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U.S.-China Economic and Security Review Commission

Monthly Summary of U.S.-China Trade Data **November 5, 2013**

Highlights of this month's edition

- **Bilateral trade:** Deficit widens but less than last year; exports outpace imports; transport equipment exports see major gains; agricultural exports down
- **Third Plenum Preview:** Expectations high for economic reform announcements at the November 9-12, 2013 Plenum; 383 Plan prompts optimism but actual reforms uncertain
- **Bilateral policy issues:** Debt ceiling debate rattles China; ITA talks proceed; USCBC survey shows cost increases are main concern for U.S. businesses in China
- **Sector spotlight:** Advanced technology products see little change; debates resurface in WTO over China's rare earths policies
- **China's economy:** Growth rebounds, pushed by real estate and debt; rebalancing limited in 2013 with the exception of FDI in services

U.S.-China Trade Deficit Up, But Growing More Slowly

Through August, the U.S. trade deficit with China in 2013 stood at $208 billion, an increase of $4.5 billion over the previous year. Although the deficit continues to widen, it is doing so at a slower rate. By contrast, in 2011-2012, the trade deficit increased by $13.7 billion in the January to August period. Cumulative exports this year are in fact outpacing imports by 1.6 percentage points; last year, exports trailed imports by 1 percentage point (see figure 1).

Figure 1: Growth of U.S. Trade with China
(YTD, year-on-year, %)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2012												
Exports	4.4%	4.5%	3.8%	4.3%	6.0%	6.7%	6.4%	5.9%	5.8%	6.4%	6.4%	6.4%
Imports	9.6%	6.6%	9.0%	9.7%	9.0%	8.2%	8.1%	6.9%	6.5%	6.5%	6.6%	6.6%
2013												
Exports	12.1%	9.1%	4.3%	4.8%	3.6%	4.3%	4.0%	4.4%				
Imports	8.1%	11.8%	3.4%	2.6%	3.1%	2.5%	2.5%	2.8%				

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, October 2013). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.[*]

[*] Owing to disruptions caused by the government shutdown, the U.S. Census Bureau has revised its release schedule for trade data. September trade data will be published on November 14, instead of November 5, as originally scheduled. This month, we use the August data. As of December, we will adhere to the revised release schedule.

Top Exports and Imports

Computer and electronic products continue to be the top U.S. import from China, maintaining approximately the same share of imports as a year ago. Transportation equipment was the top U.S. export to China in August, and so far this year has accounted for one in every five dollars that U.S. exporters earn on the Mainland. Computer and electronic product exports to China have also been unusually high, offering some cause for optimism that higher value-added U.S. products will enter China in greater volumes (see figure 2).

Figure 2: Top Exports and Imports through August 2013
(in US$ millions)

U.S. Top-Five Exports to China

	Exports	Share of total (%)	Change over Aug'12 (%)
Monthly (August 2013)			
Transportation Equipment	2,066.7	22%	22.3%
Computer and Electronic Products	1,424.6	15%	15.4%
Chemicals	1,109.0	12%	11.9%
Machinery, Except Electrical	897.1	10%	9.7%
Waste and Scrap	787.6	8%	8.5%
Other	2,995.9	32.3%	
Total	**9,280.9**	**100.0%**	
Year-to-date (thru August 2013)			
Transportation Equipment	14,258.6	19.5%	
Computer and Electronic Products	10,649.1	14.6%	
Chemicals	8,656.7	11.8%	
Agricultural Products	7,385.5	10.1%	
Machinery, Except Electrical	6,728.3	9.2%	
Other	25,420.4	34.8%	
Total	**73,098.6**	**100.0%**	

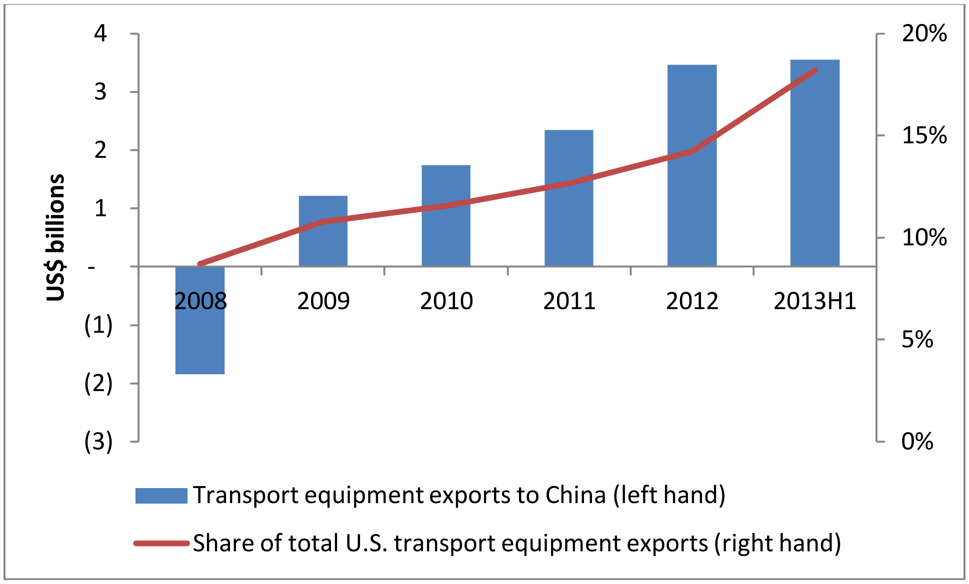
U.S. Top-Five Imports from China

	Imports	Share of total (%)	Change over Aug'12 (%)
Monthly (August 2013)			
Computer and Electronic	12,971.1	33.1%	3.6%
Apparel and Accessories	3,755.1	9.6%	5.0%
Miscellaneous Manufactured Commodities	3,555.9	9.1%	1.1%
Electrical Equipment, Appliances, and Component	3,267.0	8.3%	11.2%
Leather and Allied Products	2,431.0	6.2%	1.0%
Other	13,191.7	33.7%	
Total	**39,171.7**	**100.0%**	
Year-to-date (thru August 2013)			
Computer and Electronic	101,241.2	36.1%	
Electrical Equipment, Appliances, and Component	21,346.8	7.6%	
Miscellaneous Manufactured Commodities	21,116.2	7.5%	
Apparel and Accessories	21,085.6	7.5%	
Leather and Allied Products	16,674.2	5.9%	
Other	99,314.0	35.4%	
Total	**280,778.0**	**100.0%**	

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, October 2013). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

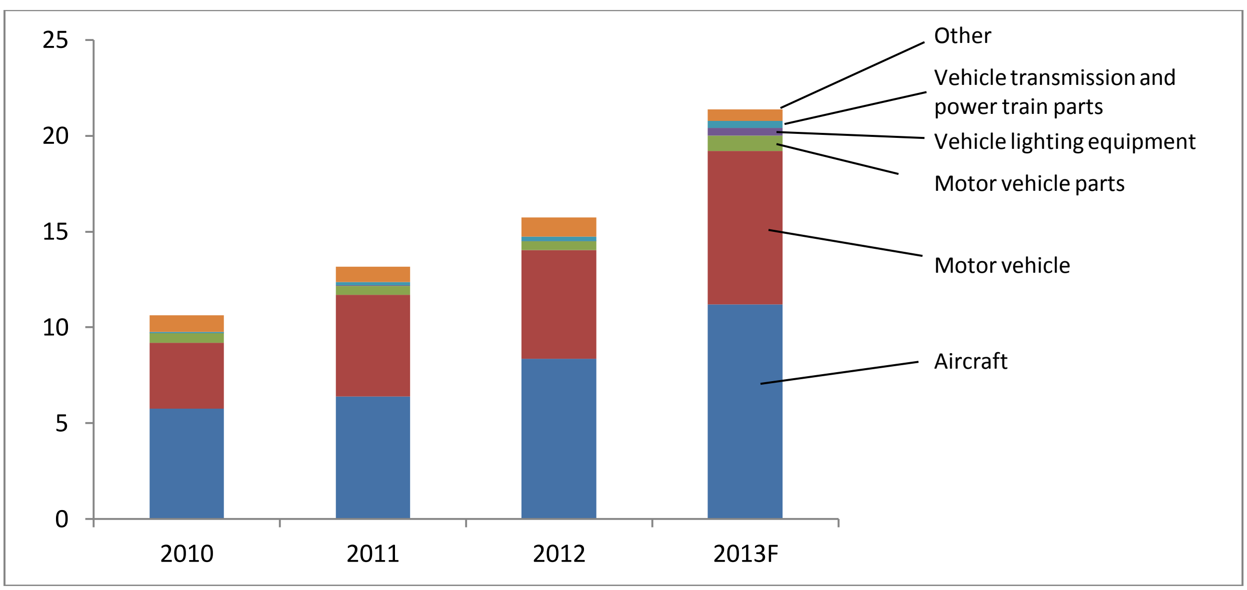
A closer analysis of U.S. transport equipment exports to China reveals that 2013 may indeed be a record year for this product category. China imported more transport equipment from the United States in the first half of 2013 than in all of 2012 combined, and increased its share of U.S. transport equipment exports to nearly 20 percent (see figure 3). While aircraft still account for over half of those exports, the most dynamic growth sectors are in the automotive industry. If these exports continue at the same rate in the final months of 2013, they will set a new record (see figure 4).

Figure 3: U.S. Transport Equipment Exports to China, January-August, 2013
(in US$ billions)



Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, October 2013). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

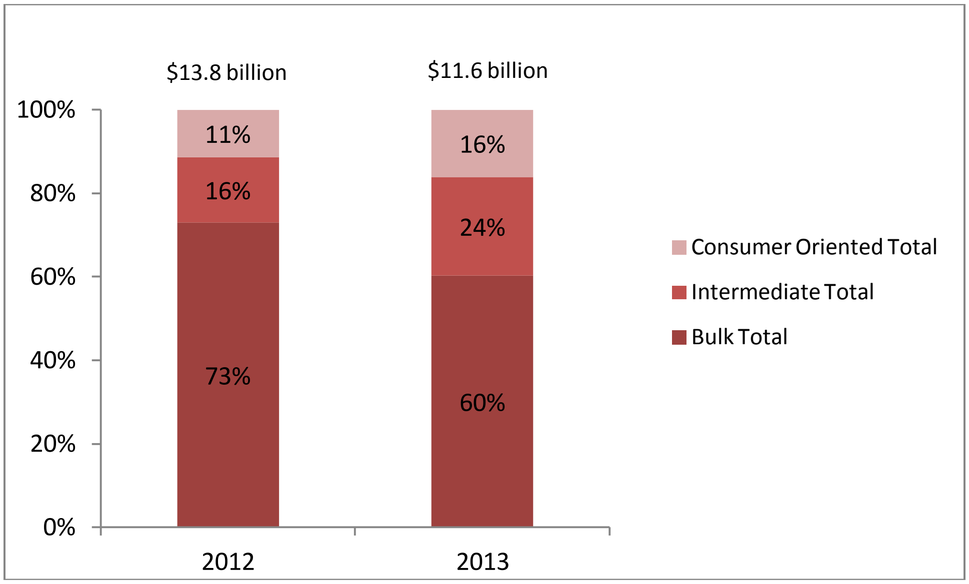
Figure 4: Breakdown of Annual U.S. Transport Equipment Exports to China, 2010-2013F
(in US$ billions)



Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, October 2013). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

One conspicuous absentee from the top-five U.S. exports is agricultural products. Agricultural products are still the second-leading U.S. export to China according to the USDA's data, which group more products under this category than the Census Bureau but 2013 may see the biggest decline in U.S. agricultural exports to China in a decade. The main source of decline has been bulk goods shipments, which comprise products such as cotton and soybeans. Consumer and intermediate goods stayed roughly level with last year. It remains to be seen whether this is a cyclical trend or a structural transition to more consumer-oriented imports by China (see figure 5).

Figure 5: U.S. Agriculture Exports to China, January-August, 2012-13
(YTD, year-on-year, %)



Note: Under the USDA's classification system, "bulk commodities" refer primarily to crops shipped in raw form, such as wheat, coarse grains, rice, soybeans, and cotton; "intermediate goods" refer to processed crops, such as flour, soybean meal, and feeds and fodders as well as products not directly for consumer use, such as live animals, planting seeds, hides and skins, and sweeteners; "consumer-oriented products" include, among others, meat and dairy products, fruits and vegetables, and snack foods.
Source: USDA (Washington, DC: Foreign Agricultural Service, 2013

China's Third Plenum Preview

The Third Plenum of the 18th CCP Central Committee is scheduled to take place in Beijing from November 9 to 12, 2013. Third plenums have both a real and a symbolic significance in contemporary Chinese politics as a venue for declaring policy shifts by a new leadership team, particularly on economic matters.[1] This tradition stems from the Third Plenum in 1978, which launched Deng Xiaoping's "reform and opening up" program, loosening state controls and ultimately opening China on a limited basis to foreign trade and investment.[†]

Decades of excessive, poorly allocated investment and dependence on the export sector have left China with a badly unbalanced economy. The new leadership understands the problems facing China as it tries to transition to an economic model, driven by consumption and innovation. But past Third Plenums demonstrate that recognizing problems and reaching consensus on the painful steps needed to solve them are two entirely different matters.

[†] Jiang Zemin, Deng Xiaoping's successor, used the 1993 plenum to reinforce market reforms that culminated in China's accession to the WTO. At the 2003 plenum, Hu Jintao, President Xi's predecessor, called for more balanced growth and social equality, but left office with the economy even more unbalanced and a significant wealth gap.

In the lead-up to the November 2013 party plenum, Chinese state media and senior CCP officials have played up the significance of this event, and hinted at major reform initiatives to be unveiled by the new senior leadership under Xi Jinping. For example, Yu Zhengsheng, head of the United Front policy portfolio in the Politburo Standing Committee, stated earlier this week that the "deep and comprehensive reforms… this time will be broad, with major strength, and will be unprecedented… Inevitably they will strongly push forward profound transformations in the economy, society and other spheres."[2]

The most substantial information about the third plenum agenda comes from the Development Research Centre of the State Council, a leading government think tank, which released a detailed roadmap of reform measures it has submitted to top leaders for discussion at the upcoming meeting. This so-called Plan 383[‡] has attracted widespread attention not only because of its comprehensive level of detail, but also its two principal authors: Li Wei, who is a former secretary to the former reformist premier Zhu Rongji, and Liu He, who is a key economic adviser to President Xi Jinping.[3]

The Plan 383 highlighted three key projects to advancing economic reform: (1) relaxing control over market access, (2) setting up a "basic social security package" for all residents (to include a modest pension, medical insurance and education subsidies); and (3) allowing sales of collectively owned rural land.[4]

The policy changes proposed by the Plan 383 form an ambitious reform agenda:

- In the corporate sector, the Plan calls for reducing the monopoly power of state-owned enterprises (SOEs) in some sectors, and boosting private investment in energy and power sectors;
- In the financial sector, the Plan calls for interest rate liberalization and eventual convertibility of the renminbi (RMB) as well as policies that force financial institutions to compete for customers by raising their interest payments on savings. It also puts forward an ambitious plan to make the RMB a major international trade-settlement and invoicing currency within 10 years, as well as a reserve currency in "regional markets" (competing with the U.S. dollar and the euro);
- To improve public administration, the Plan calls for allocating taxation power to local governments, along with greater government transparency;
- To raise living standards of China's rural population and migrant workers, the Plan calls for allowing farmers to lease out their land more easily and to receive more compensation when their land is seized by the government to be sold for commercial development. It also recommends phasing the *hukou* household registration system, which often locks migrant workers out of the welfare system because it ties access to social benefits to the holder's registered place of residence.[5]

Expectations for ambitious reform at the Third Plenum must be tempered by the inherent constraints of Chinese politics. Professor Hu Xingdou, of the Beijing Institute of Technology, points out that the top leadership "may view it necessary to push for reforms, to things such as land rights and the social security system, but how the ideas will be received by the interest groups remains to be seen." Plan 383 is just one of many other proposals presented to the government, and one of the most liberal.[6] Most likely, the announcements at the plenum will give only broad outlines of that program, not a definitive blueprint, and it will be months or years before the full details are written into regulations and laws.

If the Shanghai Free Trade Zone (SFTZ), opened on September 29, is a gauge of how liberal market reforms might progress in China, the outcome of the Third Plenum could be

[‡] "383" stands for three "key concepts," eight "areas of reform," and three "correlated reform combinations." Jamil Anderlini, "China's Grandees Ready for Crucial Political Event," *Financial Times*, November 3, 2013.

disappointing. When the SFTZ was first announced, many saw parallels with former Party Chairman Deng Xiaoping's "Southern Tour" in 1992 that demonstrated the leadership's support of market reforms in the aftermath of the Tiananmen Square crackdown of 1989. However, new Premier Li Keqiang, unlike Chairman Deng in his day, snubbed the opening ceremony of the Zone himself, sending the Commerce Minister instead.[7] According to *Inside U.S.-China Trade*, many observers also expressed disappointment at the fact that many reforms, such as the ability of wholly foreign-owned banks to operate in the SFTZ and the ability for companies to freely convert Chinese renminbi (RMB) into foreign currency, will not be implemented for at least a few years. The Shanghai municipal government did release a "negative list" of sectors that will be excluded from liberalization in the SFTZ – a positive step, because it gives investors more certainty regarding where they can and cannot invest. Yet even here, the actual impact will be moderate, as the list does not open up sectors in the SFTZ beyond what would already be allowed in China's Foreign Investment Catalogue.[8]

Other recent policies, on the other hand, do indicate earnest reforms in the making. For example, Beijing on October 25, 2013 eliminated the minimum capital requirements for setting up a new company.[9] This is an important change, since the government maintains its stranglehold over private business by withholding administrative approvals. Currently, the central government still holds final say over 1,500 types of projects; local authorities wield approvals over 17,000 more.[10] Premier Li Keqiang, speaking at an executive meeting of the State Council, China's cabinet, explained the change: "By widening the market access and establishing a transparent and efficient modern company registration system, we aim to further streamline government administration, create fair competition and support smaller businesses, especially innovative enterprises."[11]

Bilateral Policy Issues

The Debt-Ceiling Impasse's Impact on China

The legislative deadlock in the House over raising the U.S. debt ceiling appeared to expose China to considerable risks or at the very least rattled the nerves of China's leadership. China's central bank holds $3.66 trillion in reserve assets, nearly all in U.S. dollars, of which some 60 percent are parked in U.S. treasuries.[12] China's central bank is the largest foreign holder of U.S. treasuries; after temporarily reducing its exposure following the August 2011 debt ceiling impasse, it resumed its treasury purchases in recent quarters. Given that the dollar still accounts for 62 percent of the world's global foreign exchange reserves, the buying power of China's export partners is influenced by the value of the dollar as well.[13]

China's reactions to the deadlock in Washington were mixed. Predictably, high-level officials were guarded, waiting until October 7 to issue an official response. Like many officials across the world, China's Vice Finance Minister Zhu Guangyao implored the United States to avoid default in the interest of the global economic recovery. Rather than explicitly question U.S. creditworthiness, Zhu expressed concern about the "safety" of Chinese investments in the United States.[14]

Other groups in China, however, reacted with more vitriol. An op-ed published by Xinhua, the official news agency, suggested it was "a good time for the befuddled world to start considering building a de-Americanized world."[15] This rhetoric evoked parallels with 2008, when several Chinese news outlets pronounced the "crumbling of an empire" after the fall of Lehman Brothers.[16] In financial markets, meanwhile, one of China's four biggest credit rating companies, Dagong, downgraded the local and foreign currency credit ratings of the United States to A- from A, maintaining a negative outlook. It justified the move by what it viewed as a vicious cycle of debt crisis and political crisis that it argued would increase the likelihood of U.S. insolvency.[17] Dagong's downgrade stood in contrast to the top-three U.S. rating agencies – Moody's, Fitch, and Standard & Poor's – which did not alter their credit ratings.

What actions China might take in the long run as a result of the debt ceiling impasse provoked considerable debate among economists. Menzie Chinn, a professor of public affairs and economics at the University of Wisconsin, Madison, spoke for many when he claimed that the People's Bank of China can actually do very little. It can only reduce its dollar reserves through slow and painful structural reforms that gradually wean the economy off an export-led growth model. Somewhat ironically, coinciding with the debt ceiling crisis, new data showed that China's foreign exchange reserves in the third quarter of 2013 gained the most since 2011, rising 4.67 percent. At present, there is virtually no other market other than U.S. treasuries liquid enough to absorb China's excess reserves.[18]

The impending debt ceiling deadline on October 17 nonetheless raised pressure on China to diversify its reserves. Citing an anonymous source, Bloomberg reported that the State Administration of Foreign Exchange (SAFE), the branch of China's central government authorized to manage and invest the country's foreign currency reserves, was looking to ramp up investment in real estate and infrastructure projects overseas, with a focus on Western Europe.[19] Earlier this year, *The Wall Street Journal* revealed that SAFE had already invested billions in UK real estate via Gingko Tree, a third-party investment vehicle.[20]

A more public effort by China to reduce its exposure to the dollar has been through the internationalization of the RMB. A moderate breakthrough was achieved in October, when the UK central bank issued new regulations that will allow the sterling to be freely tradable with the RMB, making it only the fourth currency to do so after the U.S. dollar, the yen and the Australian dollar. A related measure will permit British institutions to apply for licenses to make limited investments in Chinese shares and bonds, giving them direct access to China's securities market for the first time. The United Kingdom will also permit Chinese banks to establish fully-owned subsidiary branches in the United Kingdom for the first time.[21]

When factoring diplomacy into the equation, the deadlock in Washington may actually have been a net benefit for Beijing. Kept at home by the impasse, President Obama was unable to attend the summit of Southeast Asian nations in Brunei. According to Kishore Mahbubani, a former high-level diplomat from Singapore, China's new president Xi Jinping made "quite a splash" at the summit in President Obama's absence.[22] Secretary of State John Kerry, who attended the summit in lieu of the president, spent much of his time reassuring China and the other countries in attendance that the United States would meet its debt obligations. The defensive statements about domestic affairs no doubt hampered Washington's efforts to advance its real diplomatic agenda.[23]

U.S.-China Business Council Releases Annual Survey

On October 8, the U.S.-China Business Council (USCBC), a Washington-based business advocacy organization, released its annual member survey, which canvasses the opinions of U.S. companies on China's business environment. Among the top-ten concerns for U.S. businesses in the survey, cost increases rank first, three spots up from last year (see figure 6). The leading reason given for cost increases in the survey is the rise in wages. Not surprisingly, "Human Resources: Talent Recruitment and Retention" ranked third on the list of top-ten concerns. Sixty-one percent of respondents said they increased wages in China by 5 to 10 percent in 2013. Nonetheless, China's slowing economy appeared to give U.S. employers some leverage – compared to 2012, there was an increase in respondents who did not increase wages at all, and 15 percent fewer respondents reported raising wages by over 10 percent.[§]

Competition with Chinese companies moved up the list of concerns for a third year running. Although U.S. businesses are more preoccupied with competition from Chinese private enterprises, 75 percent of respondents said that Chinese SOEs are a competitive threat, up from 67 percent in 2012. Among areas of preferential treatment for SOEs, seventy percent of respondents pointed to preferential government financing; that was far higher than for all other forms of preferential treatment, such as subsidies, tax breaks, and access to licenses and contracts, which were mentioned by half of respondents or fewer.[24]

The USCBC survey also illustrated that some issues much discussed by U.S. companies in the past are becoming less important. Competition with other foreign companies dropped out of the top-ten. Foreign investment restrictions ranked seventh on the list two years ago, when China published a revised version of its Catalogue Guiding Foreign Investment, but this year dropped down to tenth. Similarly, standards and conformity assessment dropped a few spots, perhaps because the debate about China's "indigenous standards" and discriminatory procurement policies has dampened. Nevertheless, IP enforcement remains a perennial concern – more companies this year saw China's IPR enforcement as "relatively unchanged", and fewer said it "somewhat improved".[25]

Figure 6: USCBC China Business Environment Survey, Top-Ten Concerns, 2011-2013

Rank	2011	2012	2013
1	Human Resources: Talent Recruitment and Retention	Human Resources: Talent Recruitment and Retention	Cost Increases
2	Administrative Licensing	Administrative Licensing	Competition with Chinese Companies in China
3	Cost Increases	Competition with Chinese Companies in China	[tie] Administrative Licensing
4	Competition with Chinese Companies in China	Cost Increases	[tie] Human Resources: Talent Recruitment and Retention
5	Intellectual Property Rights Enforcement	Intellectual Property Rights Enforcement	Intellectual Property Rights Enforcement
6	Standards and Comformity Assessment	Uneven Enforcement / Implementation of Chinese Laws	Uneven Enforcement / Implementation of Chinese Laws
7	Foreign Investment Restrictions	Foreign Investment Restrictions	Nondiscrimination / National Treatment
8	Transparency	Competition with Other Foreign Companies	Transparency
9	Nondiscrimination / National Treatment	Competition with Other Foreign or Chinese Companies Not Subject to the Foreign Corrupt Practices Act (FCPA)	Standards and Comformity Assessment
10	Market Access in Services	Standards and Conformity Assessment	Foreign Investment Restrictions

Source: U.S.-China Business Council, "China Business Environment Survey Results", 2011-2013. https://uschina.org/reports/.

§ For more information, visit https://uschina.org/reports/china-business-environment-october-8-2013#1 cost.
"USCBC 2013 China Business Environment Survey Results" (Washington, DC: U.S.-China Business Council, October 2013), pp.8-9.

Talks Resume on the Information Technology Agreement

In October, multilateral talks were restarted in Geneva for an expanded Information Technology Agreement (ITA) under the World Trade Organization (WTO). The goal of the ITA is to update trade rules that take into account the technological development and rising international trade in IT industries. The ITA was last signed in the 1990s, at a time when China played only a marginal role in the industry.[26] Today, China is at the epicenter of global IT manufacturing. The United States imported $158 billion worth of computer and electronic products from China last year, compared to a mere $33 billion a decade earlier.[27] A revised ITA could force China to lower tariffs in many product categories, in ways that might improve the competitiveness of U.S. electronics manufacturing, especially in higher-end components.

The ITA talks were temporarily suspended in July because the United States disapproved of China's negotiating stance. China had tabled a list of 148 sensitive items for which it sought exclusions or longer tariff phase-out periods under the ITA. This "sensitivity list" was the longest of any presented by the negotiating parties. The U.S. strategy of abandoning the talks was criticized by some ITA participants, who questioned whether it would prove effective in coaxing China to rethink its approach. They also worried that the U.S. withdrawal from the talks might jeopardize the timeline for concluding the talks at the next WTO ministerial meeting in December.

The United States proceeded to negotiate with China bilaterally on the sidelines of the Asia-Pacific Economic Cooperation (APEC) conference in early October. It appears that U.S. officials made the outcome of the ITA talks an important criterion for evaluating China's request to join the Trade in Services Agreement (TISA), a separate plurilateral services initiative.[28] At the conclusion of the APEC meetings, China pledged to reduce its ITA sensitivities list by 30 percent, laying the basis for the resumption of the talks in mid-October.

China's revised list, presented at the talks, was in many ways a disappointment. China kept 140 sensitive items on its proposed list. Its main concession was to consider more tariff phase-outs, instead of exclusions, for sensitive products. The precise nature of those phase-outs is now being negotiated. Even with progress in this area, it remains unclear whether the ITA will ultimately be able to include 250 products in its scope, a target initially endorsed by many of the participants. Beijing still seeks to exclude some of the most commercially relevant items. Most notably, it is continuing to resist demands from the United States and others to drop duties on a new generation of semiconductors called multi-component integrated circuits (MCOs) – which are widely used in IT products and extremely lucrative.[29]

Sector Spotlight

Advanced Technology Products

Advanced technology products so far this year have seen little change over 2012. Exports and imports have each grown by $3 billion to $4 billion, resulting in minimal shifts in the trade balance (exports $18.3 billion; imports $90.5 billion). Accounting for most of the increase in U.S. exports was aerospace, which grew from $5.2 billion in 2012 to $7.5 billion in 2013.

The Rare Earths Sector

According to Chinese officials, the WTO in October ruled against China in a dispute with the United States over Chinese restrictions on exports of rare earth minerals, tungsten and molybdenum (the *Rare Earths* case).[30] The WTO, which is expected to make the official announcement on November 21, 2013, did not comment.

The *Rare Earths* case was initiated in July 2012 by the United States, the European Union, and Japan in response to China's imposition of restrictions on the export of rare earths, tungsten, and molybdenum. Tensions between the nations have increased since China announced plans to limit its export quota in 2009, claiming to justify such action on environmental protection grounds, as it did in an earlier case on export restraints on raw materials.[**] Rare earths are crucial to many developing U.S. industries, especially clean energy. The restrictions in question are both published and unpublished and consist primarily of export restrictions in the forms of duties, quotas, minimum price requirements, and licensing that are alleged to be in violation of China's obligations under its Protocol of Accession as well as broader WTO principles.

According to U.S. Geological Survey, China is the world's largest producer of rare earths, accounting for over 95 percent of world output. In the WTO complaint, the United States and others accused China of using export taxes and quotas to force companies to move their factories to China to tap these resources. China's control of the rare earths sector gives it outsize economic influence. China curtailed shipments of rare earths to Japan in 2010 when tensions between two countries were high over Japan's seizure of a Chinese fishing vessel and its captain. After China informally placed tighter restrictions on rare earths exports to Japan, Tokyo quickly backed down and released the captain rather than risk production in electronics and hybrid vehicles, which are dependent on the rare earths.

The United States and other plaintiffs argued that these restrictions are part of an industrial policy aimed at providing substantial competitive advantages for Chinese manufacturers at the expense of foreign manufacturers. Specifically, because of China's position as a leading global producer of these materials, its export restraint measures give China the ability to significantly affect global supply and pricing. These measures can provide important advantages to China's downstream producers, to the detriment of their U.S. and other foreign counterparts. These measures also can create substantial pressure on foreign producers to move their operations, jobs, and technologies to China.[31]

China has been defending its curbs on rare earth exports as a necessary step toward protecting its environment and scarce natural resources. And indeed, rare earths mining and refining is a dangerous process, involving highly toxic chemicals. China's rare earth mining and processing industry has been mostly unregulated until recently, and has resulted in significant pollution. High demand for rare earths from foreign consumers has also led to an increase in smuggling and illegal mines. The Chinese government is also pursuing consolidation of the rare earths sector, in part to eradicate illegal mining and smuggling, and to enforce more stringent environmental standards.[32]

The United States has argued in its submission to the WTO that China's export quotas on rare earths, rather than conserving natural resources, have instead created an unfair

[**] In this case, the dispute settlement panel found most of China's export duties, quotas, and licensing regime were in violation of the General Agreement on Tariffs and Trade and China's Protocol of Accession. China appealed certain aspects of the panel's report, but the Appellate Body affirmed the WTO dispute settlement panel's findings, rejecting China's arguments that its export restraints were conservation or environmental protection measures or measures taken to manage critical shortages of supply. WTO Dispute Settlement Body, *China — Measures Related to the Exportation of Various Raw Materials*, WT/DS394. http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds394_e.htm.

market environment for foreign companies. China has invoked Article XX of the GATT 1994 to justify its restrictions on the basis of preservation of public health and natural conservation. The United States pointed out that sub-paragraph (g) of Article XX provides an exception from the requirements of the GATT 1994 for measures "relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption." By these criteria, Chinese export restrictions are not eligible for exemption since no restrictions have been imposed on domestic production or consumption of rare earths.

Furthermore, the United States argued that the export quotas are part of a regime that deliberately created two markets—an internal and an external one—for these materials. The bifurcated markets have resulted in a two-tiered pricing structure, with lower prices in China and significantly higher prices abroad, and created an incentive for foreign users of rare earths to move their manufacturing operations to China to avoid being subject to export quotas. Chen Guiyuan, deputy director of the Hohhot customs bureau in north China's Inner Mongolian Autonomous Region, noted that "[t]o get past the government regulations, some foreign companies are investing in their own rare earth metal processing centers in China, aiming to obtain more of the metals at a cheaper price."[33]

Starting in the early- to mid-2000s, China began to decrease rare earth exports, reversing its export promotion policies and eventually introducing export restrictions.[34] In 2007, the Chinese government began to apply export duties to rare earth exports (up until 2005, Chinese rare earth producers were offered export tax rebates on rare earth exports). In 2011, export duty rates ranged from 15 percent to 25 percent and were applied to several rare earth products. China more than halved export quotas from 2005 (65,580 tons) to 2011 (30,184 tons).[35] However, after six years of cutting its quota, China has begun to reverse course, increasing the quota by 2.7 percent in 2012 (to 30,996 tons) and by 0.02 percent in 2013 (30,999 tons).[36]

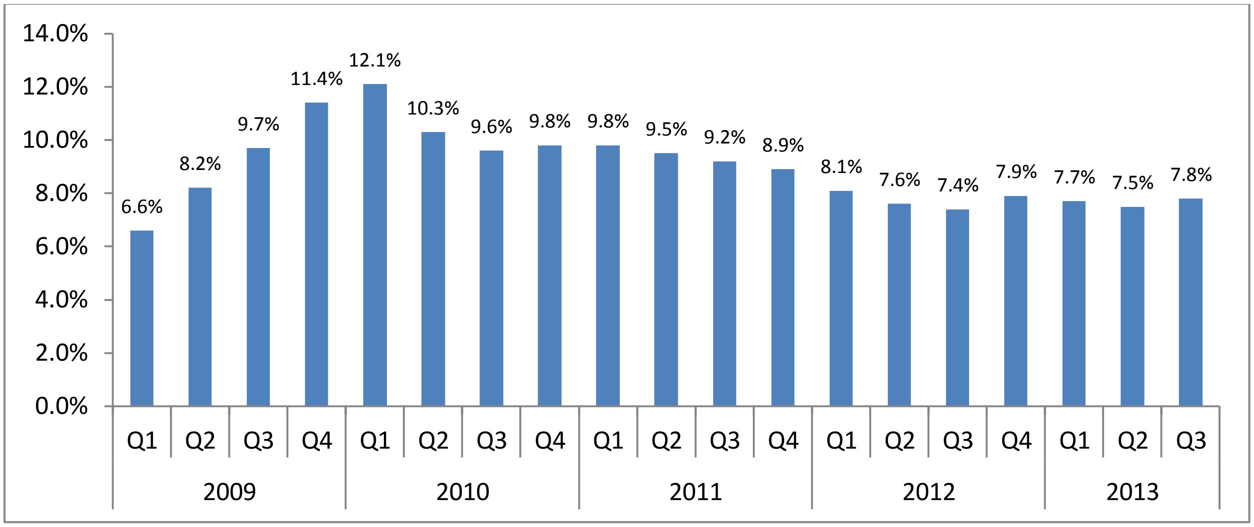
Following the sharp reduction in export quotas in the second half of 2010,[37] prices for many rare earths soared. Alarmed, rare earths users started searching for alternative materials, recycling, and investing in development of mines in the United States, Australia and, most recently Greenland.[38] The resulting decline in demand meant that actual exports of Chinese rare earths have lagged behind the quota allowance. By September, just half of the full year's quota (31,000 tons) for 2013 was exported. In 2011 and 2012, Chinese exporters used 62 percent and 52 percent of the quota, respectively.[39]

China's Economy

Growth Rebounds in Third Quarter but Outlook Uncertain

China in mid-October reported real GDP growth of 7.8 percent for the third quarter of the year (see figure 7). The figure was a moderate improvement over the first half of 2013, and exceeded many forecasts. The Roubini Monitor, an economic intelligence provider, expects China to grow by no more than 7.6 percent this year.[40] *The Economist* raised its annual growth forecast upward from 7.5 percent to 7.7 percent.[41]

Figure 7: China's Real GDP Growth, 2009Q1 – 2013Q3
(quarterly, year-on-year, %)

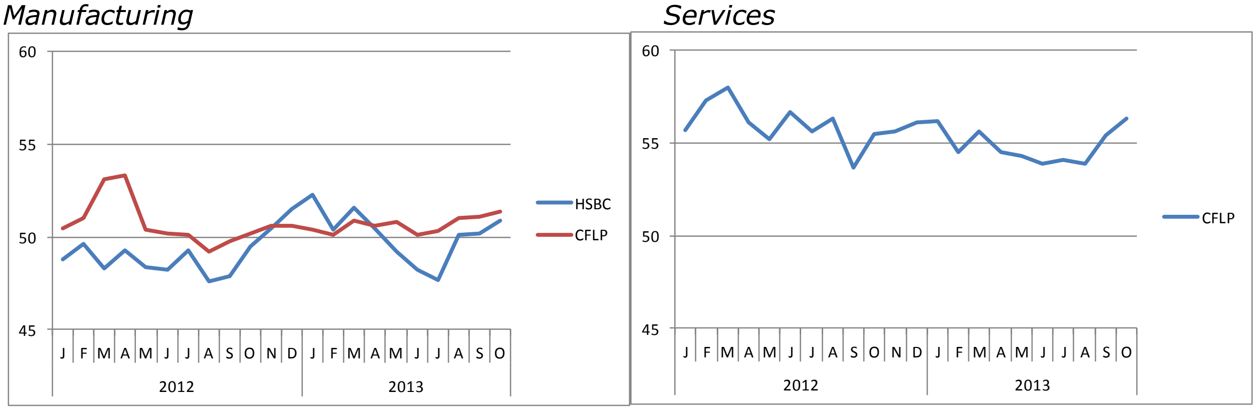


Source: China National Bureau of Statistics, via Trading Economics. *http://www.tradingeconomics.com/china/gdp-growth-annual.*

It appears that the rebound in the economy has buoyed manufacturers, who are no longer as concerned about the macro-risks posed by the financial sector, which experienced sudden liquidity tightening in June (see our July trade bulletin for more information). Beginning in August, the HSBC Purchasing Managers' Index (PMI), a survey of businesses, also jumped from contraction to expansion (see figure 8). Surveys by the China Federation of Logistics and Purchasing (CFLP) also showed a strong rebound in sentiment among businesses in non-manufacturing sectors.

Figure 8: Purchasing Managers' Index Year-to-Date (HSBC vs. CFLP)
(<50 = contraction, >50 = expansion)

Manufacturing *Services*

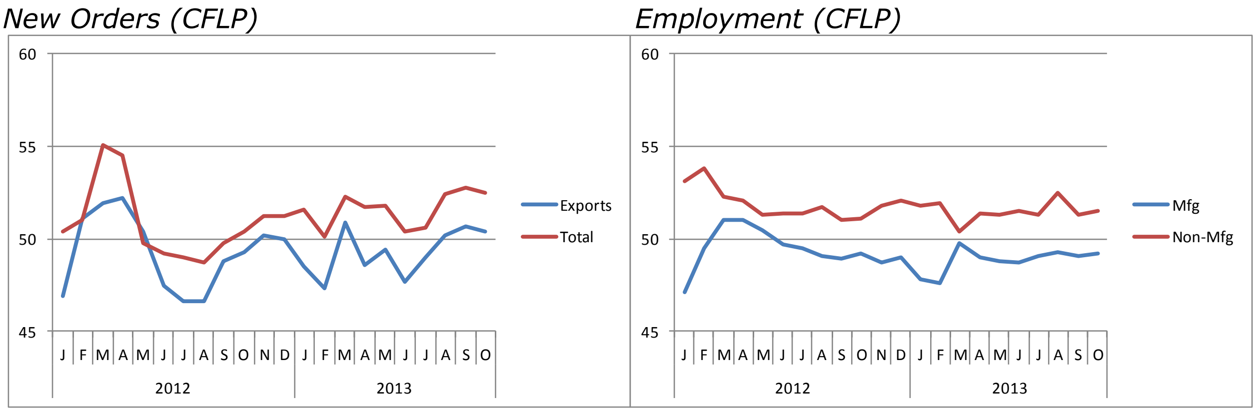


Source: HSBC Purchasing Managers' Index. http://www.hsbc.com/1/2/emerging-markets/em-index/purchasing-managers-index; National Bureau of Statistics via CEIC data.

However, other indicators offer less room for optimism about China's growth prospects. For one, the PMI surveys are ambiguous about expansion in employment and orders (see figure 9). China's industrial output also remains far less dynamic than in past years (see Figure

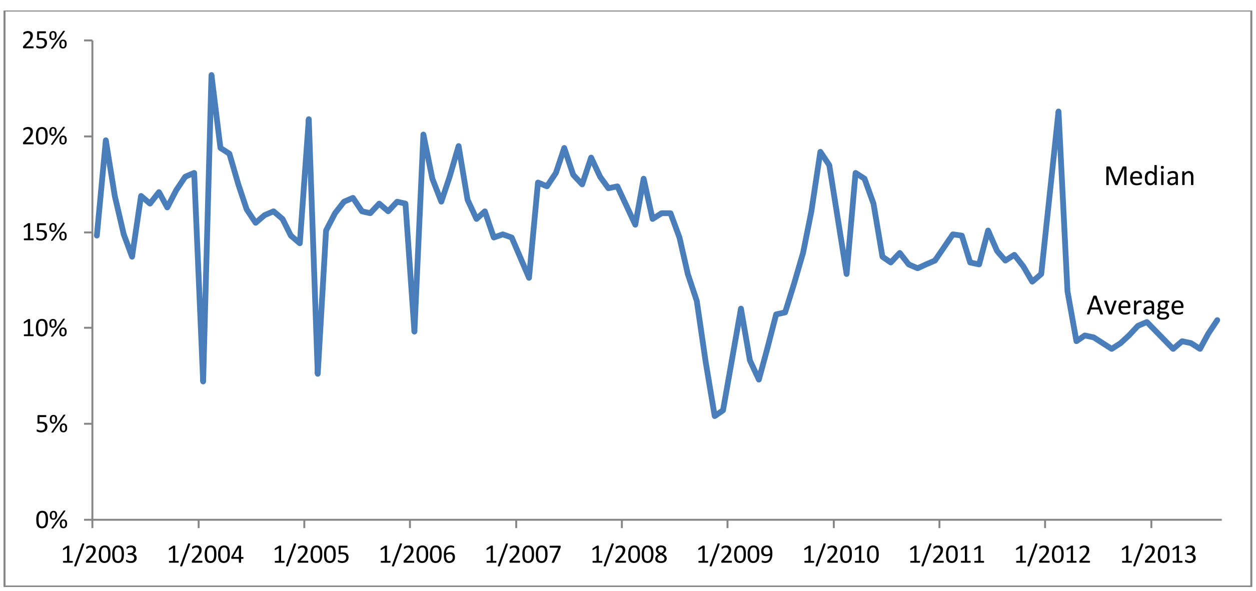
10). Producer prices improved slightly, but remain in negative territory, suggesting that factories continue to slash prices in reaction to declining orders and excess inventory.

Figure 9: Purchasing Managers' Index for Manufacturing, BRIC countries, Year-to-Date
(<50 = contraction, >50 = expansion)



Source: HSBC Purchasing Managers' Index. *http://www.hsbc.com/1/2/emerging-markets/em-index/purchasing-managers-index*.

Figure 10: Industry Value-Added in China, January 2003- September 2013
(Monthly, year-on-year, %)



Source: China National Bureau of Statistics, via CEIC Database.

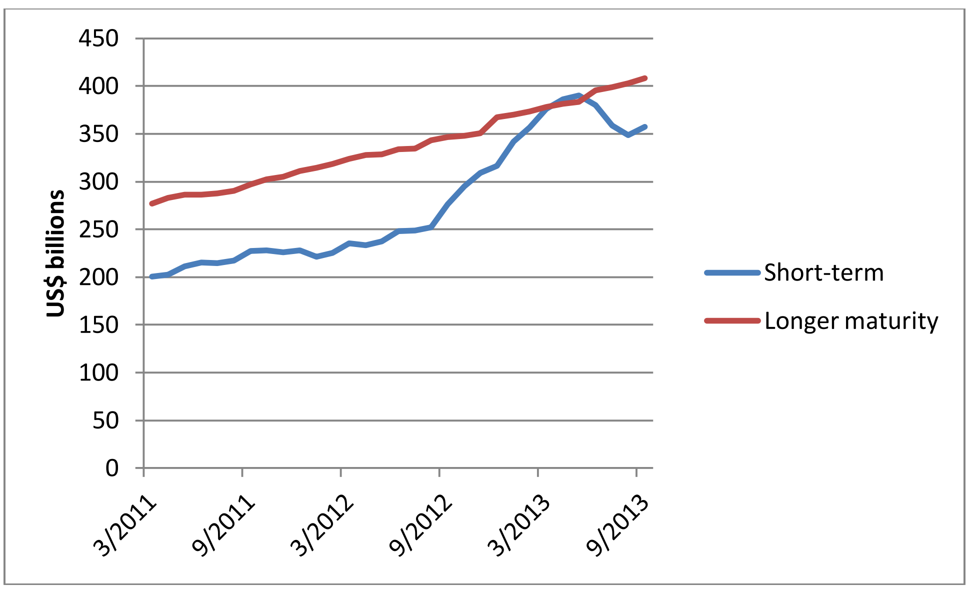
China's exports, a key driver of manufacturing, have also been volatile. A 7.1 percent year-on-year increase in August was offset by a 0.4 percent decrease in September. Some analysts have countered that there are unfair "base effects" that have made export growth look worse than it is. Exports a year ago were extremely high, because China's exporters at the time engaged in rampant over-invoicing to bypass currency controls and bring additional money into China. As a result, exports now look unusually weak when compared to the prior year.[42] Number games aside, there is sufficient evidence that China's exporters have indeed fallen on hard times. For example, at the Canton Fair, one of the largest fairs linking China's exporters to overseas customers, the number of companies with exhibits declined in both the spring and autumn sessions this, compared with 2012. That was an even poorer showing than during the global financial crisis in 2009.[43]

Financial Sector and Property Markets Driving Growth

Essential to China's rebound in the third quarter was credit growth and real estate investment. Following the "credit crunch" in June, there was a steep decline in bank lending in July. But lending picked up again in the ensuing months as the central bank loosened credit policy and injected more funds into circulation to stimulate growth. Consequently, new loans totaled 787 billion RMB ($128.6 billion) in September, substantially exceeding market forecasts of 650 billion RMB.[44] The broad money supply (M2) has exceeded the official goal of 13 percent every month this year.[45]

Besides a looser central bank policy, there were other trends driving credit growth. One was the inflow of dollars, as China's continual trade surplus combined with rapid "hot money" inflows. Many investors are looking to China for relatively stable returns as other emerging markets like Brazil and India have suffered sharp declines in their balance of payments and currency values. Predictably, loans issued by Chinese banks in foreign currency remained high, with a large share of short-term loans (see figure 11). Another factor behind credit growth was property markets. Defying many analysts' expectations, China's property market rebounded over the summer, with property prices increasing by 8 percent year-on-year in September.[46] Sales jumped 21.5 percent year-on-year by volume in September, compared to an average of 11 percent growth in the previous three months.[47]

Figure 11: Foreign Exchange Loans in China: Short-Term vs. Longer Maturity
(US$ billions)

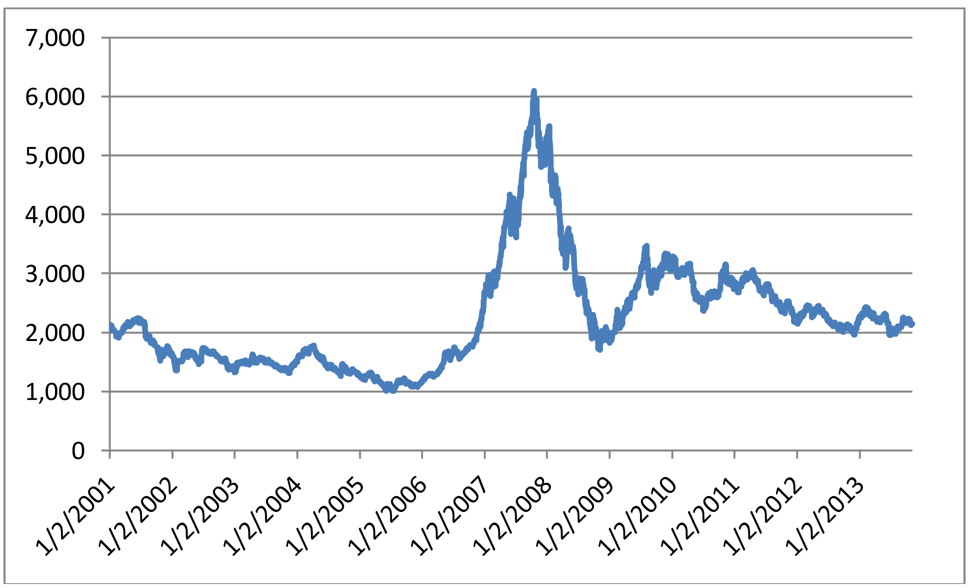


Source: People's Bank of China, via CEIC Data.

An important reason for the rebound in property markets has been the dearth of other investment options for Chinese households. In recent years, wealth management products (WMPs) have become extremely popular as a way for households to earn a higher rate of return than is possible through ordinary bank accounts, where the return is capped at a low rate. Banks use WMP funds to engage in riskier lending, often through the "shadow banking" sector. The lack of regulatory oversight over WMPs has become major risk for China's financial system, and also for individual depositors who wrongly assume that a product offered by a state-owned bank would be safe. An important part of the central bank's liquidity tightening in June was therefore aimed at reducing access to these products. In late October, the central bank even launched a small pilot program to force banks to lift "guarantees" on the returns from WMPs, and to provide greater disclosure to investors.[48] While these measures will likely help shield China's depositors from risks, they have also choked a dynamic new channel for allocating savings.

At the same time, Chinese households still have little incentive to invest in the country's stock exchanges, which are still performing poorly when compared to their peak in 2008 (see figure 12). Indeed, the past year saw stagnation in the number firms listed on the Shanghai Exchange. In mid-October, Xiao Gang, the chairman of the China Securities Regulatory Commission (CSRC), wrote in the official *People's Daily* that more needed to be done to ensure adequate disclosure by listed companies as well as illegal behavior by some of them, in order to protect the retail investors with less than 500,000 RMB ($81,900) who account for some 60 percent of the total market transaction value on the exchanges.[49]

Figure 12: Shanghai Composite Index
(19Dec1990=100)



Source: Shanghai Stock Exchange, via CEIC Data.

China's total credit is on track to rise about 20 per cent this year, nearly triple the country's real economic growth.[50] Total debt in China has shot up from 130 per cent of gross domestic product in 2008 to about 200 per cent today.[51] At 3.7 units of credit delivered per one unit of nominal GDP in the third quarter, China's credit intensity is well above a sustainable level of about 1.2.[52] Due to excess real estate investment, there is a huge supply glut in the property market: developers' unsold inventory was 30 percent of total property completions in 2012, and is on track to reach 35 percent of completions in 2013.[53]

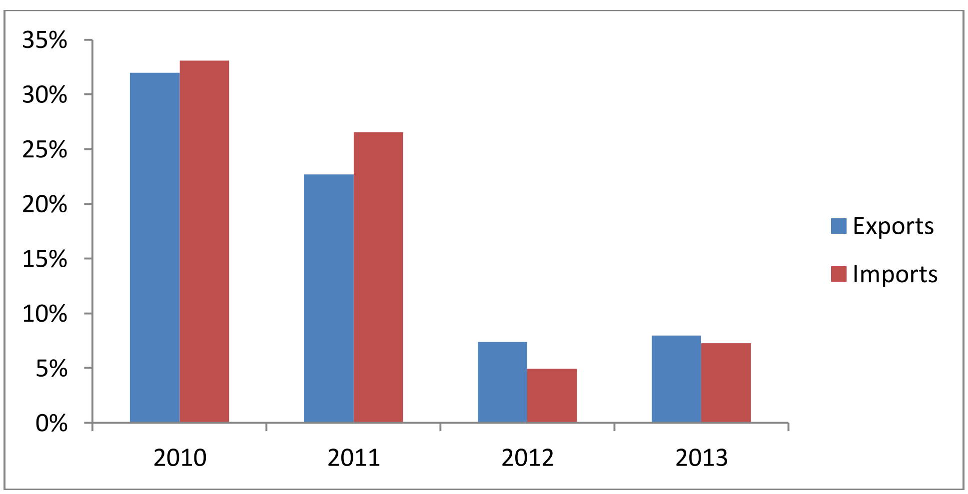
The central bank took its first steps to rein in liquidity in October. China's seven-day bond repurchase rate, a key gauge of short-term liquidity, opened at a four-month high in mid-October after the central bank decided not to inject funds into the banking system.[54] While far short of a credit crunch, the move indicated that the central bank would not tolerate the same rate of credit expansion in the fourth quarter. Analysts also predicted that, with less credit expansion, less "hot money" would flow into China in the fourth quarter, and property prices would also level off.[55]

2013 Not a Year of Rebalancing

China has witnessed only limited progress toward economic rebalancing this year. The Peterson Institute for International Economics, in its quarterly report on China's economy issued in late October, gave China's rebalancing trend a "neutral" rating throughout 2013. Last year, that rating was "slightly positive" throughout the year, prompting optimism in a "positive" rebalancing trend this year that has not been realized.[56]

In China's external accounts, the third quarter of this year witnessed the fastest increase in foreign exchange reserves since 2011. Worse yet, cumulative exports through September outpaced imports by 0.7 percentage points, continuing a trend from 2012 that has reversed the improvements in China's trade balance (see figure 13). Imports continue to slow in tandem with exports, because most imports are intermediate goods for Chinese industry.

Figure 13: Growth of China's Exports and Imports
(Cumulative, year-on-year, January – September, 2010-2013)

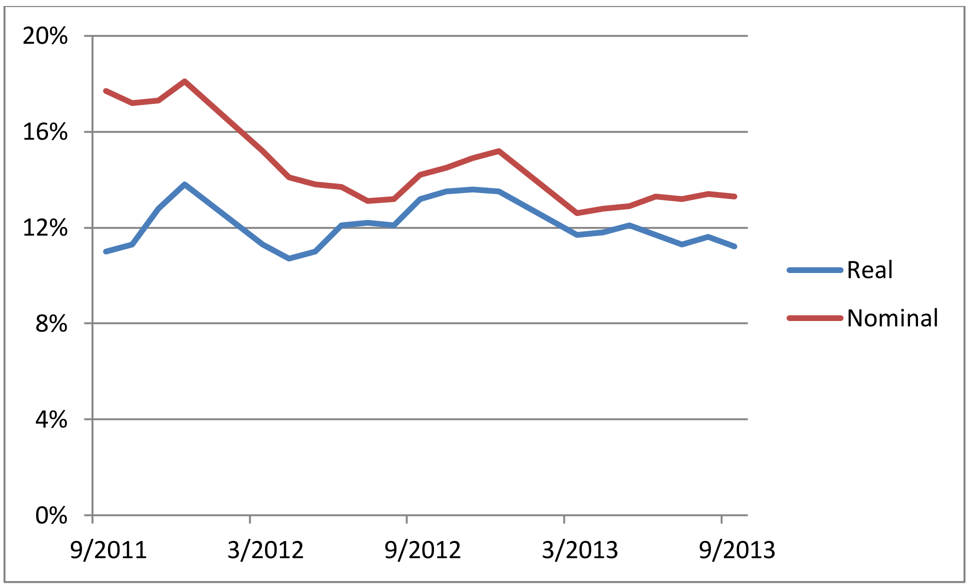


Source: China General Administration of Customs, via CEIC Database.

On the domestic front, investment continues to outpace consumption, doing little to correct the skewed composition of China's GDP. Despite a weakening economy, investment has barely slowed this year, accounting for 56 percent of China's growth in the third quarter.[57] At the same time, retail sales are decelerating at a faster rate than investment. In nominal terms, the monthly rate of increase in fixed asset investment this year has thus been 6 to 9 percentage points higher than for retail sales, a leading indicator of consumption. Averaged by month, investment growth has been 7.4 percentage points higher than consumption, compared with 7.1 percentage points during the same period last year.[58]

A stubborn obstacle to rebalancing has been consumer inflation, which reached a seven-month high of 3.1 percent in September, exceeding a median forecast of 2.9 percent in a Reuters poll.[59] In 2012, lower inflation helped to increase the real growth in retail sales despite a nominal decline, but that effect has been less salient in 2013 (see figure 14). Inflation has also reduced the real rate of return on bank deposits, which reentered negative territory in September 2013, for the first time since March 2012.[60] Not least, inflation has contributed to a sharp decline in disposable income growth this year, as households have been forced to spend more on basic items, such as housing, transport, and food. For example, the municipal government of Nanjing, a city in Jiangsu province, announced last month that it was considering a nine-fold increase in subway ticket prices, after the subway operator was no longer able to access subsidies to recoup the difference its income and expenses.[61]

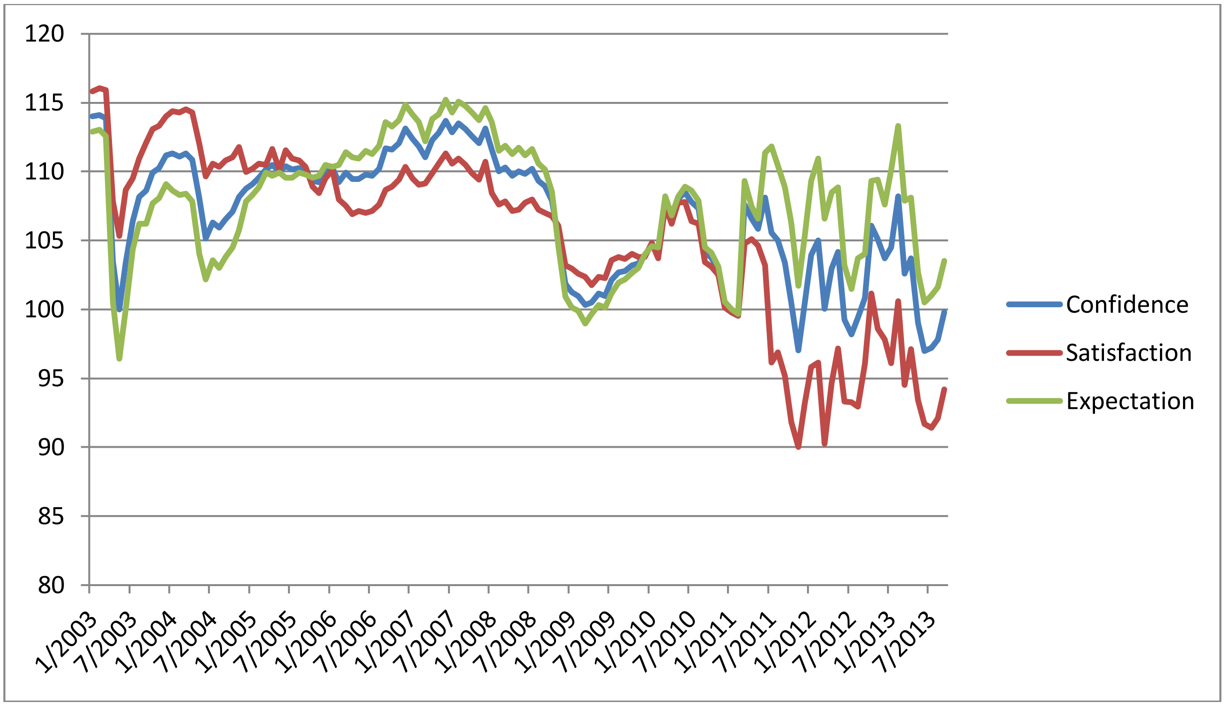
Figure 14: China's Retail Sales Growth, Adjusted (Real) and Non-Adjusted (Nominal) for Inflation
(monthly, year-on-year, %)



Source: China National Bureau of Statistics, via CEIC Database.

These trends appear to be having knock-on effects on consumer psychology. According to a monthly index released by China's National Bureau of Statistics, which samples hundreds of individuals in 20 cities across China, Chinese consumers have been dissatisfied with the current economic situation since the beginning of 2012, and this is also beginning to affect their short-term confidence (see figure 15).

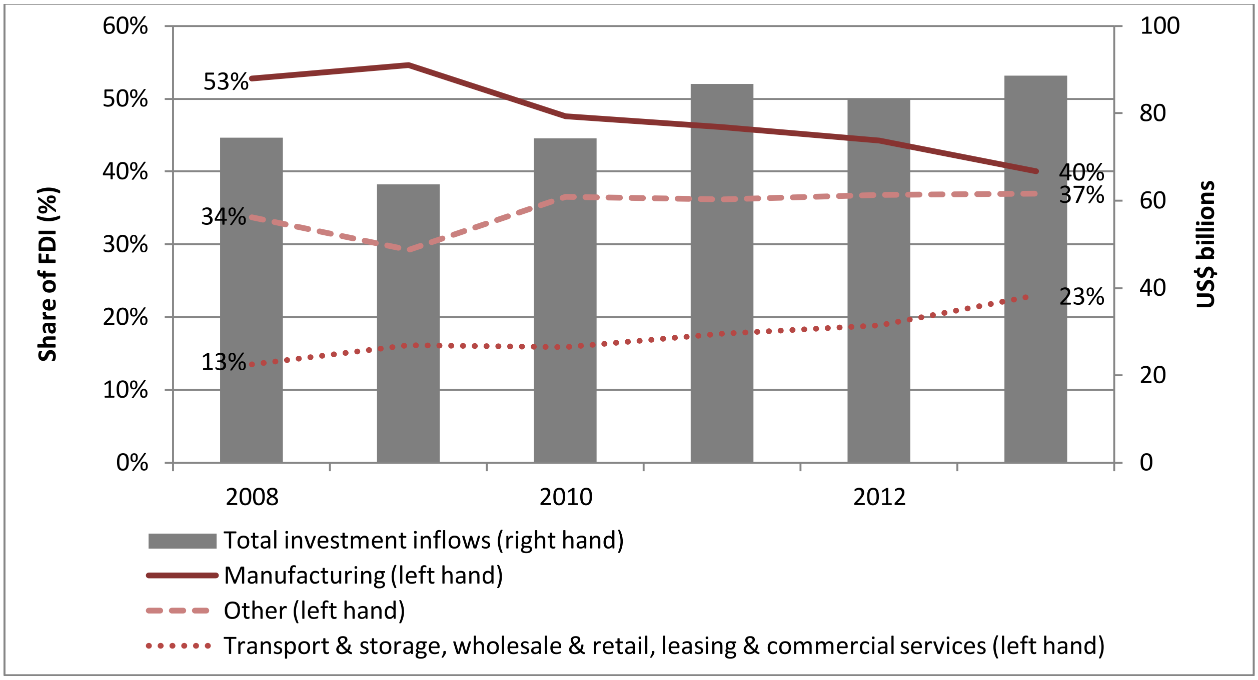
Figure 15: China Consumer Confidence and Expectation Indexes
(>100 = optimistic; <100 = pessimistic)



Source: China National Bureau of Statistics, via CEIC Database.

One positive indicator of rebalancing this year has been the reorientation of foreign investment into non-manufacturing sectors, a sign that China's services industry is steadily growing. FDI flowing into China has slowed markedly in the past two years, and may be reaching an historical peak at around $120 to $125 billion. As inflows decelerate, the composition of investment is also changing. The share of foreign investment going into transport and storage, wholesale and retail, and leasing and commercial services has seen a marked increase, while the share allocated to manufacturing declined by 13 percentage points over the same period (see figure 16). Foreign investors appear to be at the vanguard of China's transition to a service economy.

Figure 16: Composition of China's Inbound Foreign Direct Investment
(January – September, 2008-2013)



Source: China Ministry of Commerce, via CEIC Database.

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