks trade RMB,[‡] PBOC could monitor international flows of a digital RMB with far more precision, adjusting its domestic monetary policy in response to influence the RMB exchange rate. Continued interventions run the risk, however, of discouraging trading in RMB and investing in RMB denominated assets, even if China opens the capital account controls.[70] Centralized currency control and banning rival RMB-tracking digital currencies may also be a defensive move to protect China's capital controls from other digital currencies and capital flight. Widely used stablecoins pegged to the value of a national currency could become a substitute for the national currency itself, and changes in the supply or availability of the stablecoin, or a sudden decision to remove the peg, could then influence the price of the currency. Because China closely manages the value and supply of the RMB, PBOC is likely wary of allowing competing digital currencies that could make it easier for Chinese citizens to transfer assets out of China or influence the RMB's value.[§]

China's preemptive moves to assure blockchain does not undermine its capital controls may impact private-sector innovation beyond its borders. For instance, Facebook has announced plans to launch a series of digital currencies pegged to national currencies, but provisions in China's draft law regulating digital currency would make it illegal for Facebook to do this for the RMB.[71] In forging ahead with a central bank digital currency, PBOC may also render companies like Ripple, which uses its blockchain to facilitate cross border transactions, redundant intermediaries for exchanges in RMB.[72]

Chengdu-Chongqing Plan Expands China's Regional Integration Agenda

On October 16, the Chinese Politburo announced a plan for development of the Chengdu-Chongqing "economic circle," also called the Cheng-yu area,[**] to increase regional integration of the two largest cities in China's

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en-paper-financial-sector-reform-in-china-2005.pdf; Pierre Bottelier, "Managing China's Transition Debt: Challenges forSustained Development," *Financial Sector Reform in China*, 92-110, 98. *https://www.findevgateway.org/sites/default/files/publications/files/mfg-en-paper-financial-sector-reform-in-china-2005.pdf*.

[*] For example, in 2013, an investment platform on Alipay's escrow account caused a sharp liquidity shortage in China's banking system. Alipay offered returns far higher than meager returns offered for deposits at China's state-run banks, prompting hundreds of millions of users to take their money out of the banking system. PBOC ultimately intervened to cap the size of transfers allowed to Alipay, to keep deposits in the banking system. *Yicai*, "Who Did Yu'ebao Change? (余额宝们改变了谁)," February 24, 2014. Translation. *https://www.yicai.com/video/3501991.html*.

[†] PBOC could also control the exchange rate and allow the RMB to freely circulate internationally by giving up its ability to control of domestic interest rates and money supply, but this would greatly reduce China's ability to manage domestic inflation or guarantee state-owned enterprises cheap access to credit. Michael Pettis, "Do Markets Determine the Value of the RMB?" *Carnegie Endowment for International Peace*, August 18, 2015. *https://carnegieendowment.org/chinafinancialmarkets/61053*.

[‡] PBOC has attempted to control the value of RMB by imposing steep reserve requirements on offshore RMB bank accounts, tightening liquidity in offshore RMB to limit speculative trading of the currency. Enoch Liu, "Offshore Yuan Interest Rates Rockets Up to 200 Percent, with the People's Bank Eager to Punish Speculators," *South China Morning Post*, January 12, 2016. h*ttps://www.scmp.com/business/markets/article/1900060/offshore-yuan-interest-rate-rockets-200-cent-peoples-bank-eager*.

[§] It is highly unlikely any rival digital currency would make a noticeable difference in China's substantial domestic money supply of RMB, which total $32.8 trillion (RMB 216.4 trillion) for China as of September 2020. PBOC continues tightly controlling the liquidity of the much smaller supply of offshore RMB, however, and free exchange of offshore stablecoins pegged to the RMB could undermine PBOC's ability to continue exercising this control. Frank Parker, Andreas Schimpf, and Vladyslav Sushko, "Renminbi Turnover Tilts Onshore," *Bank of International Settlements Quarterly Review*, December 8, 2019. *https://www.bis.org/publ/qtrpdf/r_qt1912w.htm*; People's Bank of China via Trading Economics.

[**] "Cheng-yu" (成渝) is a portmanteau name combining Chengdu and the historic name for Chongqing, which comes from the ancient name of a Yangtze tributary river. Chongqing Municipal People's Government, *Historic Evolution* （历史沿革）, June 17, 2020. Translation. *https://www.cq.gov.cn/zqfz/zhsq/lsyg/202006/t20200617_7584025.html*.

southwest. The Cheng-yu plan is the fourth regional integration plan introduced in China after the Yangtze River Delta, the Beijing-Tianjin-Hebei plan, and the "Greater Bay Area" of Guangdong-Hong Kong-Macau. The plan builds on the already strong ties between the two cities, which until 1997 were both part of Sichuan province, to stimulate infrastructure projects, technology growth, environmental protection, and "high quality development."[73] These objectives mirror China's dual circulation strategy[*] to increase self-sufficient domestic production and increase export capability, as well as China's strategic emerging industry ambitions and carbon emissions goals.

Strengthening ties between Chengdu and Chongqing will take advantage of several promising elements of both cities. With a combined population of 100 million, the Cheng-yu area has a higher fertility rate than other urban Chinese areas, implying healthier long-term prospects for the workforce. Already home to many tech startups and hardware manufacturers, the government is trying to position this region as another "Silicon Valley of China" with a highly educated talent pool from the region's universities and a strong high-tech innovation base.[74] In 2019, the two cities were in the top ten municipalities for GDP growth.[75] The southwestern region, often viewed as a "gateway to the West," is a critical hub for the Belt and Road Initiative, making connections to 55 cities outside of China through a network of China-Europe freight trains.[76] Several projects and funds have already been initiated to focus on cutting-edge technologies such as integrated circuits and smart manufacturing, with local governments and venture capitalists raising $4.4 billion for the Chengdu-Chongqing Twin-City Economic Circle Development.[77] With the integration plan's emphasis on environmental protection, green finance initiatives and green technology programs such as hydrogen fuel cells have also attracted funding in the Cheng-yu area.[78] The Sichuan government has also invested $1.5 billion toward jumpstarting a "Civil Aviation Technology Zone," intended to be China's first civil aviation demonstration park and central to future national aviation technology.[79]

The Chinese government's focus on integration of key internal regions of China and their connectivity to outside markets is critical to its dual circulation strategy, centering on urbanization, strong exports, and innovation for development. On October 18, the National Development and Reform Commission announced a five-year plan[80] for Shenzhen from 2020 to 2025 to improve urbanization, business conditions (including foreign businesses), science and technology development, public services provision, and the environment. This pilot and continued development of the Greater Bay Area signal the Chinese government's intent to bolster Shenzhen's importance in southeast China, making it the primary link between the dual circulation economy of the mainland and international business. This move would also diminish Hong Kong's role as a hub for global commerce while further integrating Hong Kong as another mainland Chinese city.[81]

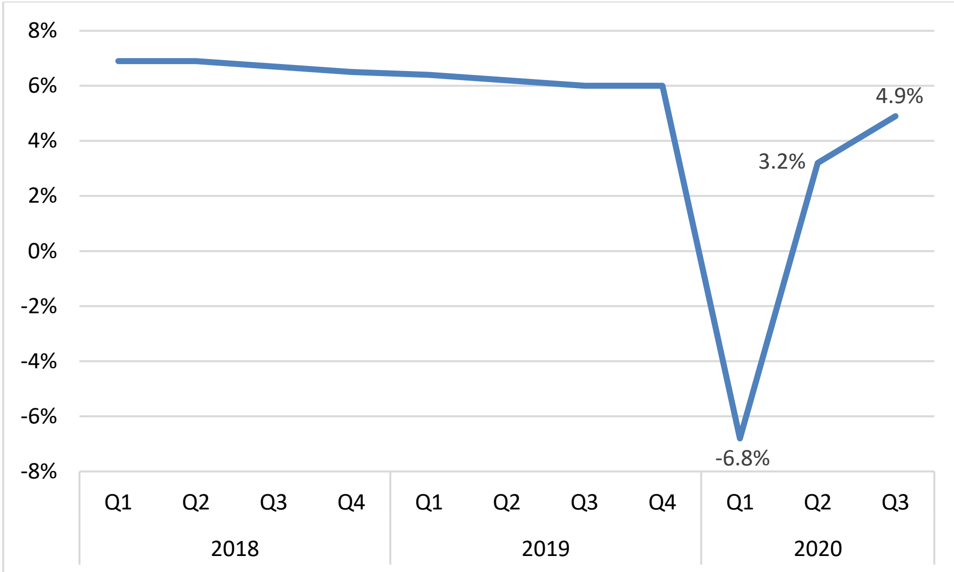
Quarterly Review of China's Economy

China's Economy Grows 4.9 Percent in Q3, but Headwinds Remain

China reported economic growth of 4.9 percent in Q3 2020 compared with the same time period in 2019, according to information released by the country's National Bureau of Statistics (see Figure 3).[82] After a record-setting 6.8 percent contraction in Q1, China's economy built on a Q2 recovery, with China's GDP growing by 0.7 percent over the first three quarters of the year—despite the significant hit from COVID-19 in Q1.[83] According to International Monetary Fund estimates, China's economy will grow 1.9 percent this year—the only major economy expected to post positive growth in 2020.[84]

[*] For more on the dual circulation economy, see the U.S.-China Economic and Security Review Commission, "August 2020 Trade Bulletin," August 6, 2020, 14–15.

Figure 3: China's Official GDP Growth, Q1 2018–Q3 2020
(year-on-year)



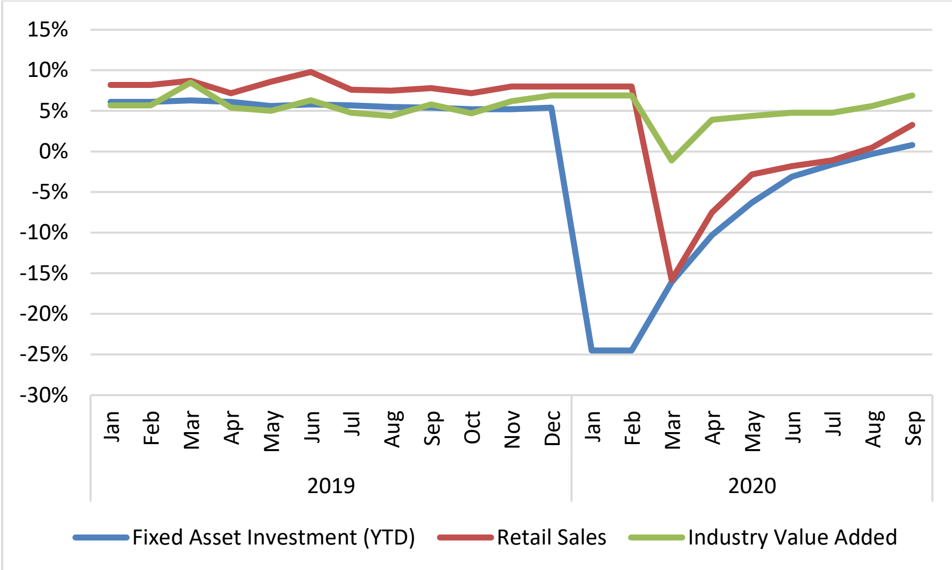
Source: China's National Bureau of Statistics via CEIC database.

As in the second quarter, Q3 growth was driven largely by industrial production, which expanded 5.8 percent compared with the same time last year, up from 4.4 percent growth in Q2.[85] Exports gave another strong showing in Q3, rising 10.2 percent year-on-year.[86] In light of slow economic recovery elsewhere in the world, however, exports' role as an important growth driver may be diminished in the coming months.[87]

Investment in China's infrastructure and property markets was also an important driver of economic growth in the third quarter. After falling short of 2019 levels all year, fixed asset investment, which includes infrastructure investment, turned positive in Q3, growing 0.8 percent through September compared with the same time period last year (see Figure 4).[88] According to Julian Evans-Pritchard, senior China economist at Capital Economics, strong fiscal support from the Chinese government through at least the beginning of 2021 should keep industrial activity and construction robust.[89] Real estate investment has also been strong, growing 5.6 percent year-to-date.[90] China's investment has been driven heavily by debt, however, adding to concerns over the accumulation of debt in China's economy.[91]

In contrast to a weak Q2, the economy recovery extended to consumption in Q3, with indicators returning to positive territory. Retail sales grew 0.9 percent year-on-year in Q3, with 3.3 percent growth in September alone.[92] Brisk spending during the "Golden Week" holiday in the first week of October is a further indicator of strengthening consumption, though only among higher-income households.[93] Imports grew 4.5 percent year-on-year in Q3, after contracting 9.7 percent in Q2.[94] The services sector grew 4.3 percent in Q3, up from 1.9 percent in Q2.[95] While these factors point to a more broad-based recovery in Q3 than in Q2, the services sector has grown more slowly than other sectors of the economy in 2020, up 0.4 percent in the first three quarters of the year, less than both agriculture (2.3 percent) and manufacturing (0.9 percent).[96] For several years before 2020, services had been the fastest-growing sector in China's economy.[97]

Figure 4: Key Chinese Economic Indicators, January 2019–September 2020
(year-on-year)



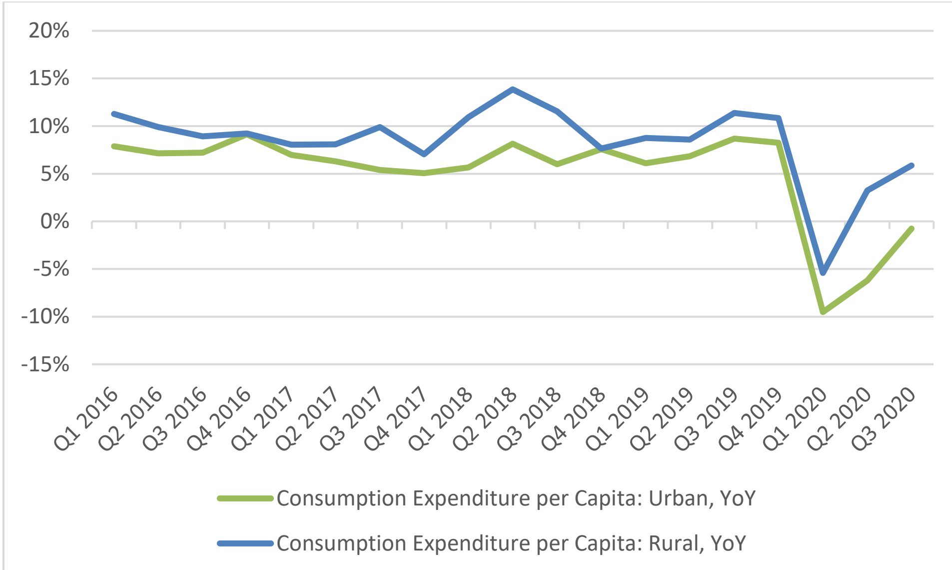
Source: China's National Bureau of Statistics via CEIC database.

Problems in China's labor market and lower household income may prevent a sustained improvement in consumption. While the official urban unemployment rate decreased to 5.4 percent in September, economists have questioned the accuracy of this statistic, noting the suspiciously stable unemployment numbers during the early months of the COVID-19 pandemic.[98] Other data, moreover, point to a weaker labor market. A spokesperson for China's National Bureau of Statistics also noted that the unemployment rate for 20- to 24-year-olds holding a college degree was 4 percentage points higher in September than the same time last year.[99] Additionally, about 3.8 million fewer migrant workers returned from rural areas to their jobs in cities in September than did last year, another sign of slower hiring in China's urban areas.[100]

"Golden Week" Sees Consumption Boost, Income Disparity on the Rise

This year's "Golden Week" saw a boost in travel and consumption compared to rest of 2020, but overall travel was still down as compared to 2019. Consumption patterns demonstrate a K-shaped recovery (see Figure 5) that has seen income levels in wealthier households increase even as lower-income brackets and rural areas struggle to recover from loss of income, with government stimulus primarily directed at industry and middle-income consumption.

Figure 5: Change in Urban and Rural Consumption Expenditure per Capita, Q1 2016–Q3 2020
(year-on-year)



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

"Golden Week," a week-long public holiday commemorating the establishment of the People's Republic of China, typically sees the second-largest internal migration in China. The holiday was anticipated to be a day longer than usual this year due to the traditional Mid-Autumn festival coinciding with the October 1–7 National Day celebration, but vacation times varied due to ongoing concerns about COVID-19. Although the Chinese Center for Disease Control and Prevention announced that residents could undertake domestic travels "as normal," some schools only gave students a half week off or required students to give advance notice for travel.[101] China's Ministry of Culture and Tourism restricted capacity at tourism destinations to 75 percent in order to allow for social distancing.[102]

Chinese residents took 637 million trips this year, down 18 percent from 782 million trips in 2019, according to the Ministry of Culture and Tourism.[103] These domestic tourists generated $68.7 billion in revenue, down 29 percent from $97 billion in 2019.[104] Many cities reduced or cut fees for tourist attractions, also potentially reducing revenue from tourism as compared to previous years. Qunar, a Chinese online tourism company, reported that domestic flights booked through their system were up 10 percent from 2019 but that airfare had dropped from the previous year, also suggesting that trip numbers might overestimate consumption spending.[105] The boost to the airline traffic, which was up 300 percent month-on-month in September, according to the tourism company Ctrip, may be short lived, driven by temporary stimulus measures and promotions targeted at holiday travel rather than a long-term shift toward increased consumption.[106] Some hotels and airlines were already offering discounted prices by October 5, a little over halfway through the holiday, according to state-affiliated news outlet *China Daily*.[107] Regardless, the boost to the Chinese tourism industry stands in contrast to the marked decline in tourism in the United States, with hotel occupancy down 32.2 percent year on year in Q3 2020 and TSA passenger screening at airports down 66.6 percent October 1–7 as compared to the previous year.[108]

While spending during the holiday suggests some signs of the recovering economy, consumption patterns suggest worsening inequality.[109] As the Chinese economy begins to recover from the COVID-19-related contraction, incomes for high-earning Chinese people continue to improve, while incomes for lower-income and rural Chinese people continue to drop. Residents of wealthier cities like Beijing and Shanghai traveled the most, and these cities also saw the largest influxes of tourists, according to Ctrip.[110] In an effort to boost consumption, more than 20 provincial and municipal governments issued travel vouchers. Such vouchers, however, mostly benefit middle- and higher-income consumers, and are unlikely to increase consumption for lower-income households that have been harder hit by job losses and do not have the disposable income to take advantage of these vouchers, which typically offer only discounts.[111]

Luxury spending also increased during the holiday. With continued limits on international travel, higher-income customers turned to e-commerce platforms for overseas brands. Sales on TMall Global (Alibaba's e-commerce platform for overseas brands), were up 79 percent over last year's Golden Week sales.[112] In contrast, overall retail sales did not see a significant increase, with this year's sales reaching $237.9 billion, compared to $226 billion worth of sales in 2019, an increase of only 4.9 percent year-on-year (by comparison, 2019 Golden Week spending saw 8.5 percent year-on-year growth over 2018, according to China's Ministry of Commerce).[113]

Low-formal skill and low-paying jobs have been hit hardest by the COVID-19 related disruptions and have been slow to recover. In March, job listings for lower-salaried workers dropped by 44 percent year-on-year.[114] Many low-skilled workers have been pushed into the informal sector, including food delivery, with former salespeople and factory workers representing a major source of new food delivery drivers this year.[115] Recent media coverage has highlighted how food delivery platforms, which rely on gig labor, maximize deliveries by using faulty algorithmic management and direction systems to assign workers deliveries that cannot be made without violating traffic laws and endangering personal safety. At the same time, the influx of workers into these sectors due to losses in lower-income jobs has driven wages down. Despite growing protests regarding decreased wages and the platforms' treatment of workers, in September the city of Beijing announced it was partially funding three million coupons for food delivery in cooperation with Ele.me and Meituan, the two largest food delivery platforms in China.[116] In the absence of reforms to protect the delivery drivers, the benefits of these vouchers are likely to accrue to middle-income consumers, restaurants, and the platforms themselves.

In general, stimulus measures following the COVID-19 pandemic have primarily focused on enterprises and industrial production rather than maintaining employment, according to Vincent Zhu, a research analyst for Rhodium Group.[117] As many as 80 million people may have been unemployed in March, with only a little over two million receiving unemployment benefits.[118] The majority of those who were unemployed likely came from a low-income or rural background, according to recent surveys by U.S. academics on the economic impact of COVID-19. People from the lowest-income families are more than twice as likely as highest-income families to have had zero income in March and April, with self-employed workers are particularly vulnerable to total loss of income, according to Yue Qian, a sociologist at the University of British Columbia, and Wen Fan, a sociologist at Boston College.[119] Researchers from Stanford University's Rural Education Action Program found 286 million of the 381 million rural workers whose employment requires travel outside of their village (either long-term employment in urban areas or commuting elsewhere in their county) were unemployed in February.[120] They estimate that the resulting loss of wages may have been as much as $143 billion per month during February and March, representing 75 percent of the $190.5 billion these workers typically earn monthly, but "almost no central government action [was] taken to directly address the plight of rural workers."[121] Relief measures announced for households in poverty were only implemented in 17 percent of villages, according to their survey of 726 randomly selected villages outside of the pandemic epicenter in Hubei, China.[122] Failure to improve incomes at the lower end of the spectrum may pose a threat to the Chinese government's turn to domestic demand as a driver of growth under "dual circulation."

Financial Markets

In Halting Ant Group IPO, Beijing Reminds Private Sector Who Is in Charge

On November 3, the Shanghai Stock Exchange announced it would suspend the widely anticipated initial public offering (IPO) of Ant Group, the parent company of Chinese digital payments giant Alipay and affiliate of multinational technology conglomerate Alibaba.[123] The decision came after China's financial authorities summoned Ant Group controller and Alibaba cofounder Jack Ma and other Ant Group executives for a "supervisory interview" one day prior.[124] According to the Shanghai Stock Exchange statement, the interview revealed that "material matters might cause [Ant Group] to fail to meet the disclosure requirements for the IPO," leading the exchange to postpone the listing of the company indefinitely.[125] Chinese Ministry of Foreign Affairs spokesperson Wang Wenbin added the decision was made to "better safeguard capital market stability and protector investor rights and interests."[126] Ant Group subsequently announced it would suspend the Hong Kong portion of its planned dual listing[127] which was expected to raise a world record $37 billion for the company across the two exchanges and catapult China's mainland equity markets to the top of global rankings in terms of capital raised in 2020.[128]

The Chinese government's abrupt decision to suspend Ant Group's IPO in Shanghai underscores its control over Chinese businesses and entrepreneurs. The decision follows, for example, the CCP's issuance of the *Opinions on Strengthening the United Front Work of the Private Economy in the New Era* last month, which calls for improving coordination between private enterprises and the government and strengthening Party-building activities in private enterprises.[*] [129] As the CCP tightens its grip over private enterprises, U.S. investors in Chinese companies become increasingly exposed to political risk. Ant Group's parent company, Alibaba, is listed in the United States.

The suspension also hints at other overlapping CCP priorities, including intolerance of any criticism of the Party and continued focus on financial supervision. Some suggest the move was in response to a speech delivered at a financial industry forum in Shanghai in late October by Mr. Ma, where he criticized China's financial regulators and accused state-owned banks of having a "pawnshop mentality" in requiring collateral and guarantees to extend credit.[130] Mr. Ma argued that China instead needs disruptive, innovative companies to expand lending options for consumers and businesses in order to create a more dynamic financial sector.[131] Separately, the China Banking and Insurance Regulatory Commission (CBIRC) released draft rules[132] on online microlending days before the planned IPO, signaling that Beijing is concerned about banks using technology platforms like those designed by Ant Group to provide loans amid fears of rising defaults in China's pandemic-hit economy.[133] The rules impose more restrictions on capital, licensing requirements, funding sources, and business scope for online microlenders, and note that such platforms will be supervised by the CBIRC and People's Bank of China instead of local bureaus, suggesting more frequent reporting and monitoring of lending.[134]

In Focus: Trends in Supply Chain Realignment

Escalations in U.S.-China trade frictions together with shortages related to the COVID-19 pandemic[†] have revealed key supply chain vulnerabilities for multinational businesses operating in China. Rising wages in China and Beijing's unfair policy support for domestic firms is also driving some multinational companies to invest in or expand production in other countries, including the United States. According to economic research firm Cornerstone Macro, in the first nine months of 2020, 176 multinational companies moved some overseas production back to the United States, expanded U.S. operations, or announced plans to do so.[135] Taiwan Semiconductor Manufacturing Company (TSMC) is one notable example, with the firm announcing in May that it would build a $12 billion chip production plant in Arizona.[136] The reassessment of China as a production base comes as national governments pay increasing attention to ensuring supply chain resilience.

Despite this momentum, shifting production is an expensive and complex operational undertaking for multinational companies. China's ecosystem of suppliers, skilled labor, and efficient transportation infrastructure is difficult to match, cementing dependencies on production networks there.[‡] According to research from Bank of America, the cost to U.S. and European companies of moving manufacturing out of China could reach $1 trillion over the next five years,[137] a hefty expense as the pandemic strains corporate finances and crimps investment. Preliminary trade data and anecdotal evidence suggest the diversification of discrete portions of production in select industries away from China, rather than a complete upheaval of supply chains out of the country, is more likely.

Companies Take Diverse Steps to Mitigate Supply Chain Risks

There is limited timely data available to track supply chain movements, but preliminary trade statistics and market forecasts suggest diversification is emerging as the more prominent trend in supply chain realignment. According to the World Trade Organization Economic Research and Statistics Division, in the first half of 2019 about $21 billion in U.S. imports diverted from China to Mexico ($6.9 billion), the EU ($6 billion), Taiwan ($4.5 billion), and

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[*] For more on the *Opinions*, see U.S.-China Economic and Security Review Commission, "CCP Tightens Its Grip on Private Sector," in *Economics and Trade Bulletin*, October 2020, 9. *https://www.uscc.gov/sites/default/files/2020-10/October_2020_Trade_Bulletin.pdf*.

[†] For more on the COVID-19 pandemic's disruptions to U.S. supply chains, see Kaj Malden and Suzanna Stephens, "Cascading Economic Impacts of the COVID-19 Outbreak in China," *U.S.-China Economic and Security Review Commission*, April 21, 2020. *https://www.uscc.gov/sites/default/files/2020-04/Cascading_Economic_Impacts_of_the_Novel_Coronavirus_April_21_2020.pdf*.

[‡] For more on U.S. and other multinational firms' dependence on China as a base for production, see Kaj Malden and Ann Listerud, "Trends in U.S. Multinational Enterprise Activity in China, 2000-2017," *U.S.-China Economic and Security Review Commission*, July 1, 2020. *https://www.uscc.gov/sites/default/files/2020-06/US_Multinational_Enterprise_Activity_in_China.pdf*.

Vietnam ($2.8 billion).[138] Looking forward, consulting firm McKinsey estimates that the production of 16 to 26 percent of globally traded goods could move to new countries over the next five years as companies and governments pursue supply chain resilience.[139]

While diversification of production beyond China is the most visible trend, survey data and anecdotal evidence suggest multinational companies are deploying a broad array of supply chain realignment strategies depending on their business priorities. Such decisions are informed by a combination of factors, including specialization, access to consumer markets, existing business relationships, and economies of scale.[140]

- *Remaining in China:* Annual business climate surveys conducted by the American Chamber of Commerce (AmCham) in China indicate U.S. companies already operating in China may choose to keep at least part of their supply chains anchored there. In 2019, 39 percent of U.S. companies surveyed identified China as a "top three" investment priority (a mild decline from 42 percent in 2018), while 20 percent identified it as the first priority (unchanged from 2018).[141] U.S. companies' commitment to the Chinese market appears durable in 2020 despite the pandemic's disruptions. According to a September 2020 survey conducted by AmCham Shanghai, 78.2 percent of U.S. companies surveyed plan to maintain current investment levels in China, a 5.1 percentage point increase compared to 2019.[142] The survey data suggest China's large pools of skilled labor and efficient logistics infrastructure continue to serve as major draws for U.S. companies.[143] While reaching China's growing consumer class is also an important factor, companies continue to produce in China for global export.[*] For example, U.S. electric vehicle manufacturer Tesla plans to ramp up production at its Shanghai factory in the fourth quarter of 2020 to ship more of its flagship Model 3 cars to customers in Singapore, Australia, New Zealand, and Europe.[144]
- *"China + 1" diversification:* U.S.-China trade frictions have pushed U.S. and other multinational firms to relocate portions of production out of China and toward other emerging markets. This dynamic has been especially true for manufacturers of electronic components, computers, and related equipment, Chinese exports of which have been subject to U.S. tariffs. Vietnam has been a major beneficiary of this "China + 1" diversification strategy, aided by its lower wages and proximity to key shipping routes and regional supply lines.[145] The country's growing youth consumer base also makes it an attractive market for high-tech consumer goods.[146] Contract manufacturers for Apple, for example, began moving some production to Vietnam in 2019, while Dell and Hewlett-Packard are reportedly considering moving up to 30 percent of notebook personal computer (PC) production in China to Vietnam, Taiwan, and the Philippines.[147] The COVID-19 pandemic is accelerating the trend, with Google and Microsoft hastening efforts to shift production of new phones, PCs, and other devices to Southeast Asia.[148] Taiwan think tank Market Intelligence and Consulting Institute forecasts the region will produce half the world's notebook PCs by 2030.[149]
- *"Nearshoring" or reshoring:* Shortages caused by the COVID-19 pandemic are sparking renewed interest in reshoring or nearshoring production closer to home markets. According to a May 2020 survey of global supply chain executives conducted by McKinsey, about 40 percent of companies intend to nearshore and increase their supplier base to bolster resilience.[150] Analysts anticipate critical supply chains for strategic industries, such as healthcare products, personal protective equipment (PPE), or pharmaceuticals, will begin to reshore and prioritize resilience and redundancy over cost.[151] Some industry representatives note, however, that reshoring may threaten some firms' global competitiveness. In testimony in September to the U.S. International Trade Commission on the pandemic's impact on U.S. supply chains, representatives from PPE and medical device trade associations said reshoring would erode the efficiency and competitiveness of U.S. firms as their supply chains are structured in a "rational and competitive manner to fulfill customer demand on a global basis."[152]

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[*] Research by Mary Lovely and Yang Liang at the Peterson Institute for International Economics found that 60 percent of China's exports to the United States from 2006 to 2014 originated in foreign-invested enterprises. Mary E. Lovely and Yang Liang, "Trump Tariffs Primarily Hit Multinational Supply Chains, Harm U.S. Technology Competitiveness," *Peterson Institute for International Economics*, May 2018, 5. *https://www.piie.com/system/files/documents/pb18-12.pdf*.

Governments Move to Bolster Supply Chain Resilience in Pandemic's Wake

Supply chain vulnerabilities exposed by the COVID-19 pandemic are leading the U.S. and other governments to formulate and implement supply chain diversification initiatives that include elements of reshoring. It is too early to evaluate the success of these initiatives, and their diversity highlights the challenges inherent in global supply chain realignment, a gradual process requiring different incentives for different companies.

The U.S. government is taking preliminary steps to reshore critical supply chains. In May 2020, the Trump Administration authorized the Development Finance Corporation to direct loans toward domestic production of strategic resources needed to respond to the COVID-19 pandemic using the Defense Production Act's Title III authorities.[153] Administration officials are also reportedly considering establishing a $25 billion fund to subsidize U.S. companies' movement of manufacturing activity out of China.[154] Similarly, the Japanese earmarked $2.2 billion to subsidize Japanese manufacturers' relocation of production out of China and diversify supply chain risks.[155] So far, 57 Japanese companies have received a total of $535 million to open new factories in Japan, while another 30 companies have received $220 million to expand production in Vietnam, Myanmar, Thailand, and other Southeast Asian countries.[156] European leaders are also seeking to reshore supply chains in some critical industries, such as medical supplies.[157] For example, in June French President Emmanuel Macron submitted a proposal to European Commission President Ursula von der Leyen asking Brussels to develop investment incentives to encourage the reshoring of active pharmaceutical ingredient production capacity to the EU.[158]

Other governments are struggling to implement such reshoring initiatives, underscoring China's resilient position as a powerhouse in global manufacturing. For example, despite Seoul's efforts to lure companies with operations in China back to South Korea, many remain reluctant to relocate given wage gaps and China's competitiveness as a base for production for global export.[159] One survey showed that only 8 percent of 200 South Korean small- and medium-sized manufacturers were willing to reshore to South Korea.[160] The complete movement of manufacturing production outside of China is made more difficult in the short term as resumption of industrial activity and economic recovery in China outpaces that of other countries still grappling with the pandemic.

[1] U.S. Census Bureau, *Trade in Goods with China*, November 4, 2020. *https://www.census.gov/foreign-trade/balance/c5700.html*.
[2] U.S. Census Bureau, *Trade in Goods with China*, November 4, 2020. *https://www.census.gov/foreign-trade/balance/c5700.html*.
[3] U.S. Census Bureau, *Trade in Goods with China*, November 4, 2020. *https://www.census.gov/foreign-trade/balance/c5700.html*.
[4] Chad Bown, "U.S.-China Phase One Tracker: China's Purchases of U.S. Goods," *Peterson Institute for International Economics*, October 26, 2020. *https://www.piie.com/research/piie-charts/us-china-phase-one-tracker-chinas-purchases-us-goods*.
[5] U.S. Census Bureau, *USA Trade Online*, November 4, 2020. *https://usatrade.census.gov/*.
[6] U.S. Census Bureau, *USA Trade Online*, November 4, 2020. *https://usatrade.census.gov/*.
[7] Anita Regmi, "China's Retaliatory Tariffs on U.S. Agriculture: In Brief," *Congressional Research Service*, September 24, 2019; U.S. Census Bureau, *USA Trade Online*, November 4, 2020. *https://usatrade.census.gov/*.
[8] U.S. Census Bureau, USA Trade Online, November 4, 2020. *https://usatrade.census.gov/*.
[9] Chad Bown, "U.S.-China Phase One Tracker: China's Purchases of U.S. Goods," *Peterson Institute for International Economics*, October 26, 2020. *https://www.piie.com/research/piie-charts/us-china-phase-one-tracker-chinas-purchases-us-goods*.
[10] Jonathan Cheng, "China Quarterly Car Sales Shift Out of Reverse for First Time in Two Years," *Wall Street Journal*, October 13, 2020. *https://www.wsj.com/articles/china-quarterly-car-sales-shift-out-of-reverse-for-first-time-in-two-years-11602577531*.
[11] U.S. Census Bureau, USA Trade Online, November 4, 2020. *https://usatrade.census.gov/*.

[12] U.S. Census Bureau, *U.S. Trade with China in Advanced Technology Products - Monthly and Cumulative Data (in Millions US $)*, November 2020. http://www.census.gov/foreign-trade/statistics/product/atp/2016/06/ctryatp/atp5700.html.
[13] U.S. Census Bureau, *U.S. Trade with China in Advanced Technology Products - Monthly and Cumulative Data (in Millions US $)*, November 2020. http://www.census.gov/foreign-trade/statistics/product/atp/2016/06/ctryatp/atp5700.html.
[14] U.S. Census Bureau, *U.S. Trade with China in Advanced Technology Products - Monthly and Cumulative Data (in Millions US $)*, November 2020. http://www.census.gov/foreign-trade/statistics/product/atp/2016/06/ctryatp/atp5700.html.
[15] U.S. Department of Commerce – Bureau of Economic Analysis, *U.S. Trade in Goods and Services by Selected Countries and Areas, 1999-Present*, U.S. Department of Commerce, Foreign Trade Division, November 4, 2020.
[16] U.S. Department of Commerce – Bureau of Economic Analysis, *U.S. Trade in Goods and Services by Selected Countries and Areas, 1999-Present*, U.S. Department of Commerce, Foreign Trade Division, November 4, 2020.
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