U.S.-China Economic and Security Review Commission

Economics and Trade Bulletin

February 9, 2021

Highlights of This Month's Edition

- **Bilateral Trade:** U.S. goods exports to China rose in 2020, but China still fell short of its purchase commitments under the Phase One trade deal; China's agricultural imports more than doubled in Q4 2020; in Q3 2020, an increase in financial services exports to China was the exception to a sustained downward trend in the U.S. services trade with China.
- **Biden Administration China Policy Preview:** Early statements from the Biden Administration signal continuity with Trump-era policies but with a renewed focus on multilateralism.
- **Quarterly Review of China's Economy:** China's economy grew 2.3 percent year-on-year in 2020, bolstered by strong industrial growth; China's retail and service sectors point to an imbalanced economic recovery and underscore struggles to increase consumption; fearing a property market bubble, policymakers introduce more stringent restrictions on real estate loans.
- **Fintech Crackdown:** In annual work conferences, China's financial authorities pledge tightened supervision of fintech companies, fortifying the role of state-owned banks in China's financial system.
- **Household Non-Performing Loans:** Regulators shift focus to household NPLs as campaign to clean up soured debt in China's economy continues apace.
- **SOE Bond Default Fallout:** Beijing continues to push for discipline in China's corporate bond market as state-backed issuers suffer fallout from high-profile defaults in late 2020.
- **Stock Markets:** China's stock market continued a ten-month-long rally on China's 2020 recovery, but liquidity and leverage raise concerns of a bubble.

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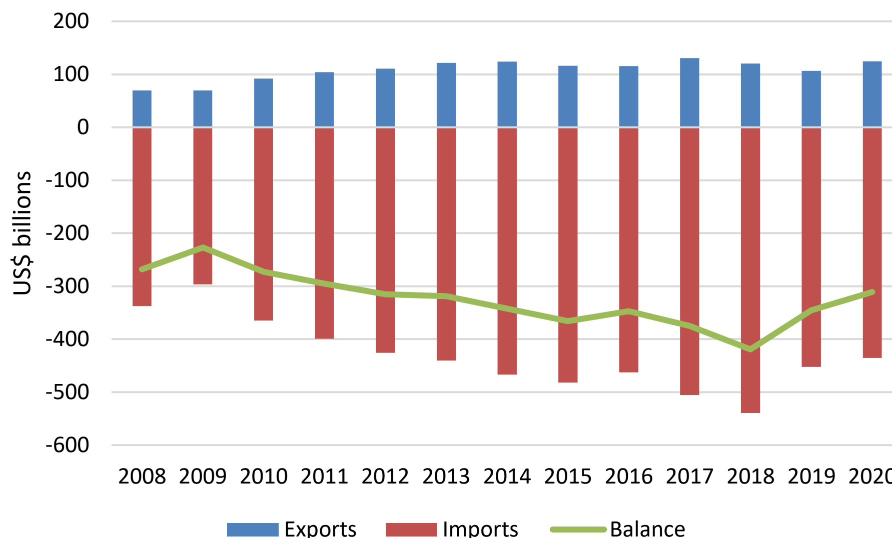
Bilateral Trade

U.S.-China Goods Trade Fails to Meet Levels Established Under Phase One

The U.S. trade deficit in goods with China in 2020 was $310.8 billion, down 10.1 percent from the previous year (see Figure 1). The shrinking deficit was primarily driven by the 16.9 percent year-on-year increase in U.S. exports: at $124.6 billion, U.S. goods exports to China were the highest since 2017. Imports from China decreased by 3.7 percent year-on-year to $435.4 billion, the lowest since 2012. The United States' shrinking trade deficit with China was the exception as the U.S. global deficit in goods rose 21 percent from 2016 to reach $916 billion in 2020.[1] Rising Chinese imports from the United States were also an exception to China's overall trading patterns, which saw exports to the world rise 3.6 percent in 2020 while imports contracted by 1.1 percent, showing continued importance of exports to China's economic growth.[2]

Although Chinese imports of U.S. goods increased in 2020, they fell short of purchase commitments China made under the Phase One trade deal, according to both Chinese and U.S. measures. At $93.7 billion, U.S. exports of goods to China covered under the agreement were only 59 percent of the $159 billion targeted for 2020, according to calculations by Chad Bown, senior researcher at the Peterson Institute for International Economics.[3]

Figure 1: U.S. Exports, Imports, and the Trade Deficit with China, Q1 2008 – Q4 2020



Source: U.S. Census Bureau and U.S. Bureau of Economic Analysis, *U.S. International Trade in Goods and Services*, February 5, 2021. *https://www.census.gov/foreign-trade/statistics/highlights/images/Congressional.pdf.*

Agricultural Exports Lead in H2 2020, but Computer Products Continue to Dominate Annual Flows

In Q4 2020, agricultural products were the top U.S. export to China for the second quarter in a row, up 228.6 percent year-on-year to reach $12.7 billion (see Table 1). China's rising demand for grain, driven by a recovering pork sector, seems to have driven the purchases, with China's imports of corn and wheat reaching record highs in 2020, according to *Reuters*.[4] China's purchased 3.3 million metric tons of corn from the United States through November, the highest since 2013, according to China-focused agricultural blog *Dim Sums*.[5] China's agricultural purchases came the closest to meeting Phase One sectoral commitments according to analysis by Dr. Bown. Through December, China purchased $27.3 billion in U.S. agricultural goods, hitting 82 percent of its target for the full year.[6]

In 2020, computer and electronic products continued to represent the largest export category annually, accounting for $21.3 billion, or 17.1 percent, of U.S. exports to China.[7] U.S. exports in this category were up 32.6 percent since

2019.[8] Computer and electronics products also represented the largest category of U.S. imports from China in 2020, but were down 50.8 percent year-on-year, as the Trump Administration implemented several actions to address security risks associated with electronics manufactured in China.[9]

Table 1: U.S. Trade with China Top Five Exports and Imports, Q4 2020

(US$ millions)

U.S. Top-Five Exports to China	Exports (in US$ millions)	Share of total (%)	Change over Q4'19 (%)	U.S. Top-Five Imports from China	Imports (in US$ millions)	Share of total (%)	Change over Q4'19 (%)
Quarter 4 (Oct-Dec' 2020)				*Quarter 4 (Oct-Dec' 2020)*			
Agricultural Products	$12,682	29.1%	228.6%	Computer & Electronic Products	$47,897	36.4%	18.2%
Computer & Electronic Products	$5,913	13.6%	16.9%	Miscellaneous Manufactured Commodities	$15,456	11.7%	41.6%
Chemicals	$4,947	11.4%	16.7%	Electrical Equipment, Appliances & Components	$12,610	9.6%	24.6%
Transportation Equipment	$4,493	10.3%	-3.1%	Machinery, Except Electrical	$8,682	6.6%	18.0%
Oil & Gas	$3,574	8.2%	2099.8%	Plastics & Rubber Products	$6,155	4.7%	43.7%
Other	$11,939	27.4%		Other	$40,759	31.0%	
Total	$43,548	**100%**		**Total**	$131,559	**100%**	
2020 Year in Total				*2020 Year in Total*			
Computer & Electronic Products	$21,293	17.1%	32.6%	Computer & Electronic Products	$141,864	32.6%	-50.8%
Agricultural Products	$20,655	16.6%	0.1%	Electrical Equipment, Appliances & Components	$42,578	9.8%	-50.0%
Chemicals	$17,349	13.9%	3.9%	Miscellaneous Manufactured Commodities	$42,422	9.7%	-50.2%
Transportation Equipment	$13,230	10.6%	3.6%	Machinery, Except Electrical	$31,602	7.3%	-51.0%
Machinery, Except Electrical	$11,115	8.9%	7.3%	Textile Mill Products	$24,592	5.6%	-34.0%
Other	$41,007	32.9%		Other	$152,392	35.0%	
Total	$124,649	**100%**		**Total**	$435,449	**100%**	

Source: U.S. Census Bureau, USA Trade Online, February 5, 2021. *https://usatrade.census.gov/.*

Advanced Technology Products

Electronics accounted for most of the U.S.-China trade in advanced technology products (ATPs), with the United States importing $11.1 billion worth of products, and exporting $3.2 billion worth in 2020 (see Table 2).[10] Overall, U.S. exports of advanced electronics to China were up 23 percent year-on-year and imports down 4 percent.[11] U.S. imports of biotechnology, life science, and weapons from China were exceptions to the overall decline in imports of ATPs, with rising biotechnology and life science imports likely driven by the demand for products triggered by the outbreak of the novel coronavirus (COVID-19). U.S. imports of biotechnology were up 125 percent year-on-year, imports of life science up 22 percent, and imports of weapons up 29 percent.[12]

Table 2: U.S.-China ATP Trade, Q4 2020

(US$ millions)

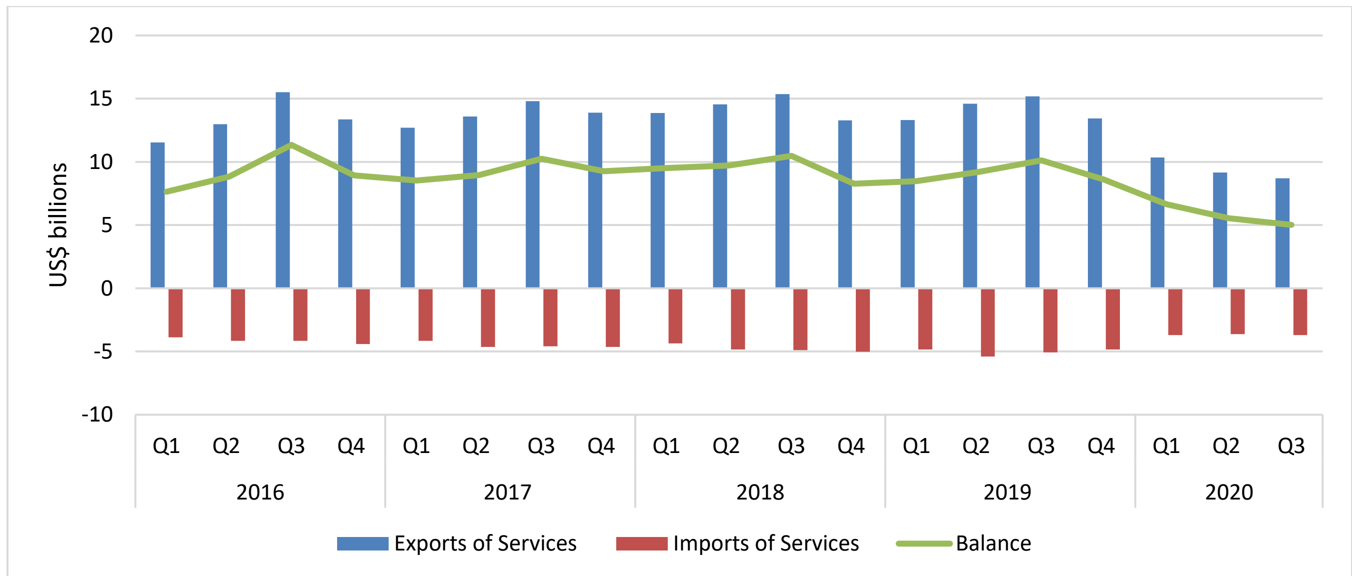
Quarter 4	Quarterly					Annual 2020			
	Exports	Imports	Balance Q4'2020	Balance Q4'2019	Balance YOY	Exports	Imports	Balance 2020	Balance 2019
TOTAL	**$8,807**	**$44,556**	**-$35,749**	**-$30,260**	**18.1%**	**$30,761**	**$133,474**	**-$102,713**	**-$102,758**
(01) Biotechnology	$706	$139	$567	$621	-8.7%	$1,851	$485	$1,366	$2,070
(02) Life Science	$1,262	$707	$555	$519	6.9%	$4,213	$3,088	$1,125	$1,379
(03) Opto-Electronics	$119	$815	-$696	-$565	23.2%	$449	$3,130	-$2,681	-$3,495
(04) Information & Communications	$903	$41,532	-$40,629	-$34,798	16.8%	$3,275	$121,693	-$118,418	-$120,763
(05) Electronics	$2,982	$884	$2,098	$1,551	35.3%	$11,103	$3,203	$7,900	$5,675
(06) Flexible Manufacturing	$1,327	$247	$1,080	$864	25.0%	$5,040	$872	$4,168	$3,016
(07) Advanced Materials	$64	$50	$14	$11	27.3%	$256	$192	$64	$0
(08) Aerospace	$1,411	$119	$1,292	$1,544	-16.3%	$4,439	$641	$3,798	$9,372
(09) Weapons	$0	$61	-$61	-$33	84.8%	$2	$162	-$160	-$124
(10) Nuclear Technology	$33	$2	$31	$26	19.2%	$133	$8	$125	$112

Source: U.S. Census Bureau (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, February 2021). *http://www.census.gov/foreign-trade/statistics/product/atp/2016/06/ctryatp/atp5700.html.*

Financial Services an Exception to Q3 Decline in U.S. Services Exports to China

In Q3 2020, the U.S. services trade surplus with China reached $5 billion, down 9.5 percent from the $5.5 billion surplus in Q2 2020.[13] This represents four consecutive quarters of sustained downward trend in the U.S. services trade with China (see Figure 2).[14] The decline continued to be primarily driven by the fall in travel due to the COVID-19 pandemic.

Figure 2: U.S.-China Trade in Services, Q1 2016–Q3 2020

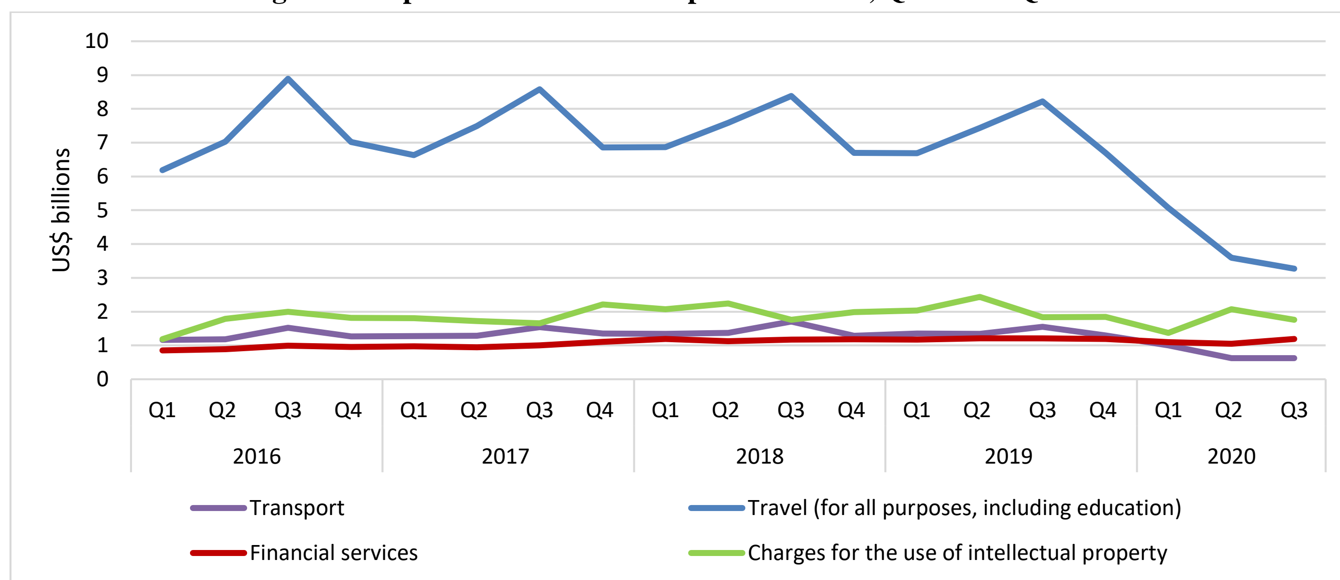


Source: U.S. Department of Commerce – Bureau of Economic Analysis, *U.S. Trade in Goods and Services by Selected Countries and Areas, 1999-Present*, U.S. Department of Commerce, Foreign Trade Division, December 18, 2020. *https://apps.bea.gov/iTable/iTable.cfm?ReqID=62&step=1*.

Total U.S. services exports to China shrank 42.6 percent year-on-year to $8.7 billion in Q3 2020.[15] Services exports for transportation and travel continued to fall due to ongoing border restrictions resulting from COVID-19, down 59.8 percent and 60.2 percent year-on-year, respectively (see Figure 3).[16] Financial services were the only major category of U.S. services exports to China to rise quarter-on-quarter. Exports of financial services were up 13.5

percent from Q2 to $1.2 billion, but were still 1.7 percent lower than a year prior in Q3 2019.[17] The increase in financial services exports to China may have been driven by China's limited opening to U.S. financial institutions paired with inflows of global foreign direct investment (FDI) to China, which in 2020 exceeded global flows to the United States for the first time in decades.[18] China received $163 billion in global FDI inflows and the United States received $134 billion, according to the UN Conference on Trade and Development.[19] U.S. financial institutions play a central role in the global economy, with four of the ten global banks with the largest market capitalization located in the United States.[20] Under the Phase One trade deal, U.S. financial institutions were granted expanded access to the Chinese market, potentially allowing them to play a larger role in global FDI flows to China.

Figure 3: Top Four U.S. Service Exports to China, Q1 2016 – Q3 2020



Source: U.S. Department of Commerce – Bureau of Economic Analysis, *U.S. Trade in Goods and Services by Selected Countries and Areas, 1999-Present*, U.S. Department of Commerce, Foreign Trade Division, December 18, 2020. *https://apps.bea.gov/iTable/iTable.cfm?ReqID=62&step=1*.

President Biden's China Policy: Same Ends, Different Means

As the Biden Administration reviews current China policies and consults with U.S. allies, statements from key officials and nominees suggest continuity with the Trump Administration's policy direction on China.[21] President Joe Biden said his economic priorities are focused on domestic recovery and industrial revitalization, but decisions about key positions and coordinating mechanisms within the executive branch point to a clear China focus for foreign policy. White House spokeswoman Jen Psaki framed the Administration's China stance, saying, "Beijing is now challenging our security, prosperity, and values in significant ways that require a new U.S. approach," and underscored the importance of U.S. "partners and allies."[22] Notably, the Biden Administration has highlighted the same challenges in the U.S.-China relationship as the Trump Administration did, but its emphasis on coordinating with U.S. allies and international institutions points to a renewed focus on multilateralism as a means of confronting Beijing. Recent high-level speeches suggest Beijing's leadership is hoping for a more significant shift in policy, as they urged the Biden Administration to chart a new course of "mutual respect" and "win-win cooperation" while abandoning the "outdated mentality of zero-sum, major-power rivalry."[23]

The president's cabinet choices to lead U.S. economic and foreign policy suggest a tough line on China. Secretary of the Treasury Janet Yellen said during her confirmation hearings that she was prepared to use a full array of tools to address China's "abusive, unfair, and illegal practices,"[24] which have included industrial subsidies, currency manipulation, forced technology transfers, and intellectual property theft, all of which are priorities consistent with the previous administration. U.S. Trade Representative-designate Katherine Tai's experience managing trade

disputes with China before the WTO signals a focus within the Biden cabinet on countering unfair Chinese trade practices through both unilateral and multilateral channels.[25]

Demonstrating his Administration's focus on strategic competition with Beijing, President Biden appointed Kurt Campbell, the chief architect behind President Obama's "pivot to Asia" policy, to the newly created role of Indo-Pacific coordinator on the National Security Council (NSC).[26] NSC spokesperson Emily Horne said, "Kurt Campbell's Indo-Pacific team will be the largest regional NSC directorate, a sign of how this NSC is prioritizing China and broader Indo-Pacific policy issues," noting that "work on China expands into virtually every NSC directorate."[27]

Marking the Administration's shift toward multilateralism, Secretary of State Antony Blinken said he would choose to work with allies while maintaining President Trump's "tougher approach."[28] In his recent *Foreign Affairs* essay with Rush Doshi (newly appointed NSC China director), Mr. Campbell echoed this strategic shift by emphasizing the need to counter China's aggressive and disruptive behavior in the Indo-Pacific. Their article emphasized working with U.S. allies to create a regional balance of power that is both rules-based and recognized as legitimate by all member states.[29] Greater coordination with allies will not be easy, however, as the United States must overcome divergent objectives among its partners. The Chinese market remains highly attractive to companies around the world, while China's foreign economic negotiators capped off 2020 by signing the Regional Comprehensive Economic Partnership,* a super-regional trade agreement centered on ASEAN, and by concluding the Comprehensive Agreement on Investment with the EU.† The EU has so far resisted U.S. calls for a common front against China, preferring instead to pursue "strategic autonomy," as exemplified by the investment agreement.[30] President Biden will also face tensions with European partners on non-China issues, including steel tariffs[31] and technology sector-related issues such as privacy and data regulation that may further complicate his efforts to bring together allies and partners on China policy.[32]

Meanwhile, in high-level speeches Chinese leaders have been exhorting the United States to abandon Trump-era policies. Yang Jiechi's February 2 speech to the board of the National Committee on U.S.-China Relations capitalized upon President Biden's focus on COVID-19 and climate change, expressing desire to cooperate on these issues as well as on global poverty alleviation, counterterrorism, and nonproliferation.[33] Although Yang used the word "cooperate" or "cooperation" 26 times in his speech, he also issued a warning to the new Administration not to cross the "red line" that constitutes the affairs of Taiwan, Hong Kong, Tibet, and Xinjiang, and to forgo the use of national security as a pretext for sanctioning Chinese companies.[34]

The Biden Administration must also carefully weigh how it will manage the implementation of various actions on China taken by the Trump Administration. The Biden Administration has thus far signaled that it will not be locked in by President Trump's policies and will carefully review all existing measures before charting a path forward. Regarding the landmark Phase One trade deal, President Biden indicated that he does not plan to lift tariffs on Chinese goods immediately, as they may provide leverage for future negotiations with Beijing.[35] President Biden's nominee for Secretary of Commerce, Governor Gina Raimondo, testified that while she would pursue Chinese anticompetitive behaviors in the aluminum and steel industries, she could not commit to keeping companies like Huawei and ZTE on the Entity List.[36] Echoing the Administration's emphasis on allied cooperation, Governor Raimondo said she would first consult with lawmakers, industry, and allies to assess what is best for "American national and economic security" before designating new Chinese entities to the Entity List, or removing companies currently on the list.[37] President Biden has also extended the investment ban deadline for new investments in any company "whose name closely matches, but does not exactly match, the name of a Communist Chinese military company" from January 28, 2021, to May 27, 2021.[3839] On Xinjiang, President Biden and his cabinet members,

* For more on the Regional Comprehensive Economic Partnership, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, December 7, 2020, 9–11. *https://www.uscc.gov/sites/default/files/2020-12/Dec_2020_Trade_Bulletin.pdf*.

† Although the EU arrived at consensus to sign the CAI, many countries with the EU have expressed diverging perspectives on how best to engage China. For more on the China-EU Comprehensive Agreement on Investment, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, January 13, 2021, 2–5. *https://www.uscc.gov/sites/default/files/2021-01/January_2021_Trade_Bulletin.pdf*.

including Ambassador to the UN-designate Linda Thomas Greenfield and Secretary Blinken, have publicly endorsed the Trump Administration's designation of China's actions there as genocide (see next section).[40]

Trump Administration's Last Actions on China

Between December 2020 and January 2021, the Trump Administration enacted 28 executive actions related to China, which China observers perceived as attempting to embed President Trump's "tough on China" policy stance within the Biden Administration.[41]

Chinese Company Designations: Between December 2020 and January 2021, the U.S. Department of Commerce Bureau of Industry and Security added 60 Chinese companies to its Entity List for actions deemed contrary to U.S. national security and foreign policy interests.[42] Entity List designations were a policy tool frequently used by the Trump Administration to restrict companies' ability to obtain critical U.S. technologies with potential dual-use capabilities. Of the Chinese companies most recently added to the Entity List, Semiconductor Manufacturing International Corporation (SMIC)[*] and Chinese National Offshore Oil Corporation (CNOOC) were significant additions, given SMIC's central role in building out China's domestic semiconductor industry and CNOOC's role in oil and gas exploration in the South China Sea. The Department of Commerce and Department of Defense have also been compiling respective "Military End User" and "Chinese Communist Military Companies" lists, which together include the names of over 100 Chinese entities[43] and shed light on the extent of involvement by private and state-owned companies in supporting China's strategy of military civil fusion.[†] Citing the use of bulk data collection to support China's economic and national security strategy, then President Trump issued an executive order on January 5, 2020, that expanded the list of banned Chinese applications to include Alipay, CamScanner, QQ Wallet, SHAREit, Tencent QQ, VMate, WeChat Pay, WPS Office, and their subsidiaries.[44]

Xinjiang Trade Restrictions and Genocide Designation: Between December 2020 and January 2021, the Trump Administration issued four executive actions related to Chinese oppression of Uyghurs and Muslim ethnic minorities in Xinjiang. The measures allow U.S. Customs and Border Protection to detain all cotton and tomato products produced in Xinjiang based on information that "reasonably indicates the use of detainee or prison labor and situations of forced labor."[45] With U.S. retailers importing an estimated 1.5 billion garments per year containing Xinjiang-produced materials, the restrictions are likely to cause significant disruption and realignment along international textile supply chains.[46] Although companies have already sought to distance themselves from Xinjiang suppliers, enforcing the ban may prove difficult due to a lack of transparency along textile supply chains and the fungibility of commodities like cotton.[47] Finally, on January 19, 2020, the U.S. Department of State also declared that China's oppression of Uyghurs and other Muslim ethnic minorities in Xinjiang constitutes genocide and crimes against humanity.[48] While still quite recent, the severity of the designation will likely accelerate the pace by which international companies look to identify new suppliers outside of Xinjiang.

Quarterly Review of China's Economy

China Becomes the Only Major Economy to Report Economic Growth for 2020

China's gross domestic product (GDP) grew 2.3 percent in 2020, according to government statistics.[49] While this is the lowest annual growth rate since 1976, China's was the only major economy to report economic growth last

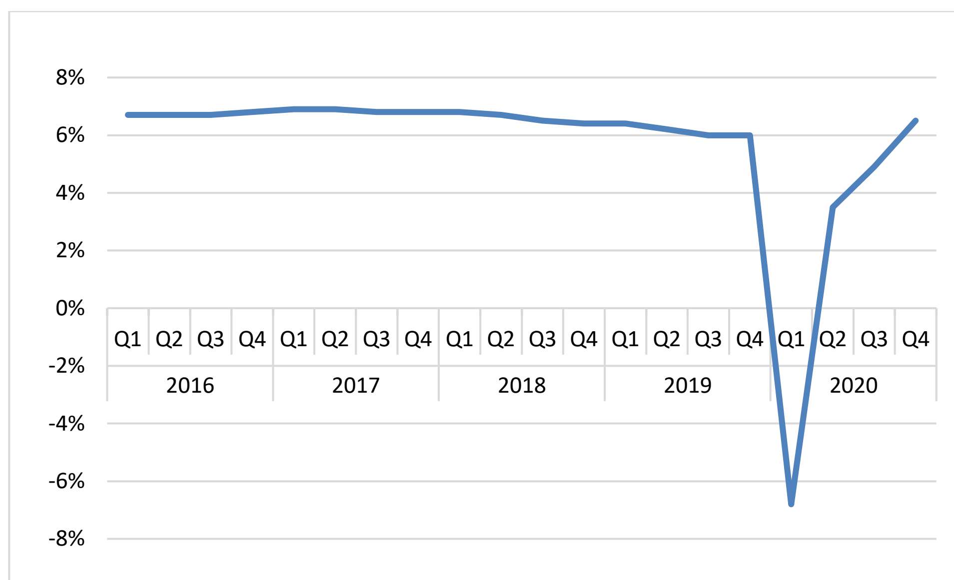
[*] For more on SMIC's addition to the Entity List, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, January 13, 2021, 14. *https://www.uscc.gov/sites/default/files/2021-01/January_2021_Trade_Bulletin.pdf.*

[†] Military-civil fusion is China's policy to leverage the capabilities of civilian sectors and civilian innovation to drive military development through a combination of policies and government-supported mechanisms. Due to the breadth and opacity of the strategy, it is increasingly likely that commercial partnerships between the United States and China could be used to develop China's defense sector. U.S.-China Economic and Security Review Commission, *2019 Annual Report to Congress*, November 2019, 205. *https://www.uscc.gov/sites/default/files/2019-11/Chapter%203%20Section%202%20-%20Emerging%20Technologies%20and%20Military-Civil%20Fusion%20-%20Artificial%20Intelligence,%20New%20Materials,%20and%20New%20Energy.pdf.*

year, as most countries faced recessions caused by the global pandemic.[50] After contracting in Q1 2020, China's economy accelerated throughout the year, expanding 4.9 percent in Q3 and 6.5 percent in Q4 (see Figure 4).[51] Many economists have questioned the accuracy of China's economic data, however, particularly in light of recent downward revisions of 2019 figures, lowering the baseline for 2020 year-on-year growth.[52] Moreover, a recent uptick in COVID-19 cases across northern China threatens to derail China's economic momentum, as authorities have begun imposing lockdowns and discouraging travel ahead of Lunar New Year celebrations in February.[53]

Figure 4: China's Official GDP Growth, 2016–2020

(year-on-year)



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

China's economic recovery was aided by a strong performance in exports, which grew 3.6 percent in 2020 compared with the previous year.[54] Export growth remained robust throughout the year, rising 18.1 percent year-on-year in December.[55] Strong global demand helped keep China's export growth resilient in late 2020, though the strengthening renminbi (RMB) may dampen demand for Chinese goods in the coming months.[56] The currency strengthened 6.7 percent in 2020, the first annual appreciation in three years.[57] In January, the exchange rate strengthened to 6.42 RMB per dollar, its highest value since June 2018.[58]

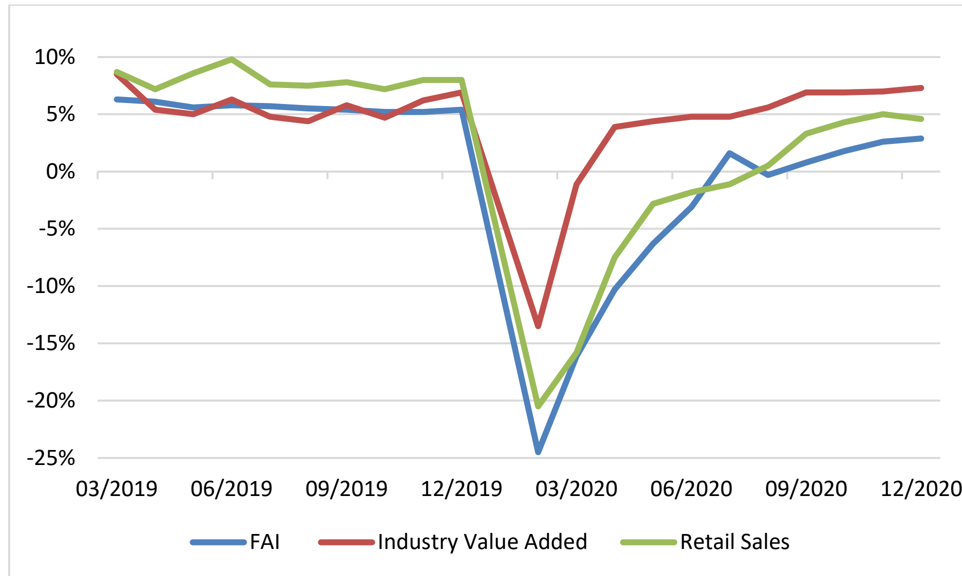
China's industrial sector outpaced overall GDP growth, expanding 2.6 percent in 2020 compared with 2019.[59] Fixed asset investment (FAI)—a traditional driver of China's growth that measures investment in physical assets such as buildings, machinery, and equipment—rose 2.9 percent year-on-year in 2020, up from 2.6 percent year-on-year growth 11 months of the year (see Figure 5).[60] China's valued-added industrial output, which measures production at factories, mines, and utilities, grew 2.8 percent year-on-year.[61] The growth in FAI and value-added industrial input indicate that China's economic recovery has been powered by traditional drivers of economic growth such as manufacturing, infrastructure spending, and property investment rather than consumption-based sectors such as retail and services.

With its reliance on government spending and investment by state-owned enterprises (SOEs) rather than private sector activity or household consumption, China's economic recovery appears fragile. The Chinese government's stimulus measures have worsened productivity growth in China's economy as larger SOEs crowd out more profitable and efficient private-sector firms.[62] A June 2020 report by the World Bank found that China's total factor productivity[*] is less than half that of the United States.[63] According to the International Monetary Fund, China's

[*] Total factor productivity measures how efficiently economies use labor and capital.

government must enact long-promised reforms to China's state-owned sector in order to match productivity growth of advanced economies such as the United States. [64]

Figure 5: China's Key Economic Indicators, March 2019–December 2020
(year-on-year)



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

Weak Consumption Points to Uneven Economic Recovery

Domestic consumption remained a weak point in China's economic recovery in 2020, highlighting the difficulties Chinese Communist Party (CCP) policymakers face in transitioning the economy away from export- and investment-led growth. Retail sales fell 3.9 percent in 2020, the first year-on-year contraction since 1968.[65] Growth improved at the end of the year, picking up 4.6 percent in December over the same time period last year.[66] Nevertheless, retail growth remains considerably lower than the 8 percent growth the sector had seen before the COVID-19 pandemic.[67] Economists have pointed to a weak labor market and higher rates of precautionary saving among Chinese households as factors contributing to a retail slowdown.[68]

The consumption slowdown has not been uniform, however. Global management consultancy Bain & Company estimates China's luxury goods market saw growth of 48 percent in 2020.[69] The booming luxury retail sector highlights the high levels of income inequality in China. According to government figures, the average disposable income of the wealthiest 20 percent of Chinese citizens was approximately $12,000 (RMB 80,000)—more than ten times the average earnings of the poorest 20 percent.[70] CCP policymakers have acknowledged the need to combat rising income inequality, with General Secretary of the CCP Xi Jinping emphasizing the importance of "common prosperity" in a speech before the CCP's Central Party School last December.[71]

China's retail sector reflects broader struggles within China's economy to transition to consumption-driven growth. China's services sector grew 2.1 percent year-on-year in 2020, lagging behind overall GDP growth.[72] The sector saw healthier growth numbers toward the end of the year, with the Caixin/Markit services Purchasing Managers' Index reaching 57.8 in November 2020, the second-highest result in the index since April 2010.[*] [73] This recovery has been led by business-oriented services such as information technology and finance, however, rather than sectors catering to household consumption.[74] According to a China Beige Book survey of Chinese firms, in Q4 consumer-

[*]A reading above 50 in the Purchasing Managers' Index indicates expanding activity in the sector, while a reading below 50 indicates contraction.

facing service subsectors such as restaurants, hospitality, and tourism lagged behind subsectors that focus on business-to-business services.

Record Housing Sales Drive Concerns of a Property Bubble

After an extreme dip and strong recovery in 2020, China's property market appears to be entering bubble territory once again, prompting Chinese regulators to introduce more stringent real estate financing rules and enforcement. In Q1 2020, China's property sector felt the impact from the COVID-19 pandemic, with purchases falling by as much as 36 percent year-on-year in the first two months of 2020.[75] However, the second quarter reversed the downturn and defied many expectations with a spike in sales as the government lowered interest rates, leading to increased funds into the market.[76] Property sales transactions increased by 2.6 percent in 2020 from 2019 as total sales values increased by 8.7 percent in the same period.[77] The year 2020 marked a record for housing sales, which make up 90 percent of the property market.[78] The uptick in sales and prices may have come as post-COVID-19 relief but indicated a clear divergence from efforts in recent years to stabilize housing prices and the government's emphasis that "houses are for living, not speculating."[79]

The record sales were accompanied by a surge in lending that stirred overheating concerns among regulators, analysts, and investors alike.[80] Rising property prices and the potential for property bubbles have long worried Chinese regulators, who have in recent years emphasized reduction of real estate debt. Michael Pettis, Peking University professor of finance, speculates that to hit necessary growth targets, China's government was willing to not only tolerate but also actively encourage expansion in reliable drivers of growth—such as real estate and FAI—even when that may deepen China's economic imbalances in the long run.[81] The real estate sector, for example, contributed 7 percent to China's GDP in 2020. The temporary increase in leverage from developers purchasing new land rights was also a means of providing local governments with more funds in a year of economic hardship.[82]

Nevertheless, concerned about overheating, in August 2020 the China Banking and Insurance Regulatory Commission (CBIRC) introduced "three red lines" to set limits on key borrowing metrics for developers: a 70 percent liability-to-asset ratio, 100 percent debt-to-equity ratio, and cash-to-short-term-debt ratio.[83] Depending on their ability to meet the three red lines criteria, developers are classified as red, orange, yellow, or green. "Red" developers exceed the prescribed limits and are barred from further borrowing, while "green" developers meet all the conditions and will be allowed a maximum 15 percent of total debt expansion in 2021.[84] Around 40 percent of China's developers meet two of the three red lines, falling under the "yellow" category.[85] In the same month, China's National Association of Financial Market Institutional Investors (NAFMII) also restricted residential property developers from applying for new bond applications other than debt refinancing.[86]

Continued unease over the potential for a bubble was clear when CBIRC Chairman Guo Shuqing called real estate financing a "gray rhino" for the second time in December 2020.[87] Chairman Guo noted that real estate-related loans made up 39 percent of all loans in China.[88] On December 31, the CBIRC imposed limits on bank loans for real estate, targeting lenders at all levels, including the "Big Six" banks,[*] state-owned policy banks and commercial banks, smaller city and rural commercial banks, rural cooperative banks and credit cooperatives, and small village banks.[89] Banks must limit the proportion of outstanding property loans to total loans with different caps for each of these five tiers, as large as 40 percent for China's largest state-owned banks and as small as 12.5 percent for small village banks.[90]

On top of the previous three red lines, the new lending caps are expected to create downward pressure on property prices and demand in 2021. The measures have been coupled with robust enforcement as branches of the CBIRC pursue investigations and penalties for illegal property loans.[91] Local governments are also limiting property sales and attempting to catch additional loopholes that allow for more purchases of property, such as fake divorces.[92]

[*] The Chinese banking sector has over 4,000 banks, of which the six largest are state owned (Industrial and Commercial Bank of China, China Construction Bank, Bank of China, Agricultural Bank of China, Postal Savings Bank of China, and the Bank of Communications) and hold just over 40 percent of commercial bank assets. For more on China's banking sector, see Virgil Bisio, "China's Banking Sector Risks and Implications for the United States," *U.S.-China Economic and Security Review Commission*, May 26, 2020, 4–5. *https://www.uscc.gov/sites/default/files/2020-05/Chinas_Banking_Sector_Risks_and_Implications_for_US.pdf*.

The prospect for defaults looms heavily over China's top property developers as new regulations restrict financing. Many Chinese property developers are trying to issue bonds as a means of raising funds while being cut off from Chinese bank loans, though Chinese developer bond defaults have been an increasing problem in recent years.[93] Offshore debts due in 2021 from mature Chinese property bonds have doubled to $53.5 billion from $24.5 billion in 2020.[94] Between January and early February, Fitch Ratings downgraded mid-tier developer China Fortune Land's rating twice due to a shortfall from $813.3 million in overdue loans.[95] Despite the troubled state of the Chinese property market, foreign investors remain exposed to the Chinese market in favor of the high yields that Chinese property bonds continue to generate (see "China's Stock Market High Raises Bubble Fears").[96]

Financial Regulators Keep Up Pressure on Fintech

In January 2020, China's financial authorities the People's Bank of China (PBOC), CBIRC, and China Securities Regulatory Commission (CSRC) each held annual work conferences in which the regulators outlined policy goals for 2021. Read together, the three conferences reaffirmed Beijing's intention to strengthen financial sector oversight, defuse systemic risks, and, notably, tighten supervision of China's fintech sector—priorities underscored at the December 2020 Central Economic Work Conference.* The PBOC and CBIRC work conferences specifically highlighted the Chinese government's intensifying concerns about the potential financial risks stemming from the expansion of fintech companies into traditional banking, a sector closely guarded by the state.

Heightened regulatory scrutiny of the sector was first signaled in policymakers' abrupt suspension of fintech giant Ant Group's planned blockbuster initial public offering (IPO) in November 2020.† According to a readout of its work conference, the PBOC called for enhanced supervision of fintech firms to prevent the "disorderly expansion of capital" and pledged continued antitrust enforcement against them.[97] PBOC Deputy Governor Pan Gongsheng expounded on the PBOC's thinking in an op-ed published in the *Financial Times*, arguing that "fintech is still finance in essence, so the principle of 'same business, same rules' should apply,"[98] suggesting Beijing seeks to subject fintech firms to similar levels of scrutiny and regulation as China's banking sector. The CBIRC's work conference advanced a similar regulatory perspective that fintech companies should be treated more like banks. According to a readout of the CBIRC work conference, fintech firms' financial activity should be "fully incorporated … into supervision in accordance with the law" with "similar businesses and entities treated equally."[99]

The classification of fintech companies as operating principally in the financial—rather than technology— sector accompanies a broader concern about the outsized role such firms play in China's payments industry. In the weeks after its annual work conference, the PBOC issued draft rules for nonbank payment companies, such as Alipay and WeChat Pay, which seek to curb monopolistic practices in the third-party payments industry. According to the draft rules, any nonbank payment company with 50 percent market share in online transactions, two such companies with a combined two-thirds market share, or three such companies with 75 percent market share could become subject to antitrust investigations.[100] The issuance of the draft rules sparked confusion in the fintech industry as the PBOC did not clarify how market share for nonbank payment companies will be defined.[101]

Though Beijing's regulatory approach is still taking shape, impacted companies are already reorganizing their businesses accordingly. On February 3, Bloomberg reported that Ant Group reached an agreement with Chinese regulators on a restructuring plan that will turn the firm into a financial holding company.[102] In turning into a financial holding company, Ant Group will become subject to strict capital requirements similar to those imposed on banks.[103] While the restructuring will ease regulatory pressure on Ant Group, the firm's profitability and pace of growth will likely be dented as a result.[104]

CBIRC Takes Aim at Household Non-Performing Loans

* For more on the 2020 Central Economic Work Conference, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, January 13, 2021, 11–15. *https://www.uscc.gov/sites/default/files/2021-01/January_2021_Trade_Bulletin.pdf*.

† For more on the failed Ant Group IPO, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, November 9, 2020, 14–15. *https://www.uscc.gov/sites/default/files/2020-11/November_2020_Trade_Bulletin.pdf*.

In its annual work conference on January 26, the CBIRC signaled, among other policy priorities, continued commitment to stabilizing debt levels in China's economy and accelerating the disposal of non-performing loans (NPLs).[105] While Chinese banks disposed of a record $467.6 billion worth of NPLs in 2020,[106] a 25.8 percent increase from the $371.6 billion disposed in 2019,[107] aggregate disposals fell short of an informal $526.5 billion target set for 2020.[*] Pilot measures in 2021 suggest the CBIRC is shifting focus toward the disposal of household and retail NPLs specifically. Chinese financial media attribute the shift in focus to the development of retail banking in China, which has seen the scale of household and personal credit loans grow rapidly, particularly amid the pandemic's pressure on household incomes.[108] On January 11, Chinese financial media outlet *21st Century Business Herald* reported the CBIRC would initiate a trial allowing banks to sell household NPLs in bulk to asset management companies (AMCs) sometime in the first quarter of 2021.[†] [109] First announced by the CBIRC in July 2020, the trial allows China's six state-owned commercial banks and 12 joint stock banks to sell household NPLs—including consumer loans and credit card overdrafts—to local and national AMCs.[110] In late January, local AMCs in Anhui, Guangxi, and Hainan provinces were approved to participate in the pilot project.[111]

The deployment of AMCs in the disposal of household NPLs comes as growth in China's household debt levels accelerates and outpaces the rest of the world. While Chinese companies took on $5.5 trillion in loans from 2014 to 2019, China's households took on a similarly staggering $4.6 trillion in the same period.[112] The difference between China's household debt as a percentage of GDP and the global average is also quickly narrowing. According to the Bank for International Settlements, China's household debt as a percentage of GDP grew from 38.9 percent in 2015 to 59.1 percent in the second quarter of 2020, while the global average grew more modestly from 56.9 percent to 59.3 percent in the same period.[113] The uptick in household debt poses a problem for policymakers as it could depress future consumption, an economic growth engine Beijing increasingly prioritizes.[114]

Capital Markets Overhaul Continues Amid SOE Bond Default Fallout

Against the backdrop of rising corporate bond defaults in 2020, Beijing is increasingly uncompromising in holding state-owned corporate debt issuers to account. Disciplinary actions taken against government-backed companies in the months since their defaults rocked China's corporate bond market and shook investor sentiment,[‡] underscoring Beijing's commitment to overhauling its capital markets. The Chinese government's increased willingness to let firms fail also comes as it tries to optimize the quality and function of its corporate bond markets and further attract foreign investors.

On January 14, China's interbank bond market regulator, the National Association of Financial Market Institutional Investors (NAFMII), announced it would ban debt sales by Yongcheng Coal and Electric Holding Group, a Henan Province SOE, from the interbank bond market for one year.[115] Yongcheng Coal had defaulted on a $153 million debt issue in November 2020.[116] According to NAFMII, an investigation into the company revealed it failed to disclose complete and accurate information in its bond prospectus, including cash transfers to Yongcheng's parent company, the fact that the parent company controlled select Yongcheng assets, and related party transactions.[117] NAFMII also referred financial institutions that underwrote Yongcheng's bonds to the CSRC and PBOC for disciplinary action, including Haitong Securities, which allegedly ordered its subsidiaries to buy bond offerings

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[*] In an August 2020 interview with state-run news outlet Xinhua, Chairman Guo said he expected China's banks to dispose of approximately $526.5 billion worth of NPLs in 2020. *Xinhua*, "Fully Support the Economic and Social Recovery and Firmly Adhere to the Bottom Line of Risk—Interview with PBOC Party Secretary and CBIRC Chairman Guo Shuqing" (全力支持经济社会恢复发展 牢牢 守住风险底线——访中国人民银行党委书记、中国银保监会主席郭树清), August 13, 2020. Translation. *http://www.xinhuanet.com/fortune/2020-08/13/c_1126362521.htm*.

[†] Chinese banks are currently only allowed to sell corporate NPLs in bulk to AMCs and could previously spin off portfolios of household NPLs only by packaging them as asset-backed securities. *Trivium China Markets Dispatch*, "The Race," January 12, 2021. *https://markets.triviumchina.com/2021/01/the-race/*.

[‡] For more on the uptick in high-profile corporate bond defaults by Chinese SOEs and companies backed by local governments in late 2020, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, December 7, 2020, 7–8. *https://www.uscc.gov/sites/default/files/2020-12/Dec_2020_Trade_Bulletin.pdf*.

made by Yongcheng to inflate their value and make them more attractive to investors.[118] In a separate action to address bond issuance problems on the exchange-traded bond market on January 12, the Shanghai Stock Exchange issued a disciplinary penalty to Brilliance Auto Group Holdings,[119] a subsidiary of the Liaoning Province government-backed Huachen Automotive, for defaulting on a bond in October 2020.[120] Without disclosing the nature of the penalties, the Exchange said the company violated its bond listing and transfer rules as well as credit risk management guidelines.[121]

Beijing is tightening the screws on corporate debt issuers despite long-protected SOEs comprising a larger share of the value of defaulted bonds. In 2020, 67 firms defaulted on 189 corporate bonds with a total value of $25.7 billion.[122] Chinese brokerage Zhongtai Securities estimates SOEs accounted for 60.3 percent ($15.5 billion) of the defaults.[123]

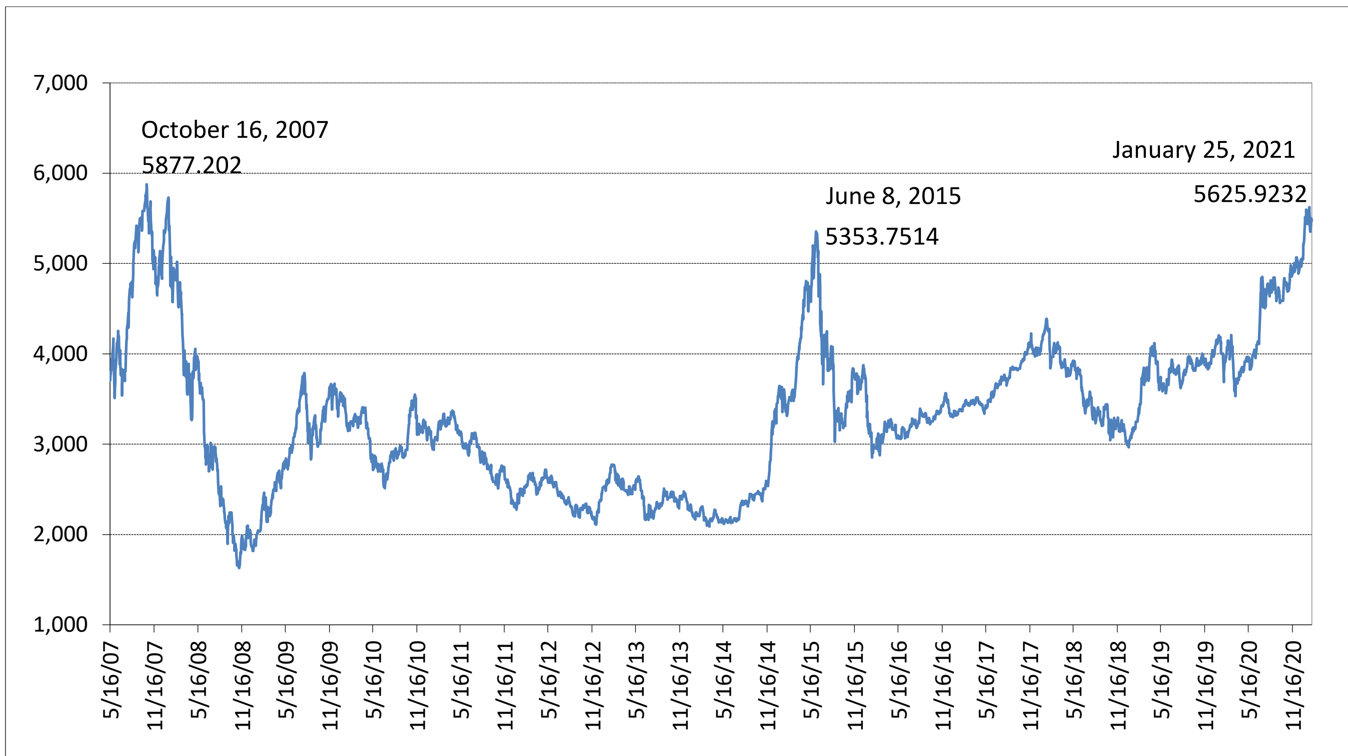
The Chinese government is also holding other actors in China's corporate debt market, including underwriters and ratings agencies, to account as it moderates implicit guarantees of financial support for government-backed issuers.[124] Under new rules for credit ratings issued by NAFMII on February 1, Chinese companies will no longer be asked to declare their credit risk when registering their bonds for trading in China's interbank market.[125] Companies should still provide a credit rating during bond issuance, but NAFMII said it plans to eliminate this requirement the future.[126] By removing the requirement that companies provide a credit rating when registering their bonds for trading, investors—rather than issuers themselves—will drive demand for credit ratings.[127]The measure thus attempts to make debt rating a more market-driven process by addressing a key conflict of interest whereby Chinese companies effectively shop for the highest rating possible among credit rating agencies, a long-running distortion in China's corporate debt market.[128] This could put pressure on credit rating agencies to improve the quality of their debt risk assessments to better serve investors as opposed to issuers.[129] Strengthening the quality of China's bond markets and eradicating flagrant credit risks is a pivotal goal for Beijing as it seeks to draw in more foreign investors into its bond markets. In an *Action Plan for Building a High Standard Market System* released by China's State Council in January 2021, the Chinese government emphasized the "optimization of management of bond issuance" as a key pillar of ongoing financial opening efforts.[130]

China's Stock Market High Raises Bubble Fears

China's mainland stock markets surged in January, with the CSI 300 index, a group of the 300 largest companies on the Shanghai and Shenzhen exchanges, passing its 2015 peak to reach 5,626, its highest point in 13 years, before lowering to 5,474 on February 4.[131] In addition to strong valuations for blue-chip stocks, or established industry leaders, capitalization of China's NASDAQ-inspired STAR Market has grown steadily since its July 2019 launch, with the tech-focused board counting its 200th IPO in December 2020.[132] Strong stock performance appears to echo China's quick economic recovery in 2020 relative to the global recession. A market rally fueled by loose monetary policy and eased margin trading restrictions is reminiscent of the last two peaks on China's mainland exchanges,[*] however, both of which were followed by rapid selloffs and trillions of dollars lost in value (see Figure 6).

[*] Margin trading was not permitted in China's stock markets until 2010 and did not contribute to the 2007 bubble. Eric C. Chang, Yan Luo, and Jinjuan Ren, "Short-Selling, Margin-Trading and Price Efficiency: Evidence from the Chinese Market," Preprint Submitted to Elsevier, June 20, 2013, 2. *https://hub.hku.hk/bitstream/10722/191802/1/Content.pdf?accept=1*.

Figure 6: Historical Values of the CSI 300 Index and Market Peaks, 2007–2020



Source: Interactive Data Pricing and Reference Data LLC via S&P Capital IQ Database, February 4, 2020.

High Valuations Reflect Stronger Fundamentals Than Past Bull Markets

Compared to the runup to past market crashes in 2015 and 2007,* China's high stock market value appears to be based on stronger corporate and macroeconomic fundamentals as well as improvements in the institutional structure of markets themselves. Chinese industrial enterprises† posted profit growth of 4.1 percent in 2020 despite a sharp contraction in the first quarter and stimulus policies that favored state firms.[133] With GDP growth reaching pre-pandemic levels by the fourth quarter of 2020, Chinese stock valuations have not outstripped corporate earnings, where high stock prices without strong revenue would suggest a bubble.[134] On a macroeconomic level, China's markets are also bolstered by increased investment on mainland exchanges by foreign asset managers, following accelerated steps to open China's capital markets in 2019 and 2020.‡ Though retail investors still dominate China's exchanges, increased presence of foreign institutional investors, who are more likely to "buy and hold" stocks for

* As shown in Table 3, both prior stock market crashes were preceded by bull markets where valuations for companies far outstripped their underlying fundamentals, and droves of inexperienced retail investors entered the market quickly for fear of missing out on the gains. In 2014 into 2015, Chinese officials touted stock market gains as evidence of the effectiveness of General Secretary Xi's policy agenda, further luring impressionable investors into the market. "CSRC Chief Xiao Gang Agrees A-Shares Rise Is a 'Reform Bull'" (证监会主席肖钢赞同 A 股上涨是"改革牛"), *Securities Daily*, March 11, 2015. Translation. *http://fund.eastmoney.com/a/1591,20150311484712873.html*.

† China's National Statistics Bureau collates statistics on "industrial enterprises above a designated size," indicating a minimum annual operating revenue of $3.1 million (RMB 20 million) and excluding small businesses that have been hit harder by economic contraction. Statistics on services are collected separately. China National Statistics Bureau, *4. Statistical System and Classification Standards*, 四、统计制度及分类标准（17）, June 19, 2020. Translation. *http://webcache.googleusercontent.com/search?q=cache:4m10kJD5MVEJ:www.stats.gov.cn/tjzs/cjwtjd/201308/t20130829_74318.html+&cd=5&hl=en&ct=clnk&gl=us&client=safari*.

‡ For further discussion of China's financial opening measures, see Chapter 2, Section 2, "Vulnerabilities in China's Financial System and Risks for the United States" in U.S.-China Economic and Security Review Commission, *2020 Annual Report to Congress*, December 1, 2020, 264–267. *https://www.uscc.gov/sites/default/files/2020-12/Chapter_2_Section_1--Year_in_Review-Economics_and_Trade.pdf*.

long-term value, should reduce volatility in China's notoriously turbulent markets. China's financial opening deliberately seeks to encourage long-term institutional investors for this reason.[135] Aside from foreign fund managers seeking to diversify their portfolios and benefit from China's economic rebound, capital inflows are also driven by a strong value of the RMB relative to other currencies.[136]

Institutional changes to markets themselves may also be lifting investor confidence. Historically, China's securities regulation imposed stringent requirements on new listings but neglected monitoring and enforcement for companies already listed.[137] The result has been long delays in IPOs, poor protections for investors, and capital markets that favored entrenched SOEs rather than serving as a vehicle for up-and-coming private firms to raise capital.[138] The launch of the registration-based IPO system on the STAR Market in July 2019 aims to move toward a model where listing requirements would be less onerous and that would later extend to all markets.[139] Companies raised $44 billion (RMB 287.6 billion) on the new board as of December 2020, with enthusiasm for tech stocks remaining high despite regulators cancelling fintech behemoth Ant Group's IPO in November 2020 and signaling an imminent crackdown in the tech sector in 2021.[140] Proposals in December 2020 to accelerate the delisting process for firms that drastically inflate profits or consistently trade below a certain value aim to improve the quality of listed firms and establish better protections for investors.[141]

Indicators of a Bubble Still Present

Despite stronger fundamentals and institutional improvements, many telltale signs of a bubble are also present in China's market rally, including increased liquidity fueling investment and a rush of retail investors entering the market (see Table 3). Following the June 2015 stock market peak and subsequent crash, regulators took steps to reduce speculation by retail investors, such as imposing stricter criteria for margin trading, or trading with funds borrowed from a brokerage, with the traded stock pledged as collateral. Regulators later loosened some rules around margin trading during a stock market downturn in January 2019, and in May 2020, they revised the formula for brokers' capital buffers to allow them to extend more loans, both changes that facilitated an increase in overall leverage fueling the rally.[142] Restrictions on other investment avenues have also encouraged more savers to enter the market.[143] Aside from a crackdown on speculative real estate purchases, efforts to limit investment in risky wealth management products offered by banks have also spurred increased stock investment.[144]

Table 3: Past and Present Signs of Irrational Exuberance in China's Market Peaks

Sign of a Potential Bubble	Oct 2007 Market Peak	June 2015 Market Peak	Jan 2021 Market Peak
Valuations are not based on underlying fundamentals, often shown through a sharp escalation in stocks' average price to earnings (P/E) ratios.	Average P/E ratios for the Shanghai Stock Exchange increased 258.6 percent over the preceding 18 months, reaching 69.6.	Average P/E ratios for the Shanghai Stock Exchange increased 90.4 percent over the preceding 18 months, reaching 21.	Average P/E ratios for the Shanghai Stock Exchange increased 21.8 percent over the preceding 18 months, reaching 16.8.
Retail investors pour into the market, evidenced by a surge in new brokerage accounts.	In April 2007, the government announced that 1.2 million new accounts were opened in five consecutive trading days, compared to 850,000 total in 2005.	4.4 million new accounts were opened the last week of May 2015, compared to 150,000 on average the preceding five years.	New weekly accounts averaged 366,923 in December 2020, continuing a trend that began in March 2020.
Investments are fueled by increased liquidity.	Rather than stimulating the economy, the PBOC raised interest rates in 2007 in attempt to cool	The PBOC repeatedly reduced banks' capital reserve requirements to boost liquidity in the preceding year.	Both domestic stimulus and increased global liquidity have driven Chinese markets higher.

	China's overheating export sector.		
A surge in margin trading, or buying stocks on credit and using the stock as collateral, increases overall leverage in the market.	China's securities regulator only permitted margin trading via a pilot program launched in March 2010.	Margin debt reached a total of $361 billion (2.24 trillion RMB) in June 2015.	Total outstanding margin debt reached $264 billion (RMB 1.7 trillion) on January 25.

Source: Various.[145]

Beneath Rally, Market Dynamics Show Policy Objectives Remain Elusive

Regardless of whether equity valuations continue to climb, the rally throughout 2020 into January 2021 demonstrates the Chinese government's struggle to advance policy goals for both the stock market and the broader economy. In 2020, investors poured savings into the stock market just as policymakers reinvigorated efforts to increase domestic consumption both to correct China's lopsided economic recovery and to secure new drivers of growth as global recovery and bilateral economic relations with the United States remain uncertain.[146] China's policymakers are eager to improve investor confidence as more robust capital markets help to meet long-term objectives to increase corporate fundraising on capital markets rather than via bank loans and to improve markets' utility as a safe haven for investor assets and retirement savings. Nevertheless, the stimulus-fueled savings glut occurred as consumer confidence remained weak, with a 3.9 percent contraction in retail sales in 2020 (See "Quarterly Review of China's Economy").[147]

Market dynamics also suggest investors continue to view China's exchanges as short-term speculative opportunities rather than long-term safe havens. China's fledgling asset management industry showcases this trend, with mutual fund assets surging 48 percent to a record $3.1 trillion (RMB 30 trillion) in 2020.[148] Some 80 percent of investment in mutual funds went to new fund launches, but many new funds struggled to keep investors, who withdrew after an initial profit to reinvest in other debuting funds.[149] In general, market turnover remains extremely high on Chinese exchanges, and the rapid increase in new retail investor accounts has far outstripped the increase in institutional investor participation, contributing to further volatility.[150]

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

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