U.S.-China Economic and Security Review Commission

Economics and Trade Bulletin

May 18, 2021

Highlights of This Month's Edition

- **Bilateral Goods Trade:** U.S. goods exports to and imports from China both rose drastically in Q1 2021, reflecting ongoing recovery that is bringing the countries' economies closer together; U.S. agricultural exports continued to lead trade with China but at levels far below the preceding quarter; at $34.5 billion, U.S. imports of computer and electronics products from China nearly equaled the total value of U.S. exports to China.
- **Bilateral Services Trade:** For full-year 2020, U.S. services exports to China were down 32.9 percent year-on-year due to the COVID-19 pandemic; services related to tourism and culture primarily account for the precipitous decline between 2019 and 2020, with travel services exports alone plummeting by 48.6 percent.
- **IP:** USTR's 2021 Special 301 Report highlights persistent challenges faced by U.S. IP rights holders in China as Beijing takes new steps to secure access to foreign technology and IP.
- **Boao Forum:** At the Boao Forum, Chinese government officials sought to portray the country as a leader of economic globalization and global cooperation while also promising to control volatility in the domestic stock market caused by inflows of foreign capital.
- **Quarterly Review of China's Economy:** China's economy grew 18.3 percent year-on-year in Q1 2021, according to official statistics; this recovery was highly lopsided, with strong industrial output overshadowing faltering consumption; stimulus measures drove debt buildup within local governments and property sector, prompting renewed de-risking efforts by policymakers.
- **Huarong:** Investors' assumptions about implicit guarantees in China's corporate debt market are challenged as state-owned asset manager Huarong struggles to repay bonds.
- **Chinese Big Tech:** Big tech companies continue to face increased scrutiny from Beijing as regulators imposed a record fine of $2.8 billion against Alibaba and opened investigations into other big tech firms.

Contents

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Bilateral Trade

U.S Trade Deficit with China in Goods Tracks Pre-2018 Levels

- **In Q1 2021, U.S. exports to China reached a record first quarter level,* boosted by Phase One trade agreement purchases.** China's imports from the United States are nevertheless not on track to meet targets under the agreement, according to Chad P. Bown, senior fellow at the Peterson Institute for International Economics. As of March, China had purchased $26.3 billion of goods covered in the agreement, or 61 percent of the $43.1 billion it would have had to purchase to be on track, based on U.S. Census Bureau data.[1] The U.S. trade deficit in goods with China in Q1 2021 reached $78.6 billion, up 45.7 percent year-on-year, though during the same period last year the trade deficit contracted 32.6 percent due to the onset of the novel coronavirus (COVID-19) pandemic (see Table 1).[2]

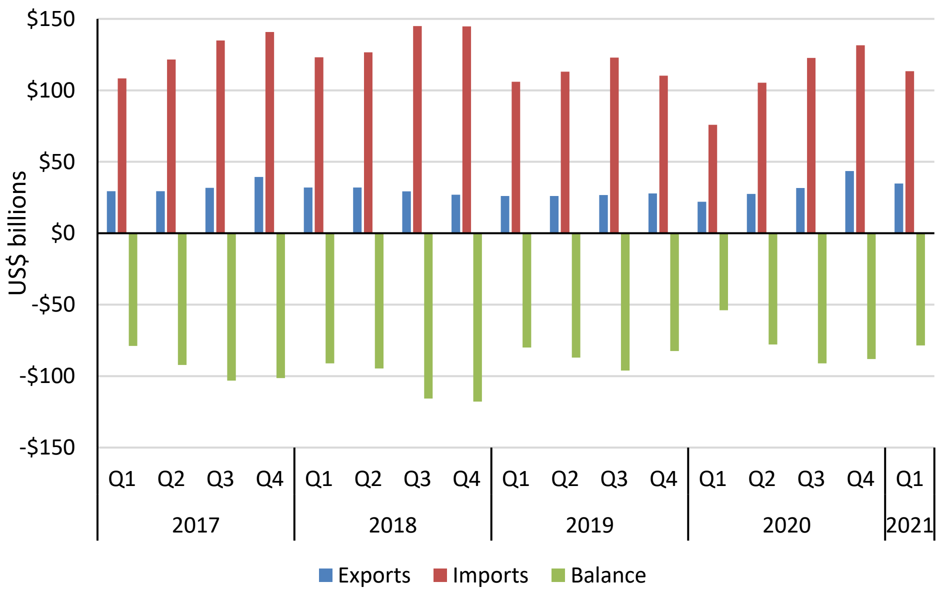
Table 1: Key Indicators for U.S.-China Trade in Goods, Q1 2021

	U.S. Exports to China	U.S. Imports from China	U.S. Trade Deficit with China
Value	$34.8 billion	$113.3 billion	$78.6 billion
Year-on-year Change	58.2 percent	49.4 percent	45.7 percent

Source: U.S. Census Bureau, *Trade in Goods with China*, May 4, 2021. *https://www.census.gov/foreign-trade/balance/c5700.html.*

- **The U.S. trade deficit with China snapped back to pre-pandemic levels, as both economies' recoveries deepen commercial integration**. In spite of increasingly tense rhetoric, respective recoveries in U.S. consumption and Chinese production following contractions throughout 2020 due to the COVID-19 pandemic have deepened the commercial integration of the two countries.[3] U.S. goods imports from China during Q1 2021 exceeded the quarterly imports volume reached in Q1 2019, after tariffs from the Trump Administration's Section 301 Investigation went into effect, but remain $10 billion shy of imports in Q1 2018 before the tariffs (see Figure 1).[4]

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



Source: U.S. Census Bureau, *Trade in Goods with China*, May 4, 2021. *https://www.census.gov/foreign-trade/balance/c5700.html*.

* They did not set an overall quarterly record, as Q3 and Q4 imports generally exceed imports in Q1 and Q2 due to seasonal factors. U.S. Census Bureau, *Trade in Goods with China*, May 4, 2021. *https://www.census.gov/foreign-trade/balance/c5700.html*.

Agricultural and Computer Products Lead Exports

- **In Q1 2021, agricultural products were the top U.S. export to China for the third quarter in a row.** U.S. agricultural exports [*] were up 261.1 percent year-on-year to reach $6.0 billion (see Table 2); nonetheless, they did not sustain the even higher record levels from the preceding quarter.[5] In the second half of 2020, U.S. agricultural exports to China surged as it grappled with a grain shortage caused by pests and widespread flooding during the summer. Slowing Chinese purchases of U.S. maize in Q1 2021 may temper global prices, which reached eight-year highs following China's 2020 shortages.[6] A key part of purchase commitments under the Phase One deal, China's imports of U.S. agricultural products are only on track to reach 72 percent of annual targets based on Q1 2021 levels, according to Dr. Bown.[7]

- **Computer products continued to constitute nearly a third of total imports from China, with electronic appliances, miscellaneous manufactures, and plastic products growing relative to other imports.**[8] U.S. purchases of both miscellaneous manufactured commodities and electrical equipment and appliances accounted for just over 10 percent each of total imports from China, reflecting strong U.S. consumer spending on household goods.[9] There was also a sharp rise in imports of plastics and rubber products, seldom among the top five U.S. imports from China, reflecting increased sourcing of plastics, such as packaging and plumbing components, from China relative to other trading partners.[10]

Table 2: 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 Q1'20 (%)	U.S. Top-Five Imports from China	Imports (in US$ millions)	Share of total (%)	Change over Q1'20 (%)
Quarter 1 (Jan-Mar 2021)				*Quarter 1 (Jan-Mar 2021)*			
Agricultural Products	$6,021	17.3%	261.1%	Computer & Electronic Products	$34,473	30.7%	48.8%
Computer & Electronic Products	$5,896	16.9%	27.2%	Miscellaneous Manufactured Commodities	$12,018	10.7%	96.2%
Chemicals	$5,104	14.7%	42.8%	Electrical Equipment, Appliances & Components	$11,833	10.5%	58.3%
Machinery, Except Electrical	$3,249	9.3%	41.5%	Machinery, Except Electrical	$8,544	7.6%	35.7%
Transportation Equipment	$2,812	8.1%	3.2%	Plastics & Rubber Products	$6,474	5.8%	80.5%
Other	$11,732	33.7%		Other	$38,995	34.7%	

Source: U.S. Census Bureau, *USA Trade Online*, May 4, 2021. *https://usatrade.census.gov/*.

Advanced Technology Products

- **U.S. ICT product imports led a $23.5 billion deficit in ATP with China in Q1 2021.** Given a sharp contraction from the COVID-19 pandemic, the U.S. trade deficit with China in advanced technology products (ATP) increased 61 percent year-on-year to reach $23.5 billion (see Table 3).[11] The deficit was nonetheless well below 2018 levels, when it reached $33.4 billion in the first quarter.[12] Information and communications technologies (ICT) continued to constitute the vast majority of U.S. ATP imports from China in Q1 2021. This category includes items manufactured by U.S. multinationals in China, such as Apple iPhones.[13] Excluding ICT products, the United States ran a $5.3 billion surplus in ATP with China.[14]

[*] Unless otherwise specified, U.S. trade in goods reflects categories under the North America Industry Classification System (NAICS) used at the three-digit level (e.g., "111 Agricultural Products"). NAICS is a standard used by Federal agencies to classify business establishments in gathering and analyzing data on the U.S. economy. It was developed by the U.S. Economic Classification Policy Committee, Statistics Canada, and the Mexican Instituto Nacional de Estacistica y Geografia, with support from the U.S. Office of Budget and Management, to create comparable business statistics between the North America Economies. Adopted in 1997, it replaced the Standard Industry Classification System. U.S. Census Bureau, "North American Industry Classification System." *https://www.census.gov/naics/*.

- **Among U.S. ATP exports to China, electronics and flexible manufacturing exports[*] surged above pre-pandemic and trade tension levels**. By contrast, aerospace products, a top U.S. export to China routinely constituting more than $1 billion per quarter, declined year-on-year to only $855 million, with decreased travel due to COVID-19 likely exacerbating a multi-year trend; previously, this export category dropped from $3.2 billion in Q1 2019 to $1.1 billion in Q1 2020.[†] [15]

Table 3: U.S.-China ATP Trade, Q1 2021
(US$ millions)

	Exports	Imports	Balance Q1'2021	Balance Q1'2020	Balance YOY
TOTAL	**$8,872**	**$32,388**	**-$23,517**	**-$14,607**	**61.0%**
(01) Biotechnology	$1,076	$141	$935	$110	748.0%
(02) Life Science	$1,167	$693	$475	$354	33.9%
(03) Opto-Electronics	$97	$572	-$475	-$409	16.2%
(04) ICT	$955	$29,797	-$28,841	-$18,047	59.8%
(05) Electronics	$3,166	$760	$2,406	$1,665	44.4%
(06) Flexible Manufacturing	$1,461	$208	$1,253	$840	49.2%
(07) Advanced Materials	$69	$46	$23	$27	-14.0%
(08) Aerospace	$855	$122	$732	$841	-12.9%
(09) Weapons	$2	$48	-$46	-$15	210.5%
(10) Nuclear Technology	$24	$2	$22	$25	-12.4%

Source: U.S. Census Bureau, *U.S. Trade in Advanced Technology Products by Country (YTD MARCH 2021)*, May 4, 2021. *https://www.census.gov/foreign-trade/statistics/product/atp/select-atpctry.html.*

Pandemic Impacts Bring U.S.-China Services Trade to New Low in 2020

- **Impact of pandemic-related travel restrictions evident in a weak year for U.S.-China services trade in 2020.** U.S. services exports to China fell 32.9 percent from 2019, with overall U.S.-China bilateral services trade dropping a total of 30.3 percent in 2020. The U.S. services trade surplus experienced its fifth consecutive decline, dropping 4.4 percent from $5.2 billion in Q3 (see Figure 2).[16] In Q4 2020, U.S. services exports to China increased 1.9 percent from the previous quarter but fell 30.8 percent year-on-year.

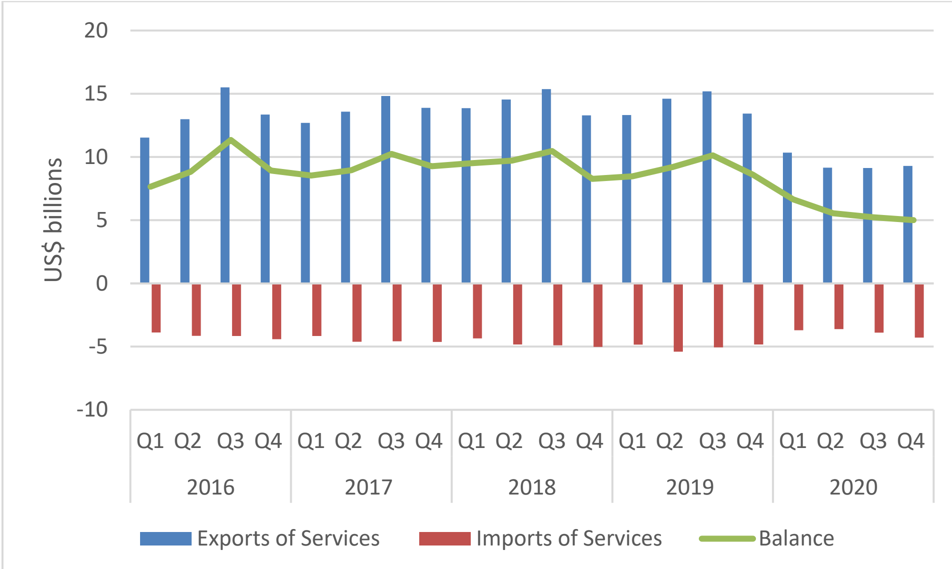
- **Services related to tourism and culture primarily account for the precipitous decline between 2019 and 2020, with travel services exports alone plummeting by 48.6 percent.** Pandemic-era travel restrictions imposed in Q1 2020 halted typical travel of overseas students, which normally translates into higher U.S. services exports between Q2 and Q3. (Travel, including for purposes of education, accounted for half of all services exports to China in 2019.) Despite the overall slump in U.S. services exports, there were some notable gains in Q4 2020 from the previous quarter, including a 12.9 percent rise in the export of charges for intellectual property (IP), the second-largest U.S. services export to China in 2020 (see Figure

[*] Flexible manufacturing systems are able to produce different components without significant retooling. Exports in this category consist primarily of robotics, numerically-controlled machine tools, and other products involved in industrial automation. U.S. Census Bureau, "Advanced Technology Product Code Descriptions." *https://www.census.gov/foreign-trade/reference/codes/atp/index.html*. Gordana Colovic, *Management of Technology Systems in Garment Industry*, Woodhead Publishing India Pvt Ltd, 2011, 153-196. https://doi.org/10.1533/9780857094049.153

[†] China's Civil Aviation Administration has not re-certified the Boeing 737 MAX since grounding it in March 2019, contributing to the sharp drop off in U.S. aerospace exports to China. Boeing's revenues from China dropped 58.7 percent from $13.8 billion in 2018 to $5.7 billion in 2019, and dropped further to $1.8 billion in 2020. Other major markets have approved the jet to fly again following the U.S. approval in November 2020. Amanda Lee and Cissy Zhou, "China Unlikely to Certify Boeing 737 MAX To Fly Again Any Time Soon, Analysts Say," *South China Morning Post*, May 2, 2021. *https://www.scmp.com/economy/china-economy/article/3131973/china-unlikely-certify-boeing-737-max-fly-again-any-time-soon*; Tim Hepher, David Shepardson, and Eric M. Johnson, "Boeing Urges U.S. to Separate China Trade and Human Rights," Reuters, March 31, 2021. *https://www.reuters.com/article/us-usa-trade-boeing/boeing-urges-u-s-to-separate-china-trade-and-human-rights-idUSKBN2BN30A*; Boeing, Form 10-K (2021), February 1, 2021, 126. *https://www.sec.gov/ix?doc=/Archives/edgar/data/12927/000001292721000011/ba-20201231.htm*.

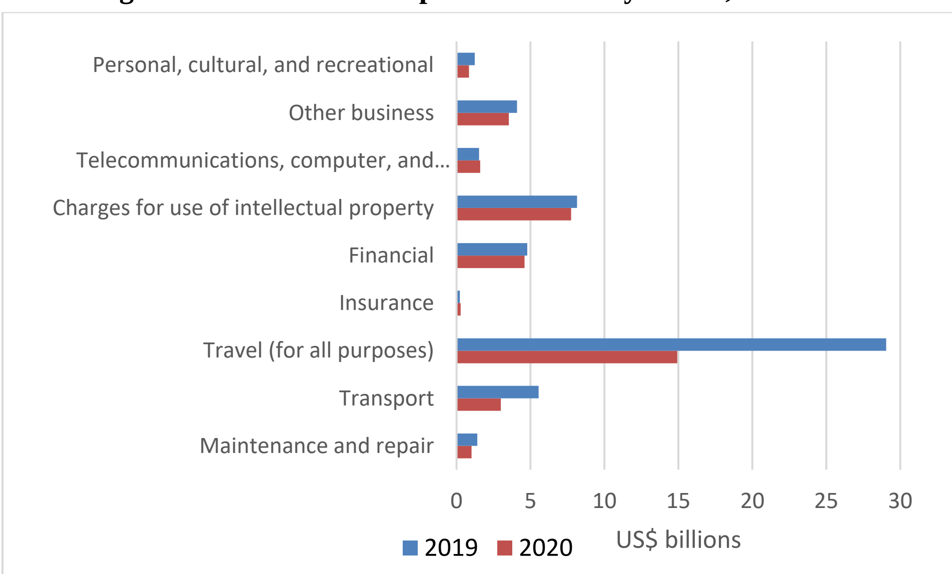
3). Other business services,* the fourth-largest U.S. services export to China in 2020 and the only other services sector to experience double-digit growth, rose by 15.2 percent from Q3 to Q4.[17]

Figure 2: U.S.-China Trade in Services, Q1 2016–Q4 2020



Source: U.S. Department of Commerce Bureau of Economic Analysis, *Table 1.3. U.S. International Transactions, Expanded Detail by Area and Country ((A, QNSA) (2003-present))*, March 23, 2021. *https://apps.bea.gov/iTable/iTable.cfm?ReqID=62&step=1*.

Figure 3: U.S. Services Exports to China by Sector, 2019–2020



Source: U.S. Department of Commerce Bureau of Economic Analysis, *Table 1.3. U.S. International Transactions, Expanded Detail by Area and Country ((A, QNSA) (2003-present))*, March 23, 2021. *https://apps.bea.gov/iTable/iTable.cfm?ReqID=62&step=1*.

- **Increases in U.S. exports in two categories—insurance services and telecommunications, computer, and information services—may reflect changes in Chinese policy.** Only two sectors saw export growth

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* "Other business services" is a catch-all category that includes research and development services, professional and management consulting services, and technical or trade-related business services. Some other services transactions related to construction as well as personal, cultural, and recreational services are categorized under this classification as well to cover the management and administration work in these areas. U.S. Department of Commerce Bureau of Economic Analysis, *U.S. International Economic Accounts: Concepts and Methods*, September 22, 2014, 10–52. *https://www.bea.gov/sites/default/files/methodologies/ONE%20PDF%20-%20IEA%20Concepts%20Methods.pdf#page=50*.

over the course of 2020: insurance services (by 26 percent) and telecommunications, computer, and information services (by 4.2 percent).[18] These two sectors combined accounted for less than 5 percent of total U.S. services exports to China in 2020. The Chinese government committed to limited market openings for the financial services and insurance sectors in the Phase One deal.[19] China's Ministry of Commerce also eliminated restrictions on foreign investment in telecommunications (e.g., call center services) and life insurance when it removed items from the 2019 and 2020 negative lists, which enumerate sector-based restrictions on foreign investment and control.[20]

China's IP Regime Once Again in the Spotlight

In its annual Special 301 Report released April 30, the Office of the U.S. Trade Representative (USTR) found the Chinese government continues to make uneven progress in addressing longstanding U.S. concerns about IP protection and enforcement. The report comes as Beijing advances new regulations that may complicate the ability of foreign businesses to store IP relevant to their China operations both in China and abroad. The pattern is most readily apparent in the Chinese government's recent policies on semiconductor industry development, which reflect new efforts to secure access to foreign technology.

New USTR Special 301 Report Highlights Gaps in China's IP Regime

The USTR's 2021 Special 301 Report[*] points to the Chinese government's ongoing failure to address longstanding U.S. concerns regarding uneven IP protection and enforcement.[21] For the 17th year in a row, the USTR placed China on its "Priority Watch List."[†] This year's report is notable in its broadened coverage of the full range of regulatory deficiencies in China's IP regime, cataloguing China's civil, criminal, and administrative enforcement challenges.[22] It also draws attention to issues that remain unresolved, such as continued bad faith trademarks[‡] and rampant counterfeiting in the Chinese market, noting the latter has been exacerbated by the COVID-19 pandemic's acceleration of online shopping.[§] [23]

While the USTR welcomed the Chinese government's recent legislative measures to strengthen IP protection per commitments made under the Phase One agreement, such as amendments to the Patent and Copyright Laws, it cautioned that it remains to be seen whether these measures will meaningfully address existing challenges to rights holders.[24] According to Mark Cohen, Director for the Berkeley Center for Law and Technology at the University of California, Berkeley, the Chinese government's amendments to national laws governing IP rights do not necessarily create binding obligations at the provincial and lower levels of government in China.[25] For example, China's Law on Legislation stipulates that local-level regulations can override national-level ones within the locality

[*] The "Special 301" Report is an annual review of the adequacy and effectiveness of U.S. trading partners' protection and enforcement of IP rights. This review is conducted pursuant to Section 182 of the Trade Act of 1974, as amended by the Omnibus Trade and Competitiveness Act of 1988 and the Uruguay Round Agreements Act. Office of the U.S. Trade Representative, *USTR Releases Annual Special 301 Report on Intellectual Property Protection*, April 30, 2021. *https://ustr.gov/about-us/policy-offices/press-office/press-releases/2021/april/ustr-releases-annual-special-301-report-intellectual-property-protection*.

[†] A country's placement on the list indicates that problems regarding IP protection, enforcement, or market access for U.S. entities relying on IP remain unaddressed. Aside from China, the USTR placed Argentina, Chile, India, Indonesia, Russia, Saudi Arabia, Ukraine, and Venezuela on the list in 2021. Office of the U.S. Trade Representative, *2021 Special 301 Report*, April 30, 2021, 5–6. *https://ustr.gov/sites/default/files/files/reports/2021/2021%20Special%20301%20Report%20(final).pdf*.

[‡] A bad faith trademark refers to a trademark filed in one jurisdiction that is the same or very similar to one filed by the original rights holder in another jurisdiction. Trademarks can include a product or brand name, logo, slogan, or even shape of a product. Businesses rely on these marks to identify their products and differentiate them from those offered by competitors while consumers rely on them to distinguish among competing producers and determine authenticity. Protections granted to these trademarks exist only within the country whose law granted the rights to the trademark. The USTR 2021 Special 301 report finds many Chinese companies continue to file trademarks with the Chinese government that are similar to those otherwise owned by U.S. companies, enabling Chinese firms to pass off counterfeit products as the same as or similar to those produced by the U.S. trademark holder. According to the report, China continues to be the world's leading source of counterfeit and pirated goods, with China and Hong Kong accounting for over 80 percent of U.S. IP seizures. Office of the U.S. Trade Representative, *2021 Special 301 Report*, April 30, 2021, 43-44. *https://ustr.gov/sites/default/files/files/reports/2021/2021%20Special%20301%20Report%20(final).pdf*; U.S. Patent and Trademark Office, "Don't Sit and Wait: Stopping Trademark Squatters," July 19, 2016. *https://www.uspto.gov/learning-and-resources/newsletter/inventors-eye/dont-sit-and-wait-stopping-trademark-squatters*.

[§] While total retail sales in China declined 3.9 percent year-on-year in 2020, online retail sales grew 10.9 percent in the same period, reaching $1.8 billion. China's National Bureau of Statistics via CEIC database.

in which they are enacted.[26] Accordingly, the Special 301 Report notes the USTR is liaising with U.S. businesses and other stakeholders to evaluate whether recent legislative changes in China have resulted in improved IP rights protection at the national, provincial, and local levels.[*] [27]

Beijing Seeks to Secure "Indigenous Innovation" through IP Regulatory Changes

The Special 301 Report comes as China's government increasingly links IP regulation with national development and seeks to advance "indigenous innovation." In a press conference on April 25, Shen Changyu, head of China's National Intellectual Property Administration, said the Chinese government deemed IP essential to China's "future development and competitiveness," while Premier Li Keqiang separately described the safeguarding of IP rights as "protecting innovation."[28] The comments followed the Chinese Communist Party's (CCP) issuance of the far-reaching 14th Five-Year Plan,[†] which called for increases in "high value patent" ownership and pledged to scrutinize outbound transfers of IP.[29]

The Chinese government is also tying IP rights more closely to notions of national security, with implications for the imposition of Chinese IP regulations globally. Article 16 of the IP Judicial Protection Plan (2021–2025) issued by the Supreme People's Court on April 22 notes the Chinese government will promote the "extraterritorial application of China's laws and regulations" and "safeguard national security" in advancing its IP regime.[30] The Chinese government's decision to view IP through a national security lens raises concerns that foreign companies and IP holders will fall afoul of the Chinese government's vague but expanding framing of national security. In late April, Bloomberg reported that new measures announced by China's Ministry of State Security will enable it to draft lists of Chinese companies and organizations deemed "susceptible to foreign infiltration."[31] China's security agencies could then access computer systems and data held by the companies and organizations placed on such lists.[32] Without clarifications on what companies would be listed, the vagueness of the rules raises the risk that foreign business partners of Chinese companies placed on the list could have their data and technology made available to China's government, creating additional pathways to extract foreign IP and technology.[‡]

The government is also tightening its control over company data. China's National People's Congress is considering adding a clause to the country's draft Data Security Law[§] that would punish companies operating in China, whether foreign or Chinese, for sharing domestically stored data with foreign law enforcement agencies without Beijing's consent.[33] Such policies are likely to complicate operations for U.S. and other foreign businesses in China. Any U.S. company (or Chinese company partnered with one) would be required to refuse a U.S. court request to access data otherwise stored in China without the Chinese government's approval.[34] These restrictions on the movement

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[*] Observers question whether U.S. companies will be forthright in discussing their experience with China's coercive regulations. Fearing retaliation, many companies are reluctant to admit they have been pressured to share knowledge or technology with their Chinese business partners. That said, some businesses report improved IP rights protection in China. For example, in the American Chamber of Commerce China's 2020 Business Climate Survey, only 37 percent of U.S. companies felt the risks of IP leakage or data security threats were greater in China than in other markets, lower than the 53 percent of respondents who felt this way in 2018. Mark Cohen, "What the 301 Report Says about Future Relations on IP with China," *China IPR Blog*, May 3, 2021. *https://chinaipr.com/2021/05/03/what-the-301-report-says-about-future-relations-on-ip-with-china/*; Trefor Moss, "U.S. Companies in China Say Political Tensions Remain Top Concern," *Wall Street Journal*, March 8, 2021. *https://www.wsj.com/articles/u-s-companies-in-china-say-political-tensions-remain-top-concern-11615248000*.

[†] For an in-depth review of China's 14th Five-Year Plan, see U.S.-China Economic and Security Review Commission, "14th Five-Year Plan Sets Visions for 2021–2025 and Beyond" in *Economics and Trade Bulletin*, April 2021. *https://www.uscc.gov/sites/default/files/2021-04/April_2021_Trade_Bulletin.pdf*.

[‡] For more on how Chinese companies—in many cases with the backing of the Chinese government—acquire U.S. technology and IP, see Sean O'Connor, "How Chinese Companies Facilitate Technology Transfer from the United States," *U.S.-China Economic and Security Review Commission*, May 6, 2019. *https://www.uscc.gov/sites/default/files/Research/How%20Chinese%20Companies%20Facilitate%20Tech%20Transfer%20from%20the%20US.pdf*.

[§] Such an addition would reinforce the troubling pattern of China's digital governance regime asserting extraterritorial jurisdiction over data and internet activity outside of China. China's draft data security law, released in July 2020, grants Chinese law enforcement the power to access data and regulate, investigate, and prosecute data controllers located outside of China that harm "the national security, the public interest, or the law interests of [Chinese] citizens or organizations." Lester Ross, Kenneth Zhou, and Tingting Liu, "China Publishes Draft Security Law," *Wilmer Hale*, July 10, 2020. *https://www.wilmerhale.com/en/insights/client-alerts/20200710-china-publishes-draft-data-security-law*.

of data could cover personal and corporate data, which may potentially include IP, and formalize the Chinese government's tools for controlling access to foreign technology capabilities and expertise.*

Beijing Eyes Foreign IP in Advancing Chip Ambitions

Recent policies focused on the development of China's semiconductor industry suggest the Chinese government is evolving the mechanisms it uses to extract foreign IP and technology and then control them within China's borders. Since August 2020, the Chinese government has advanced an array of measures to support the development of China's semiconductor industry.† For example, measures jointly issued by China's General Administration of Customs, State Taxation Administration, and Ministry of Finance encourage foreign semiconductor companies to transfer technology, IP, talent, and research and development activities into China by offering preferential tax, tariff, and financing terms for firms willing to establish related capabilities in the country.[35] While the Chinese and other governments have long deployed such tactics to secure foreign technology and expertise, guidance issued by the National Development and Reform Commission on March 31 clarifies only Chinese entities can own any IP secured via the aforementioned measures, forbidding simultaneous foreign ownership or control of the same IP outside of China absent licensing agreements allowing otherwise.‡ [36] Read together, the measures underscore the Chinese government's efforts to secure access to foreign expertise, capabilities, and IP as it pursues its ambitions for technological development.

Boao Forum: CCP Seeks to Portray China as a Champion of Economic Openness

The Boao Forum for Asia, held from April 18 to 21, was the first major international meeting to be held primarily in person this year.[37] The conference, often described as China's version of the World Economic Forum, had the theme "A World in Change: Join Hands to Strengthen Global Governance and Advance Belt and Road Cooperation." More than 2,000 in-person participants attended the forum, including Chinese and foreign government leaders, officials from international organizations, business executives, and journalists.[38] Drawing on the forum's theme, General Secretary of the CCP Xi Jinping presented the Chinese government as a leader of global cooperation and economic globalization, including through the Belt and Road Initiative (BRI). In comments clearly aimed at the United States, General Secretary Xi condemned unnamed countries for decoupling and their "cold-war and zero-sum mentality."[39] While General Secretary Xi sought to portray China as a champion of economic openness, at the same forum Chinese officials emphasized the government's ability to manage the economy, including by controlling volatility in the stock market caused by inflows of foreign capital.

- *General Secretary Xi portrays the CCP as a champion of economic growth and global cooperation while condemning unnamed "big countries" for unilateralism and Cold War thinking:* Noting the centennial of the CCP, General Secretary Xi portrayed the Party as critical to China's economic development, which he described as a "notable contribution to human civilization and progress."[40] General Secretary Xi also claimed the Chinese government was an advocate of "democracy and freedom," global governance, and economic globalization.[41] He contrasted China's actions with those of nameless countries attempting to "meddle in others' internal affairs," engage in "ideological confrontation," and limit economic engagement through policies including

* The proposed restrictions on the movement of data echo other regulatory actions recently taken by the Chinese government. For example, China's Biosecurity Law, enacted in 2020, requires foreign pharmaceutical companies conducting research with Chinese business partners to seek the Chinese government's approval prior to transferring any research data outside of China. Office of the U.S. Trade Representative, *2021 Special 301 Report*, April 30, 2021, 47. *https://ustr.gov/sites/default/files/files/reports/2021/2021%20Special%20301%20Report%20(final).pdf*.

† For a detailed review of these recent measures, see Karen Sutter, "China's New Semiconductor Policies: Issues for Congress," *Congressional Research Service* R46767, April 20, 2021. *https://crsreports.congress.gov/product/pdf/R/R46767*.

‡ In a typical IP licensing deal in China, a foreign licensor may grant a Chinese licensee the right to produce or sell goods, use the licensor's brand or trademark, or use the licensor's technology. A license-back clause or provision requires the licensee to license back to the licensor certain rights to practice the IP or improvements to the IP. Dan Harris, "China Licensing Deals So Horrible They Are Hard to Believe," *Harris Bricken*, September 24, 2018. *https://harrisbricken.com/chinalawblog/china-licensing-deals-so-horrible-they-are-hard-to-believe-is-this-a-new-scam/*; *Origin Technology and IP Law Glossary*, "License-Back Clause, Provision," June 14, 2013. *http://www.ipglossary.com/glossary/license-back-clause-provision/*.

decoupling, which General Secretary Xi described as "counter to the law of economics and market principles."[42] In the past year, the CCP has faced rising criticism from the United States and other countries for its human rights violations in Hong Kong and Xinjiang, use of economic coercion to limit criticism by governments and companies, and use of subsidies and forced technology transfers to promote domestic companies.

- *Chinese representatives defended BRI at the Boao Forum by emphasizing its focus on cooperation and the role of recipient country demand:* General Secretary Xi claimed the BRI "aims at mutual benefits" and portrayed the initiative as representative of the Chinese government's commitment to multilateral cooperation.[43] The forum's focus on promoting the BRI comes amid increasing concerns regarding debt levels in BRI countries, especially given the lack of transparency by the Chinese government about the amounts, terms of the loans, or conditions for renegotiating debt.[44] Statements at this year's forum by Zhou Xiaochuan, former governor of the People's Bank of China (PBOC), were aimed at diffusing this criticism by claiming the BRI meets demand in developing countries, while also allowing China to export overcapacity. Mr. Zhou also sought to dispel accusations that BRI projects are driven by the state, saying, "The banks take decisions by themselves, they are not told to do it, and the financing is based on the market rates."[45]

- *Chinese officials encouraged foreign investment, hosted prominent U.S. business leaders:* General Secretary Xi's speech stressed the importance of China developing a "higher-standard open economy" and welcomed investors to "share in the vast opportunities of the Chinese market."[46] Several prominent U.S. business leaders, including Tim Cook of Apple, Elon Musk of Tesla, Ray Dalio of Bridgewater, and Stephen Schwarzman of Blackstone, participated in the conference.[47] In recent months, the Chinese government has been particularly vocal in calling for U.S. companies with economic interests in China to urge the U.S. government to defuse trade frictions with China.[48]

- *CCP stresses its ability to prevent volatility from increased foreign capital inflows:* At the same time they are promoting capital inflows, Chinese officials are attempting to mitigate the potential that increased flows of foreign capital could expose the domestic market to equity bubbles and other instability in foreign markets.[49] China's post-COVID economic recovery and opening to foreign capital have been driving foreign capital inflows: China received $46 billion in foreign direct investment in the first quarter of 2021, up 40 percent year-on-year.[50] The services sector received $36.6 billion in investment, up 51.5 percent year-on-year, and investment in the high-tech sector was up 32.1 percent year-on-year.[51] In recent weeks, Chinese officials have criticized U.S. economic stimulus for negatively impacting developing economies by "[exacerbating] global liquidity" and creating unstable demand.[52] Fang Xinhai, vice chairman of the China Securities Regulatory Commission (CSRC), said the CSRC will maintain daily quotas on foreign investment in mainland stock markets through the stock connect programs that link the Hong Kong stock market with the Shanghai and Shenzhen markets[*] and could temporarily suspend trading by foreign investors found to cause "significant volatility in the stock market."[53] Foreign investors currently hold 5 percent of Chinese stocks, according to Mr. Fang, representing $520 billion of China's $10.9 trillion market in 2020.[54]

Quarterly Review of China's Economy

China's Lopsided Recovery Slows amid Signs of Slackening Manufacturing Growth

China's economy grew by 18.3 percent year-on-year in Q1 2021 according to official data released by China's National Bureau of Statistics (see Figure 4).[†] [55] Double digit year-on-year growth overstates the actual performance

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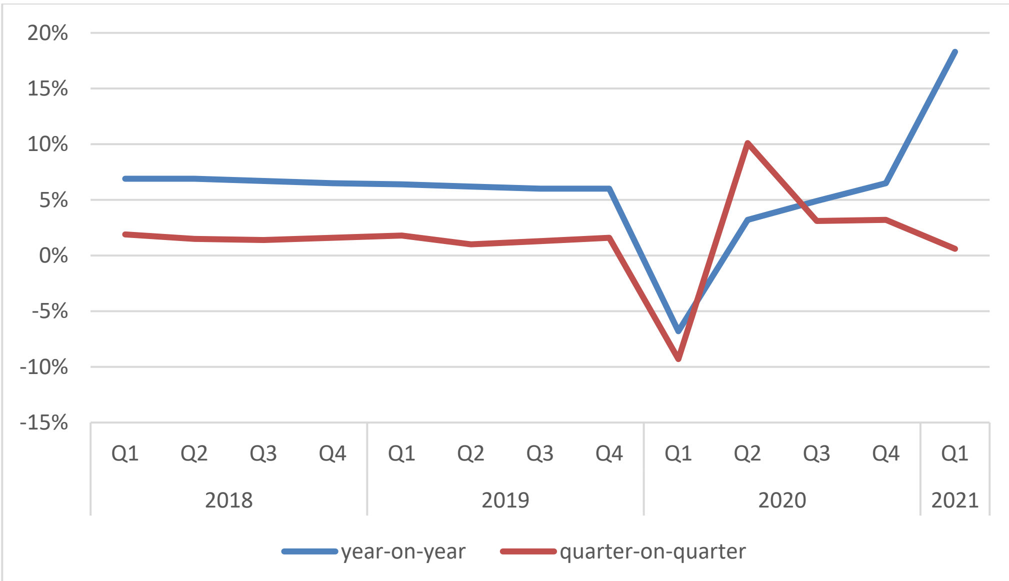
[*] Stock Connect, which links China's mainland markets and the Hong Kong Stock Exchange, currently restricts daily flows into China to $7.9 billion and daily flows to Hong Kong from China to $6.5 billion. China's State Administration of Foreign Exchange and the central bank listed quota restrictions on investments through the Qualified Foreign Institutional Investor program (QFII) and the RMB Qualified Foreign Institutional Investor program (RQFII) in May 2020. More than 400 foreign institutional investors had participated in the program as of May 2020. Cissy Zhou, "China Ready with 'Precautionary Measures' to Stop Foreign Traders Causing Market Volatility, Regulator Says," *South China Morning Post,* April 20, 2021. *https://www.scmp.com/economy/china-economy/article/3130325/china-ready-precautionary-measures-stop-foreign-traders*; Peng Qinqin and Denise Jia, "China Scraps Quota Limits on QFII, RQFII Foreign Investment Systems," Caixin, May 8, 2020. *https://www.caixinglobal.com/2020-05-08/china-scraps-quota-limits-on-qfii-rqfii-foreign-investment-systems-101551248.html*.

[†] Quarterly and monthly economic growth are usually given relative to the same period in the preceding year to eliminate seasonal affects, which may create more variability between months or quarters that obscure deeper macroeconomic trends. Because of the contraction

of China's economy, given the 6.8 percent contraction it experienced in Q1 2020 during the onset of the COVID-19 pandemic.[56] Though the headline figures suggest China's economy has been recovering for four consecutive quarters, quarter-on-quarter growth highlights a different trend. In Q1 2021, China's economy grew only 0.6 percent compared to Q4 2020, the lowest on record except for the first quarter of 2020 and a clear slowdown compared to 3.2 percent quarter-on-quarter growth the preceding quarter.[57] Since the spring of 2020, China's recovery has been lopsided, with strong industrial output overshadowing faltering consumption.[58] In a reversal of this trend during Q1 2021, total retail sales bounced back 33.9 percent compared to Q1 2020, and up 1.86 percent from Q4 2020, but consumption is still far from powering growth.[59] Weak March indicators for industrial production, investment by nonstate firms, and credit expansion are likely to compound the slowing recovery.[60]

Figure 4: China's Official GDP Growth, 2018–Q1 2021
(year-on-year)



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

For the past year, economic recovery in China has been highly uneven, driven by stimulus policies that favor investment and producers as well as the rebound in the U.S. economy, which has helped Chinese exporters. In Q1 2021, export-oriented manufacturing continued to grow quickly, while investment in property development, a key driver of other economic activity, grew 25.6 percent year-on-year.[61] Households and the services sector, by contrast, have been left behind in China's recovery. Prior to the pandemic, China's services sector accounted for 63.5 percent of gross domestic product (GDP) growth, nearing levels above 70 percent common in many high-income countries.[*] [62] After dropping to 47.3 percent in 2020, the services sector reached only 50.9 percent of GDP in Q1 2021.[63] Recovery of the services sector is extremely important for restoring employment and thus boosting consumption—a key objective for the Chinese government.[64]

The consequences of uneven recovery are apparent in diverging inflation indicators for China's producers versus consumers. The producer price index (PPI), a benchmark for the rate at which production input costs are increasing, grew sharply in the first quarter of 2021, reaching 104.4 in March.[†] Meanwhile, China's Consumer Price Index

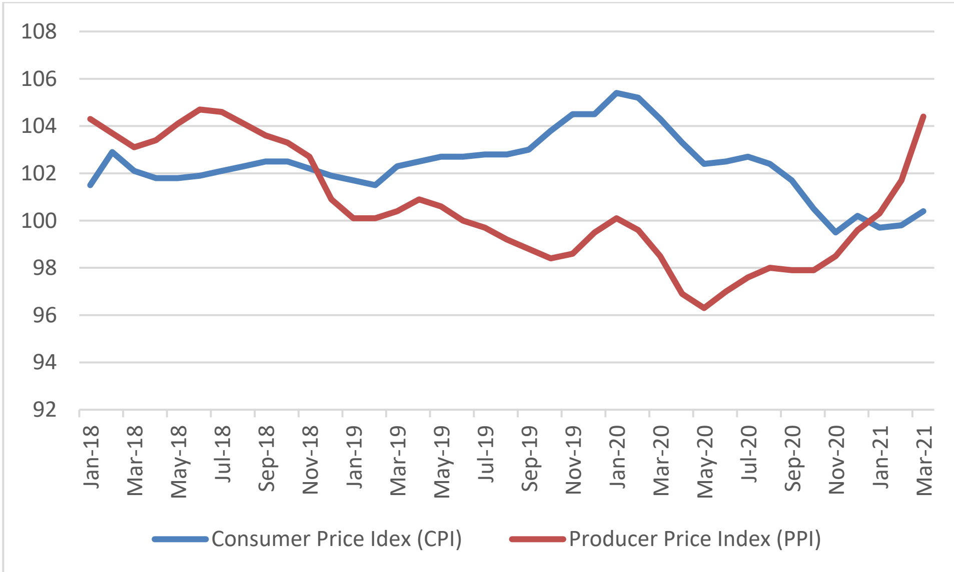
caused by the COVID-19 pandemic, however, year-on-year growth for many of China's economic indicators will seem to overstate the dynamism of the economy, so quarter-on-quarter growth is also listed throughout this section.

[*] Services contributed roughly 80 percent of U.S. GDP growth in 2017, for instance. High-income, manufacturing-dependent economies Japan, South Korea, and Germany all have services ratios slightly below 70 percent. U.S. Central Intelligence Agency, "GDP – Composition, By Sector of Origin," *World Factbook*. *https://www.cia.gov/the-world-factbook/field/gdp-composition-by-sector-of-origin/*.

[†] For both inflation indicators, a value greater than 100 indicates prices are increasing, while a value below that indicates deflation. China's consumer inflation target for the year, unveiled in the annual Government Work Report during March, is "around 3 percent." Stella Qiu and Kevin Yao, "China Sets 'Low Bar' for GDP Growth, Pledges More Jobs," *Reuters*, March 4, 2021. *https://www.reuters.com/article/us-china-parliament-gdp/china-sets-low-bar-for-gdp-growth-pledges-more-jobs-idUSKBN2AX03L*.

(CPI) climbed to 100.4 in March after being in deflationary territory for the first two months of the year, reflecting slackening demand for consumer goods (see Figure 5).[65]

Figure 5: China's Consumer and Producer Price Indices, 2018–March 2021



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

Continued divergence of producer prices and domestic consumer demand threatens China's recovery, as producers will either need to pass increased input costs onto consumers, accept lower profit margins, or export their products. The last option is likely to come under pressure, however, because competition from other major exporters will increase as the rest of the world resumes production.[66] Overall, the macroeconomic dynamics of China's recovery are almost opposite of those envisioned by its leadership in the "Dual Circulation Strategy," which aims to supplant external demand with domestic consumption.[*]

Economic headwinds were also evident in monthly indicators for industrial production and nonstate investment in March 2021, in comparison to first quarter trends. As Logan Wright and Allen Feng of Rhodium Group observe, year-on-year industrial value-added growth of 14.1 percent (and monthly growth of just 0.6 percent) fell far below market expectations, weighed down by weak production of heavy vehicles and a decline in export demand.[67] Similarly, analysts at Trivium China noted that investment in the manufacturing sector and nonstate sector fixed-asset investment also slowed in March, down to 2.2 percent and 2.5 percent growth, respectively, compared to 2.9 and 5 percent growth for the first two months of the year.[68] These trends both suggest manufacturing will contribute less to growth in the coming months. An abrupt jump in retail sales growth in March 2021 to 34.2 percent year-on-year and 1.75 percent over the previous month constituted a bright spot with monthly data but does not suggest a reversal of overarching trends in weak household consumption is enough to offset slowing production.[69] Urban income growth, a key driver of consumption, has not kept pace with China's economic recovery, growing 12.2 percent in Q1 2021 compared to the same period in 2020.[70]

Debt Pressures Mount amid COVID-19 Recovery

China has touted its economic recovery amid the global economic downturn in 2020, yet its growth has come at a price. According to the PBOC, in Q1 2021 China's debt-to-GDP ratio stood at 276.8 percent, a 20.9 percentage point increase above 2019 levels.[71] Estimates of China's debt vary due to the opacity of China's economic data reporting and the ubiquitous presence of the shadow banking sector,[†] which by nature is impossible to estimate

[*] For further discussion of the "Dual Circulation Strategy," see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, April 30, 2021, 4. *https://www.uscc.gov/trade-bulletins/april-2021-trade-bulletin*.

[†] Shadow banking is lending that occurs outside the formal banking sector and is therefore not subject to the same prudential regulations as bank lending. Examples of shadow banking components include trust loans, entrusted loans, peer-to-peer lending, wealth management products, certain kinds of asset management plans, and structured deposits. For more background on China's shadow banking sector, see

fully. China's debt is of growing concern as it opens its markets to international investors and financial institutions, thus increasing international exposure to its domestic financial risks.[*] [72] Debt growth in 2020 is largely a result of China's fiscal stimulus and credit injection in response to economic contraction in Q1 2020, which channeled credit to state-owned enterprises (SOEs), encouraged local government spending on infrastructure, and provided tax and fee reductions for households and small businesses.[73] Facing reduced revenue streams but a mandate to maintain expenditures, local government debt raised through public bonds, local SOEs, and local government financing vehicles (LGFVs)[†] accounts for a substantial portion of new debt accumulation since the onset of the pandemic.[74]

Though China's deleveraging campaign took a backseat to fiscal stimulus during 2020, Chinese policymakers have indicated de-risking is once again a priority this year. The 2021 Government Work Report, which was delivered by Premier Li to the delegates of the National People's Congress during the annual "Two Sessions" legislative conference in March, highlights what the CCP views as the critical role of deleveraging to promote high-quality development within the real economy.[75] In setting a modest GDP growth target of more than 6 percent for 2021,[‡] the work report also signaled to officials that they need not engage in excessive stimulus efforts this year to promote growth.[76] With a growing focus on the quality of economic growth and tapering stimulus, Chinese policymakers are targeting new de-risking policies at local governments and the property sector, two engines of China's post-pandemic recovery that are also highly leveraged.

State Council Targets Local Government Debt

According to China's Ministry of Finance, in Q1 2021 outstanding local government debt stood at approximately $4 trillion (renminbi [RMB] 26.2 trillion). The actual amount of local government debt is likely much larger, however, due to "off balance sheet" borrowing via local government financing vehicles (LGFVs) and local SOEs.[77] China's Ministry of Finance calls funding raised through LGFVs "implicit debt," and it is not explicitly recognized as a government obligation, but investors often treat LGFV bonds as backed by the central government, creating moral hazard.[§] [78] A Chinese government-linked think tank estimated that by the end of 2020, local government implicit debt had reached approximately $2.3 trillion (RMB 14.8 trillion), bringing total local government debt up to approximately $6.3 trillion (RMB 41 trillion).[79] Signaling the Chinese government's renewed focus on reducing local implicit debts, a recent State Council circular on budget-management reform emphasized that the reduction and prevention of implicit local government debt would be strictly enforced, with local cadres held personally accountable for raising "problematic" debt during their terms.[80] The circular also targeted LGFVs, indicating they

U.S.-China Economic and Security Review Commission, Chapter 1, Section 1, "Year in Review: Economics and Trade," in 2017 Annual Report to Congress, November 2017, 49–50; U.S.-China Economic and Security Review Commission, Chapter 1, Section 3, "Governance and Accountability in China's Financial System," in 2013 Annual Report to Congress, November 2013, 113–152.

[*] China's debt poses systemic risk not just because of its total volume, but because debt is highly concentrated within the banking system, and the growth of off-balance-sheet financing via shadow banking products obscures the true size and composition of debt. For more background on systemic risks in China's financial system and their implications for the United States, see U.S.-China Economic and Security Review Commission, "Chapter 2, Section 2: Vulnerabilities in China's Financial System and Risks for the United States" in *2020 Annual Report to Congress*, December 1, 2020, 243–292. *https://www.uscc.gov/sites/default/files/2020-12/Chapter_2_Section_2--Vulnerabilities_in_Chinas_Financial_System_and_Risks_for_the_United_States.pdf*.

[†] Prior to the enactment of the most recent Budget Law in 2015, local governments could not legally issue municipal debt. Instead, they relied on LGFVs, SOEs controlled by the local governments, to raise capital on their behalf. Technically corporate debt, the proliferation of LGFV bonds exacerbates debt risk because it is not clear if the central government will intervene in the event of default, but bond holders may have purchased the debt under the assumption it was government backed. Philippe Wingender, "Intergovernmental Fiscal Reform in China," *International Monetary Fund Working Paper* 18/88, April 2018, 4–5, 13, 18; Donald C. Clarke and Fang Lu, "The Law of China's Local Government Debt Crisis: Local Government Financing Vehicles and Their Bonds," *George Washington University Law School* Public Law Research Paper No. 2016-31, June 2016, 1. *https://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2472&context=faculty_publications*.

[‡] A target of 6 percent year-on-year growth is modest given the Chinese economy's growth of 2.3 percent in 2020.

[§] Despite 2014 State Council provisions disavowing the central government's obligation to cover new LGFV bonds in the event of default, bondholders may assume China's central government will back debt associated with cities and provinces. In China's financial system, a default on local government implicit debt could cause creditors to other LGFVs to worry about the safety of their loans or bonds, and potentially spark a financial crisis. By contrast, in the United States the federal government is not liable for debt incurred by municipal governments. Detroit's bankruptcy in 2013 had no impact on perceptions of U.S. sovereign debt capacity or the integrity of the U.S. financial system. Zhuo Chen, Zhiguo He, and Chun Liu, "The Financing of Local Government in The People's Republic of China: Stimulus Loan Wanes and Shadow Banking Waxes," *Asian Development Bank Institute* Working Paper No. 008, January 2018, 11-12. *https://www.adb.org/sites/default/files/publication/396826/adbi-wp800.pdf*.

would no longer be permitted to accept guarantee documents from local officials or departments and should either restructure or initiate bankruptcy proceedings if they cannot repay their debts.[81]

The impact of Beijing's intensifying scrutiny of local government explicit and implicit debt is becoming visible as local governments planned to sell only approximately $34.4 billion (RMB 222.7 billion) in special purpose bonds, or municipal debt raised explicitly to fund approved projects in Q1 2021.[82] This represents an 80 percent decrease below 2020 levels.[83] As a result, local governments will likely announce fewer infrastructure projects in the near future and may reassess ongoing projects that are considered duplicative or of low economic return. In April alone, two high-speed rail projects in Shaanxi and Shandong provinces worth $20 billion (RMB 130 billion) were halted amid concerns about their commercial viability and excessive leverage.[84] While the central government's expectations for local governments to fuel economic growth have lessened as China tapers its fiscal stimulus measures, local governments' options for stimulating growth in the future are becoming increasingly narrow as Beijing increases oversight of local debt.

Policymakers Tighten Real Estate Sector Regulations

China's highly leveraged real estate sector is also a primary target of Beijing's de-risking efforts, and Chinese policymakers are increasingly relying on tighter banking oversight to remedy the problem. In January 2021, China's "three red line" policy, which outlines capitalization and borrowing criteria for real estate developers, came into effect. The "red lines" laid out in the framework (1) set a ceiling for developers' debt-to-asset ratios at 70 percent; (2) set net debt-to-equity ratios at 100 percent; and (3) cap short-term borrowing on par with cash reserves. If implemented, these rules threaten to cut off developers' access to new bank loans if criteria are not met, thereby potentially preventing China's multitude of highly leveraged developers from using new debt to expand their operations or service existing liabilities.[85] The PBOC has also instructed banks to improve their due diligence screenings to ensure operating loans made to businesses are not being used for real estate speculation, while local governments are imposing tighter property purchasing restrictions such as requiring purchasers to hold real estate assets longer before reselling them.[86]

Despite Beijing's attempts to limit credit growth to the real estate sector, Q1 2021 bank loans to the sector have increased by 10.9 percent year-on-year.[87] The pace of credit growth has slowed down, however, potentially indicating that tighter regulations are beginning to prevent large speculative inflows into the sector.[88] At the same time, real estate firms constituted 27 percent of China's Q1 2021 record corporate bond defaults amid the new regulations, demonstrating the regulations' impact on highly indebted developers.[89] There is also some likelihood that tighter regulations have caused some property developers to move their debts off of their balance sheets into the shadow banking sector. Regulators have been clear in their intentions to de-risk the sector, however, and will likely continue to roll out new regulations to counteract circumvention and decrease options for shadow financing.[*][90] If successful, Beijing's regulatory tightening of both real estate and shadow banking could reduce systemic risks and prevent overheating in the sector. Such efforts may ultimately contribute to slowing growth as real estate continues to be an important engine of China's economy. While the Chinese government has said it will allow indebted firms to fail, rising defaults in the real estate sector will likely test the extent to which policymakers are willing to deleverage the sector.

Huarong Woes Raise Concerns about China's Debt Sustainability

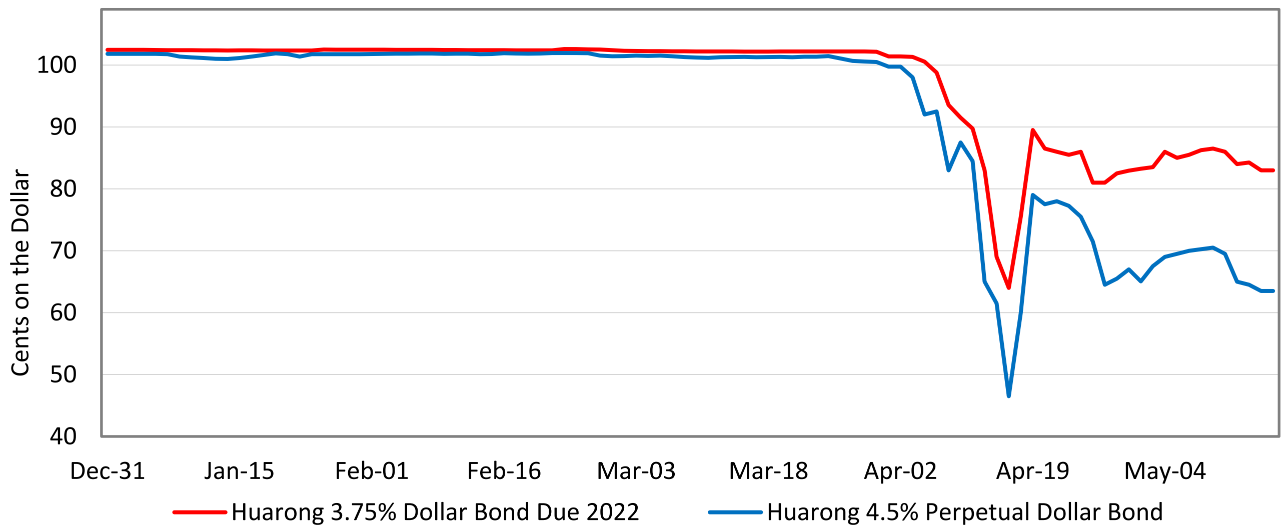
On April 1, Hong Kong-listed shares of state-owned China Huarong Asset Management Company[†] were suspended from trading after the company failed to meet a March 31 deadline for publishing its 2020 annual report.[91] The

[*] According to estimates by China Banking and Insurance Regulatory Commission (CBIRC), between 2017 and 2019, assets within China's shadow banking sector decreased by approximately 16 percent from their peak of $15.6 trillion in 2017 as a result of regulators' efforts to defuse systemic financial risks. While shadow banking assets grew during the pandemic due to expansionary monetary and fiscal policy, analysts at Moody's Investor Services predict that the expansion will be short-lived as stimulus measures recede and regulators resume their efforts to cut off options for shadow financing. Michael Taylor and Lillian Li, "Moody's - China's Shadow Banking Sector Continues to Dim as Regulators Seek to Contain Systemic Risk," *Moody Corporation*, January 4, 2021. *https://www.moodys.com/research/Moodys-Chinas-shadow-banking-sector-continues-to-dim-as-regulators--PBC_1258754*.

[†] The firm is majority owned by the Chinese government, with China's Ministry of Finance holding 57 percent of the firm's common stock outstanding, followed by China's National Council for Social Security Fund holding 6.3 percent at the end of 2019. S&P Capital IQ database.

missed deadline ignited a selloff in the firm's bonds in the weeks that followed as concern about Huarong's financial health mounted and investors struggled to ascertain whether the Chinese government would intervene to guarantee the company's debt obligations (see Figure 6).[92] While the China Banking and Insurance Regulatory Commission (CBIRC) claimed in mid-April that Huarong had "ample liquidity," the company's bond rout resumed following reports that regulators were considering options for restructuring the firm's debt.[*] [93] The Singapore branch of Chinese state-owned Industrial and Commercial Bank of China gave Huarong a loan to help repay its $453 million bond due April 27, following a request from CBIRC for banks "to extend loans to Huarong by at least six months to help the company refinance debt," according to Bloomberg.[94] On May 13, Huarong said it is prepared to meet future debt obligations and claimed there is no evidence "to indicate any change of support the company receives from the government."[95] On May 17, Bloomberg reported Huarong reached funding agreements with state-owned banks to ensure it can repay debt through at least the end of August 2020, by which time the company also aims to have completed its 2020 financial statements.[96]

Figure 6: Huarong Dollar Bond Price, December 31, 2020–May 17, 2021



Source: Mergent data via S&P Capital IQ database.

Analysts assess Huarong is one of China's largest issuers of offshore debt, with estimates of the firm's outstanding offshore bonds ranging from $21.3 to $22.9 billion. [†97] Bloomberg reports $3.7 billion of Huarong's offshore bonds are due this year.[98] This offshore debt represents roughly half of Huarong's more than $43 billion in total bonds outstanding. More than half of all Huarong's bonds come due at the end of 2022.[99]

The selloff in Huarong's bonds is testing foreign investors' assumptions that Beijing will always bail out state-backed companies that borrow on international markets. This is because Huarong's offshore debt contains a form

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[*] Analysts from economic research firm Gavekal predict such a restructuring could include a potential 10 percent haircut for offshore creditors, an approach that would be similar to the Chinese government's 2019 seizure of Baoshang Bank. Xie Yu and Chong Koh Ping, "Chinese Asset Manager Suffers Bond Selloff After Delaying Results," *Wall Street Journal*, April 15, 2021. *https://www.wsj.com/articles/chinese-asset-manager-suffers-bond-selloff-after-delaying-results-11618496945.*

[†] Among those holding Huarong debt are U.S. investment management firm BlackRock and the asset management arm of Goldman Sachs, with the latter estimated to have $116 million of exposure as of late February to a $350 million bond maturing in 2030, according to Bloomberg data. Thomas Hale, "Bonds of China's Largest Bad Investor Plunge to Record Low," *Financial Times*, April 13, 2021. *https://www.ft.com/content/53323f21-85c6-461d-8f5f-a27e77fb700f.*

of credit protection called a keepwell agreement.[*] Were Huarong not to observe this keepwell agreement and renege on its debt obligations, resulting losses to foreign bondholders could rupture confidence in China's offshore corporate debt market.[100] In all, about $119 billion of Chinese offshore bonds outstanding use the keepwell structure, according to Bloomberg (for the size of China's onshore and offshore corporate bond markets, see Table 4).[101]

Table 4: Size of China's Bond Markets

	December 2020
China's domestic bond market	$15 trillion
Foreign holdings in China's domestic bond market	$445 billion
China's domestic corporate bond market	$5.6 trillion
Foreign holdings in China's domestic corporate bonds	$1.52 billion
China's offshore corporate bond market	$752 billion

Note: The estimate of China's offshore corporate bond market is as of November 2020.
Source: Various.[102]

Huarong is one of the original four asset management companies established by the Chinese government in 1999 to take nonperforming loans (NPLs) off the balance sheets of the country's state-owned banks amid the government's broader bailout of them at the time. Since 2006, Huarong has expanded into several other lines of non-core business, including banking, brokerage, and fund management services, as well as lending to property developers, thereby departing from its original mandate of helping state-owned banks dispose of NPLs and growing in systemic importance.[103] Analysts claim the rapid accumulation of related assets could be of dubious quality given the company's leadership.[104]

Internal sources at Huarong told Chinese financial media outlet *Caixin* that some of the company's investments were given to enterprises linked to its own managers.[†] [105] The firm's rapid business expansion has also been financed primarily through bank loans and bond issuance, with borrowing from onshore banks and financial institutions amounting to $119 billion as of June 20, 2020, more than double its total bonds outstanding.[106] In January 2021, Huarong chairman Lai Xiaomin was executed after being found guilty of taking RMB 1.8 billion ($277.9 million) in bribes over a 10-year period.[107]

Investor confusion about the extent to which the Chinese government will support Huarong led international rating agencies to downgrade their credit ratings[‡] for the firm. On April 26, Fitch Ratings cut Huarong's credit rating three notches from A to BBB.[§] [108] Fitch stated the downgrade was driven by "a reassessment of the government support

[*] A keepwell agreement is a common form of credit enhancement used by Chinese companies to facilitate the issuance of offshore bonds by their subsidiaries. In a typical keepwell agreement, an onshore Chinese parent company promises foreign bondholders that its offshore subsidiary issuer remains solvent and has sufficient liquidity to pay the interest and principal of bonds. Such agreements, however, usually also contain a provision stating the parent company does not guarantee its subsidiary's debt obligations. The agreements often include other provisions stating the parent will purchase equity interest or assets in the offshore subsidiary as a way of servicing payments on overseas notes. Jay Lee et al., "Keepwell Deeds: A Pathway for Enforcement," *Simmons + Simmons*, January 21, 2021. *https://www.simmons-simmons.com/en/publications/ckk6xamik1crr09927sdfif4s/keepwell-deeds-a-pathway-for-enforcement*; Rebecca Chong Wilkins et al., "What 'Keepwell' Means in Case of China Bond Defaults," *Bloomberg*, May 14, 2020. *https://www.bloomberg.com/news/articles/2020-05-14/how-a-keepwell-clause-protects-china-bonds-or-not-quicktake?sref=mxbIZFb4*.

[†] For example, according to business records and sources, Huarong and manganese products manufacturer Ningxia Tianyuan held stakes in one another's subsidiaries through a complex web of transactions. Lai placed close Huarong business associates in positions at Ningxia Tianyuan's financial services subsidiaries and provided them with capital injections. In return, Ningxia Tianyuan acted in concert with Huarong to cover up the latter company's failed investments. Dong Jing et al., "In Depth: Bad Business at a 'Bad Bank,'" *Caixin*, April 23, 2018. *https://www.caixinglobal.com/2018-04-23/bad-business-at-a-bad-bank-101238048.html*.

[‡] Credit ratings help investors differentiate between bonds with higher credit risks (those assigned a lower credit rating) and lower credit risk (those assigned a higher credit rating). Investment-grade bonds with the safest credit rating are rated as AAA, while those with the lowest credit rating are rated as BBB or BAA, depending on which global rating agency's scale is being used. Nina Boyarchenko and Or Shachar, "What's in A(AA) Credit Rating?" *Liberty Street Economics*, January 8, 2020. *https://libertystreeteconomics.newyorkfed.org/2020/01/whats-in-aaa-credit-rating.html*.

[§] Huarong is not the only nor the first Chinese state-owned issuer to be rated BBB by international ratings agencies. For example, Fitch Ratings downgraded its rating of state-owned Chongqing Energy Investment Group from BBB+ to BBB in November 2019 and placed the company on "Rating Watch Negative" in February 2021 due to ambiguity on the Chongqing government's willingness to provide liquidity to the company following planned mine closures. The company otherwise maintains an AA+ rating with Chinese credit rating agency China Chengxin International. The divergence highlights the obfuscation of debt risks in China's credit rating ecosystem, with Chinese credit rating agencies obscuring debt credit risks to investors by systematically inflating bond ratings on assumptions of implicit factors under Fitch's Government-Related Entities* rating criteria," expressing concern that Beijing's "indication of support has not been as forthcoming" and the belief that "timely indication of support has not yet materialized."[109] Moody's Investors Services also lowered Huarong's credit rating from A3 to Baa1 on April 29.[110] Moody's cited Huarong's "weakened funding profile due to market volatility and heightened uncertainty surrounding the company" in explaining its rationale for the downgrade, adding "the level of government support for Huarong AMC and its offshore subsidiaries remains uncertain."[111]

Huarong's debt woes follow a string of SOE bond defaults in late 2020 and early 2021.† According to Fitch Ratings, SOEs defaulted on a record RMB 79.5 billion ($12.1 billion) of local bonds in 2020, increasing their share of onshore defaults to 57 percent from 8.5 percent in 2019.[112] In the first quarter of 2021, SOEs accounted for 72 percent of onshore defaults.[113]

Chinese Regulators Ramp Up Big Tech Enforcement

A series of actions taken by Chinese regulators in April highlight Beijing's recent scrutiny of big tech companies in China. While the most significant penalties have so far focused on e-commerce giant Alibaba and its affiliate Ant Group, regulators are increasingly focusing attention on other firms. Regulators have expressed concern over several practices by China's big tech companies, including monopolistic behavior in online marketplaces, the mass collection of user data, and the entry of big tech firms into China's financial services market. Many observers believe the recent crackdown also reflects the CCP's increasing tendency to prevent powerful tech firms from amassing too much political influence.[114]

On April 10, China's State Administration for Market Regulation (SAMR), the country's antitrust regulator, announced a record fine of $2.8 billion (RMB 18.2 billion) on e-commerce giant Alibaba.[115] The announcement came after a SAMR investigation, which began in December 2020, concluded Alibaba had violated China's Antimonopoly Law by preventing merchants selling on Alibaba platforms from selling on rival companies' platforms, a practice known as "pick one of two".[116] In a statement, Alibaba said it accepted the fine "with sincerity" and would improve its internal controls "to better serve our responsibility to society."[117]

According to SAMR, Alibaba's fine is equivalent to 4 percent of the company's domestic revenues in 2019.[118] This fine is far greater than the previous record fine of $975 million, imposed by Chinese regulators on U.S. semiconductor company Qualcomm in 2015, though the Qualcomm fine was equivalent to 8 percent of Qualcomm's China revenues in 2013.[119] Markets reacted positively to the Alibaba fine, with the price of the company's U.S.-listed shares jumping more than 9 percent on the first day of trading after the announcement amid investor relief that regulators did not require more significant remedies.[120]

guarantees of government support in the event of default. On average, Chinese credit rating agencies rate bonds issued by Chinee companies six or seven grades higher than foreign ratings agencies. Despite an uptick in corporate bond defaults in recent years and the COVID-19 pandemic's strain on corporate finances in 2020, China's credit rating agencies continue to issue favorable ratings to Chinese corporate bond issuers. Fitch Ratings, "Fitch Places Chongqing Energy's 'BBB' Ratings on Rating Watch Negative," February 5, 2021. *https://www.fitchratings.com/research/corporate-finance/fitch-places-chongqing-energy-bbb-ratings-on-rating-watch-negative-05-02-2021*; Cai Yuekun and Zhang Xiaohui, "A Total of 915 Million Bank Notes and Letters of Credit Issued by Chongqing Energy Group Have Expired Without Funds Being Returned, Debt Disposal Plan Not Resolved" (银票、信用证合计 9.15 亿到期未归还 重庆能源集团处置方案待解), *Economic Observer*, March 6, 2021. Translation. *https://www.163.com/dy/article/G4EAS5590542OQ4C.html*; Serena Ng, "In China, Not All Triple-A-Rated Bonds Are Created Equal," *Wall Street Journal*, October 22, 2020. *https://www.wsj.com/articles/more-corporate-bonds-are-rated-triple-a-in-china-despite-coronavirus-pandemic-11603272614*; Fitch Ratings, "Fitch Downgrades Chongqing Energy to 'BBB;' Outlook Stable," November 15, 2019. *https://www.fitchratings.com/research/corporate-finance/fitch-downgrades-chongqing-energy-to-bbb-outlook-stable-15-11-2019*.

* Fitch Ratings deems an entity "government-related" when a government, either at the national, regional, or local level, has sufficient control over the entity. This control is typically indicated by the government having majority (direct and/or indirect) economic or voting control over the entity. Fitch also considers an entity government-related when it assesses it is likely a government will step in to support an entity in financial distress to avoid negative socio-political repercussion of a default. Fitch Ratings, "Government-Related Entities Rating Criteria," September 30, 2020, 2. *https://www.fitchratings.com/research/international-public-finance/government-related-entities-rating-criteria-30-09-2020*.

† For more on the spate of local SOE debt defaults in late 2020, see U.S.-China Economic and Security Review Commission, "SOE Defaults Shake Investor Confidence in Guarantees of Government Support" in *Economics and Trade Bulletin*, December 2020, 7–8. *https://www.uscc.gov/sites/default/files/2020-12/Dec_2020_Trade_Bulletin.pdf*.

While most investors do not expect any immediate further action against Alibaba, its affiliate Ant Financial remains subject to ongoing investigations. On April 12, Ant released a statement outlining a restructuring plan it had developed with China's financial regulators, including restructuring as a financial holding company, which will subject Ant to stricter capital requirements similar to those imposed on banks.[121] Other aspects of the restructuring plan include returning the focus of Ant's payment business to consumers and small companies, strengthening consumer rights protection, and adhering to fair competition rules.[122] Additionally, on April 27, the *Wall Street Journal* reported Beijing was investigating how Jack Ma, the founder of Alibaba and controlling shareholder of Ant, was able to gain fast-track approval for Ant's planned initial public offering (IPO) last year.[*] [123]

Ant's restructuring will allow the company to keep its core businesses, which include payments processing, microlending, wealth management, credit scoring, and insurance.[124] Unlike Alibaba, however, Ant's business growth is expected to be significantly slower because of the regulatory actions, which will make it more difficult for the company to direct users of its Alipay payment platform to other Ant services.[125] As a result, Ant's valuation has fallen sharply. Fidelity Investments, a mutual fund company that bought into Ant in 2018, disclosed in recent regulatory filings that at the end of February it valued Ant at $144 billion, down from $295 billion in August 2020.[126]

Some of China's biggest technology firms are now in government crosshairs. Following the announcement of the fine on Alibaba, Chinese regulators gathered representatives from 34 of China's largest internet companies, including Tencent, Meituan, and Didi Chuxing, telling them to "pay full heed to the warning of Alibaba's case" and instructing them to complete "self-inspections" over the following month.[127] Chinese regulators have further singled out firms expanding into finance. On April 29, regulators ordered 13 tech firms with financial services operations, including Tencent, JD, Baidu, and ByteDance, to strengthen their regulatory compliance efforts and stop the "disorderly expansion of capital."[128]

Regulators have already begun taking action against some companies. On April 26, SAMR announced it was opening an antitrust investigation into Meituan, an online services company that dominates China's food delivery market, for engaging in the same "pick one of two" practices as Alibaba.[129] On April 29, Reuters reported that Chinese regulators would issue a fine of at least $1.5 billion (RMB 10 billion) against Tencent, China's largest technology company.[130] The fine stems from various alleged anticompetitive practices, including in the company's subsidiary Tencent Music Entertainment Music Group.[131] Tencent is expected to keep its core businesses, though regulators may require it to sell off some of its music streaming services.[132]

In addition to investigating anticompetitive practices by internet platforms, Chinese regulators have placed increasing levels of scrutiny on the types of mergers and acquisitions that allowed many of China's largest internet companies to reach their current scale. Since December, China's regulators have fined 13 internet companies for failing to seek approval from antitrust regulators for mergers and acquisitions that took place over the past several years.[133] At only $77,000 (RMB 500,000) for each company, the fines are little more than a slap on the wrist. Planned revisions to China's Antimonopoly Law, however, would expand the maximum penalties to 10 percent of a company's sales from the previous year.[134]

Regulators have also increased scrutiny of variable interest entities (VIEs), a type of corporate structure used by many tech companies, including Alibaba and Tencent, to list abroad in circumvention of China's restrictions on foreign investment in certain sectors.[†] [135] In February, SAMR issued new guidelines for the "platform economy" that for the first time clarified that the Antimonopoly Law applied to VIEs, following the issuance of draft guidelines last November.[‡] [136] Previously, many internet companies using VIEs had exploited ambiguities in the law to avoid declaring potential mergers and acquisitions to SAMR for regulatory approval.[137]

[*] For more on the cancelation of Alibaba's 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*.

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China's regulators appear to be preparing for a longer-term shift toward more stringent antitrust enforcement. On April 11, Reuters reported that amid the expansion of China's antimonopoly regulations, SAMR expects to increase its workforce from its current staff of 40 up to 60 or 70 employees. To supplement this relatively small workforce, SAMR will also temporarily employ staffers from other agencies for cases requiring additional investigation.[138] Budgeting for antimonopoly investigations will also increase, and SAMR reportedly plans to delegate case reviewing power to local offices.[139]

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