CHAPTER 2

U.S.-CHINA ECONOMIC AND TRADE RELATIONS

SECTION 1: YEAR IN REVIEW: ECONOMICS AND TRADE

Abstract

In 2022, China's economic growth slowed significantly due to the government's stringent novel coronavirus (COVID-19) containment measures, collapse in housing construction and sales, and slow infrastructure construction. Cut off from easy bank loans and other financing, China's highly indebted property developers faced a crisis of confidence as home prices faltered and owners halted mortgage payments on presold units throughout the country. Economic uncertainty amid continued lockdowns also prompted households to save rather than spend, deepening the economy's dependence on exports to drive growth. China's economic slump and weak currency prompted an exodus of foreign capital from China's financial markets and contributed to cooling enthusiasm for expanding China-based operations among multinationals. Beijing also faced continued challenges in its external economic relations throughout 2022, particularly as it has attempted to maintain economic ties with Russia while avoiding economic sanctions.

Key Findings

- China's economy faltered in the first half of 2022 as protracted Zero-COVID lockdowns caused local economies to grind to a halt. The Chinese government attempted to employ a modest infrastructure-led stimulus in the second half of the year, though its impact may be limited as local governments struggle to identify useful projects. Despite the economic damage caused by the lockdowns, the Chinese Communist Party (CCP) remains committed to its Zero-COVID policy, demonstrating its ability to maintain political control even in the absence of economic growth.
- Beijing's credit tightening toward the property sector has become a significant drag on economic growth as developers strain to deliver on presold housing projects. Mortgage boycotts throughout the country demonstrated growing public anger toward property developers as well as broader pessimism about the state of China's economy. With about 60 percent of urban household wealth concentrated in residential property, a protracted downturn in real estate values would likely exacerbate

already anemic consumption among households and continue to weigh on China's economic growth prospects.

- U.S. businesses and investors are reevaluating their engagement in China. Many multinational businesses are delaying further expansion of their China operating segments as stringent COVID-19 measures worsen the business climate and geopolitical tensions arising from Russia's unprovoked invasion of Ukraine strain global supply chains. Despite the CCP continuing to encourage foreign capital to flow into its financial markets, U.S. investors in China's financial markets have started to reduce the investment positions they built up, causing capital outflows to accelerate in 2022.
- In 2022, the Chinese government significantly reduced its lending to developing countries while developed countries pushed back against the Chinese government's use of economic coercion and pursued supply chain diversification away from China. Although it has been careful thus far to avoid triggering secondary sanctions, the Chinese government has maintained friendly relations with Russia after its invasion of Ukraine, supporting the regime by purchasing Russian oil and natural gas. Beijing likely sees coordinated sanctions against Russia as an example of potential repercussions for its intensified aggression against Taiwan, driving China to accelerate ongoing efforts to harden its economy against sanctions and undermine the dollar-led financial system.

Introduction

In 2022, China's economy suffered from strict self-imposed COVID-19 lockdowns as the highly contagious Omicron variant spread through the country's economic and industrial hubs. A collapse in housing construction and sales exacerbated the slowdown and deepened signs of financial distress among highly indebted property developers. Squeezed by slow income growth, mounting unemployment, industrial shutdowns, faltering real estate values, and continued economic uncertainty largely stemming from Zero-COVID lockdowns, households continued to consume less. Beijing's attempts to spur infrastructure spending may provide only a small cushion against economic deceleration in 2022 as local governments struggle to identify revenue-generating projects.

The CCP's external economic relations in 2022 faced challenges stemming from China's domestic economic slowdown as well as opposition to its coercive economic practices and support for Russia's unprovoked invasion of Ukraine. Frictions persisted in bilateral commercial relations between the United States and China as the Chinese government continued its unfair trade practices, and U.S. companies reconsidered their presence in the Chinese market due to the Zero-COVID policy. The Chinese government continued to pursue its coercive economic policies while providing an economic lifeline to Russia amid coordinated sanctions and export controls. As a result, China faces growing backlash from a number of countries and possible secondary sanctions or other countermeasures from countries intent on supporting Ukraine and defending the rules-based international order.

This section examines key developments and trends in China's domestic economy and external economic relations, including U.S.-China bilateral relations and other key relationships. Section 2, "Challenging China's Trade Practices," examines China's nonmarket practices and the unilateral and multilateral options the United States has to challenge them. Section 3, "China's Energy Plans and Practices," explores China's energy system and clean energy technology ambitions. Finally, Section 4, "U.S. Supply Chain Vulnerabilities and Resilience," discusses U.S. supply chain vulnerabilities vis-à-vis China and presents options for ameliorating them. For analysis of the CCP's decision-making processes, see Chapter 1, "CCP Decision-Making and Xi Jinping's Centralization of Authority."

China's Economy Falters in 2022

China's growth deteriorated in 2022, due in part to government-imposed Zero-COVID lockdowns. In 2021, Chinese economic growth leveled out after the government curtailed support intended to help the economy rebound from initial Zero-COVID lockdowns in early 2020. When a series of COVID-19 outbreaks occurred in China throughout 2022, the Chinese government maintained its rigid approach to domestic COVID-19 outbreaks, enforcing strict lockdowns and movement restrictions in major cities like Shanghai, Beijing, and even Sichuan Province's capital Chengdu during September, in spite of the 6.8 magnitude earthquake that struck the city in the beginning of the month.[1] Response to locally identified cases occurred through a policy known as "Zero-COVID" and later "dynamic Zero-COVID."[2] Due to fear of punishment for inadequately managing the virus, local cadres throughout the country have employed a strict approach to containment. No sector of the economy has been spared from the policy, as Zero-COVID lockdowns caused consumption to plummet while causing business closures throughout the employment-driving services sector. Zero-COVID lockdowns further spurred supply chain disruptions due to factory closures and restrictions on interprovincial transport.[*][3] Despite significant economic damage caused by the lockdowns, the CCP expressed unwavering commitment to its Zero-COVID policy, demonstrating its willingness to accept immediate economic costs in order to use public health as a way to maintain control (for more on the CCP's COVID-19 decision-making, see Chapter 1, "CCP Decision-Making and Xi Jinping's Centralization of Authority").

Meanwhile, China's property sector downturn has deepened in 2022, becoming a critical drag on overall economic growth. What began in 2021 as an attempt to stem credit to highly indebted property developers has caused a wave of defaults and bled into weakened demand for housing. China's property sector accounts for 25–30 percent of gross domestic product (GDP) according to different estimates, and slower construction is having a ripple effect on

*As of April 2022, mass testing requirements and checkpoint systems for transportation created severe supply chain disruptions. With about 75 percent of China's domestic freight shipments relying on truck drivers, differing local compulsory testing regimes and long lines at travel checkpoints clogged China's logistics system. The requirements have created onerous conditions for truck drivers, some of whom have reported being sealed into their trucks for over 24 hours while they waited at checkpoints. *Bloomberg*, "Truckers Caught in Covid Controls Snarl China Supply Chains," April 13, 2022.

other sectors of the economy.[4] Property also accounts for the majority of urban household wealth, and sliding property valuations are likely further dampening already weak household spending.[5] New construction sank to an 18-year low in July. Developers also lacked funding to finish construction on existing units, including those that have already been sold. Protesting delays on delivery of housing that cost many buyers their life savings, thousands of owners of incomplete homes ceased mortgage payments, further complicating developers' cashflow challenges.

Lockdowns Halt Growth in 2022

The economic impact of China's COVID-19 containment measures was evident in official data, with China's GDP reportedly growing 4.8 percent year-on-year in the first quarter of 2022, then slowing to 0.4 percent growth in the second quarter.[*][6] Mounting economic headwinds ultimately forced Beijing to walk back its 2022 growth target midyear, as dismal Q2 GDP data revealed the economic damage of Zero-COVID. In March 2022, China's National People's Congress set an annual GDP growth rate target of 5.5 percent,[†] aiming to maintain strong economic growth ahead of the 20th National Party Congress. While CCP officials appeared intent on achieving the target in the first half of the year, dismal GDP growth in Q2 combined with ongoing COVID-19 outbreaks forced Beijing to soften its exhortations of local officials to meet the target. In its July quarterly meeting, China's Politburo announced that provinces should "maintain economic operations in a reasonable range and strive to achieve the best results," while "provinces in the position to do so should strive to achieve the expected economic and social development goals."[7]

Topline Growth Claims Cast Doubt on Credibility

In the first half of 2022, Chinese data revealed an economic reality that many analysts found implausible.[8] Already viewed with suspicion due to a lack of transparency and a history of falsified statistics, irregularities in China's economic data releases in the first half of 2022 raised additional doubt. Likely in reaction to this widespread skepticism, Beijing publicly attempted to demonstrate its resolve to crack down on rampant data falsification. Despite this, it has yet to admit that any falsification occurred in 2022.[9]

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* Foreign economists, investors, and analysts remain skeptical about the reliability of China's official reported economic data. As a key metric in official performance evaluations as well as government legitimacy, economic data are highly politicized at all levels of government. For more on the reliability of China's GDP, see Iacob Koch-Weser, "The Reliability of China's Economic Data: An Analysis of National Output," *U.S.-China Economic and Security Review Commission*, January 28, 2013. For more on the reliability of China's trade data, see U.S. Congressional Research Service, *What's the Difference? Comparing U.S. and Chinese Trade Data*, May 20, 2020.

† Following China's reported growth of 0.4 percent for the second quarter of 2022, Chinese officials began openly commenting that 4 percent may be a more realistic annual target. In 2020, Chinese leaders refrained from setting a GDP growth target and claimed the economy grew 2.2 percent that year. In 2021, Chinese leaders looked to achieve growth at "above 6 percent," with the National Bureau of Statistics reporting 8.1 percent GDP growth that year. Trivium China, "Bowing to the Inevitable," *China Markets Dispatch*, July 18, 2022; World Bank, "GDP Growth (Annual %)"; Evelyn Chang, "China Sets 2021 GDP Growth Target of More than 6% as Premier Warns of 'Formidable Tasks' in Finance," *CNBC*, March 4, 2021.

Topline Growth Claims Cast Doubt on Credibility—*Continued*

With a deepening contraction in the property sector and Zero-COVID lockdowns impacting industrial production and supply chains, economists expressed skepticism that China's economy actually grew by 4.8 percent year-on-year in Q1. According to analysis from economic research firm Rhodium Group, when accounting for the slowing property sector, the remaining sectors of China's economy would need to have grown at 7–8 percent amid the lockdowns to achieve the growth rate posted by China's National Bureau of Statistics (NBS).[10] Subcomponent data raised additional questions. For example, in May the NBS reported that steel output, an energy-intensive industry reliant on thermal power, had increased by 12.1 percent year-to-date.[11] This occurred despite reporting from China's Electricity Council that May utilization of fossil fuel power-generating equipment had actually declined by 5 percent year-on-year.[12]

Such data irregularities are consistent with the government's pandemic response, in which it attempts to portray the superiority of its model by masking the true extent of economic damage caused by its Zero-COVID policies. In testimony before the Commission, Shehzad Qazi, chief operating officer at economic consulting firm China Beige Book, explained that survey data from Chinese firms consistently portray the economy as weaker than official data.[13] In 2020, the Chinese government created a political victory by claiming its economy was the first to recover from the pandemic. To do this, China's statistics bureau deflated the previous year's economic data to create the appearance of year-on-year growth at the end of 2020.[14] By contrast, independent data from China Beige Book indicate that the economy actually posted a full-year contraction in 2020.[15]

Due to the politicized nature of economic data in China, data smoothing and falsification methods are likely already embedded within headline indicators such as GDP growth. Statements by top leaders in the first half of 2022 demonstrate a recognition of challenges to CCP credibility posed by widespread data falsification, prompting a flurry of data fraud investigations throughout the country. For example, in March 2022 the CCP's Central Commission for Discipline Inspection announced it would increasingly monitor NBS for data falsification, admitting that cases of fraud were "still relatively prevalent" despite NBS attempts to investigate and punish violators.[16] Later in May, NBS claimed it had uncovered data violations stemming from 2020 and 2021 in multiple provinces, leading to the dismissal or demotion of local officials in Hebei, Henan, and Guizhou provinces.[17] In citing data releases from the past two years, NBS likely intended to boost confidence in Beijing's attempts to improve data credibility without undermining data from the current year. With punished officials hailing from relatively underdeveloped provinces that contribute less to China's GDP, the campaign to identify data violators has also left officials from more economically important industrial hubs relatively untouched.

Lockdowns weakened household consumption and the services sector in 2022, contributing to rising unemployment and causing pervasive supply chain disruptions. With strict Zero-COVID lockdowns preventing Chinese consumers from going to restaurants and shopping malls, Chinese households' reduced consumption became a drag on the economy and contributed to contraction in the services sector. Because nonstate small- and medium-sized enterprises (SMEs) comprise the backbone of the services sector, China's policy response to COVID-19 continues to weaken SMEs and the nonstate sector. Households also continue to bear the brunt of lockdowns, with curtailed operations and closures among businesses contributing to worsening unemployment and slow disposable income growth in the first half of 2022, in addition to the human toll of severe containment restrictions (see textbox below). Finally, exports provided a small buffer against economic deceleration; however, supply chain disruptions continued to hamper China's manufacturing industries.

- *Consumption:* China's strict lockdowns of major population centers in the first half of 2022 contributed to a steep decline in consumer spending. Retail sales, which serve as a proxy measure for consumption within the Chinese economy, declined by 11.1 percent year-on-year during the height of the lockdowns in April.[18] Even after easing lockdowns around the country, China's retail sales continued to reflect caution among households about the likelihood of future restrictions and stiffer economic headwinds, with sales declining by 6.7 percent year-on-year in May and improving only slightly by July.[19] Online retail sales also showed slower growth in 2022 than in the previous two years, reflecting deepening consumer pessimism and sluggish disposable household income growth.[20] While some businesses and local governments have attempted to stimulate consumption by slashing prices and issuing coupons, such measures have done little to buoy consumer retail spending.[21] Weak consumption and household borrowing may be further indications of a growing "balance sheet recession" among Chinese households as they save a greater proportion of their income while spending and investing less, deepening economic imbalances.*[22]
- *Services:* China's services sector has been particularly hard hit by China's Zero-COVID policy, as local governments forced in-person businesses such as those in the tourism, entertainment, and restaurant industries to shutter operations.[23] The sector contributed to only 1 percent of China's GDP growth in Q2, marking a continual decline from its peak of 9.3 percent in Q1 2021.[24] The sharp downturn in labor-intensive services in particular has likely had a severe impact on employment throughout China's economy in 2022, in turn contributing to

*Chief Economist at Nomura Research Institute Richard Koo coined the term "balance sheet recession" to describe economic contraction caused by private borrowers reducing debt and therefore expenditures, rather than a contraction from a downturn in the business cycle (i.e., a decline in output, employment, income, and sales). Dr. Koo argues that a collapse in asset values is likely to trigger a balance sheet recession, as firms and households reduce borrowing and expenditures and focus on paying down debt to avoid or get out of negative equity. Richard Koo, "Balance Sheet Recession Is the Reason for 'Secular Stagnation,'" *VoxEU*, August 11, 2014.

anemic consumption, though full-year data will not be released until 2023.*[25]

- *Unemployment:* With lockdowns forcing many service-based businesses to cut back or shutter operations, China's surveyed urban unemployment rate reached 6.1 percent in April 2022, its highest level since the first wave of COVID-19 lockdowns in February 2020.†[26] In July 2022, urban unemployment moderated slightly to 5.4 percent; however, unemployment among young workers aged 16–24‡ increased to 19.9 percent in July, reaching its peak since China's youth unemployment survey began in 2018.[27] The severe downturn in employment opportunities for youth could lead to depressed labor productivity for years to come, as young graduates are forced to accept jobs that do not match their education and skills. Despite the impact of Zero-COVID lockdowns on employment-generating sectors, the Chinese government has yet to provide sufficient assistance to households grappling with unemployment. According to a March 2022 report by a group of Chinese university professors, a 2020 survey revealed that only 8 percent of laid-off workers benefited from unemployment insurance, while 86 percent of total laid-off workers received no social assistance whatsoever.[28]
- *Export-oriented manufacturing:* China's General Administration of Customs reported strong export data in the first half of 2022; however, China's export-oriented manufacturing sector confronted mounting challenges due to rising input prices, disruptions from lockdowns, and decreasing demand from the global economic downturn. Exports grew only 7.1 percent in August 2022 over the previous year, down from 18 percent in July and below an industry forecast of 12.8 percent.[29] Industrial value added, an indicator for the amount China's manufacturing and extractive industries contribute to aggregate economic output, contracted sharply in April, posting a 2.9 percent year-on-year decline before moderating in the summer months.[30] The slowdown was caused by strict COVID-19 lockdowns between March and May that snarled domestic supply chains and caused widespread factory closures de-

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*Chinese official statistics indicate the services sector accounted for 48 percent of employment in 2021 versus 46.1 percent in 2018, but job growth was not in industries most impacted by the pandemic, such as restaurants and tourism. C. Textor, "Distribution of the Workforce across Economic Sectors in China from 2010 to 2020," *Statista*, July 27, 2022; China's National Bureau of Statistics, *The Director of the National Bureau of Statistics Answers Reporters' Questions on the Operation of the National Economy in 2021* (国家统计局局长就2021年国民经济运行情况答记者问), July 17, 2022. Translation.

†According to China's Ministry of Human Resources and Social Security, there were about 11 million unemployed people in China as of Q1 2022, increasing from about 9.5 million people in Q3 2019. China's urban unemployment rate likely understates the actual level of unemployment in China's economy as it does not account for China's migrant workforce, estimated at 300 million people. Because these individuals are increasingly concentrated within China's low-end services sector and gig economy, both sectors hard-hit by COVID-19 lockdowns, they likely suffer from disproportionately high unemployment rates. Emily Feng, "Migrant Workers in China Find New Jobs—and Precarious Conditions—in COVID Control," *NPR*, April 20, 2022; Eli Friedman, "China's Record Urban Youth Unemployment," *ChinaFile*, June 16, 2022. China's Ministry of Human Resources and Social Security, "China Unemployed Persons," *Trading Economics*, 2022.

‡China's Compulsory Education Law of 1986 mandates that all children receive nine years of education, usually through the age of 15. Children aged 16 and above are therefore considered to be part of China's young workforce. State Council of China, *Compulsory Education Law of the People's Republic of China*.

spite attempts to keep companies like Tesla and Semiconductor Manufacturing International Corporation running by forcing workers to live onsite.* [31] Highly industrialized provinces were particularly hard hit by lockdowns and transportation restrictions, with the GDP of Jilin, China's automotive manufacturing hub, shrinking by 6.6 percent and 5.9 percent year-on-year in Q1 and Q2, respectively.[32] Amid lockdowns, China's government continued to report strong exports, with the total value of May exports rising by 16.8 percent year-on-year.[33] Global inflationary pressures likely account for a proportion of the 16.8 percent increase, however, as export volumes only increased by 1.1 percent year-on-year in the same period.[34] Export data may also reflect a surge in shipments as backlogged orders are filled and factories resume operation. China's initial COVID-19 export boom is dissipating, however, as demand from key export markets like the United States and Europe weakens amid mounting inflationary pressures.[35]

The Human Toll of China's Zero-COVID Policy

Aside from immediate economic disruption, China's extreme containment measures in response to COVID-19 outbreaks in Shanghai and other cities in 2022 have had human consequences on individual wellness and long-term livelihoods. While city residents have been confined to their houses for weeks or months, travel restrictions have resulted in homelessness for migrant workers who could not access transportation to return to their hometowns and were not provided with shelter through an employer. For those that have had housing through an employer, such shelter has often amounted to a cramped dormitory or even sleeping on a factory floor.[36] Strained by the response to stringent testing measures, China's underequipped hospitals have also refused healthcare to patients with non-COVID illnesses or who had not taken or were waiting for results of COVID tests.[37] In January 2022, a pregnant woman in the central city of Xi'an lost her baby after she was denied entry to the hospital because her negative test result was four hours old, according to reporting from the *Guardian*.[38] Multiple sources similarly reported that patients had died while waiting for negative tests in order to gain entry to hospitals. In other instances, small children who tested positive were separated from their parents to quarantine.[39]

The compounding effects of social isolation and fear of food and water shortages during lockdowns, as well as economic uncertainty in the wake of the pandemic, are likely to deepen China's challenges in addressing inadequate access to treatment for mental health disorders. A June editorial in the med-

*Local governments allowed companies in critical sectors such as advanced technology components to maintain operations amid COVID-19 lockdowns. Companies like battery manufacturer Contemporary Amperex Technology Co Ltd. and chip producer Semiconductor Manufacturing International Corporation maintained operations using "closed-loop systems" that forced workers to live onsite. *Bloomberg*, "Shanghai Factories Isolate Staff to Keep Operating in Lockdown," March 28, 2022; *Assembly*, "Closed-Loop Systems Allow Chinese Plants to Operate during Lockdown," March 28, 2022.

The Human Toll of China's Zero-COVID Policy—*Continued*

ical journal the *Lancet* noted, "China's lockdowns have had a huge human cost. This cost will continue to be paid in the future, with the shadow of mental ill-health adversely affecting China's culture and economy for years to come."[40] In a national survey on psychological distress after the outbreak of COVID-19 in 2020, 35 percent of respondents reported experiencing distress, including anxiety and depression.[41] A survey of more than 1,000 residents of Shanghai just two weeks into the city's seven-week lockdown similarly reported 40 percent were on the brink of depression.[42]

Fears of Healthcare System Strain Drive Zero-COVID

China's weak healthcare system and minimally effective vaccine have driven Beijing to deepen its commitment to the Zero-COVID policy. In May 2022, researchers at China's Fudan University and the U.S. National Institutes of Health published a report predicting that China would incur approximately 1.55 million deaths if it were to abandon its Zero-COVID policy in the near term.[43] In testimony before the Commission, Yanzhong Huang, senior fellow for Global Health at the Council on Foreign Relations, discussed China's dangerous immunity gap. He noted that despite a population-wide vaccination rate of about 90 percent, the lower efficacy of vaccines from Chinese companies Sinovac and Sinopharm* mean China's population is less protected from the virus compared to countries using more effective mRNA vaccines.[44] In order for foreign drugmakers to secure approval to sell COVID-19 vaccines in the domestic market, China's government has required them either to transfer technology or to establish production facilities in China with a local partner.[45] As of the beginning of October 2022, Chinese regulators had not approved any mRNA products for therapeutic purposes, and Moderna's negotiations to sell mRNA vaccines in China had reportedly collapsed because of the tech transfer prerequisite.[46] China has also struggled to fully vaccinate its elderly population likely due to widespread skepticism about vaccine side effects on seniors, as a very small proportion of seniors participated in China's vaccine clinical trials.[47] Furthermore, China's population also lacks immunity gained from prior infection due to low levels of community spread.[48] Ultimately, a nationwide outbreak would likely overwhelm China's already weakened healthcare system. The risk of such an outbreak is compounded by other societies reopening and people engaging in more travel after obtaining immunity through stronger vaccines or herd immunity.

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*According to the World Health Organization, Sinopharm's vaccine has a 79 percent efficacy rate after two doses. By comparison, the Pfizer BioNTech vaccine is 95 percent effective after two doses and the Moderna vaccine is 94.1 percent effective after two doses. World Health Organization, "The Sinopharm COVID-19 Vaccine: What You Need to Know," June 10, 2022; World Health Organization, "The Moderna COVID-19 (mRNA-1273) Vaccine: What You Need to Know," June 10, 2022. World Health Organization, "The Pfizer BioNTech (BNT162b2) COVID-19 Vaccine: What You Need to Know," June 10, 2022.

China's Healthcare System Underequipped for a Nationwide COVID-19 Outbreak

Geography and income level determine the quality of healthcare accessible to much of China's population. Due to pervasive funding gaps and fewer opportunities to attract talented medical professionals, most rural healthcare institutions offer lower-quality care. Many Chinese patients therefore prefer to receive care from urban institutions, even if they are forced to travel long distances and pay higher fees to access it. China's system has therefore become over-reliant on large urban hospitals to provide even basic and preventative care. Urban hospitals provided about 44 percent of national outpatient services despite only accounting for 3.5 percent of nationwide healthcare institutions in 2019.[49] With outsized demands on its hospital systems, China's hospitals suffer from acute capacity shortfalls despite better access to funding and higher skilled doctors compared to private clinics. For example, with only 3.6 intensive care unit beds for every 100,000 citizens, compared with 25.8 and 33.9 in the United States and Germany, respectively, China's hospital system lacks sufficient resources to care for a nationwide COVID-19 health crisis.[50]

After two years of propaganda proclaiming the CCP's superiority in containing COVID-19, strict adherence to China's Zero-COVID policy in spite of the economic and human costs likely reflects a belief that easing restrictions will undermine CCP legitimacy. Since 2020, China has trumpeted a strict zero-tolerance approach to fighting COVID-19 as a successful model worthy of emulation by other countries, crediting China's top-down mobilization of resources and strict containment measures as key to China's low reported case count and death toll * and relatively quick economic recovery from the initial wave of COVID-19.[51] In 2022, the reopening of other economies has challenged the CCP's narrative, as China's intensified lockdowns to contain the spread of more transmissible variants have precipitated considerable economic slowdown and human catastrophe. Faced with this challenge, General Secretary of the CCP Xi Jinping and state media have redoubled emphasis of Zero-COVID as continued evidence of the CCP's superiority and the best policy option for China, claiming short-term economic disruption is necessary for long-term economic stability achieved from fewer cases and deaths.[52] After censors were

* China's official case count and death toll likely far understate the actual impact of COVID-19. As of September 26, 2022, China's National Health Commission reported 5,226 deaths, just over one-third of the 15,260 deaths from COVID-19 on the Mainland estimated by John Hopkins University's Coronavirus Resource Center as of September 23, 2022. China's National Health Commission claimed there had not been a death from COVID-19 on the Mainland since May 2022, while John Hopkins estimated there were 165 deaths on the day of September 23, 2022. China National Health Commission, *The Latest Situation of Novel Coronavirus as of Midnight on September 26* (截至9月26日24时新型冠状病毒肺炎疫情最新情况), September 26, 2022. Translation; John Hopkins University's Coronavirus Resource Center China National Health Commission, China, September 26, 2022; *The Latest Situation of Novel Coronavirus as of Midnight on May 26* (截至5月26日24时新型冠状病毒肺炎疫情最新情况), May 26, 2022. Translation; China National Health Commission, *The Latest Situation of Novel Coronavirus as of Midnight on May 25* (截至5月25日24时新型冠状病毒肺炎疫情最新情况), May 25, 2022. Translation.

initially overwhelmed by an outpouring of public backlash on social media from the Shanghai lockdown in April and May 2022, China's extensive censorship apparatus has increased suppression of any content critical of Zero-COVID. A May Politburo meeting similarly stressed the importance of "resolutely fighting any attempts to distort, question, or dismiss China's anti-COVID policy," signaling to Party officials across China to maintain tight controls even as the central government exhorted localities to increase economic growth. In testimony before the Commission, Manoj Kewalramani, fellow in China studies and chair of the Indo-Pacific studies program at the Takshashila Institution, assessed that China's leaders likely fear that lower efficacy of Chinese vaccines, weak public health infrastructure, and lack of herd immunity will lead to devastating consequences if China eases restrictions.[53]

Beijing's Efforts to Rein in Debt Sap Key Growth Drivers in 2022

Tight credit sapped China's traditional growth drivers like property, contributing to weak economic performance in 2022. In 2021, the Chinese government imposed greater restrictions on access to credit for property developers and local governments as it looked to reduce rising debt levels following its investment-driven 2020 rebound. China's total outstanding debt, according to the Bank for International Settlements, stood at $51.5 trillion, or 286.6 percent of GDP, at year-end 2021.* Credit tightening in 2021 caused economic growth to slow by 2022 as property developers were forced to reign in investments on new construction and the central government cracked down on off-balance-sheet lending to local governments for infrastructure projects. According to surveys conducted by China Beige Book, tight credit conditions impacted borrowing across China's economy in 2021 and 2022, with only 14–16 percent of surveyed firms taking out loans and only 9–11 percent of firms issuing bonds in 2022 Q2, both lows not seen since China's government initiated its deleveraging campaign in 2016.† [54] A substantial portion of new lending in the first half of 2022 has come in the form of short-term loans commonly used to manage operating expenses, however, rather than medium and long-term loans, which are often used to finance investments supporting long-term economic expansion.[55] With credit demand weakening throughout China's economy, by July year-to-date medium- and long-term lending had decreased by 24.4 percent year-on-year.[56]

China's Property Crisis Continues to Weigh on Growth

China's property sector continued to post negative growth in 2022 following the government's 2021 imposition of the "three red lines," a campaign to cut off new bank loans to real estate developers that do not meet specific prudential

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*For comparison, total outstanding debt stood at $5.3 trillion, or 142.5 percent of GDP, just prior to 2008. Household debt grew from $694.8 billion (18.9 percent of GDP) just prior to 2008 to $11.1 trillion (61.6 percent of GDP) at year-end 2021, corporate debt grew from $3.5 trillion (94.3 percent of GDP) to $27.5 trillion (152.8 percent of GDP), and general government debt grew from $1 trillion (29.3 percent of GDP) to $12.9 trillion (72.2 percent of GDP). Bank for International Settlements, "Credit to the Non-Financial Sector," June 13, 2022.

†China Beige Book derived Q2 credit data based on 4,354 interviews: 1,050 between April 22 and 27 and 3,304 between May 18 and June 15.

requirements.* Chinese policymakers' campaign to tighten financing to the highly leveraged property sector created a meaningful drag on economic growth in 2022, as new activity in the sector virtually collapsed. By July 2022, developer financing fell by 26 percent year-on-year.[57] With developers' funding channels narrowing, they have been forced to cut down on new investments, and new starts declined by 45.8 percent year-on-year in July 2022, marking the deepest decline since 2004, according to data from Trivium China.† [58] Furthermore, presales, which account for 87 percent of home sales, have faltered in particular.[59] This undermines a major source of cashflow for developers, which have relied on presales to fund their operations since the Chinese government started tightening off-balance-sheet lending to the property sector in its deleveraging campaign beginning in 2016.[60]

Credit tightening in 2021 has trickled down to housing demand in 2022, with new transactions grinding to a halt. High-profile developer defaults, developers' inability to deliver prepaid homes, and broader economic headwinds cut into demand for new housing in 2022. Reflecting this, the balance of outstanding residential mortgage debt grew by only 5.6 percent in Q2 2022 to reach $6 trillion (renminbi [RMB] 40.2 trillion),‡ compared to the double-digit year-on-year residential mortgage growth reported by the People's Bank of China (PBOC) from the beginning of the dataset in 2005 to 2021.[61] With fewer households investing in new housing, property sales and prices have declined. July sales declined by 28.8 percent year-on-year and average prices also fell by 7.4 percent year-on-year.[62] Slowing sales have impacted real estate values throughout the country, including within the wealthiest areas that usually see less volatility in prices. For example, average housing prices in southeastern Guangdong Province have decreased year-on-year for six straight months, dropping by 13.4 percent year-on-year in April, the steepest decline on record.[63] Peaking demand for housing in Guangdong's first-tier cities § Shenzhen and Guangzhou had previously driven average property prices in the province to increase by roughly 350 percent since 2003.[64] Guangzhou is not an anomaly, as property prices in two-thirds of China's 70 largest cities have declined since the imposition of the three red lines in fall 2021.[65]

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* Chinese policymakers instilled the three red lines in an attempt to deleverage the property sector amid rising debt levels. These requirements include the following: (1) setting a ceiling for developers' debt-to-asset ratios at 70 percent, (2) setting net debt-to-equity ratios at 100 percent, and (3) capping short-term borrowing on par with cash reserves. For more on the impact of the three red lines campaign on China's property sector, see U.S.-China Economic and Security Commission, "In Focus: Evergrande Debt Crisis Forces Tough Choices," in *Economics and Trade Bulletin*, October 20, 2021, 8–12. Pearl Liu, "Chinese Developers Face Potential Price War in Second Half amid Glut as State Issues 'Red Lines' in Deleveraging Campaign," *South China Morning Post*, September 2, 2020.

† China's National Bureau of Statistics reported that new starts had only declined by 36.1 percent year-on-year. China's National Bureau of Statistics via CEIC Database.

‡ Unless noted otherwise, this Report uses the following exchange rate from June 30, 2022, throughout: 1 U.S. dollar = 6.70 RMB.

§ Chinese cities are unofficially but widely grouped into four "tiers" based on population, affluence, and whether they are governed at a provincial level (e.g., Shanghai, Chongqing, Beijing, and Tianjin are provincial-level municipalities), as provincial capitals, or at lower echelons of administrative hierarchy. For example, Shanghai is a first-tier city; Chengdu, the populous capital of Sichuan Province and a regional hub in the southwest, is a second-tier city; Wenzhou, a prefecture-level port city and tourist destination on the coast of Zhejiang Province, is a third-tier city; and Xiangcheng, a county-level city in Henan Province famous foremost as the birthplace of the first president of the Republic of China, Yuan Shikai, is a fourth-tier city. Dorcas Wong, "China's City-Tier Classification: How Does It Work?" *China Briefing*, February 27, 2019.

Mortgage boycotts in the summer of 2022 reflect growing unrest concerning China's property downturn. Reports emerged beginning in late June of numerous Chinese households refusing to make mortgage payments on presold real estate development projects that had not yet been constructed. Given extensive demand for real estate in China, developers often sell properties before they are complete and use mortgage payments toward construction costs. Property developers are struggling to finish housing projects amid an ongoing debt and liquidity crisis stemming from Beijing's credit tightening. Protests were initially focused on a stalled project by highly indebted property developer Evergrande in Jingdezhen, Jiangxi, but they spread throughout the country to at least 319 projects in about 113 cities by late July.[66] Independent assessments estimate that the total value of mortgages affected by the boycotts could range from $270 billion to $600 billion (RMB 1.8–4 trillion).[67] Suppliers for Evergrande and other struggling property developers similarly threatened to suspend work and pause debt payments as they had yet to receive compensation for their completed work.[68] In a joint statement signed by hundreds of suppliers and sent to local authorities, suppliers claimed that developers like Evergrande had stopped paying some of them for over a year.[69]

The downturn in property construction and sales has exacerbated financial risks and led to initial signs of financial distress in China's highly indebted economy. In August 2022, Bloomberg indicated Chinese developers had defaulted on a record $28.8 billion of offshore bonds in 2022, nearly all from property developers.[70] Developer defaults and halted mortgage payments likely do not pose systemic risk to the Chinese financial system: the vast majority of developer defaults have been in China's offshore bond market, and much of the debt was rated as "junk bonds" because of developers' poor balance sheets, while the value of mortgages involved in the boycotts is only about $164.2 billion (RMB 1.1 trillion), or about 15 percent of the value of losses required to trigger a systemic financial crisis according to a report from DBS Group.[*] [71] Nonetheless, the slowdown in construction is causing ripple effects through China's economy and turbulence in housing values is harming already stressed households.

- *The downturn in land sales resulting from stressed property developers has created financial risks for local governments that depend on land sales as a key source of revenue.* With land sales declining by 33.2 percent year-on-year in July, local governments may be more inclined to raise funds through alternative methods, including off-balance-sheet loans, or by using the proceeds from special purpose bonds[†] for operating expenses rather than their intended use for revenue-generating infrastructure projects (see Beijing's Fiscal Response Stresses Local

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*In July, 15 banks announced their exposures to the mortgage boycotts, reporting that only about 0.01 percent of their mortgage lending had been impacted. Iris Ouyang, "Mortgage Boycott Risks Manageable for China's Banking System, but Small Lenders Vulnerable, Experts Say," *South China Morning Post*, July 10, 2022.

†Special purpose bonds are municipal debt local governments may issue to fund revenue-generating items such as infrastructure projects and other long-term expenditures. China's Ministry of Finance sets an annual special purpose bond quota, which sets the maximum value of debt local governments may issue per year through the bonds. Special purpose bonds are commonly purchased by Chinese state-owned banks.

Governments below for more discussion of China's local government finances).[72]

- *The decline in construction cuts into a key growth driver of the Chinese economy.* China's property sector and related industries together account for 25 to 30 percent of GDP according to different estimates.[73] Construction fuels employment within numerous ancillary industries including the steel and cement industries.
- *The downturn in housing values may generate broader financial panic among households, who have most of their wealth tied up in property.* A 2019 survey conducted by the PBOC found residential real estate accounted for 59.1 percent of the average urban Chinese household's wealth.[74] China's economy may slow even more as would-be buyers no longer view property as a safe investment and mortgage holders reduce spending for fear of going into negative equity.

Amid China's 2022 economic downturn, authorities are walking back elements of their strict crackdown on the property sector and attempting to prevent financial panic. In response to mortgage boycotts, the China Banking and Insurance Regulatory Commission (CBIRC) urged local governments and banks to support property developers in delivering homes to buyers as quickly as possible, while financial regulators also discussed the possibility of allowing households to pause mortgage payments on stalled projects.[75] By early August, the local government of Zhengzhou, the capital of Henan Province, launched a $1.48 billion (RMB 9.9 billion) bailout fund to channel capital to struggling developers unable to complete projects.[76] Reports also indicate that local state-owned asset management companies, financial institutions tasked with acquiring nonperforming assets, intend to set up similar bailout funds in other provinces.[77] Chinese policymakers will likely continue to pursue solutions that avoid fully reversing credit tightening in the property sector while providing relief for households and suppliers to stave off popular unrest and deeper market pessimism.

Beijing's Fiscal Response Stresses Local Governments

Infrastructure investment did not provide a significant boost to the Chinese economy in the first half of 2022 but is likely to bolster the economy later in the year as new projects get underway. In 2022, China's central government set local governments' special purpose bond quota at about $545 billion (3.65 trillion RMB), keeping the quota constant with the previous year.[78] By the end of May, local governments issued approximately half (54 percent) of their special purpose bond quota.[79] To jumpstart economic growth in the second half of the year, however, China's Ministry of Finance mandated that local governments complete issuing their bond allocations by the end of June, with deployment of funds to occur in August.[80] Rushing to meet the Ministry of Finance deadline, China's local governments set a new record for the most special purpose bonds issued within a single month, with nearly $210 billion (RMB 1.41 trillion) in bonds sold in June alone.[81] In contrast to the diverse group of institutional and retail investors that purchase municipal bonds in the United States, in China roughly 85 percent of local government bonds are bought by state-controlled banks.*[82] The ongoing turn from local bank lending to central government-approved bond issuance may render local debt accumulation more visible and strengthen central government financial control over localities, but it nonetheless still reflects a continuation of China's state-centric and debt-fueled growth model. With local governments racing to issue as many bonds as possible, and given the oversaturation of infrastructure building in China over the last decade, it is unlikely they have successfully identified an equivalent number of high-quality revenue-generating infrastructure projects on which to spend the bonds' proceeds.[83] These investments may drive up short-term economic data in 2022, yet they may ultimately constitute wasteful spending with low returns.

The Chinese government's plan to shore up growth through investment-oriented fiscal stimulus threatens to create additional wasteful investment. To achieve growth in the second half of 2022, the central government is encouraging localities to initiate more infrastructure projects funded by special purpose bonds. Unlike the period following China's massive stimulus in 2008, when much of China's high-speed rail network was still under construction, there are far fewer nationwide infrastructure projects likely to generate a return on investment.[84] As the International Monetary Fund (IMF) argued even prior to Beijing's current infrastructure push, China's "investment-driven recovery has reversed earlier, hard-won progress in rebalancing, adding to the challenges of achieving sustainable high-quality growth over the medium term."[85]

Beijing is pushing local governments to issue more debt to fund fiscal expenditures. While calls for increased local expenditure have been routine in pursuit of Beijing's politically motivated growth target and COVID-related economic "stabilization" efforts, Chinese Premier Li Keqiang's May 25th speech to over 100,000 Party and state officials represented a campaign-style inducement to increase these efforts.[86] Further, in June the State Council ordered the PBOC to provide an additional $120 billion (RMB 800 billion) credit line to Chinese policy banks to support infrastructure investments by local governments.†[87] The central government's incitement to focus on infrastructure-induced growth, however, not only directs increasingly scarce funds into likely unproductive investment but also may come at the expense of already inadequate social welfare funding.

Limited central government support is likely insufficient to alleviate local governments' already overburdened finances, increasing risk of misallocations. Local governments only collect

* Nearly 80 percent of local government bonds in China are purchased by national commercial banks, city commercial banks, and rural financial institutions. Contrary to their name, almost all such banks are Party-state-controlled entities. China's policy banks hold another 5–10 percent of local government bonds. Alex Holmes and David Lancaster, "China's Local Government Bond Market," *Reserve Bank of Australia*, June 2019.

† China has three national state-owned policy banks: China Development Bank, Export-Import Bank of China (China EXIM Bank), and Agricultural Development Bank of China. The policy banks were established as part of a restructuring effort in 1994 to separate commercial and policy financing functions, with each bank charged with specific policy domains. For example, China Development Bank was formed specifically to finance domestic and international development projects, while China EXIM Bank provides financial services for importers and exporters. For more information on China's banking sector, see Virgilio Bisio, "China's Banking Sector Risks and Implications for the United States," *U.S.-China Economic and Security Review Commission*, May 27, 2020.

roughly half of China's fiscal revenue, but they are responsible for as much as 85 percent of expenditure obligations, including infrastructure and public services like healthcare, pensions, and education.[88] Although the central government has been increasing transfers and funding for localities, these transfers remain inadequate to cover the budgetary shortfall. This shortfall is now particularly pressing as local governments are increasingly unable to use off-balance-sheet funding via sales of land usage rights to bridge the gap.[89] Local government sales of land usage rights to property developers, which typically represent roughly 50 percent of their revenue, have experienced precipitous declines throughout 2021 and 2022 owing both to COVID lockdowns and the crackdown on the property sector.[*][90] Further, while centrally approved bond issuance for infrastructure has increased, extensive local social welfare mandates continue to be underfunded by China's central government.[91] As a result, local governments are reallocating proceeds from bond issuance originally earmarked for infrastructure to pay for other unfunded obligations. According to China's National Audit Office, an inspection at the beginning of the year found ten regions had "misused" $3 billion (RMB 13.7 billion) raised from special purpose bonds to pay wages and cover operating costs rather than fund infrastructure, while others used the proceeds to pay down debt.[92] According to data from China's Ministry of Finance, total officially recognized local government debt at the end of May 2022 stood at $5 trillion (RMB 33.3 trillion) or 28.4 percent of GDP, up from $3.8 trillion (RMB 25.7 trillion) or 25 percent of GDP at the end of 2020.[93] Actual local government debt is substantially larger, owing to "implicit debt" issued by local government financing vehicles, local state-owned enterprises (SOEs) used by local governments to raise additional capital.[†][94] The IMF estimates local government financing vehicle debt was equivalent to 48 percent of China's total GDP in 2022.[95]

In spite of the PBOC setting historically low rates in an attempt to boost lending and spur economic activity, Chinese banks are struggling to lend. Beijing's ongoing deleveraging campaign[‡] and related policies, including the three red lines campaign, have contributed to a cautious atmosphere in bank lending

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*The difference between revenue and expenditure drives local government reliance on land sales and debt. Jonathan Cheng, "China's 'Common Prosperity' to Squeeze Cash-Strapped Local Governments," *Wall Street Journal*, January 25, 2022. Philippe Wingender, "Intergovernmental Fiscal Reform in China," *International Monetary Fund* Working Paper 18/88, April 2018, 5–6.

†Prior to 2015, municipal governments could not issue debt directly, with exception to a few pilot programs authorized by China's central government. Because local governments' revenue bases were often insufficient to meet their expenditure obligations, they used local government financial vehicles to evade these restrictions, a practice that has continued since China legalized municipal debt issuance in 2015. China's Ministry of Finance refers to funding raised through local government financial vehicles as "implicit debt," and it is explicitly recognized as corporate debt rather than a government obligation, but investors often treat these debt obligations as backed by the government, creating moral hazard. Frank Tang, "China Debt: State Council Says Local Governments Must 'Tighten Their Belts' and Cut Debt to Reduce Financial Risks," *South China Morning Post*, March 16, 2021; Zhiguo He, written testimony for the U.S.-China Economic and Security Review Commission, *Hearing on China's Quest for Capital: Motivations, Methods, and Implications*, January 23, 2020, 6, 10.

‡The deleveraging campaign began in 2016 principally as a de-risking effort as regulators sought to curb rapid credit growth in shadow financing channels, such as wealth management products, that provided opaque financing largely to property developers and local government financial vehicles. The three red lines campaign, which aggressively limits bank lending to the property sector, is a continuation of that effort. Christopher J. Kushlis, "China Deleveraging: Domestic and Global Impacts," *T. Rowe Price*, February 2022; Logan Wright, Lauren Gloudeman, and Daniel H. Rosen, "The China Economic Risk Matrix," *Rhodium Group*, September 2020, 71–76.

departments, just as corporate and household demand for credit has plummeted amid Zero-COVID lockdowns.[96] While the PBOC has been lowering banks' funding costs via lower deposit rates and interbank lending rates, including guiding the loan prime rate* lower by 20 basis points between December 2021 and August 2022, the effect on credit growth has been muted, reflecting the depressed state of China's economy.[97] Government guidance has lacked consistency as pushes for rapid increases in lending are set against admonishments to do so "reasonably" and prioritize "sound" fundamentals.[98] As regulatory goals hinder state bank credit growth on the supply side and COVID-19 lockdowns hinder credit growth on the demand side, Beijing has turned to fiscal policy to spur growth.

While Beijing is consciously signaling support to SMEs, particularly those in the manufacturing and technology industries, success in implementation remains questionable. A plethora of fiscal policies and tax rebates have been promulgated in support of SMEs, with the most high profile of these initiatives being the ongoing campaign to support so-called "little giants."† [99] Of the $385 billion (RMB 2.58 trillion) China's State Taxation Administration has recorded in tax rebates and refunds through June 2022, an estimated 70 percent went to SMEs.[100] China's financial system, however, remains dominated by state-owned banks that face systemic incentives to lend to SOEs. This is due to the fact that SOEs are, by design, massive firms, often with quasi-monopolies and more stable revenue. SMEs, meanwhile, are the most vulnerable to shocks such as the ongoing Zero-COVID disruptions. This makes them relatively less attractive to lend to and, Beijing's recent policy pronouncements notwithstanding, places them at a disadvantage.[101] The manufacturing Purchasing Managers' Index (PMI), a numerical index based on survey data tracking the performance of the manufacturing sector, reveals the dichotomy between large firms and SMEs. In July 2022, China's National Bureau of Statistics recorded the PMI of large enterprises as 49.8, while that for small enterprises was 47.9.[102] Anything below the 50-point mark indicates contraction, while values above indicate expansion.

The Party's fiscal expenditures in support of consumption and individual households remain extremely weak. The IMF noted in 2021 that despite improvements, China's "social protection system is still incomplete."[103] In particular, the IMF report highlights that fewer than half of all urban employees are covered by unemployment insurance. Among the uninsured are over 230 million internal migrant workers (roughly 60 percent of the migrant

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*The loan prime rate is the average lending rate that 18 of China's largest banks offer their most credit-worthy customers. The PBOC guides the loan prime rate by linking it to its Medium-Term Lending Facility, which is a monetary policy instrument the central bank relies on to increase liquidity in the bank system. This lending facility is in turn based on the effective short-term (seven-day) interest rate the PBOC offers banks through its extensive reverse repurchase agreement lending operations. Virgilio Bisio, "China's Banking Sector Risks and Implications for the United States," *U.S.-China Economic and Security Review Commission*, May 27, 2020.

†Beijing directs local governments to select and financially support cohorts of thousands of ostensibly innovative technology-focused SMEs, which are referred to as "little giants." General Office of the Ministry of Industry and Information Technology, *Notice of the General Office of the Ministry of Industry and Information Technology on Carrying Out the Cultivation of the Fourth Batch of Specialized and New "Little Giant" Enterprises and the Review of the First Batch of Specialized and New "Little Giant" Enterprises*, (工业和信息化部办公厅关于开展第四批专精特新"小巨人"企业培育和第一批专精特新"小巨人"企业复核工作的通知), June 15, 2022. Translation.

population).* [104] These limitations, in addition to those in healthcare and education spending, induce households to save at an extremely high rate to take care of themselves, a phenomenon known as precautionary savings.[105] Analysts Allen Feng and Logan Wright at Rhodium Group note that the ratio of time deposits to demand deposits at banks, which is an indicator of precautionary savings among households, has strengthened substantially through 2022.[106] Beijing's ongoing response to the pandemic has been unique among major economies in the degree to which it prioritizes supply-side interventions at the expense of support to households.[107] Justifying this approach at the start of the pandemic, Jia Kang, former head of the Chinese Finance Ministry's in-house think tank, argued that China's government should concentrate fiscal spending on development projects that lift people out of poverty.[108] He also suggested, to the extent it supports household consumption, that China's government should issue vouchers for specific goods so the state can guide households to consume what it determines is necessary.[109] Beijing has maintained this approach in spite of worsening household consumption. A May 2022 State Council compendium of 33 measures to stabilize the economy focused almost exclusively on businesses. The measures included tax relief, value-added tax (VAT) rebates, fee reduction, loan support, deferred social security contributions, deferred principal and interest repayment, and encouragement of local governments to boost infrastructure investment.[110]

Financial Market Regulation Creates Policy Mechanisms to Enhance Control

CCP leaders developed tools to contain financial risk and strengthen control over capital market development as volatility plagued China's markets in 2022. In further ensuring a role for the state in managing financial markets, however, CCP leaders are moving the development of China's financial system farther away from market economy norms. Foreign investors cut their investments in China's markets throughout 2022. Increased market volatility and signals of increased state control heightened the risks associated with U.S. financial exposure to China.

CCP Leaders Prioritize Financial Stability as Uncertainty Plagues Markets

As lockdowns spread from China's financial center Shanghai to the capital Beijing, investors responded to the economic toll of the Chinese government's Zero-COVID policy. Market sentiment temporarily improved when the Chinese government pledged to stabilize the economy on March 16,† but the rally

*China's rapid urbanization coincided with substantial internal migration from the countryside to urban centers. This process was complicated by China's internal passport system, termed *hukou*, which linked social benefits to the passport and broadly divided residents between urban and rural. As a result, rural hukou holders have not been able to receive healthcare, education, or social security benefits in the cities they live and work in. Kam Wing Chan, "China's Hukou Reform Remains a Major Challenge to Domestic Migrants in Cities," *World Bank*, December 17, 2021.

†Amid the rout of Chinese technology stocks in mid-March, Chinese Vice Premier Liu He convened an emergency meeting of the State Council's Financial Stability and Development Committee where he pledged the government would intervene with "policies favorable to the market." In linking together discussion of China's property market slowdown, regulatory uncertainty for U.S.-listed Chinese stocks, and the Chinese government's "rectification of the platform economy," Vice Premier Liu's speech at the meeting appeared aimed at broadly shoring up equity market

in stock prices shortly reversed.[111] On April 25, the Shanghai Composite and CSI 300 indices* fell 5.1 percent and 4.9 percent, respectively, after a reported outbreak in Beijing. The decline marked the largest single-day drops for both benchmarks since February 2020, when anxiety over the COVID-19 outbreak in Wuhan drove sharp falls in Chinese markets.[112] Narrowing yield spreads between U.S. and Chinese government bonds further drove outflows of foreign and Hong Kong capital† from China's financial market as Beijing eased monetary policy to spur credit growth and Washington hiked rates to tame inflation.[113] As capital flowed out of China, the RMB depreciated 7.9 percent against the dollar from January 1, 2022, to August 25, 2022.[114]

In the first quarter of 2022, the value of RMB-denominated assets held by foreigners fell by more than $150 billion (1 trillion RMB).[115] The selloff of onshore and offshore Chinese stocks by Chinese, Hong Kong, and foreign investors intensified in March 2022 after Russia's unprovoked invasion of Ukraine and following the U.S. Securities and Exchange Commission's (SEC) identification of Chinese firms to be delisted from U.S. markets.[116] Between January and June 2022, foreign and Hong Kong holdings of onshore Chinese bonds fell by a record $75.2 billion (RMB 504.1 billion), from $606.07 billion (RMB 4.1 trillion) to $532.2 billion (RMB 3.6 trillion).[117] Widespread forecasts that China's economy would fall short of the government's 2022 target of 5.5 percent GDP growth further dragged on investors' willingness to hold Chinese assets. Foreign investor holdings of Chinese government bonds are unlikely to rebound as Beijing's fiscal policy has not ramped up to stimulate the economy and the weaker RMB makes Chinese assets relatively unattractive compared to safe-haven assets.[118] The Institute of International Finance forecasts that China could see $300 billion of foreign and Chinese capital outflows by the end of 2022, up from $129 billion in outflows in 2021.[119]

The Chinese government introduced draft legislation requiring banks to contribute to a fund for bailing out troubled financial institutions, increasing the central government's control over financial intervention and reducing local government autonomy. Premier Li announced the financial stability fund,‡ intended to deal with troubled but systemically important

sentiment. Daniel H. Rosen and Logan Wright, "Beijing's Message to Financial Markets: We're Listening," *Atlantic Council*, March 25, 2022. State Council of the People's Republic of China, *Liu He Presides over Meeting of the State Council Financial Stability and Development Committee to Study the Current Situation* (刘鹤主持国务院金融委会议研究当前形势), March 16, 2022. Translation.

*The Shanghai Composite is a stock market index of all companies traded on the Shanghai Stock Exchange, the largest stock exchange in China. The CSI 300 is an index of 300 of the largest companies listed on the Shanghai and Shenzhen stock exchanges.

†Foreign investors include companies and individuals located in Hong Kong, many of which are subsidiaries of mainland Chinese companies. Residents of Hong Kong and Macau are treated as foreigners for the purposes of constructing China's balance of payments data. International Monetary Fund, "Special Data Dissemination Standard," January 30, 2022.

‡The United States and EU have established similar funds to provide the money needed to rescue or liquidate systematically important financial institutions. Such funds seek to guard against the financial contagion that could arise if a particularly large business that is interconnected with the rest of the economy fails, thereby putting stress on the broader economy. In 2010, Congress enacted the Dodd-Frank Act, which established an Orderly Liquidation Fund within the Federal Deposit Insurance Commission to provide funds needed in the liquidation of failed businesses. In 2016, the EU established a Single Resolution Fund responsible for resolving failed banks. Tang Ziyi and Peng Qinqin, "Caixin Explains: Why China's Creating a Financial Security Fund," *Caixin*, March 8, 2022.

financial institutions, at the March legislative session.[120] Details on the fund were provided in a draft Financial Stability Law released the following month.[121] The draft law codifies the existing processes for financial risk management and disposal, effectively institutionalizing a bailout process over which the central government can exercise direct control.[122] The planned fund and legislation follow a series of ad hoc interventions by China's central government to bail out risky financial institutions, including Anbang Insurance Group, Tomorrow Holding Co. Ltd., Baoshang Bank, and Huarong Asset Management Company.[123] To capitalize the fund, the PBOC—together with six other State Council ministries—raised $9.6 billion from state-owned banks in May 2022.[124] China's government announced its intent to transfer a total upward of $100 billion into the fund by September 2022, but by the end of that month it had not disclosed any further contributions following the initial $9.6 billion.[125] In creating the fund, the central government seeks to impose greater discipline on financial risk management to limit the ability of local governments to engage in indiscriminate lending. However, the law simply reshuffles the moral hazard created by the state's backstopping of the financial system.[126]

Runs on Small Banks Highlight Pressures Facing the Banking System

In April 2022, five rural banks in China prevented depositors from accessing their savings after becoming insolvent. The banks, four of which are located in Henan Province and the fifth of which is located in neighboring Anhui Province,* drew depositors with high interest rate savings accounts, using online platforms to attract funds beyond their limited home bases.[127] Instead of placing the savings in accounts protected by China's depository insurance,† the banks fabricated lending agreements to fund off-the-book activities through Henan New Fortune Group, a company that is the largest shareholder in each bank.[128] According to reporting from Chinese state-owned magazine *Sanlian Lifeweek*, more than 3,000 depositors with over $210 million (RMB 1.4 billion) in funds were impacted.[129] On July 10, around 1,000 protestors gathered outside the Zhengzhou branch of the PBOC seeking redress.‡ [130] Plainclothes security forces clashed with the crowd to disperse the protest, with some protestors taken away by police.[131] Henan officials have pledged to repay the deposits in batches, but they did not specify a timeframe for larger accounts

*The banks are Yuzhou Xinminsheng Rural Bank, Shangcai Huimin County Bank, Zhecheng Huanghuai Community Bank, Kaifeng New Oriental Rural Bank, and Guzhen Xinhuaihe Village Bank. In China, local banks may only obtain deposits from a local customer base, but the banks used third-party platforms to acquire customers from outside the region online. Amanda Lee and Ji Siqi, "How China's Henan Bank Scandal Threatens a 'Crisis of Confidence' in Nation's Financial System," *South China Morning Post*, July 14, 2022.

†China introduced a national deposit insurance system in 2015, covering deposits up to $74,627 (RMB 500,000). People's Bank of China, *Deposit Insurance Regulation*, February 17, 2015.

‡Groups of depositors unable to access funds had traveled to Zhengzhou prior to the July 10 gathering and the Zhengzhou government reportedly modified their health codes, a system China uses to track COVID-19 cases, imposing travel and quarantine restrictions on the depositors. One depositor from Beijing reported his code turned back to normal after local police escorted him to a train home. Nectar Gan, "China's Bank Run Victims Planned to Protest. Then Their Covid Health Codes Turned Red," *CNN*, June 15, 2022.

Runs on Small Banks Highlight Pressures Facing the Banking System—*Continued*

or a maximum on the size of repayment, potentially leaving some depositors with a fraction of their savings.[132]

The bank runs underscore the deterioration of asset quality and profits of small rural lenders during the pandemic. According to the CBIRC, rural commercial bank earnings did not recover with the rest of the economy between the first quarter of 2020 and the first quarter of 2021, as loans to SMEs constitute a much larger proportion of their portfolios.[133] While deposits held at small banks accounted for 28.8 percent of all deposits at domestic banks at the end of 2021, the PBOC does not view the Henan and Anhui bank runs as indicative of a systemic problem.[134] Nonetheless, the CBIRC will allocate $47.8 billion (RMB 320 billion) in special purpose bonds for recapitalizing small banks by September 2022.[135]

CCP Leaders Underscore Intent for Capital Markets to Serve National Priorities

At the 2021 Central Economic Work Conference (CEWC),* Chinese leaders announced they would establish a "traffic light" mechanism to enhance the supervision and development of capital markets. As of October 2022, no formal policy has been released, but numerous officials and financial commentators have penned articles describing a potential regulatory mechanism that would incentivize investment in "green light" priority areas and prevent investment in "red light" areas, which will be identified by financial regulators and the Cybersecurity Administration of China based on risks to the financial system and data security.† [136] The stated goals of the mechanism are to ensure capital markets serve overall national development objectives and "prevent capital from growing wildly."[137] Numerous opinions published in state media sources suggest the red light would be aimed primarily at "platform monopolies," referring to the consumer technology companies that provide a platform or marketplace connecting consumers with sellers or providers, such as e-commerce giant Alibaba.[138] Platform monopolies were targeted by regulatory action throughout 2021 and 2022. The CBIRC also noted in its 2022 work report that it would set up "traffic lights" to curb the use of funds by banks and insurers for "blind overleveraging," financial monopolies and unfair competition, and unlicensed financial business.[139] The "traffic light" system would supplement existing levers the CCP uses to guide capital toward priority investments and maintain overall financial stability, including government guidance funds that blend state and nonstate capital to support investment in strategic technologies, and the national team, a group of brokerages China's government has directed to buy up equities during market downturns.

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*The CEWC is China's preeminent annual economic conference, attended by top leadership from the CCP, the State Council, and the National People's Congress. General Secretary Xi and Premier Li both attended the 2021 conference. *Xinhua*, "China Holds Key Economic Meeting to Plan for 2022," December 10, 2021.

†As the CEWC does not formally publish any laws or regulations, the resulting "guidance" from the CEWC annual meeting is transmitted through Party and government internal communications, with key themes made public in limited readouts and propaganda.

Regulatory Tightening Eases, but Tech Sector Recovery Shaky

The Chinese government eased regulatory tightening against tech companies in 2022, though many of the previous year's new regulations came into effect in early 2022. Beginning in late 2020 and through 2021, CCP leaders launched a series of investigations, issued numerous penalties, and introduced new regulations targeting nonstate consumer technology and e-commerce companies.* Key drivers of this campaign included establishing state control over consumer data, containing tech firms' expansion into financial services, and ending e-commerce giants' anticompetitive practices.† In addition to securing data within China's borders, new regulations reflect Chinese policymakers' desires to better direct technological developments in China and control the expansion and influence of nonstate companies. The shift in the government's approach to a more predictable style of enforcement came as confidence in the Chinese economy was dimming from Zero-COVID lockdowns and slowing growth. In a clear move to ease investor concerns around stability, the Politburo announced easing on the tech sector in April 2022. Chinese officials later met with tech executives to assure them that the government would be taking a more predictable and consistent approach to regulating companies.[140] China's Vice Premier Liu He followed up the meeting with a public statement of support for the digital economy and its role in sustaining China's growth.[141]

Chinese tech company performance and continued confidence in the sector remain uncertain. Following the government's public assurances, U.S.-listed Chinese tech company valuations rose between 5.5 percent and 13.5 percent after the year-long downturn caused by regulatory investigations and fines.[142] At the same time, in May 2022 Chinese ride-sharing company Didi Chuxing announced it would delist from the New York Stock Exchange and finally exited on June 10.[143] The company had been under intense pressure from Chinese regulators since its listing on the New York Stock Exchange in June 2021, when regulators also launched a cybersecurity investigation into the company and prohibited new downloads of the app in China.[144] Didi Chuxing has indicated it may relist on the Hong Kong Stock Exchange once the delisting process in the United States is complete.[145] Even for companies that have survived regulatory probes, reporting indicates that during the spring of 2022, platform companies also laid off large numbers of employees in response to regulatory and economic uncertainty.[146] In early July 2022, Chinese company valuations suffered again, dragging the

* For more on the campaign, see U.S.-China Economic and Security Review Commission, Chapter 2, Section 1, "Year-in-Review: Economics and Trade," in *2021 Annual Report to Congress*, November 2021, 134–136.

† For example, in April 2021 China's financial regulators met with 13 nonstate technology firms, including embattled ride-hailing giant Didi Chuxing and Tencent, and signaled more stringent scrutiny of their financial businesses. Among other things, the regulators stated that companies must obtain licenses to provide financial services, cut "improper links" between their payment services and other financial products, and restructure their financial assets into holding companies to bring the businesses under proper supervision. Hu Yue and Han Wei, "China Orders 13 Tech Companies to Overhaul Fintech Operations," *Caixin*, April 30, 2021.

Hang Seng Tech Index down by as much as 3.7 percent after the State Administration for Market Regulation fined internet platforms Alibaba and Tencent for improper disclosure of prior transactions.[147] The drop demonstrated low investor faith and perceptions of an exceptionally unpredictable regulatory enforcement.

China's government has introduced new measures on data regulation and strengthened coordination on data governance between agencies. In late 2021 and early 2022, several new laws and regulations came into effect that limit the transfer of data and constrain companies' abilities to collect and use data. Although some of these new rules address consumer protection, they also reinforce China's mercantilist data strategy. While these policies affect all companies, foreign firms are likely to have the most difficulty in continuing to access China's market and Chinese consumers, as these data protection laws restrict cross-border data flows and technical functionality. March 2022 provisions on regulating algorithms broadly prohibit firms from using algorithms to "over-recommend, manipulate topic lists or search result rankings, or control hot search terms" as well as to "carry out acts influencing online public opinion."[148] Both prohibitions may be broadly interpreted by Chinese regulators and present significant risk to firms operating in the Chinese market. These restrictions can be particularly challenging for e-commerce companies as well as entertainment and social media platforms that rely on algorithms to boost popular products and content. Meanwhile, the Chinese government has emphasized the importance of data collection and processing for the development of key technologies that have significant commercial and national security implications. Between late 2021 and 2022, China released several technology-specific, five-year plans for smart manufacturing, robotics, national informationization, big data, and bioeconomy development.[149] These plans build on the 14th Five-Year Plan (2021–2025) and Long-Term Objectives for 2035 released in March 2021 and underscore the importance of these technologies for China's near- and long-term growth strategy. Each of these plans also emphasizes the role of data in the effective development of these technologies and the importance of data-driven applications.

U.S.-China Commercial Relations

U.S. businesses are reevaluating their engagement with China and investors are reducing their investment positions in China's financial markets. Although many U.S. firms remain attracted to what they believe are economic opportunities in China's market, developments in 2022 raised the risks and costs associated with engagement in China's economy. U.S. imports of Chinese goods remained robust in the first half of 2022, but U.S. firms were reluctant to deepen their long-term investments in the Chinese market. This uncertainty is driven chiefly by the consequences of the Zero-COVID policy for China's economy. Geopolitical tensions and regulatory misalignment with the United States on issues including auditing standards and forced labor protections have further contributed to a fraying of the bilateral trade and investment relationship. The U.S. government is promoting efforts to mitigate supply chain vulnerabilities from Chinese sources and promote alternative trading arrangements, including the Indo-Pacific Economic Framework for Prosperity (IPEF).

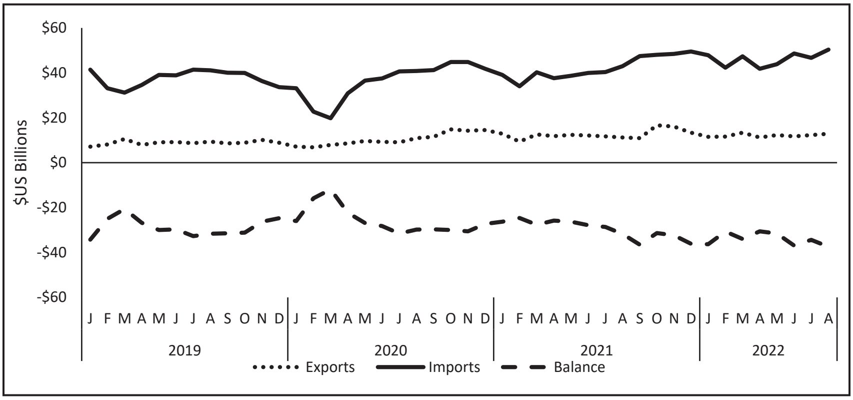
Trade

Bilateral Trade Deficit Continues to Widen as Phase One Expires

The U.S. goods deficit with China continued to expand in 2022 as China structured its pandemic control measures to enable export industries to continue operating. In the first eight months of 2022, the U.S. goods trade deficit with China totaled $271.9 billion, increasing by 24.2 percent year-on-year (see Figure 1).[150] This increase was led by U.S. imports from China, which rose through August by 17.8 percent to reach $368.8 billion.[151] Chinese local governments' support to the export sector even in the face of stringent pandemic control measures enabled Chinese producers to meet resilient U.S. demand. To keep factory lines open and production humming despite broader lockdowns, local authorities in manufacturing hubs such as Shenzhen, Dongguan, and Changchun allowed firms to use a "closed-loop" system.[152] Under this system, workers at certain firms—including major Chinese battery manufacturer Contemporary Amperex Technology Ltd. (CATL)—could continue to work but had to confine themselves to the worksite to eliminate outside exposure to COVID-19.[153] These workers were forced to live in onsite dormitories or temporary housing, many of which lacked adequate amenities, such as beds.[154] In May 2022, the poor living and working conditions led hundreds of workers at a Shanghai factory of Quanta Computer, a Taiwan-owned supplier to Apple, to protest and clash violently with guards who were trying to keep workers in isolation.[155]

China's Zero-COVID policies and rising inflation cooled overall demand for U.S. exports. Although the value of U.S. exports to China in the first eight months of 2022 increased 2.4 percent year-on-year, totaling $96.8 billion, the total value of exports was inflated by rising commodity prices. Exports by volume moderated or declined, especially for agriculture products. The price of agriculture commodities rose sharply due to Russia's unprovoked invasion of Ukraine, higher global demand, and adverse supply factors, causing the value of U.S. agriculture exports to rise 17.0 percent year-on-year in the first half of 2022 despite export shipments falling 2.7 million tons, equivalent to a 9.3 percent decline.[156] Other major U.S. exports to China, including computer and electronic products, fell in value terms as China's declining industrial output and weak consumption slowed demand for inputs and finished goods.[157]

Figure 1: U.S. Bilateral Trade with China, January 2018–August 2022



Source: U.S. Census Bureau, *Trade in Goods with China*, October 5, 2022.

The U.S. trade deficit in advanced technology products (ATP) widened as Chinese demand for U.S. exports weakened. Through August 2022, the U.S. trade deficit in ATP with China increased 15.1 percent year-on-year to $73.7 billion, which is the largest deficit over the same period since 2018, when the United States and China began imposing tariffs amid heightened trade tensions.[158] U.S. imports of Chinese technology products rose 10.3 percent, while U.S. ATP exports to China declined by 1.7 percent.[159] The growth in the trade deficit was driven by increases in U.S. imports of Chinese information and communications technology and a fall in Chinese demand for U.S. advanced electronics products.[160] Biotechnology product imports from China, including pharmaceutical products,* also increased sharply, rising by 385.4 percent to reach $1.8 billion.[161] Purchases of immunological products containing monoclonal antibodies led this increase.†

The Office of the U.S. Trade Representative (USTR) signaled that tariffs serve as a source of leverage in bilateral negotiations with Beijing following China's failure to comply with the Phase One Economic and Trade Agreement. In an October 4, 2021, speech on U.S.-China economic and trade relations and the

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*Pharmaceutical imports from China are subject to product safety risks because Chinese facilities frequently impede inspections by the U.S. Food and Drug Administration's (FDA) field office in China. Additionally, since the outbreak of COVID-19, the FDA has conducted far fewer inspections in China, with only 25 pre-approval, for-cause, and current good manufacturing practices (CGMP) surveillance inspections in fiscal year 2021, and 11 in fiscal year 2022 as of early July. In contrast, the FDA conducted an average of 165 inspections per year in China between fiscal years 2016 and 2019. The FDA has also been unable to implement a pilot program for unannounced foreign inspections of drug manufacturers in China due to COVID-19 lockdowns and travel restrictions. For more on China's pharmaceutical production and limitations on FDA inspection in China, see U.S.-China Economic and Security Review Commission, Chapter 3, Section 3, "Growing U.S. Reliance on China's Biotech and Pharmaceutical Products," in *2019 Annual Report to Congress*; U.S. Government Accountability Office, DRUG SAFETY: FDA Should Take Additional Steps to Improve Its Foreign Inspection Program. January 2022, 20; U.S. Food and Drug Administration, *Resiliency Roadmap for FDA Inspectional Oversight*, May 2021, 3.

†The U.S. government has increased its procurement of antibody therapy treatments for COVID-19, including contracts for etesevimab, which is codeveloped by Eli Lilly and Shanghai Junshi Biosciences. U.S. Census Bureau, *USA Trade Online*, August 18, 2022; Sasha Pezenik and Cheyenne Haslett, "Government Nearly Exhausts Monoclonal COVID Treatment Funding with New Purchase," *ABC News*, June 30, 2022; Eli Lilly, "Lilly to Supply 614,000 Additional Doses of Bamlanivimab and Etesevimab to the U.S. Government for the Treatment or Post-Exposure Prevention of COVID-19," November 2, 2021.

future of the Phase One agreement, USTR Katherine Tai noted the Chinese government has "doubled down on its state-centered economic system" and does not have plans to address longstanding U.S. trade concerns.[162] Ambassador Tai stated that China's performance under the Phase One deal would serve as a starting point for negotiation with Beijing over its economic and trade practices.[163] The Chinese government failed to meet its purchase commitments under the terms of the agreement. According to Chad Bown, senior fellow at the Peterson Institute for International Economics, China bought only 57 percent of the additional $200 billion of covered U.S. goods China committed to buy under the agreement.[164] China began paring back its purchases of U.S. agriculture products in the first half of 2022, after the Phase One deal commitments expired.[165]

The tariffs imposed under the Trump-era Section 301 investigation remain in place, though inflation has increased pressure on the Administration to remove them. There is clear disagreement among cabinet officials in the Biden Administration about the purpose and potential benefit of these tariffs. In June 2022, U.S. Secretary of the Treasury Janet Yellen said some tariff cuts "may be warranted" and that some of the tariffs serve "no strategic purpose."[166] That same month, Ambassador Tai said the tariffs provide "significant leverage."[167] Both officials have noted that cutting tariffs is not a "panacea" to addressing inflation.[168] USTR is currently conducting a review of tariffs on Chinese goods. Reporting from several outlets in early 2022 revealed that USTR was contemplating launching another Section 301 investigation into China's subsidies, but no such investigation has been announced.[169]

Finance and Investment

Economic Headwinds and Geopolitical Tensions Stem Foreign Portfolio Investment Flows

U.S. and foreign investor interest in China's financial markets moderated in 2022 due to China's slowing economic growth, refusal to condemn Russia, and declining interest rates and currency value. After years of surging U.S. and foreign investor participation in China's equity and bond markets,* foreign investment tightened as capital outflows began to accelerate in 2022 due to uncertainty plaguing China's markets. Weakening economic growth and increasing political risk weighed on stock valuations, while the interest rate advantage narrowed for Chinese government bonds. In mid-March, analysts at JPMorgan signaled their caution toward investments in Chinese companies, describing shares of Chinese internet companies as "uninvestable."[170] According to index provider Eurekahedge, between January and July 2022 hedge funds focused on China, Hong Kong, Macau, and Taiwan reported $3.6 billion in net outflows—the largest drop in the dataset's 15-year history.[171] By contrast, the index showed net inflows of $1.8 billion in 2021 and $8.7 billion in 2020.[172] The analysis was not universal on Wall Street, however, as some major banks, including

*U.S. holdings of Chinese equity and debt securities grew nearly twofold from $387.9 billion in 2015 to $1.14 trillion at the end of 2020, the latest year for which data are available from the U.S. Department of the Treasury. U.S. Department of the Treasury, *Treasury International Capital (TIC) System: Securities (C): Annual Cross-Border Portfolio Holdings*, December 30, 2021.

Bank of America and Goldman Sachs, advised clients to "buy the dip," assuring U.S. investors that Chinese securities would recover quickly as soon as COVID-19 containment measures ameliorated.[173]

U.S. fund managers pursue new opportunities in China's private pension market. The Chinese government will pilot a private pension scheme, enabling foreign investors to enter China's state-dominated pension system.* According to an April 21 circular from China's State Council, workers participating in China's basic pension schemes can join a new private pension scheme.†[174] Draft rules published by the China Securities Regulatory Commission (CSRC) in June 2022 state that mutual funds with at least $7.5 million (RMB 50 million) of assets over the preceding four quarters will be eligible to participate in the scheme.[175] The launch of private pensions comes as slowing population growth strains China's fragmented public pension system, which is largely managed at the local level rather than operating as a national system.[176] A 2019 report from the state-backed Chinese Academy of Social Sciences warned that China's national urban enterprise employee basic pension insurance fund, which covers nearly half of individuals participating in a government-based pension scheme, will become insolvent by 2035.[177] Allowing foreign fund managers to invest in Chinese pensions enables the Chinese government to utilize foreign expertise in developing its pension management market and alternative savings outlets for Chinese households. This task is assuming increased urgency in 2022 because urban residents keep the majority of their wealth in China's slumping property market and need alternative investments.[178] The private pension scheme initiative underscores how the Chinese government permits foreign participation in China's financial markets when it suits the national interest. Four U.S. firms have received approval to establish wealth management and/or mutual fund businesses: BlackRock and Goldman Sachs for majority-owned wealth management joint ventures in May 2021; Neuberger Berman Group for a wholly owned mutual fund business in September 2021; and Fidelity and BlackRock for wholly owned mutual fund businesses in August 2021 and August 2020, respectively.[179] While details on how the scheme will operate are scant, foreign asset managers are already making moves to participate in a market slated to grow from $300 billion currently to at least $1.7 trillion by 2025.[180] U.S. asset manager BlackRock plans to launch a pilot pension wealth management product in Chengdu and Guangzhou later this year, while JPMorgan has applied for regula-

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*China has a multilayered pension system. The first layer consists of several public pension schemes, some mandatory, such as the Basic Old Age Insurance and Public Employee Pension, and some voluntary, such as the Urban Resident Pension and New Rural Resident Pension. These schemes provide basic social security to all residents when they retire, regardless of whether they were employed. The second layer consists of employer-sponsored annuity programs, which employers voluntarily provide as a supplement to the public pension scheme. The third and most underdeveloped layer is the household savings-based annuity insurance policies, or private personal pension funds. According to analysts at Chinese brokerage Industrial Securities Co. Ltd., these personal pension funds accounted for less than 0.01 percent of China's total pension funds in 2020. Zhang Yukun. "Five Things to Know about China's Private Pension System," *Caixin*, April 21, 2022; Hanming Fang and Jin Feng, "The Chinese Pension System," in Marlene Amstad, Guofeng Sun, and Wei Xiong, eds., *The Handbook of China's Financial System*, Princeton University Press, 2020, 421–443.

†According to Chinese state news agency Xinhua, 1.025 billion people were covered by China's basic pension scheme as of November 2021. *Xinhua*, "National Basic Pension Insurance Participation Amount Grows to 1.025 Billion" (全国基本养老保险参保人数达10.25亿人), February 1, 2022. Translation.

tory approval of its 100 percent takeover of China Investment Fund Management, its onshore fund manager and joint venture partner with Shanghai International Trust Company.[181]

China Takes Steps to Comply with U.S. Listing Standards

U.S. and Chinese regulators reached an agreement allowing the Public Company Accounting Oversight Board (PCAOB) to inspect auditors of U.S.-listed Chinese firms, which may resolve a decades-long impasse and potentially prevent the mass-delisting of Chinese issuers from U.S. exchanges.[182] Following the SEC's implementation of the Holding Foreign Companies Accountable Act (HFCAA),* on August 26, 2022, the CSRC and China's Ministry of Finance signed a Statement of Protocol for U.S. inspections of auditors based in China and Hong Kong. In September 2022, PCAOB inspectors traveled to Hong Kong and began reviewing the audit work done by PricewaterhouseCoopers Hong Kong and KPMG China for U.S.-listed issuers under the conditions of the framework deal.[183] PCAOB personnel are reportedly traveling to Hong Kong instead of the Mainland due to uncertainty over travel restrictions and adverse quarantine conditions,† meaning that U.S. investigators are relying on Chinese regulators to provide access to the work papers and personnel of auditors located in mainland China.‡ [184] The text of the agreement has not been publicly released and the Commission has not reviewed the document.§

Despite the agreement, PCAOB investigators may still be unable to access the material they require to perform their oversight activities, a gap that would likely lead to more delistings. According to the Sarbanes-Oxley Act, the PCAOB must review complete audit papers of publicly traded companies on U.S.

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*The HFCAA was signed into law on December 18, 2020. The law requires certain issuers of securities to establish that they are not owned or controlled by a foreign government. Issuers must make this certification if the PCAOB is unable to inspect an issuer's audit work papers. Securities from issuers whose audit work papers cannot be inspected by the PCAOB for three consecutive years are then prohibited from being traded on U.S. exchanges. On December 2, 2021, the SEC adopted amendments to finalize rules to implement strengthened disclosure requirements for U.S.-listed Chinese companies as directed in the HFCAA. Those companies whose auditors cannot be inspected by the PCAOB are then designated "Commission-Identified Issuers" and are required to disclose the percentage of their shares owned by a government entity, whether a government entity has a controlling financial interest in the company, the name of each CCP official who is a member of the company's board of directors, and whether the company's articles of incorporation contain any charter of the CCP. If a company is designated as a Commission-Identified Issuer for three consecutive years, trading of its securities on U.S. exchanges becomes prohibited.

†For over two years, Chinese COVID-19 restrictions on foreign travel have hampered the ability of multiple U.S. agencies to carry out on-the-ground inspections and ensure regulatory compliance. The Department of Commerce's Bureau of Industry and Security has also been unable to perform its usual inspections of verified Chinese end users of controlled U.S. exports due to China's COVID-19 restrictions. As noted above, the FDA is also unable to implement a pilot program for unannounced foreign inspections of Chinese drug manufacturers. Judith McMeekin, "Webinar with Dr. Judith McMeekin, Director of the Office of Regulatory Affairs," *Alliance for a Stronger FDA*, April 6, 2022, 21; U.S. Government Accountability Office, *Drug Safety: FDA Should Take Additional Steps to Improve Its Foreign Inspection Program*, January 7, 2022; Jeremy Pelter, oral testimony for U.S.-China Economic and Security Review Commission, *Hearing on U.S.-China Relations in 2021: Emerging Risks*, September 8, 2021, 173.

‡Neither the PCAOB nor the CSRC have commented on whether the agreement will enable PCAOB personnel to travel to mainland China in the future. Qianer Liu and Tabby Kinder, "Alibaba and Yum China First in Line for Audit Checks by U.S. Regulator," *Financial Times*, August 31, 2022; U.S. Embassy & Consulates in China, *Fact Sheet—PCAOB Agreement with China on Audit Inspections and Investigations*, August 27, 2022.

§The PCAOB has signed cooperative arrangements with 26 foreign audit regulators to facilitate U.S. regulatory inspections, and it has released the text for all but five of these agreements. It has not published the Statement of Protocols signed with Australia, Canada, China, South Korea, and Singapore. U.S. Public Company Accounting Oversight Board, *PCAOB Cooperative Arrangements with Non-U.S. Regulators*, 2022.

exchanges.[185] The audit agreement does not permit any redactions within audit papers, although the PCAOB has agreed to confidentiality measures when reviewing sensitive data and personal identifiable information.[186] The CSRC indicated, however, that Chinese laws and regulations may require it to use "specialized handling procedures" for sensitive information.[187] The framework may permit agencies like China's Ministry of Finance and the Cyberspace Administration of China to review information requested before it is provided to the PCAOB, potentially limiting the completeness of its inspection.[188] In addition, the CSRC's April 2022 draft revisions to confidentiality rules governing offshore listings of Chinese companies stipulate that Chinese firms must first submit in writing an overview of information that they will make available to foreign audit regulators to the CSRC for approval.[189] While these rules are not yet in effect, they underline the priority the CCP places on control over the transmission of data collected by Chinese companies. SEC Chair Gary Gensler stated that the PCAOB will determine by December 2022 whether China has denied it the level of access agreed to in the deal, which could lead to delistings of noncompliant Chinese companies in accordance with the HFCAA.[190]

Until the PCAOB rules on the compliance of Chinese regulators with the audit deals, Chinese companies that are noncompliant with the HFCAA face an uncertain future. As of September 30, 2022, the SEC designated 164 Chinese companies as Commission-Identified Issuers, including 33 issuers trading over-the-counter or that have no substantial operations in China.[191] The 131 noncompliant Chinese companies listed on major U.S. exchanges had a total market capitalization of $760.2 billion on September 30, 2022.* [192] Should the PCAOB determine that it is not granted full access in accordance with the deal, Chinese companies that remain noncompliant with the HFCAA will likely preemptively delist, rather than face forced delisting under the HFCAA. A number of companies that have been designated as Commission-Identified Issuers—including Alibaba, the largest Chinese company on U.S. exchanges by market capitalization—have applied for primary listings † on the Hong Kong Stock Exchange.[193] This approach could

*In total, as of September 30, 2022, 262 Chinese firms are listed on major U.S. exchanges, with a combined market capitalization of $776 billion. U.S.-China Economic and Security Review Commission, *Chinese Companies Listed on Major U.S. Stock Exchanges*, September 30, 2022.

†Chinese issuers listed on U.S. stock exchanges can list on the Hong Kong Stock Exchange by applying for either a secondary listing or a dual-primary listing. In a dual-primary listing, the Chinese company must comply with all the regulatory requirements of both the U.S. exchange and the Hong Kong Stock Exchange. The Hong Kong Stock Exchange applies less stringent regulatory requirements for companies under a secondary listing, but a qualifying U.S. exchange (the New York Stock Exchange or the Nasdaq) must remain the main trading market for the issuers' shares. If the Chinese issuer's securities are delisted from U.S. exchanges while it holds secondary-listing status on the Hong Kong Stock Exchange and does not otherwise satisfy the requirements for a primary listing, it may also be delisted in Hong Kong. Prior to 2022, Alibaba and other overseas-listed issuers in high-tech sectors that utilize certain dual-class share structures and/or variable interest entities were not eligible for primary listings on the HKEX, but they could apply for secondary listings. The HKEX revised the rules for overseas issuers seeking to apply for dual listings to permit these ownership structures, and the amendments took effect on January 1, 2022. Kelsey Cheng, "Why U.S.-Traded Chinese Firms Are Choosing Dual Primary Listings in Hong Kong," *Caixin Global*, September 6, 2022; Hong Kong Stock Exchange, "Change of Listing Status from Secondary Listing to Dual-Primary or Primary Listing on the Main Board," HKEX GL 112-22, January 2022, 18; Skadden, Arps, Slate, Meagher & Flom LLP, "HKEx Finalizes New Rules on Listings for Overseas Issuers," December 14, 2021; Gordon Tsang and Rain Huang, "Homecoming Listings of China Concept Stocks on the HKEX: The Three Pathways," *Hong Kong Lawyer*, August 2020.

create a pathway for investors to convert American Depository Receipts (ADRs) of delisted Chinese issuers into shares of their Hong Kong listings.* [194]

Chinese companies that control data and information deemed sensitive by the CCP may be compelled to delist by China's government in spite of the audit deal. On August 12, 2022, five Chinese SOEs† announced their plans to delist their ADRs from the New York Stock Exchange.[195] Although the SOEs cited the low turnover in the United States and "high administrative burden and costs" as the reasons for delisting, the coordination of the delistings on the same day suggests that China's Ministry of Finance directed these companies to do so, likely due to the possibility of an audit deal and the sensitivity of information they oversee.[196] More Chinese companies that control information and data the CCP deems sensitive may be compelled to delist to shield their financial documents from U.S. regulators.[197] Because the PCAOB is tasked with retrospectively investigating fraud by U.S. issuers, investigations could require Chinese regulators to provide access to the auditors and work papers for Chinese issuers even if they have voluntarily delisted from U.S. exchanges.[198]

Foreign Direct Investment

U.S. direct investment into China stalls as multinational companies face an uncertain business environment in China. According to preliminary data compiled by Rhodium Group, U.S. foreign direct investment (FDI) transactions in China fell to their lowest level since 2004, with U.S. companies investing $8.5 billion into new projects, expansions, and acquisitions in China.[199] The value of U.S. FDI flows into China in 2021 remained below the 2020 total of $8.7 billion, when the COVID-19 pandemic caused a sharp decline in investment activity (see Table 1).[200] The multiyear slowdown in FDI underlines a reevaluation of China as an investment priority for U.S. multinational businesses.

Table 1: Value of U.S. FDI in China (2019–2021)

Year	U.S. FDI transactions in China	Year-on-year change
2019	$13.1 billion	4.8 percent
2020	$8.7 billion	-35.1 percent
2021	$8.5 billion	-2.3 percent

Note: FDI data compiled by Rhodium Group includes completed transactions of over $1 million and encompasses acquisitions and greenfield investment with over 10 percent ownership stakes and the expansion of existing FDI operations. Thilo Hanemann et al., "Two-Way Street: 2021 Update U.S.-China Investment Trends," *Rhodium Group*, May 2021, 36.
Source: Various.[201]

*ADRs are certificates issued by U.S. banks that trade in the United States but represent shares of a foreign stock. Most foreign issuers prefer ADRs because they are easier to transfer and manage than foreign shares directly listed on U.S. exchanges. U.S. Securities and Exchange Commission, *Investor Bulletin: American Depository Receipts*, August 2012.

†The five Chinese SOEs are China Petroleum and Chemical Corporation (Sinopec), China Life Insurance, Aluminum Corporation of China (Chalco), PetroChina, and Shanghai Sinopec Petrochemical Company. Another SOE, Huaneng Power International, delisted on July 7, 2022; These SOEs remain listed on the Shanghai Stock Exchange. *Reuters*, "Five Chinese State-Owned Companies, under Scrutiny in U.S., Will Delist from NYSE," August 12, 2022; Huaneng Power International Inc., "Announcement of Intention to Delist American Depositary Shares from the New York Stock Exchange and Intention to Deregister and Terminate Reporting Obligations under the U.S. Securities Exchange Act," June 21, 2022.

U.S. firms indicate plans to moderate their operations in the Chinese market as Beijing's stringent pandemic control measures upset the operating environment. In testimony before the Commission, Harvard Business School professor Willy Shih observed that the Chinese government's Zero-COVID policy has injected a "major degree of uncertainty" into the business environment and cooled multinational firms' commitment to operating in China.[202] Business survey data bear out Dr. Shih's observation. According to a "flash survey" conducted by business chamber American Chamber of Commerce (AmCham) in China from April 29 to May 5, at the height of an extensive lockdown in Shanghai, half of the 121 responding U.S. companies said they already plan to delay or decrease investment in China as a result of the Chinese government's pandemic control measures.[203] Just over half of respondents indicated they would continue to pare back investment if pandemic controls persisted into 2023.[204] In its separate 2022 Business Climate Survey, an annual review of the operating environment facing U.S. firms in China, AmCham China member firms underscored their increased concern with sporadic pandemic controls: "inconsistent/unclear laws and/or regulations and enforcement" became U.S. firms' second-biggest challenge in 2022, up from the third spot in 2021 (see Table 2).[205] U.S. firms are not alone in reconsidering their exposure to the Chinese market. According to an EU Chamber of Commerce in China survey conducted at the end of April, nearly one in four European firms operating in China are considering shifting production out of the country.[206]

Table 2: Top Five Challenges Facing U.S. Businesses in China, AmCham China 2022 Business Climate Survey Report

2022 Business Climate Survey Rank	2022 Business Climate Survey Challenge	2021 Business Climate Survey Rank
1	Rising tensions in U.S.-China relations	1
2	Inconsistent/unclear laws and/or regulations and enforcement	3
3	Rising labor costs	2
4	Regulatory compliance risks	6
5	Concerns about data security	5

Source: AmCham China, "2022 American Business in China White Paper," May 2022, 8. *https://www.amchamchina.org/wp-content/uploads/2022/05/WP2022-Final.pdf.*

China's politicized regulatory environment is forcing some U.S. businesses to terminate their operations in China. According to the AmCham China survey, an increasing number of firms cited "regulatory compliance risks" as a top challenge.[207] In July 2022, the multinational automotive corporation Stellantis announced it would terminate its joint venture with Guangzhou Automobile Group that produces and distributes Jeep vehicles for the

Chinese market.*[208] Stellantis CEO Carlos Tavares stated that the decision was made due to the "growing political interference in the way we do business as a western company in China."[209] U.S.-run web service providers, including Airbnb, Amazon's Kindle, and Yahoo!, have also stopped operating in China since 2021, when China began implementing new cybersecurity laws that increase government control over data transfers and companies' use and collection of data.[210] An increasing number of U.S. manufacturers are pursuing "China + 1" strategies to move portions of their manufacturing processes outside of China.[211] (For more on China's position in multinational firms' supply chains, see Chapter 2, Section 4, "U.S. Supply Chain Vulnerabilities and Resilience.")

China's External Economic Relations and Diplomacy

China's economic outreach to other countries continued to slow in 2022. Although this slowdown has occurred with both developing and developed countries, the nature of the slowdown differs. China has continued to slow its lending to many developing countries, even as it attempts to extend its economic influence among these countries through efforts such as the newly announced Global Development Initiative. Meanwhile, China's economic relations with advanced economies have continued to experience setbacks. Developed countries have shown increasing awareness of the risks of economic overreliance on China and increasing willingness to push back against the Chinese government's use of economic coercion, particularly its punishment of Lithuania for allowing Taiwan to set up a de facto embassy in Vilnius. Russia's unprovoked invasion of Ukraine has also affected China's external economic policies, as Beijing has sought to avoid running afoul of economic sanctions on Russia while simultaneously searching for ways to lessen its own vulnerability to financial sanctions and other economic policy responses from the United States and its partners.

Lending to Developing Countries Slows, but Debt Problems Persist

Beijing's lending to developing countries has slowed down sharply compared with pre-pandemic levels. While the Chinese government does not publish official data on China's overseas lending, research by outside experts has shown a considerable slowdown in different regions. According to the Inter-American Dialogue's China-Latin America Finance Database, in both 2020 and 2021 Chinese policy banks did not provide any lending to countries in Latin America and the Caribbean, down from $1.9 billion in 2019.[212] Similarly,

*Earlier in 2022, Stellantis announced intentions to increase its stake in the joint venture from 50 to 75 percent, following China's government's removal of a cap on foreign ownership in passenger vehicle joint venture at the start of 2022. In February 2022, BMW also paid $4.2 billion to increase its 50 percent stake with troubled Brilliance China Automotive Holdings Ltd. to 75 percent. In a September 2, 2022, regulatory filing, Hong Kong-listed Brilliance revealed its state-owned parent Huacheng Automotive Group Holdings Co. Ltd conducted illegal transfers and guarantees amounting to $7.7 billion (RMB 52 billion) from Brilliance and its subsidiaries without approval from the company's board of directors or notification of the company's shareholders. An Min and Guo Yingzhe, "$1.2 Billion Sucked Out of BMW's Chinese Partner through 'Ghost' Transactions," *Caixin Global*, September 6, 2022. Peter Campbell, "Boss of Carmaker Stellantis Warns of Growing China Interference in Business," *Financial Times*, July 29, 2022.

the Boston University Global Development Center's Chinese Loans to Africa Database recorded $1.9 billion in loans to Africa in 2020, down from $8.2 billion in 2019.[213] While comprehensive data for 2022 are not yet available, comments from developing countries suggest China's lending has continued to slow down. In February 2022, Rotimi Amaeichi, the transport minister of Nigeria, said the Nigerian government was seeking money from European lenders because "the Chinese are no longer funding."[214]

Even as China's new lending has slowed down, obligations under existing loans have placed a strain on developing countries' finances. This effect has been exacerbated by the expiration of COVID-related debt relief. According to the World Bank, of the $35 billion in debt service payments due from the world's 74 lowest-income countries in 2022 to bilateral and private sector lenders, $13.1 billion is due to Chinese lenders, with bilateral debt to all other countries accounting for $8.6 billion.* In August 2022, the Kenyan government disclosed that its debt service payments to Chinese lenders for the fiscal year from July 2021 to June 2022 totaled $641.2 million (73.5 billion Kenyan shillings), an increase of 135.1 percent from the previous fiscal year.† [215] The Chinese government's historical unwillingness to significantly renegotiate debt terms with borrowing countries has also led to delays in debt relief from international financial institutions, which often require recipient countries to restructure debt owed to other creditors. For example, in April 2021 Suriname reached a deal with the IMF to receive a $690 million loan in exchange for debt restructuring and economic reforms.[216] Disbursements from the loan were delayed until late 2021, reportedly due in part to China Exim Bank's refusal to renegotiate approximately $1 billion in debt owed to it by Suriname.‡ [217] The Chinese government's reluctance to renegotiate its debt has also contributed to Sri Lanka's ongoing economic and political crisis. (For more on Sri Lanka's debt crisis, see "Chinese Lending to Sri Lanka Exacerbates Ongoing Financial Crisis" in Chapter 3, Section 3, "China's Activities and Influence in South and Central Asia.") In August 2022, Chinese Foreign Minister Wang Yi announced the Chinese government would cancel the debt of 23 interest-free loans to 17 African countries that had matured by the end of 2021, without specifying the countries or the amount of the loans.[218] According

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*A further $13.4 billion is due to private sector lenders. Shabtai Gold, "China Is Owed 36% of Poor Countries' Debt Payments in 2022: World Bank," *Devex*, January 19, 2022.

†Payments to China accounted for 72 percent of the Kenyan government's $842 million (102.1 billion Kenyan shillings) in bilateral debt service payments from July 2021 to June 2022. The Kenyan government's debt service to multilateral lenders over the same period amounted to $42 million (51 billion Kenyan shillings), while debt service to commercial lenders totaled $1.3 billion (152.3 billion Kenyan shillings). As of August 2022, Kenya's total external public and publicly guaranteed debt stands at $36.4 billion, of which $6.8 billion is bilateral debt to China. Unless noted otherwise, this section uses the following exchange rate throughout: $1 = 114.6 Kenyan shillings. Kenya's National Treasury, *Quarterly Economic and Budgetary Review*, August 2022, 25–27; Kenya's National Treasury, *Quarterly Economic and Budgetary Review*, May 2022, 25–27.

‡The IMF began disbursements in December 2021, despite the fact that Suriname had not reached an agreement with China or India. In general, the IMF does not allow disbursements to be made to a country that remains in arrears to its creditors, though such lending is allowed in limited circumstances. In September 2022, Gerry Rice, the director of the communications department for the IMF, cited negotiations with China and India as part of the work that needed to be done in order to get the IMF's Suriname program "back on track." International Monetary Fund, "Transcript of IMF Press Briefing," September 15, 2022. International Monetary Fund, "Suriname: Request for an Extended Arrangement under the Extended Fund Facility-Press Release," December 23, 2021.

to a range of estimates by Boston University's Global Development Policy Center, the value of the loans could not have exceeded $609.6 million and was likely close to $200 million.[219] The Global Development Policy Center noted that interest-free loans such as these account for only 1 percent of China's loan commitments to Africa between 2000 and 2020.[220]

In 2022, the Chinese government cochaired the creditor committee as part of the G20's efforts to restructure Zambia's debt, signaling a greater willingness to participate in multilateral debt relief efforts. Zambia, the first country to default in the wake of the COVID-19 pandemic, had a debt burden of approximately $32 billion at the end of 2021, of which $17 billion was owed to external creditors.[221] Debt to China accounted for approximately one-third of this external debt, according to Zambian government data.[222] In May 2022, Zambia's president announced that France and China agreed to cochair a creditors' committee to renegotiate the country's external debt, with the first meeting occurring in June 2022.[223] According to a French official, debt relief for Zambia was delayed due to China's relative inexperience in coordinating the process as well as disagreement between Chinese agencies: while the PBOC was reportedly prepared to move ahead, China's Ministry of Finance was wary of "setting a costly precedent" for other countries by accepting significant losses on its Zambian debt.[224] In July, Zambia's creditors' panel released a statement pledging to renegotiate the country's debt, paving the way for a $1.4-billion IMF bailout package that had been agreed to in December 2021, conditional on Zambia's ability to reduce debt to sustainable levels.[225] Shortly before reaching this agreement with the creditors' panel, the Zambian government announced the cancelation of $2 billion in undisbursed loans from external creditors, including $1.6 billion in loans from Chinese creditors.[226]

Outreach Efforts to Developing Countries Encounter Mixed Success

While China's lending activity has slowed down, the Chinese government has nevertheless continued to promote itself as a key development and economic partner. At a speech before the UN General Assembly in September 2021, General Secretary Xi proposed a "Global Development Initiative" whose aims included "foster[ing] global development partnerships that are more equal and balanced, forg[ing] greater synergy among multilateral development cooperation processes, and speed[ing] up the implementation of the UN 2030 Agenda for Sustainable Development."* Chinese state media have likened the Global Development Initiative to the Global Security Initiative proposed by Xi in April 2022. (For more on the Global Security Initiative, see Chapter 3, Section 1, "Year in Review: Security and Foreign Affairs.") Specifics of the Global Development Initiative remain unclear. According to Yu Jie, senior

*The UN 2030 Agenda for Sustainable Development is a resolution adopted by all UN members in 2015. The resolution contains 17 "sustainable development goals," including ending poverty in all forms, achieving gender equality, ensuring sustainable consumption and production patterns, and ensuring access to affordable, reliable, sustainable, and modern energy for all. United Nations General Assembly, "Transforming Our World: The 2030 Agenda for Sustainable Development," October 21, 2015.

research fellow on China at Chatham House, Beijing likely hopes to use the initiative to supplement, though not replace, its signature Belt and Road Initiative. In particular, according to Dr. Yu, the Global Development Initiative could focus on digital infrastructure and co-financing projects with international financial institutions while acting as a means for Beijing to influence development assistance to the "Global South."[227] In January 2022, China's mission to the UN launched the Group of Friends of the Global Development Initiative, a platform within the UN, to implement the initiative.[228] The Chinese government's promotion of the Global Development Initiative has led to concerns it could be used as part of Beijing's ongoing efforts to undermine widely accepted development norms that emphasize human rights as well as economic progress.[229]

Reaction among developing countries to the Chinese government's most recent outreach efforts has been mixed. Chinese state media and officials have cited international support for the Global Development Initiative. According to Foreign Minister Wang, "More than 100 countries have expressed their support for the [Global Development Initiative], and more than 50 countries have joined the Group of Friends of the Global Development Initiative."[230] Despite these claims of widespread support, several other notable efforts by the Chinese government to further economic integration with certain countries have met with less enthusiastic responses from other countries:

- In June 2022, leaders of ten Pacific island countries rejected China's draft "Common Development Vision," a proposal that called for cooperation across a range of political, strategic, and economic issues. The document included a proposal for a regional free trade area and encouraged the China-led Asian Infrastructure Investment Bank to engage more in the region.[231] In rejecting the proposal, Pacific island leaders voiced concern that agreeing to the deal could spark a larger confrontation between China and other countries active in the Pacific.[232] Despite their rejection of the proposed deal, however, some Pacific island countries continue to pursue economic deals with China. In August 2022, the Solomon Islands signed a deal to borrow approximately $67 million (RMB 448.9 million) from China Exim Bank to fund the construction of 161 mobile phone towers built by Chinese telecommunications giant Huawei.[233] The deal marks the first time the Solomon Islands government has borrowed money from a major Chinese lending institution and has added to concerns about debt in Pacific island countries. According to World Bank and IMF figures, seven Pacific island countries—Kiribati, the Marshall Islands, Micronesia, Papua New Guinea, Samoa, Tonga, and Tuvalu—are at high risk for overall and external debt distress. Additionally, the Solomon Islands and Vanuatu are at moderate risk for overall and external debt distress.[234] In some of these countries, a significant portion of this debt is owed to China.* [235]

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*For instance, Tonga's external debt accounts for more than 35 percent of its GDP, and two-thirds of this debt is owed to China Exim Bank. In his testimony before the Commission, Derek Grossman, senior defense analyst at the RAND Corporation, said that highly indebted Pacific island countries could "make some trade-offs with China in the future to sustain the level of engagement they have with the Chinese." Derek Grossman, oral testimony for the U.S.- China

- At the BRICS* summit in June 2022, China's Vice Minister of Commerce Wang Shouwen proposed a free trade bloc among the five BRICS countries.[236] The summit's final communique did not include any mention of the free trade proposal, however.[237] India's government has been particularly reluctant to join any trade agreements with China, and since 2020 it has been taking increasing steps to restrict the extent of its economic ties to China. (For more, see "India Attempts to Reduce Economic Reliance on China" in Chapter 3, Section 3, "China's Activities and Influence in South and Central Asia.")

China Encounters Continued Pushback from Developed Countries

In 2022, the Chinese government's growing use of economic coercion saw continued pushback from other countries. Over the past several years, Beijing has shown increasing willingness to use economic measures to punish countries that do not adhere to the Chinese government's preferred policies. One of the most notable instances of this economic coercion occurred with Lithuania, whose government announced in July 2021 that it would allow Taiwan to set up a representative office in Vilnius to serve as its de facto embassy.† Beijing retaliated by downgrading diplomatic ties with the country and placing restrictions on Lithuanian products, with Lithuanian exports to China falling by 91 percent year-on-year in December 2021.[238] In response, a number of countries and organizations took measures to both support Lithuania's economy and safeguard against further instances of Chinese economic coercion:

- In November 2021, the U.S. Export-Import Bank also signed a memorandum of understanding with Lithuania pledging $600 million in export credits with a focus on manufacturing, renewable energy, and business services.[239]
- In December 2021, the European Commission published a proposal for an anti-coercion instrument, with potential tools including the suspension of tariff concessions, restrictions on FDI, and broader export controls.[240] (For more, see Chapter 2, Section 2, "Challenging China's Trade Practices.")
- In January 2022, the Taiwan government announced a $200 million fund to invest in Lithuania as well as a $1 billion fund for joint projects between Lithuanian and Taiwan companies.[241]

Economic and Security Review Commission, *Hearing on Challenges from Chinese Policy in 2022: Zero-COVID, Ukraine, and Pacific Diplomacy*, August 3, 2022; Taina Kami Enoka, "China Insists Tonga Loans Come with 'No Political Strings Attached,'" *Guardian*, June 28, 2022.

*BRICS refers to five major developing economies: Brazil, Russia, India, China, and South Africa. The countries have held annual summits since 2009 (with South Africa joining in 2010).

†Taiwan maintains "representative offices" that function as de facto embassies in over 20 other European countries and more than 50 countries globally. These are generally called "Taipei representative offices," using a naming convention similar to other subnational representative offices, like consulates, which typically use the name of the city they are located in. Following this convention is viewed as a way to avoid direct challenge to China's unresolved claim that Taiwan is part of its sovereign territory and still allow Taiwan its own representation. By contrast, Taiwan's office in Lithuania will be called a "Taiwan representative office," implying the senior official is the "Taiwan Representative to Lithuania" and the counterpart Lithuanian in Taipei is the "Lithuanian Representative to Taiwan." These titles are more akin to those used by ambassadors than consuls. Reid Standish, "Beijing's Spat with Lithuania Sets the Stage for Shaky New Era of Europe-China Ties," *Radio Free Europe Radio Liberty*, August 17, 2021.

- Also in January 2022, the EU filed a suit against China at the WTO alleging that its treatment of Lithuanian goods violated China's obligations under international trade agreements.[242] As of August 2022, there are no updates on the status of the WTO suit.

Policymakers from developed countries have also discussed the need to diversify supply chains away from China. In May 2022, for instance, South Korean President Yoon Suk-Yeol said South Korea needed to reduce the country's economic dependence on China by diversifying imports and forming supply chain alliances.[243] Policymakers in some advanced economies have already begun to enact new provisions that would strengthen governmental oversight over supply chains. For example, in May 2022 Japan's government passed an economic security law that, among other provisions, requires policymakers to draw up resiliency plans for certain strategic resources.[244] Shortly before the passage of the law, a Japanese government trade analysis found that Chinese goods had a greater than 50 percent share in 1,133 categories of Japanese imports, accounting for 23 percent of Japan's imports in 2019—a level of reliance on China nearly twice as high as that of the United States using the same measurement.[245] (For more on efforts to reduce supply chain dependence on China, see Chapter 2, Section 4, "U.S. Supply Chain Vulnerabilities and Resilience.")

Russia's Unprovoked Invasion of Ukraine: Economic Lessons for China

China is attempting to walk a narrow middle path in its economic relations with Russia that supports the bilateral partnership without running afoul of wide-reaching sanctions regimes. Chinese officials continue to promote a narrative that blames the United States and NATO for Russia's unprovoked invasion of Ukraine, and China's Ministry of Commerce urged Chinese companies "not to submit to external coercion and make improper external statements." (For more on China's attempts to discredit the United States and NATO, see Chapter 3, Section 1, "Year in Review: Security and Foreign Affairs.") Several major Chinese technology firms have quietly backed out of the Russian market due to sanctions and export controls, including smartphone maker Xiaomi and personal computer manufacturer Lenovo.* [246] Drone maker DJI also withdrew after reports that its drones had been used in the military conflict in Ukraine, issuing a rare public statement as it halted Russian sales.[247] According to the U.S. Department of Commerce, by March Chinese laptop and telecommunications equipment exports to Russia declined by 40 percent and 98 percent month-on-month, respectively.[248] Despite the precipitous decline in Chinese consumer technology exports to Russia, some Chinese technology services, such as ridesharing app Didi, are still also operating in Russia to maintain a show of support.[249]

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*Xiaomi uses semiconductors from U.S. chip designer Qualcomm and U.S. chipmakers Qorvo and Skyworks Solutions, while Lenovo relies on Advanced Micro Devices and Intel's processors for its personal computing products. Both firms' businesses would be devastated if they were cut off from U.S. technology for selling to Russia. Debby Wu and Jenny Leonard, "U.S. Expects Chinese Tech Firms to Help Choke Off Russia Supply," *Bloomberg*, February 28, 2022.

China continues to trade with Russia, becoming its predominant trading partner and primary customer for now-discounted commodities like agricultural products and energy. As other markets for Russian exports dry up amid broad-based sanctions on the Russian economy, China continues to provide Moscow with an economic lifeline by increasing its purchases of Russian energy and agricultural goods. With the market price of Russian exports declining, China has managed to purchase commodities from Russia at a discount and using RMB.[250] Despite a brief decline following Russia's invasion of Ukraine, Chinese imports of Russian goods resumed by March 2022, and by August 2022 had increased 51.3 percent year-to-date compared to the same period in 2021, according to China's General Administration of Customs.[251]

The Department of Commerce says it does not believe China is systematically supporting Russia's war effort, yet Chinese companies continue to export items to Russia that could assist its war effort. On June 28, the Department of Commerce added five Chinese companies to the Entity List for supplying controlled technologies to Russia's military.* The Department of Commerce also announced it had evidence that two Chinese companies already on the Entity List—both of which are subsidiaries of major Chinese defense Chinese Electronic Technology Group Corporation (CETC)—continued to supply technologies subject to export controls to the Russian military.[252] Overall Chinese exports to Russia had declined 17.4 percent year-on-year during Q2 2022, but Chinese exports of potentially dual-use items and materials to Russia have increased.[253] Year-to-date exports of microchips to Russia more than doubled by May, while other electronic components like printed circuits also demonstrated double-digit growth.[254] Chinese exports of other materials vital to Russian military production have also increased. After Australia halted aluminum oxide exports to Russia in March, citing its use in weapons development, Chinese aluminum oxide exports to Russia surged, reaching 153,000 metric tons in May 2022 versus 227 metric tons in May 2021.[255]

China sees the coordinated response to Russia's invasion as an example of what could happen if it intensified aggression against Taiwan. Indicating that Chinese leaders may believe they could one day be the target of coordinated economic reprisals, the Chinese government ordered a "stress test" to study the impact of similar sanctions on the Chinese economy. According to reporting from the *Financial Times*, in April 2022 Chinese regulators from the PBOC, CSRC, and Ministry of Finance met with top domestic and

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*In response to Russia's unprovoked invasion of Ukraine, the United States in coordination with its allies and partners added significant controls on the export and reexport to, and transfer within, Russia and Belarus of a multitude of previously uncontrolled items produced both in the United States and abroad. The Department of Commerce also added 322 entities to its Entity List for supporting the Russian military. The Department of Commerce's Bureau of Industry and Security implements and enforces export controls on the export, reexport, and in-country transfer of some less sensitive military items, commercial items that have both commercial and military or proliferation applications, and purely commercial items without an obvious military use. Exporters must apply for a license for goods depending on their technical characteristics, destination, end user, and end use. For more on export control reform, see Emma Rafaelof, "Unfinished Business: Export Control and Foreign Investment Reforms," *U.S.-China Economic and Security Review Commission*, June 1, 2021. Akin Gump, "U.S. Government Imposes Expansive, Novel and Plurilateral Export Controls against Russia and Belarus," March 8, 2022. U.S. Bureau of Industry and Security, *Export Controls Basics*, 2020. U.S. Department of Commerce, *Commerce Adds 71 Entities to Entity List in Latest Response to Russia's Invasion of Ukraine*, June 2, 2022.

foreign banks to assess exposure of Chinese overseas assets to U.S.-led sanctions.[256] Using the Organization for Economic Cooperation and Development's Trade in Value Added (TiVA) database, Nikkei estimated that if the United States, EU, and Japan were to levy sanctions on China following an invasion of Taiwan, China would lose approximately $1.34 trillion in export revenues while sanctioning countries would lose $1.27 trillion.[257] The report further noted that China would likely face a food crisis in such a scenario, as China relies upon the United States for 30 percent of its soybean imports, a key feedstock for Chinese pig farms.[258] With a globalized economy that is still heavily dollar dependent, China is highly susceptible to foreign sanctions. At the same time, the breadth and depth of U.S. and U.S. allies and partners' sanctions on Russia would be far more difficult to achieve on China without significant disruption to many key supply chain networks due to the size and global integration of the Chinese economy. Despite the difficulty some may see in taking similar actions against China, these April impact studies suggest Beijing sees the potential exposure to sanctions and export controls as real. This perception is driving China even further to consider workarounds to the U.S.-led financial system and dependencies on foreign imports, including through promotion of RMB settlement in cross-border e-commerce and domestic innovation of genetically modified crops.[259]

China Attempts to Mitigate Its Exposure to Financial Chokepoints

China's imports are subject to two chokepoints in the international financial system: (1) the interbank communication system used by the vast majority of banks globally to process transactions, known as SWIFT; and (2) the U.S. dollar clearing system known as the U.S. Clearing House Interbank Payments System, or CHIPS.[260] The United States can target Chinese transactions via either or both.

- *SWIFT:* SWIFT is a secure electronic messaging service used to coordinate payments between banks. It is a Belgium-based cooperative society collectively owned by its more than 11,000 member institutions.*[261] In part because of SWIFT's speed and security, it has become a dominant mechanism in international trade, processing 38 million messages per day and coordinating the transfer of trillions of dollars per year by 2020.[262] Removal from SWIFT is a significant impediment for banks coordinating major cross-border transactions, but less efficient workarounds such as encrypted telegrams and email may enable banks to continue conducting trade even after removal from SWIFT.†[263]

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*SWIFT is collectively supervised by the European Central Bank and G-10 central banks (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, UK, United States, Switzerland, and Sweden), and use of SWIFT in international sanctions requires political agreement across the overseeing countries. The Belgium Central Bank is the primary supervisor, while a board of directors exercises governance and oversight functions. The board of directors is composed of 25 independent directors whose nationality is determined by SWIFT's shareholder composition. SWIFT, "SWIFT and Sanctions." Henry Farrell and Abraham L. Newman, "Weaponized Interdependence: How Global Economic Networks Shape State Coercion," *International Security* 44:1 (2019): 42–79, 66–67. SWIFT, "SWIFT's Organization and Governance," 2022.

†Removal from SWIFT is not equivalent to being sanctioned. As a Belgium-based company, however, SWIFT must comply with EU and Belgian sanctions law.

Workarounds to using SWIFT would almost certainly be less efficient and secure, potentially leading to a fall in transaction volumes and increases in costs for each transaction.[264]

- *CHIPS:* CHIPS is a private sector system that facilitates large transactions denominated in dollars. For example, the vast majority of international oil sales are denominated in U.S. dollars regardless of the resources' origin or destination and are therefore subject to U.S. government intervention. Most international transactions are ultimately cleared in dollars by U.S. correspondent banks; even for transactions between two non-U.S. banks, foreign banks must comply with U.S. sanctions requests in order to access CHIPS.* [265] If Chinese customers or banks were blocked from the system, they would face significant challenges purchasing bulk dollar-denominated commodities like oil.[266]

China's government has thus far been largely unsuccessful in bypassing U.S. influence over the financial chokepoints of global trade. While China's central bank has launched the Cross-Border Interbank Payment System (CIPS)† as an alternative for financial messaging and interbank payments, its network of participating institutions remains too limited for CIPS to be a tool to circumvent SWIFT altogether. According to the CIPS website, only 1,322 financial institutions participate in the network, with 545 of the institutions residing in China.[267] In comparison, over 11,000 institutions participate in SWIFT.[268] CIPS continues to face significant challenges as a potential replacement for SWIFT given the dollar's dominance as a global currency and because financial institutions currently using SWIFT have little incentive to participate in an alternative system.[269]

China Is Dependent on the U.S. Dollar for Energy Trade

China has no functional alternative to the U.S. financial clearing system to process transactions denominated in U.S. dollars. While China's government has attempted to denominate oil transactions in currency other than dollars, oil producers will likely resist de-dollarizing transactions given the historical abundance and reliability of the dollar.[270] Further, China cannot fully secure its oil trade against foreign sanctions unless its oil exporters agree to conduct transactions denominated in RMB. Denominating energy transactions in euros, as

* Banks using FedWire or the Automated Clearing House (specifically the International ACH transactions, or IAT) to access the U.S. financial system must also comply with U.S. Office of Foreign Assets Control sanctions screening protocols. U.S. Office of the Comptroller of the Currency, Payment Systems, *Comptroller's Handbook*, October 2021, 8–12, 25. Karen Young, "How the US Uses the Dollar Payments System to Impose Sanctions on a Global Scale," *South China Morning Post*, August 25, 2020. *Economist*, "America's Aggressive Use of Sanctions Endangers the Dollar's Reign," January 18, 2020.

† CIPS is not a dedicated financial messaging service and currently partners with SWIFT for messaging. While serving as the founding director of the Brookings Institution's China Strategy Center, Rush Doshi noted, however, that "China is clearly investing in the ability for CIPS to act as a messaging system, allowing Beijing to bypass SWIFT entirely for interbank communications." He assessed that CIPS would not challenge SWIFT until it becomes better established. Mr. Doshi is currently director for China at the National Security Council. Rush Doshi, "China's Ten-Year Struggle against U.S. Financial Power," *National Bureau of Asian Research*, January 6, 2020.

China Is Dependent on the U.S. Dollar for Energy Trade—*Continued*

China and Russia agreed to do in a February 2022 30-year gas deal, continues to expose Chinese purchasers to European sanctions that deny Chinese banks access to the requisite euro-clearing system.[271] To date, the United States has not imposed sanctions on Chinese energy importers, though it has imposed secondary sanctions on China and Hong Kong-based entities for conducting energy trade with sanctioned countries, including sanction on four Hong-Kong based entities for facilitating oil purchases from Iran in August 2022.* [272] If the United States were to impose broad-based financial sanctions on Chinese entities akin to embargoes on North Korea and Iran, China would find it difficult to pay for energy imports. China's vulnerability to these financial chokepoints was made clear in February 2022 after Russia's unprovoked invasion of Ukraine, when Chinese oil importers announced a pause to new seaborne purchases of Russian crude oil following European banks' restrictions of commodity-trade finance and letters of credit against cargo originating in Russia.[273]

Whether the U.S. dollar retains its dominance in global oil sales, however, is currently being tested. In March 2022, the *Wall Street Journal* reported the governments of Saudi Arabia and China were actively discussing denominating some of their oil transactions in RMB.[274] While Saudi Arabia has denominated its oil sales exclusively in dollars since 1974, it has previously threatened to accept other currencies as a means of political leverage against the United States.† [275] In prior years, China's government has repeatedly sought to buy Saudi oil using RMB.[276] While these efforts have not been successful, in 2022 Saudi Arabia's government signaled that it would consider denominating some oil sales in RMB, though as of July it has not taken any steps to do so. The Saudi Arabian riyal is pegged to the U.S. dollar, and contracting oil sales in the less stable, tightly controlled RMB could undermine the Saudi government's fiscal outlook.‡ [277]

Still, China's government would face potentially prohibitive barriers to denominating its oil transactions with foreign firms in RMB. The RMB is currently uncompetitive as a global currency when compared to the dollar.[278] Because the RMB

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*As of September 27, 2022, the United States had imposed sanctions on 275 China and Hong Kong-based organizations under various sanctions programs. U.S. Department of Treasury Office of Foreign Asset Control, *Sanctions List Search*.

†In April 2019, Saudi Arabia threatened to sell its oil in non-U.S. dollar currencies in response to a bill being considered by Congress that would expose members of the Organization of Petroleum Exporting Countries (OPEC) to antitrust lawsuits. The bill, known as the No Oil Producing and Exporting Cartels Act (NOPEC), did not pass in 2019 and was later reintroduced in March 2021 by Republican Senator Chuck Grassley of Iowa. Dmitry Zhdannikov, Rania El Gamal, and Alex Lawler, "Exclusive: Saudi Arabia Threatens to Ditch Dollar Oil Trades to Stop 'NOPEC'—Sources," *Reuters*, April 4, 2019. U.S. Congress, "S.977—NOPEC," May 5, 2022.

‡In 2021, Saudi Arabia sold about $43.7 billion worth of oil to China while importing $30.4 billion worth of goods from China. With oil exports to China alone exceeding total imports by $13.3 billion, denominating a significant proportion of these transactions in RMB could expose Saudi Arabia to currency risk should the RMB significantly depreciate. China's General Administration of Customs via CEIC Database.

is subject to the Chinese government's strict capital controls, which restrict the flow of RMB into and out of the Chinese monetary system, it is less attractive as a global reserve currency.[279] According to the Bank of International Settlement's 2019 triennial Central Bank Survey on Foreign Exchange, the RMB accounted for a mere 4.3 percent of over-the-counter conversion* while the dollar accounted for about 88.3 percent.[280]

*Because two currencies are involved in any conversion or settlement, the total sums to 200 percent. "Over the counter" refers to exchanges conducted directly between counterparties rather than mediated through an exchange. Chinese state media often tout alternative metrics of a currency's international prominence, such as trade settlement and payment receipts, for which the RMB's share of global transaction is much higher. However, in many cases these metrics double-count transactions between mainland entities and foreign counterparties that are intermediated through Hong Kong. Callan Windsor and David Halperin, "RMB Internationalisation: Where to Next?" *Reserve Bank of Australia Bulletin*, September 2018, 23.

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