CHAPTER 1

U.S.-CHINA ECONOMIC AND TRADE RELATIONS

SECTION 1: YEAR IN REVIEW: ECONOMICS AND TRADE

Key Findings

- In 2016 and the first half of 2017, the Chinese government has reported it met or exceeded the targets it set for gross domestic product (GDP) growth—an important deliverable in advance of the political leadership transitions at the Chinese Communist Party's 19th Party Congress scheduled for October 2017. The Chinese government has achieved this high growth through reliance on old drivers: credit and real estate. However, the government's unwillingness to allow the market to play a bigger role has resulted in deteriorating investment efficiency, meaning higher levels of debt are necessary to generate growth. Household consumption—an essential element of China's economic rebalancing—is growing but at a sluggish pace due to the slow rate of reform.
- China's high and rising debt levels pose a growing threat to the country's financial stability. China's total debt reached $27.5 trillion, or 257 percent of GDP, at the end of 2016. The dramatic rise in China's debt burden can be attributed to the relentless expansion of credit the government has relied on to generate growth since the global financial crisis.
- The U.S. trade deficit in goods with China totaled $347 billion in 2016, the second-highest deficit on record. In the first eight months of 2017, the goods deficit increased 6.2 percent year-on-year to $239.1 billion, with U.S. exports to China reaching $80.2 billion, an increase of 15 percent year-on-year, while imports from China grew 8.3 percent year-on-year to $319.3 billion. In 2016, the U.S. services trade surplus with China reached a record high of $37 billion, driven almost entirely by an increase in Chinese tourism to the United States.
- China's foreign investment climate continues to deteriorate as government policy contributes to rising protectionism and unfair regulatory restrictions on U.S. companies operating in China. The newly implemented cybersecurity law illustrates this trend. The law contains data localization requirements and a security review process U.S. and foreign firms claim can be used

to discriminatorily advantage Chinese businesses or access proprietary information from foreign firms.

- U.S. government efforts to tackle China's trade-distorting practices continue to yield limited results. The inaugural Comprehensive Economic Dialogue, created following a meeting between President Trump and President Xi in April 2017, concluded with no concrete agreements or future agenda.
- At the World Trade Organization (WTO), the United States continues to challenge China's non-compliance with key provisions of its accession agreement, including failure to notify subsidies. In the past year, the United States requested WTO consultations over China's management of tariff rate quotas for rice, wheat, and corn, and subsidies to select producers of primary aluminum.

Introduction

In 2017, main priorities for the Chinese government include increased Party control and consolidation of political power. Indeed, the administration of the Chinese President and General Secretary of the Chinese Communist Party (CCP) Xi Jinping has begun implementing policies in pursuit of these goals to prepare for the leadership transition due to take place at the 19th Party Congress in October 2017.* Despite President Xi's stated commitment in 2013 to allow market forces to play "a decisive role" in the economy, genuine liberalization has stalled; instead, growth and stability are among the key economic objectives for the government.

To stimulate the economy, China's government continues to rely on old standbys, such as investment in infrastructure and real estate, and funnels funding to the state sector to the detriment of private enterprise and market orientation. The amount of credit the government is pumping into the economy has swelled to levels not seen since the global financial crisis, and corporate debt has continued to climb to new heights. The hand of the state is also evident in how Beijing treats foreign companies operating in China and in the impact its trade-distorting policies have on its trade partners. This year, U.S. companies reported feeling less welcome in China than ever before—the continuation of a troubling trend.

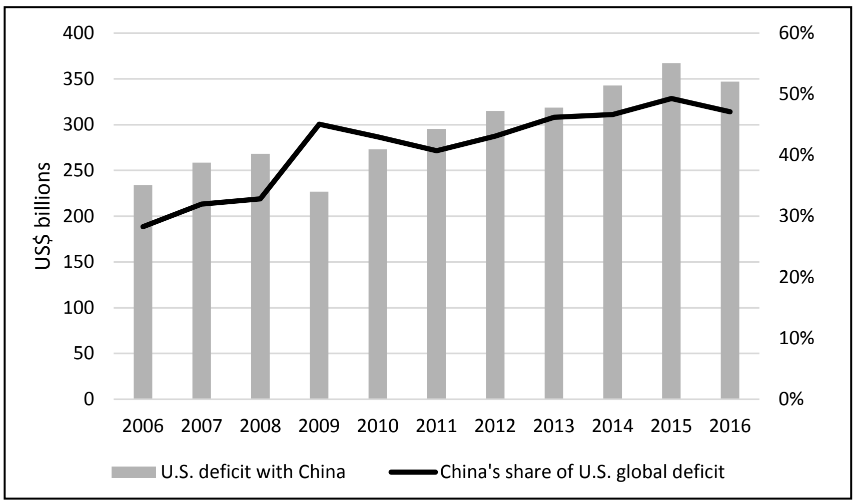
This section examines China's domestic and external economic rebalancing as well as key developments in U.S.-China bilateral and multilateral economic engagement since the Commission's *2016 Annual Report to Congress*. For analysis of Chinese foreign direct investment (FDI) in the United States and presence of Chinese companies on U.S. stock exchanges, see Chapter 1, Section 2, "Chinese Investment in the United States." U.S. ability to access China's financial services, e-commerce, and logistics industries is discussed in Chapter 1, Section 3, "U.S. Access to China's Consumer Market." Finally, industrial policies driving Chinese advancement in cutting-edge technologies are analyzed in Chapter 4, Section 1, "China's Pursuit of Dominance in Computing, Robotics, and Biotechnology."

*The Commission's Report is current as of October 6, 2017, and does not capture the outcomes of the 19th Party Congress, which is scheduled to start on October 18, 2017.

U.S.-China Bilateral Trade

The U.S. trade relationship with China remains extremely unbalanced, as evidenced by a substantial goods deficit, which totaled $347 billion in 2016, the second-highest deficit on record (see Figure 1).[1] The goods deficit decreased 5.5 percent year-on-year in 2016, driven by declining U.S. imports from China, which dropped 4.3 percent year-on-year to $463 billion.[2] U.S. goods exports remained flat, declining 0.3 percent over 2015 levels to $116 billion.[3] China continues to dominate the United States' global deficit in trade in goods. As seen in Figure 1, in 2016 the United States' goods deficit with China was equal to 47 percent of its total deficit, down from 49 percent in 2015.[4]

Figure 1: U.S. Goods Trade Deficit with China, 2006–2016



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

In the first eight months of 2017, U.S. exports to China reached $80.2 billion, an increase of 15 percent over the same period in 2016 (see Table 1). U.S. goods imports from China have also picked up, increasing 8.3 percent year-on-year to $319.3 billion, with the overall goods deficit increasing 6.2 percent year-on-year to $239.1 billion.[5]

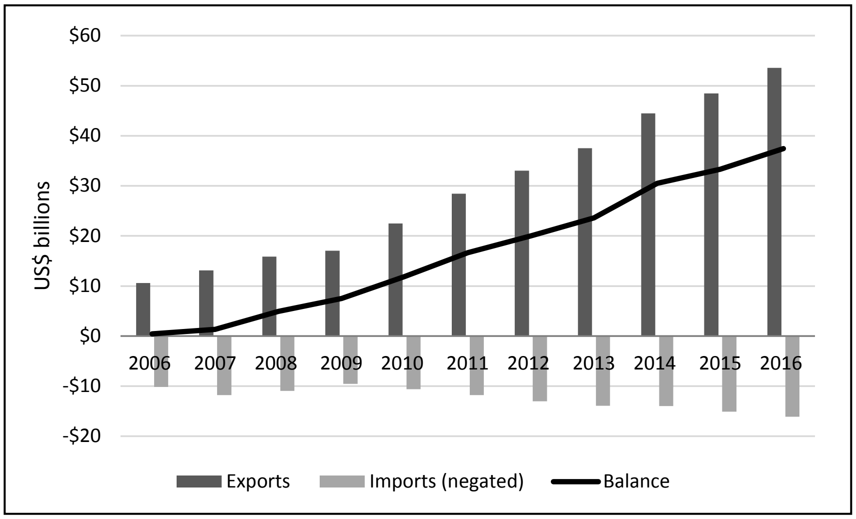
Table 1: U.S.-China Goods Trade, January–August 2017

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
Exports	$10.1	$9.8	$9.6	$9.8	$10.2	$9.7	$10.1	$10.9
Imports	$41.4	$32.8	$34.2	$37.5	$41.8	$42.3	$43.6	$45.8
Balance	($31.3)	($23.0)	($24.6)	($27.6)	($31.6)	($32.6)	($33.6)	($34.9)

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

The United States' surplus in services with China continues to grow, reaching a record of $37 billion in 2016, driven primarily by an increase in Chinese tourism to the United States.* U.S. services exports increased 10.5 percent in 2016 year-on-year, from $48 billion in 2015 to a record high of $54 billion in 2016 (see Figure 2).[6] Growth in Chinese tourism over the same period accounted for 94 percent of this increase.[7] U.S. services imports from China grew at 6.6 percent over 2015, reaching a record $16 billion.[8]

Figure 2: U.S.-China Services Trade, 2006–2016



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Table 1.3 U.S. International Transactions, Expanded Detail by Area and Country*, July 18, 2017.

Challenges for U.S. Companies in China

The combination of China's changing economic conditions, rising costs, and tightening regulations continues to make China a less attractive place to do business. In 2016, global FDI flows into China fell for a second year in a row—a trend continued in the first half of 2017.[9] In the *2017 Business Climate Survey* † released by the American Chamber of Commerce (AmCham) in China in January 2017, 81 percent of companies surveyed reported feeling less welcome in China in 2016 than they did in 2015.[10] Thirty-one percent of companies reported a deteriorating investment environment, compared to 19 percent in 2012; only 24 percent thought the overall environment was improving. This is the least optimistic U.S. companies have been since AmCham China began asking this question in 2011.

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*Under international and U.S. standards, tourism is broadly defined to include travel and related expenses for business purposes and travel and expenses for personal purposes, such as vacation, education, and medical services. International Monetary Fund, *Balance of Payments and International Investment Position Manual*, 2009; U.S. Department of Commerce, *Comprehensive Restructuring of the International Economic Accounts: New International Guidelines Redefine Travel*; U.S. Department of Commerce, Bureau of Economic Analysis, *Table 1.3 U.S. International Transactions, Expanded Detail by Area and Country*, July 18, 2017.

†AmCham China asked a total of 849 companies, of which 522 responded in whole or in part. American Chamber of Commerce in Republic of China, "2017 China Business Climate Survey Report," January 2017.

The report's list of the top five challenges U.S. businesses face in the coming year helps explain this pessimism. In 2017, firms anticipate inconsistent regulations and increasing labor costs to be the biggest challenges (see Table 2). This is the fifth consecutive year these were among the top two challenges. Despite increasing profits, only 10 percent of technology and research and development companies are optimistic about the implementation and enforcement of regulations over the next two years. Services, consumer, and industrial and resources firms were a little more sanguine; about one-fifth of these firms were optimistic about future regulation. Among companies surveyed, concerns over labor expenses and regulations were compounded by uncertainty over investment restrictions. Two-thirds of companies either doubt or are unsure whether China will further open markets to foreign investment, and domestic protectionism in general became their third-biggest reported challenge in 2017.[11] Systemic corruption in China, which has historically been a major problem for foreign companies, has fallen off the list of top five business challenges in 2014.

Table 2: Top Five Business Challenges in China for U.S. Firms, 2013–2017

2013	2014	2015	2016	2017
Labor costs: 44%	Labor costs: 46%	Labor costs: 61%	Inconsistent regulatory interpretation and unclear laws: 57%	Inconsistent regulatory interpretation and unclear laws: 58%
Inconsistent regulatory interpretation and unclear laws: 38%	Inconsistent regulatory interpretation and unclear laws: 39%	Inconsistent regulatory interpretation and unclear laws: 47%	Labor costs: 54%	Labor costs: 58%
Shortage of qualified employees: 35%	Shortage of qualified employees: 37%	Shortage of qualified employees: 42%	Obtaining required licenses: 29%	Increasing Chinese protectionism: 32%
Corruption: 30%	Shortage of qualified management: 31%	Shortage of qualified management: 32%	Shortage of qualified employees: 29%	Shortage of qualified management: 30%
Shortage of qualified management: 30%	Obtaining required licenses: 31%	Increasing Chinese protectionism: 30%	Industry overcapacity: 29%	Obtaining required licenses: 29%

Source: American Chamber of Commerce in the People's Republic of China, "2017 China Business Climate Survey Report," January 2017.

In light of China's continued reliance on trade-distorting practices, James McGregor, chairman of the greater China region for the consulting firm APCO Worldwide and former AmCham China chairman, called for reciprocity to become "the bedrock underlying trade and investment agreements between China and the United States." He elaborated:

No Chinese-connected entity should be allowed to invest in or acquire U.S. assets unless American companies have equal market and acquisition access in China. This would require applying "regulatory reciprocity" that takes into account the real on-the-ground situation in China. Rather than accepting China's assertions of openness, the United States must carefully assess China's market-distorting policies that block foreign business.[12]

During an April 2017 visit to Washington as part of an AmCham China delegation, Mr. McGregor noted that, prompted by China's worsening treatment of foreign companies, reciprocity is gaining traction among U.S. businesses and policymakers as a new framework for conducting economic relations with China.[13]

Cybersecurity Law

China's cybersecurity law, first approved last November, entered into effect June 1 despite calls from 54 foreign business associations* to reconsider the law and delay its implementation.[14] The law imposes sweeping restrictions on data transfer out of China. Under the law, firms must seek permission from the government to transfer any datasets in excess of 1 terabyte; datasets pertaining to more than 500,000 people; data related to geographic, chemical, engineering, or military matters;† or data pertaining to "critical information infrastructure"—an expansive category, the scope of which is ultimately determined by China's State Council. To date, "critical infrastructure" has been interpreted very broadly; banks, energy, and transportation companies and firms that provide services to public Chinese entities or are important to national security are included in the law, and the State Council can expand the scope further.[15] Chinese regulators have ruled that even fast food delivery companies are included due to the large number of people they service.[16] The law also permits Chinese regulators to prohibit any overseas data transfers they deem necessary through their own regulations.[17]

Under the law, firms that fall under critical information infrastructure are required to store their data inside China, although China appears to have granted firms a grace period until 2018 to comply with some data storage requirements.‡ As U.S. businesses

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*In May 2017, a broad set of business associations including the U.S.-China Business Council, AmCham China, Business Europe, the Japan Chamber of Commerce and Industry, and the Korea-Business Council sent a letter to the Chinese government urging a delay in the law's implementation. These groups expressed serious concerns that the law may discriminate against foreign businesses, and stated that the impact of the law encompasses "enormously consequential issues for China's economy, its relations with economic and commercial partners, and the global economy. Eva Dou, "Global Tech Companies Call on China to Delay Cybersecurity Law," *Wall Street Journal*, May 15, 2017.

†The law requires approval for transfer of data related to nuclear facilities, chemical biology, national defense, large engineering activities, ocean environmental protection, and sensitive geographic information. In the past, China has interpreted sensitive geographic information very broadly. In 2010, a U.S. geologist was jailed for purchasing information about Chinese oil reserves—which were deemed a state secret—and civilian aviation corridors in China are notoriously narrow as the majority of China's airspace is under the control of the military, ostensibly for national security purposes. Steven Jiang, "Flying Pains as China Struggles to Keep up with Aviation Growth," CNN, August 26, 2014; Keith Richburg, "China Sentences American Geologist to 8 Years for Stealing State Secrets," *Washington Post*, July 5, 2010; Scott Theil, "China's New Cyber Security Law Is Only 6 Weeks Away," *DLA Piper*, April 21, 2017.

‡On June 1, Chinese authorities stated that requirements under the law to store personal and "significant" data in China had been waived until 2018; however, Paul McKenzie, a partner at Beijing-based law firm Morrison and Foerster, said implementation of data storage requirements

typically transfer data between their foreign and domestic business operations and many rely on cross-border data transfer to interact with Chinese suppliers and customers, these restrictions will likely complicate the ability of U.S. firms to conduct business in China. For example, companies are starting to fear tightening restrictions will materially impede their ability to run day-to-day business operations, including cross-border communications, obtaining business-critical information, and using collaborative tools such as Google Docs.[18] The U.S. Chamber of Commerce also argues that domestic data storage requirements jeopardize the privacy of companies' and customers' data, as firms are forced to split their data protection resources across multiple data centers, resulting in less protection at each site.[19]

The law also requires firms that interact with critical information infrastructure or that provide services that may affect national security to be subject to a security review by Chinese authorities.[20] If in this review Chinese regulators decide to demand these services be "secure and controllable," foreign firms may be compelled to hand over important intellectual property assets such as source code to Chinese authorities for inspection.[21] A proposed supplementary law published in April empowers the government to compel companies to decrypt data—for example, decrypting secure online communications or unlocking the smartphone of an individual identified by the Chinese government.[22]

These regulations add to several others China adopted over the past two years to gain greater control over Internet firms and online activity. China has already passed a national security law that may compel foreign Internet information firms to hand over source code to Chinese authorities through "secure and controllable" requirements, and has enacted rules restricting the use of virtual private networks (VPNs), which are used by individuals and businesses to circumvent China's extensive censorship apparatus.[23] (For an in-depth assessment of these and other measures used by the Chinese government to control information, see Chapter 3, Section 5, "China's Domestic Information Controls, Global Media Influence, and Cyber Diplomacy.")

U.S. business associations have raised concerns that Chinese restrictions on the flow of information could serve as vehicles for protectionism.[24] For example, restrictions on international data transfer could impede the ability of Chinese consumers to access U.S. cloud computing services, advantaging Chinese firms such as Alibaba that already store most of their data locally.[25] The security review also has no clear criteria for deeming whether a technology firm's products are trustworthy, and may give Chinese authorities license to favor domestic suppliers over U.S. firms on the basis of cybersecurity.[26] According to a survey by the European Union Chamber of Commerce, 22 percent of responding foreign firms reported that China's Internet restrictions had affected 10 percent or more of their revenue in 2017, up from 16 percent of respondents in 2015.[27] A similar survey conducted by AmCham China found that 92 percent of surveyed firms were negatively affected by Chinese restrictions preventing the use of online tools in 2016, a significant increase from 56 percent of respondents in 2015.[28]

is still "murky." Sherisse Pham, "China's New Cyber Law Just Kicked in and Nobody's Sure How It Works," CNN, June 1, 2017.

China's Domestic Economic Rebalancing

Over the past year, the Chinese government has focused on enhancing and sustaining economic growth in advance of the political leadership transitions at the CCP's 19th Party Congress scheduled for October 2017, when the National People's Congress, China's parliament, will appoint officials to the CCP's most important leadership bodies: the Central Committee, the Politburo, and the Politburo Standing Committee.* The reshuffle of the Politburo Standing Committee will be particularly consequential as it is the primary locus of power within the CCP, and five of its seven members are due to retire in 2017.[29] The CCP maintains power, in part, by delivering economic growth, and President Xi has been focused on ensuring the economy stays stable ahead of the Party Congress, since an economic shock could call into question his ability to lead, and undercut his base of support within the CCP.[30]

According to official statistics, in 2016, China's gross domestic product (GDP)† grew 6.7 percent, comfortably within the 6.5–7 percent target range set by the government.[31] For 2017, the official GDP growth target was lowered to 6.5 percent.‡[32] State-led investment, higher industrial output, and greater domestic consumption allowed China's economic growth to exceed this target, reaching an average 6.9 percent growth in the first half of 2017.[33]

Although the Chinese government has stabilized the economy, it has done so by relying on old growth drivers, like credit-fueled investment (heavily concentrated in the real estate sector), which only adds to China's debt troubles just as the returns from these investments are slowing (see "Debt and Lending Continue to Rise," later in this section). Progress in enacting policies that would fundamentally reform China's economic model has been limited.[34] Household consumption—an essential element of China's economic rebalancing—is growing but at a sluggish pace due to slow progress in opening the financial sector. Expanding government spending on the social safety net (including healthcare, pensions, education, and poverty alleviation), which would free consumers from the need to save such a large share of their income, would also help boost consumer spending.[35] Repeated pledges to permit greater market access for private domestic and foreign firms remain unfulfilled due to concerns over employment and loss of state control.§ Progress in financial reform faced setbacks in 2016 and 2017 as enormous cap-

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*The CCP Central Committee is a political body comprising China's top political leadership (currently 205 members and 168 alternates). According to the CCP constitution, the Central Committee is vested with the power to select the Politburo (a group of 25 people who oversee the CCP). Within the Chinese political system, the ultimate power resides with the Politburo Standing Committee (nominally elected by the Central Committee). The current Politburo Standing Committee has seven members, with Xi Jinping serving as the General Secretary of the CCP and China's head of state.

†In July 2017, China's National Bureau of Statistics revised its 2002 GDP calculation method to align with international standards and include contributions from new economy sectors such as healthcare and tourism. The methodology will be rolled out gradually and was not used to calculate the data for the first half of 2017. Yawen Chen, "China Revises GDP Calculation Method to Add Healthcare, 'New Economy,'" Reuters, July 14, 2017; Zheping Huang, "China's Economic Growth Is Driven by All the Things It Says It Wants to Get Rid of," *Quartz*, July 17, 2017.

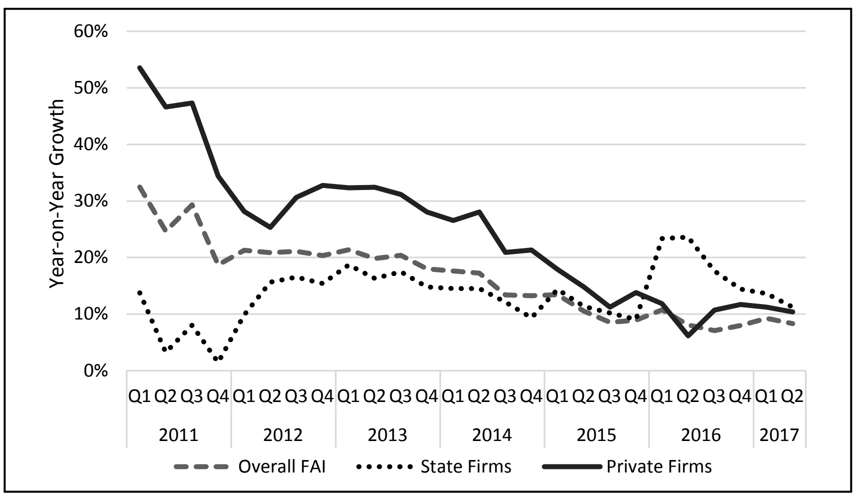
‡The Chinese government sets a GDP growth target for every year. In 2005–2011, the target was set at 8 percent, and easily exceeded each year, leading some analysts to call it a minimum acceptable level, rather than a goal in and of itself. However, the GDP target has been gradually reduced since 2012 as the government began to acknowledge China's economic slowdown.

§For more information on China's state-owned enterprises and announced reforms, see U.S.-China Economic and Security Review Commission, "State-Owned Enterprises, Overcapacital outflows forced the Chinese government to defend its currency and reinstitute official and unofficial capital controls (see "Renminbi Reforms and Capital Outflows," later in this section).

Investment and Real Estate Remain Key Drivers

Fixed asset investment*—a traditional driver of China's growth—continues to buttress China's economy, but compared with past performance, its contribution is weakening. In the first half of 2017, growth in fixed asset investment slowed to 8.8 percent year-on-year driven primarily by government infrastructure spending (see Figure 3).[36] Of note, since 2015, investment by state-owned enterprises (SOEs) has grown faster than investment by private firms, reversing a long-term trend. In addition, these investments are producing less growth per renminbi (RMB) spent, creating a vicious cycle of high debt levels and investment misallocation. Brian McCarthy, Managing Director and Chief Strategist at the Emerging Sovereign Group, who participated in the Commission's June 2017 roundtable on the health of China's economy characterized China as "a fine-tuned capital misallocation regime… rife with market distortions."[37]

Figure 3: Growth in Fixed Asset Investment, 2011–Q2 2017



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

Real estate is a major driver of fixed asset investment and consumer of industrial manufacturing goods such as steel, aluminum, cement, and glass.[38] In 2015, the Chinese government eased credit access and home purchase restrictions, accelerating property sector growth through 2016.[39] Beginning in mid-2016, the Chinese government, fearing a bubble, attempted to moderate property price growth by increasing mortgage interest rates and slow new development through restricting access of real estate developers to financ-

ity, and China's Market Economy Status," in *2016 Annual Report to Congress*, November 2016, 91–114.

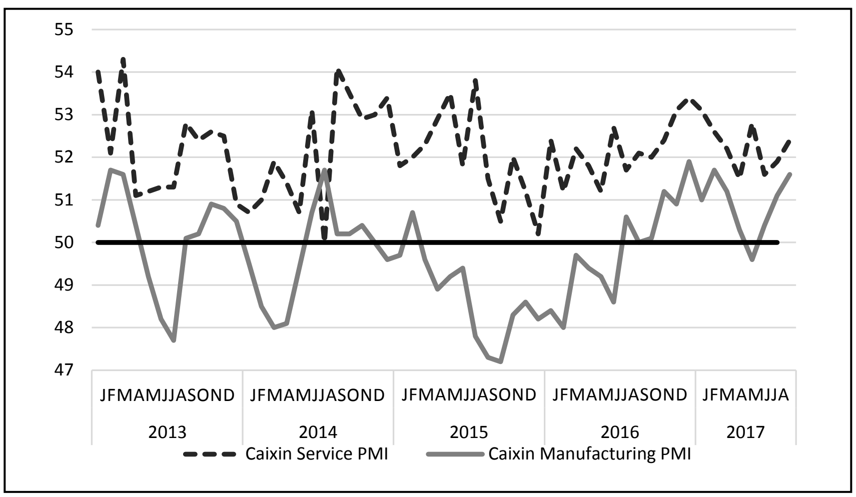
*Fixed asset investment is a measure of capital spending, or any type of investment by government and the private sector in physical assets such as buildings, machinery, or equipment.

ing, but was only successful in moderating the property prices.[40] In a positive development, average property price growth moderated to 4 percent year-on-year in the first eight months of 2017 compared with 10.5 percent year-on-year increase in the first eight months of 2016.[41] Real estate investment, however, continued to accelerate in 2016 despite government measures to tamp it down, growing 7.9 percent year-on-year in the first eight months of 2017 compared with 5.4 percent year-on-year in the first eight months of 2016.[42]

Manufacturing and Exports Rebound

Beginning in the second half of 2016, China's manufacturing and industrial production recovered from its 2015 and early 2016 slowdown in part due to a rally in the property market and global growth.[43] Unofficial estimates by the Chinese financial media firm Caixin found China's manufacturing Purchasing Managers' Index (PMI),* a measure of economic expansion and industrial utilization, improved over the last year to reach 51.6 in August 2017 (see Figure 4).[44] A reading below 50 indicates a contraction of the manufacturing sector. The services sector—one of the new sources of economic growth—has continued to expand, with Caixin's service PMI remaining above 50 since mid-2014.[45] Value-added industrial growth—another growth indicator—expanded 6 percent year-on-year in the first eight months of 2017.[46] This recovery is in part due to the pickup of global growth, leading Chinese exports to increase 3.8 percent year-on-year in the first eight months of 2017.[47]

Figure 4: Caixin Service and Manufacturing PMIs, 2013–August 2017



Source: Caixin and IHS Markit, "Caixin China General Manufacturing PMI," Markit Economics, September 1, 2017; Caixin and IHS Markit, "Caixin China General Services PMI," September 5, 2017.

*The PMI measures the production level, new orders, inventories, supplier deliveries, and employment level to gauge the economic activity level in the manufacturing sector. The global financial information service provider Markit Economics compiles the Caixin-Markit China manufacturing PMI from monthly questionnaires to more than 420 manufacturing purchasing executives (including small and medium-sized enterprises). By comparison, China's official PMI tracks larger state-owned companies, generally leading to a stronger reading than private PMIs.

Domestic Consumption and Service Sector

The Chinese government seeks to leverage the consumer spending of the world's second largest economy as a new source of growth. Retail sales of consumer goods—a proxy for overall consumption—showed steady growth increasing 10.5 percent year-on-year in 2016 and 10.6 percent year-on-year in the first eight months of 2017.[48] Consumption's contribution to GDP increased from 60 percent in 2015 to 65 percent in 2016, but fell to 63 percent in the first half of 2017.[49]

Despite these positive changes, growth in Chinese households' disposable income* is slowing.[50] In 2016, China's annual national disposable income per capita increased 8.4 percent year-on-year—its slowest annual growth rate in the last five years—to reach $3,518 (RMB 23,821).†[51] By comparison, U.S. annual national disposable per capita income totaled $43,194 in 2016.[52] As the economy rebounded in the first half of 2017, growth of national disposable income per capita accelerated to 8.8 percent year-on-year, but growth in consumption expenditure per capita increased only 7.6 percent year-on-year in the first half of 2017 compared with 8.8 percent in the first half of 2016.[53] Speaking at the Commission's roundtable on the health of China's economy, Gene Ma, chief China economist at the Institute of International Finance, noted household debt was on the rise, likely due to the fact that Chinese households' borrowing is higher to afford the ever more expensive housing.[54] (Because they lack other options due to limited financial reforms, Chinese households continue to favor real estate purchases as a form of investment.)

The contribution of the service sector to GDP continued to grow from 45.3 percent of GDP in 2012 to 51.6 percent in 2016 (see Figure 5).[55] In the first half of 2017, services continued their upward trend, growing 11.5 percent year-on-year.[56] The service sector could grow faster—thus accelerating the rebalance—if the Chinese government reduced regulatory barriers for private domestic and foreign firms and eliminated preferential treatment for SOEs.[57] Debt-ridden SOEs remain a drag on the economy with lower profitability and weaker efficiency than the private sector.[58] In the first seven months of 2017, industrial SOE profits increased just 9.8 percent year-on-year compared with the 14 percent year-on-year growth in the private industrial enterprises' profits over the same time period.[59] In addition, SOEs only accounted for 20 percent of industrial value-added despite controlling 40 percent of industrial assets.[60]

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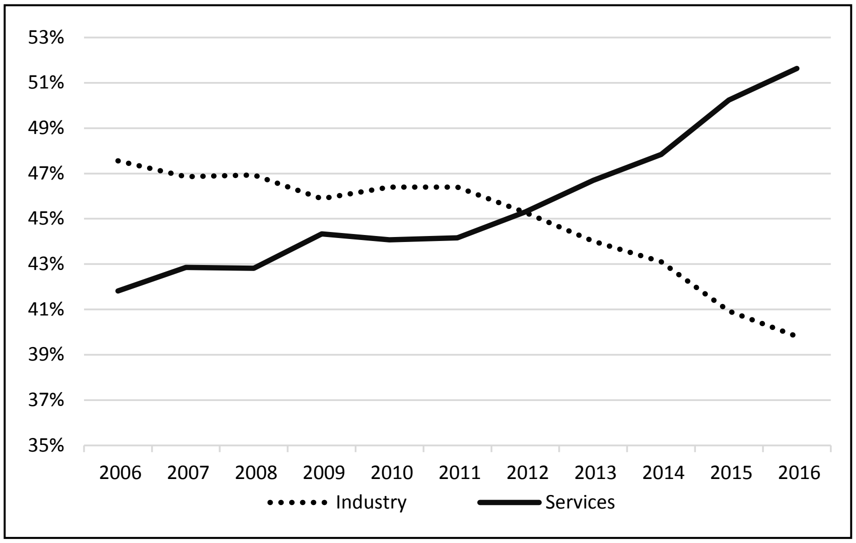
*Disposable personal income is the amount of income households have for spending and saving after income tax.

†Unless noted otherwise, this section uses the following exchange rate throughout: $1 = RMB 6.77.

Figure 5: Service Sector as a Share of GDP, 2006–2016



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

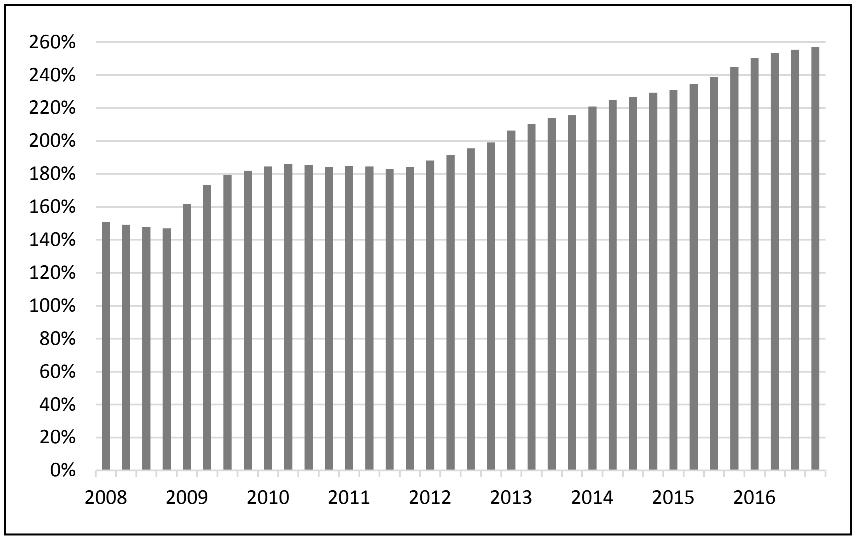
Debt and Lending Continue to Rise

China's high and rising debt levels pose a growing threat to the country's long-term economic stability. In May 2017, Moody's Investors Service downgraded China's sovereign debt rating from Aa3 to A1* due to "expectation that China's financial strength will erode somewhat over the coming years, with economy-wide debt continuing to rise as potential growth slows."[61] China's total debt (government and private) reached $27.5 trillion, or 257 percent of GDP, in fourth quarter of 2016, according to data from the Bank for International Settlements, up from 147 percent at the end of 2008 (see Figure 6).†

*The highest investment-grade rating is Aaa, representing minimum credit risk, while the lowest is Baa3, which is listed as medium-grade. China moved from a high-grade rating, Aa3, to an upper-medium grade A1, which remains within the investment grade rating range. Moody's Investors Service, "Moody's Rating System in Brief."

†In comparison, the United States' total debt reached $47 trillion, or 252 percent of GDP, in the fourth quarter of 2016. Bank for International Settlements, "Credit to the Non-Financial Sector," June 6, 2017.

Figure 6: China's Total Debt-to-GDP Ratio, 2008–2016



Source: Bank for International Settlements, "Long Series on Total Credit to the Non-Financial Sectors," June 6, 2017.

Analysts are particularly concerned about the speed of China's debt buildup.[62] According to Bank for International Settlement data, China's credit-to-GDP gap,* a measure of debt accumulation, hit a record 28.8 percent in the first quarter of 2016 before falling to 24.6 percent in the fourth quarter of 2016 (see Figure 7).[63] Based on Bank for International Settlement research, a credit-to-GDP gap above 10 percent signals excessive credit growth and elevated risk of a banking crisis.† [64]

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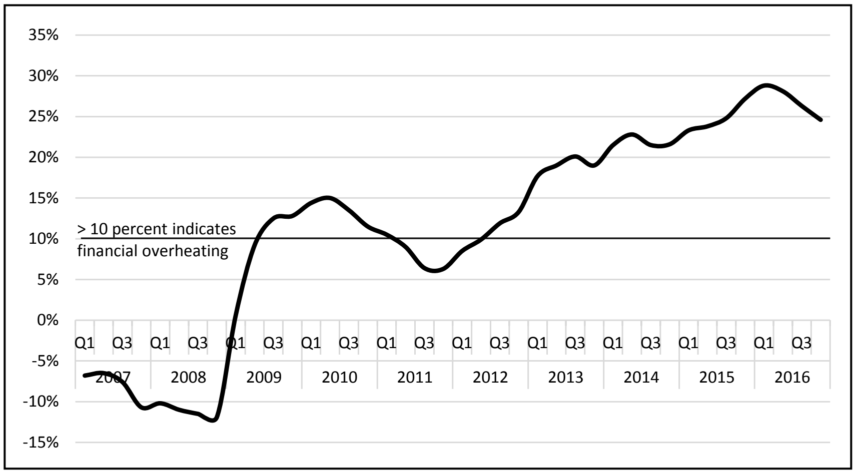
*The Bank for International Settlements defines the credit-to-GDP gap as the difference between the credit-to-GDP ratio and its long-term trend. Bank for International Settlements, "Credit-to-GDP Gaps," December 11, 2016.

†According to IMF economists Luc Laeven and Fabian Valencia, in a systemic banking crisis "a country's corporate and financial sectors experience a large number of defaults and financial institutions and corporations face great difficulties repaying contracts on time. As a result, non-performing loans increase sharply and all or most of the aggregate banking system capital is exhausted." Based on an analysis of a large cross-section of countries over the past three decades, Bank for International Settlements considers the credit-to-GDP gap a robust early warning indicator for banking crises. For example, prior to the 1997 Asian financial crisis, Thailand's credit-to-GDP gap in 1995 and 1996 averaged 26.3 percent. In the United States, the credit-to-GDP gap reached a high of 12.4 percent a few months before the global financial crisis began. Bank for International Settlements, "Credit-to-GDP Gaps and Underlying Input," June 6, 2017; Mathias Drehmann and Kostas Tsatsaronis, "The Credit-to-GDP Gap and Countercyclical Capital Buffers: Questions and Answers," *Bank for International Settlements*, March 9, 2014, 66; Luc Laeven and Fabian Valencia, "Systemic Banking Crises: A New Database," *International Monetary Fund Working Paper*, November 2008, 5.

Figure 7: China's Credit-to-GDP Gap, 2007–2016



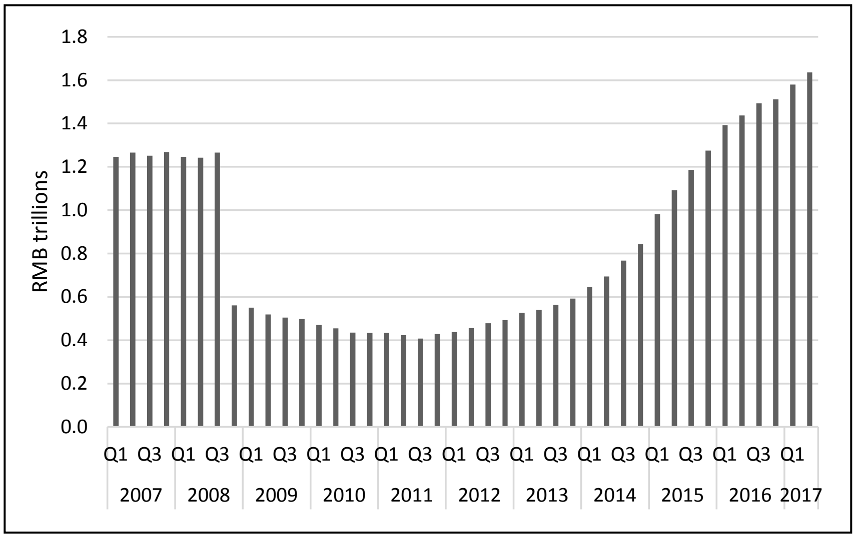
Source: Bank for International Settlements, "Credit-to-GDP Gaps and Underlying Input," June 6, 2017.

The largest category of debt is held by nonfinancial corporations, which comprises two thirds of China's total debt.[65] Corporate debt reached 166 percent of GDP in the fourth quarter of 2016, up from 96 percent in the fourth quarter of 2008.[66] China's corporate debt largely consists of loans made to SOEs by state-owned banks; SOEs continue to enjoy privileged access to bank loans in return for delivering investments and public services in line with Chinese government interests.[67] According to estimates from the International Monetary Fund (IMF), SOEs account for around 55 percent of corporate debt.[68]

Meanwhile, nonperforming loans (NPLs)—loans that are unlikely to be paid back—continue to rise. According to the China Banking Regulatory Commission, the amount of NPLs held by Chinese commercial banks climbed from $77 billion (RMB 518 billion) in the second quarter of 2009 to $242 billion (RMB 1.64 trillion) in the second quarter of 2017.[69] While that accounted for 1.74 percent of total loans at the end of June 2017, private estimates suggest the actual NPL ratio may be much higher.* For example, Fitch Ratings said in a 2016 report that NPLs account for as much as 15 percent to 21 percent of total loans.[70] However, even official data show China's NPL rates have been gaining rapidly since the global financial crisis of 2008 and China's massive stimulus package that kept the economy going (see Figure 8).

*The discrepancy between the official NPL ratio and unofficial estimates comes from how banks categorize NPLs. The IMF considers a loan nonperforming if interest and principal payments are more than 90 days overdue. In China, a loan more than 90 days overdue is considered nonperforming only if loans are doubtful or loss making. As SOE borrowers are presumed to have government backing, it can be difficult for banks to characterize their loans as nonperforming. Reuters, "China Commercial Banks' NPL Ratio 1.74 Percent at End-June—Regulator," August 14, 2017; Shuli Ren, "CLSA: 15–19% of China's Bank Loans Are Bad," *Barron's Asia*, May 6, 2016; International Monetary Fund, "The Treatment of Nonperforming Loans," June 2005, 4.

Figure 8: NPLs Held by Chinese Commercial Banks, 2007–Q2 2017



Source: China Banking Regulatory Commission via CEIC database.

The rapid growth of China's opaque and lightly regulated shadow banking sector is another cause for concern due to the risks it poses to financial stability.* [71] According to estimates from Moody's, China's shadow banking sector grew 21 percent in 2016 to $9.5 trillion (RMB 64.5 trillion), equivalent to 87 percent of GDP, up from less than 10 percent a decade ago.[72] Particularly troubling has been the rapid growth in wealth management products (WMPs), the largest component of shadow banking, which rose 30 percent year-on-year to reach $3.8 trillion (RMB 26 trillion) at the end of 2016.[73]

What are China's Wealth Management Products?

WMPs are investment products packaged and sold by banks, and then transferred from banks' balance sheets to nonbank financial institutions to circumvent capital reserve requirements and restrictions on bank investment in certain sectors. WMPs promise higher returns on investment than standard bank deposits, but are not insured by the government—although many investors erroneously believe they are—and typically contain various types of assets (including stocks, bonds, and loans) that carry different risks, meaning investors know very little about the product they are buying.[74]

Chinese banks often invest in WMPs packaged by other banks; thus, a single default could spread widely through the banking system, and as the stock of these products grows, so do the risks.[75] In the event of a credit crunch, the growing inter-

*Shadow banking is lending that occurs outside of the formal banking sector. Examples include wealth management products, credit guarantees, entrusted loans, and peer-to-peer lending.

What are China's Wealth Management Products?—*Continued*

dependence between banks could result in large losses for both banks and investors.[76] Some investors find parallels between the buildup of WMPs in China and the growth of complex investment assets in the United States in advance of the financial crisis in 2008. For example, Charlene Chu, senior partner at Autonomous Research said, "We're starting to see layers of liabilities built upon the same underlying assets, much like we did with subprime asset-backed securities, collateralized debt obligations [CDOs], and CDOs-squared in the [United States]."[77]

The dramatic rise in China's debt burden can be attributed to the relentless expansion of credit following the global financial crisis, which the government has relied on to generate growth. In 2016, Chinese banks issued a record $1.87 trillion (RMB 12.65 trillion) in new loans.[78] Credit expansion continued in the first half of 2017, with new loans reaching $1.18 trillion (RMB 7.97 trillion), a 6 percent increase year-on-year.[79] According to a People's Bank of China (PBOC) official, 82.5 percent of new lending in the first half of 2017 went to service and high-tech manufacturing industries, while 5.4 percent went to "industries with excess capacity."[80] Total social financing, a broad measure of credit that includes both bank loans and off-balance-sheet financing, reached $1.65 trillion (RMB 11.17 trillion) in the first half of 2017, up from $1.45 trillion (RMB 9.8 trillion) in the first half of 2016, driven by a surge in off-balance-sheet lending.[81] At the same time, credit efficiency declined. The IMF estimates that China's credit intensity—the amount of new lending needed for an additional unit of output—grew from an average of 1.1 before the global financial crisis to a post-crisis average of 2.7.*[82]

Chinese leaders have identified the containment of debt and financial risks as a top priority for 2017.[83] In the first quarter of 2017, the PBOC tightened monetary policy by guiding short-term interest rates higher to curb leverage.[84] In addition, financial regulators issued tighter regulations and cracked down on shadow banking.[85] At the July 2017 National Financial Work Conference, a high-level meeting held twice a decade, President Xi Jinping announced the creation of the Financial Stability and Development Committee, a cabinet-level body tasked with coordinating financial regulation and oversight.†

*In comparison, the United States' credit intensity dropped from an average of 2.8 before the global financial crisis to a post-crisis average of 1. International Monetary Fund, *Regional Economic Outlook: Asia and Pacific*, April 2014, 36.

†China has separate regulatory bodies for the banking, insurance, and securities industries. China's financial regulators have at times acted in isolation and even at odds with one another. Lingling Wei, "China's Xi Jinping Forges New Body to Tighten Financial Controls," *Wall Street Journal*, July 15, 2017.

U.S. Financial Exposure to China

A May 2017 report prepared by Commission staff examines the scope of the U.S. financial sector's exposure to China.[86] China's direct financial linkages with the United States are growing but remain modest relative to bilateral trade linkages. Beijing has taken steps to gradually open its financial sector to foreign participation, but U.S. financial firms and investors have displayed limited interest since the reforms are happening as Chinese policymakers impose tighter restrictions on foreign currency conversions and outbound capital flows.[87] The report's key findings include:

- The U.S. financial sector's greatest direct exposure is through China's holdings of U.S. government securities. At the end of 2016, China held $1.06 trillion in U.S. Treasuries, or 7 percent of publicly held U.S. debt, placing it behind Japan as the second-largest foreign holder of U.S. Treasuries.[88] Nonetheless, the Commission report finds that moves by Beijing to cut its Treasury holdings in 2016 to defend the RMB have had limited effects on the U.S. economy.[89] In the first half of 2017, China increased its holding of U.S. Treasuries, which reached $1.17 trillion in July 2017.[90]
- U.S. banks have limited direct exposure to China's banking sector. In the fourth quarter of 2016, U.S. banks' exposure to China reached $78.7 billion—0.6 percent of total U.S. banking assets.[91]
- U.S. investors have very low direct exposure to China's domestic equity markets. At the end of 2016, U.S. investors held $104 billion in Chinese stocks, just 0.4 percent of their total equity holdings.[92] However, the June 2017 decision of leading index provider MSCI to include RMB-denominated shares of 222* Chinese companies in its benchmark emerging markets index (effective June 2018) is expected to attract more foreign capital into Chinese stocks.† According to MSCI, the decision will initially draw about $17 billion of global assets into Chinese stocks and could eventually attract more than $340 billion of foreign capital if China achieves full inclusion in the index.[93] (For more on U.S. investors' exposure to Chinese companies listed on U.S. stock exchanges, see Chapter 1, Section 2, "Chinese Investment in the United States.")

The Commission report finds economic and financial developments in China can affect U.S. financial markets more substantially through indirect channels, as was evident in the reaction of U.S. equities to China's stock market crashes in 2015 and 2016.[94] More broadly, the impact of China's slowing growth and economic reforms on trade, commodities demand, and investor confidence affects global financial markets, which in turn influence U.S. financial markets.‡[95]

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*Of the 222 firms included in MSCI's decision, 50 are finance firms and 44 industrial firms. Dion Rabouin and Michelle Price, "China Shares Get MSCI Nod in Landmark Moment for Beijing," Reuters, June 21, 2017.

†For more background on MSCI's decision, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, July 6, 2017, 4–5.

‡Goldman Sachs estimates that a 1 percent decline in China's GDP growth reduces U.S. GDP growth by 0.1 percent. Estimates from economists at the Federal Reserve Bank of Dallas are slightly higher: they assess that a 1 percent decline in China's GDP lowers U.S. output growth

Renminbi Reforms and Capital Outflows

Amid rising financial sector vulnerabilities, Beijing has found it difficult to strike a balance between internationalizing the RMB by making its exchange rate more flexible and relaxing controls on capital flows, and maintaining stability by preventing excessive capital outflows. After the PBOC revised its method for setting the daily reference rate for the RMB in the onshore currency market in August 2015* and introduced a new basket for setting the RMB daily rate in November 2015 (see Figure 9),† expectations were high for a more market-determined RMB exchange rate.

Yet over the past two years, as China's economic growth moderated and pressure rose on the RMB to depreciate, the Chinese government has intervened repeatedly to support the value of the currency‡ rather than let the market determine its exchange rate.[96] The PBOC is seeking to manage the volatility of the RMB's exchange rate in order to prevent a destabilizing devaluation and reassure global and domestic investors about the stability of China's state-led economic growth.[97] But this policy comes at a significant cost: the PBOC has to buy RMB with its foreign reserves to artificially create demand and support the RMB's value. As a result, China's foreign reserves§ have fallen $936 billion from their $3.99 trillion peak in June 2014 to $3.06 trillion in June 2017.[98]

In attempting to simultaneously defend its exchange rate, control interest rates, and keep its capital account closed China faces an "impossible trinity" problem. Under the "impossible trinity" concept a government can maintain only two of the following three policies: (1) a fixed (or managed) exchange rate, (2) an independent monetary policy, or (3) free international capital flows.[99] The United States maintains open capital markets and control over both the money supply and interest rates, but has relinquished control over the dollar exchange rate. In contrast, Chinese policymakers are trying to control all aspects of the trinity. At the moment, China is choosing to manage its currency and tighten its monetary policy at the expense of choking off capital flows, but it has not resolved the fundamental contradictions in China's economy. If the exchange rate stabilizes, the government may allow more flexibility in the capital controls. In essence, Mr. McCarthy noted during his presentation, Chinese policymakers are "just bouncing around to whatever is the most vulnerable."[100]

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by 0.2 percent. Sharmin Mossavar-Rahmani, "China's Toughest Test Is within Its Walls," *Financial Times*, January 26, 2016; Goldman Sachs, "Walled In: China's Great Dilemma," *Investment Strategy Group*, January 2016, 13; Alexander Chudik and Arthur Hinojosa, "Impact of Chinese Slowdown on U.S. No Longer Negligible," *Federal Reserve Bank of Dallas*, May 2016.

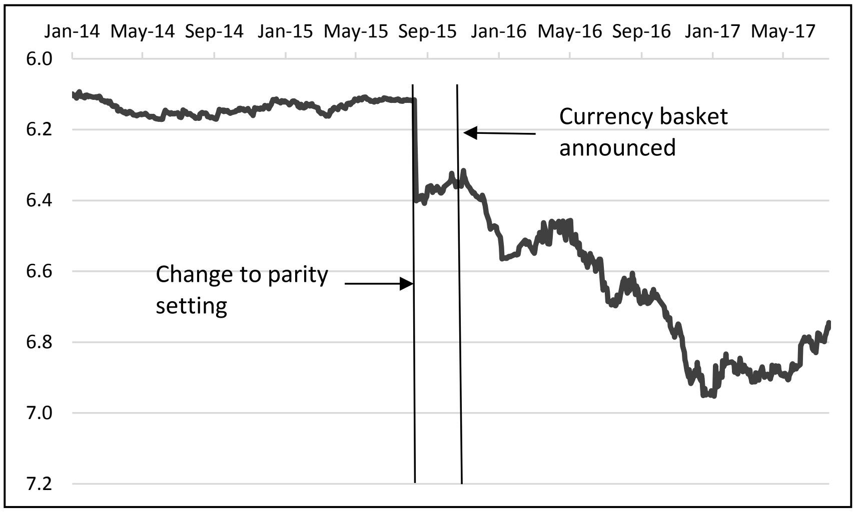
*The PBOC said it would take into account the previous day's closing exchange rate—which could rise or fall up to 2 percent under the currency's trading band—as well as the exchange rate movements of other major currencies. Nicholas Lardy, "China's Latest Currency Actions Are Market Driven," *China Economic Watch* (Peterson Institute for International Economics blog), August 11, 2015.

†As of 2017, the China Foreign Exchange Trade Center (CFETC) currency basket includes currencies of China's 24 major trade partners. The U.S. dollar carries a 22.4 percent weight in the basket, followed by the euro with 16.3 percent and the Japanese yen with 11.5 percent. China Foreign Exchange Trade System, "Public Announcement of China Foreign Exchange Trade System on Adjusting Rules for Currency Baskets of CFETC RMB Indices," December 29, 2016.

‡The PBOC prevents RMB's depreciation in two main ways: Resetting the daily reference rate to a stronger value and buying up the RMB while selling U.S. dollars from its foreign exchange reserves.

§While the exact composition of China's foreign exchange reserves is a state secret, analysts estimate about 60 percent is held in U.S. dollar-denominated assets, mostly U.S. Treasury securities.

Figure 9: RMB to U.S. Dollar Exchange Rate, January 2014–July 2017



Source: State Administration of Foreign Exchange via CEIC database.

In addition, the State Administration of Foreign Exchange has sought to slow the pace of RMB leaving the country by tightening controls on outflows.[101] But this approach has lowered China's attractiveness for foreign investors. As Dr. Ma noted in his presentation, investors are really discouraged by the uncertainty of China's capital controls, which has had a significant chilling effect on capital inflows.[102] It has also stalled the RMB's international usage: Based on data from the Society of Worldwide Interbank Financial Telecommunications (SWIFT), in June 2017 only 1.98 percent of global payments were made in RMB, down from 2.09 percent in June 2015.[*] [103] Restrictions on capital outflows and foreign currency transactions have also affected Chinese FDI abroad, which declined significantly at the end of 2016 and in early 2017 as new rules took effect (for more on Chinese outbound FDI, see Chapter 1, Section 2, "Chinese Investment in the United States").

U.S.-China Bilateral Economic Engagement

The Trump-Xi Summit

On April 7, 2017, President Donald Trump hosted a summit with President Xi in Florida. While the daylong meeting led to little in the way of tangible results, the two sides laid the groundwork for future interaction by establishing new diplomatic channels, a timeline for discussion on trade issues, and a cooperative stance on North Korea.[104] After the meeting, the two sides announced the restruc-

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* RMB's international presence is boosted, albeit in a small way, by its inclusion (effective October 2016) in the IMF's Special Drawing Rights (SDR) basket. The SDR is IMF's international reserve asset made up of five major reserve currencies. For more information, see Eswar S. Prasad, "China's Efforts to Expand the International Use of the Renminbi" (prepared for the U.S.-China Economic and Security Review Commission), February 4, 2016, 82–89.

turing of a key bilateral dialogue and established a 100-day plan to tackle outstanding trade and investment issues.

The 100-Day Plan

The first announcement was a 100-day plan to address trade and investment issues between the United States and China.[105] In May 2017, the U.S. Department of Commerce announced the first deliverable of the 100-day plan: a new agreement with China to promote market access in a range of sectors, including agriculture, financial services, and energy—though in most cases these were promises China had already made in the past.[106] While Secretary of Commerce Wilbur Ross hailed the ten-point agreement as a "herculean accomplishment" that "will help us to bring down the deficit for sure," observers pointed out that many of the items in the deal are long-time obligations China has failed to meet.[107] Most of the items had a deadline of July 16, 2017, the 100th day after the Trump-Xi meeting.[108] In most cases, while China has adhered to the letter of its commitments made under this agreement, in practice, U.S. companies will continue to face challenges. Table 3 summarizes the progress on key issues addressed in the 100-day plan; a more in-depth assessment follows the table.

Table 3: The 100-Day Plan Scorecard

Sector	Status	Notes
U.S. Beef	Complete	First shipments of U.S. beef delivered in June 2017, but only a small minority of U.S. beef producers meet the standards.
Chinese Poultry	Complete	U.S. Department of Agriculture determined China's poultry slaughter inspection system meets U.S. food safety standards.
U.S. Biotechnology	Partial	Only four of eight pending U.S. biotech products approved.
Electronic Payments	Partial	China released new guidelines for licensing foreign electronic services processing companies, but the licensing process would result in long delays.
U.S. Liquefied Natural Gas (LNG)	Complete	The United States affirmed China's eligibility to import U.S. LNG.

Source: Compiled by Commission staff.

- **U.S. beef:** On June 12, 2017, China and the United States finalized technical standards for U.S. beef exports to China, lifting a 14-year ban.[109] This agreement mirrors a September 2016 announcement by China's Ministry of Agriculture and the General Administration of Quality Supervision, Inspection and Quarantine that they would lift the ban on U.S. bone-in and boneless beef for livestock under 30 months contingent upon mutually agreed traceability, inspection, and quarantine requirements.[110] China, the world's second-largest importer of beef, will now permit imports of U.S. bone-in and boneless beef for livestock under

30 months that can be traceable to a U.S. birth farm or first place of residence or port of entry.[111] Because only 15 percent of U.S. cattle are verified through this voluntary beef traceability system, gains for U.S. exporters hoping to reach the Chinese market will be limited.[112]

- **Chinese poultry:** In return for gaining market access for U.S. beef, the United States will allow imports of Chinese cooked poultry.[113] Chinese poultry has been banned in the United States due to food safety concerns (China is prone to outbreaks of avian flu and has a long history of food safety scandals).[114] In March 2016, an audit report published by the U.S. Department of Agriculture's Food and Safety Inspection Service (FSIS) found China's poultry slaughter inspection system meets U.S. food safety standards.[115] With this satisfactory audit, on June 16, 2017, the FSIS proposed a regulatory amendment adding China to the list of countries eligible to export poultry products from birds raised and slaughtered in China.[116] The amendment was open for public comment until August 15, after which the FSIS was expected to make a final determination.[117] Meanwhile, China continues to maintain a ban on U.S. poultry, which has been in effect since 2015 after bird flu was discovered in a wild duck. In July 2017 a group of three dozen senators sent a letter to the U.S. Secretary of Agriculture urging him to press China to end this ban.[118]
- **Electronic payments:** China agreed to issue guidelines to allow U.S.-owned suppliers of electronic payment services to "begin the licensing process" in a sector that has been dominated by UnionPay, China's state-owned payments network.[119] U.S. companies hoped for a speedy access to the Chinese bank card payments market, which, according to the PBOC, reached $8.4 trillion in 2015 and is projected to become the world's largest by 2020.[120] Instead, the guidelines released by the PBOC on June 30 lay out a two-step licensing process, possibly with a national security review provision, which means U.S. companies would have to wait two or more years before they can participate in the Chinese market.[121] The release of the guideline marks another in a long line of delays and obstructions used by the Chinese government to deny foreign companies access. China had committed to granting access to foreign payment companies as part of its accession to the World Trade Organization (WTO) in 2000, but did not honor that commitment, prompting a U.S. challenge.[122] In 2012, the WTO ruled China's rules governing access to its domestic electronic payments market unfairly discriminated against foreign payment card companies. By the time China started taking steps to implement the WTO ruling in 2015, most foreign companies had formed joint ventures in China to gain access.[123] (For an in-depth assessment of U.S. market access to China's financial services market, see Chapter 1, Section 3, "U.S. Access to China's Consumer Market.")
- **Liquefied Natural Gas:** Under the new agreement, the United States welcomed Chinese companies to import LNG from U.S. suppliers, including purchases under long-term

contracts.[124] While U.S. companies are already able to export LNG to China, industry analysts believe this high-level statement of support could encourage investment in U.S. LNG export terminals needed to support higher levels of U.S. exports.[125] China is the fastest-growing market for LNG, as the country transitions from coal generation to a cleaner energy mix.[126] The deal "will let China diversify, somewhat, their sources of supply and will provide a huge export market for American LNG producers," said Secretary Ross.[127] However, U.S. LNG exporters may see only limited benefits from the deal, at least in the near term. According to data from Bloomberg New Energy Finance, Chinese companies have long-term LNG contracts with non-U.S. suppliers * through at least 2023 that exceed domestic demand.[128] Moreover, the United States currently lacks the infrastructure to export more LNG, and any increase in exports to China would have to wait until more LNG export terminals are built.[129]

- **Biotechnology:** China promised "to conduct science-based evaluations of all eight pending U.S. biotechnology product applications to assess the safety of the products for their intended use."[130] Products that pass the safety reviews are to receive certificates "within 20 working days" that will enable to them to be sold in China.[131] In June 2017, China approved two genetically modified strains of soybeans and corn developed by Monsanto and Dow Chemical, respectively, for import into its market.[132] Approval for two more genetically modified corn types, from Syngenta and Monsanto, followed in July.[133] However, four more products await approval, leading U.S. companies to complain about the lack of transparency in China's review process.† [134] The Chinese government has designated biotechnology as a strategic emerging industry, and in a 2014 speech President Xi said foreign companies should not be allowed to "dominate the [domestic] agricultural biotechnology product market."[135] Beijing has blocked imports of genetically modified seeds from U.S. companies like Monsanto, and DuPont, citing safety concerns, but U.S. industry analysts believe these policies are aimed at protecting China's domestic biotechnology industry from foreign competition.[136]

The U.S.-China Comprehensive Dialogue

The second outcome of the Trump-Xi April summit was an agreement to restructure the Strategic and Economic Dialogue (S&ED) ‡ creating the United States-China Comprehensive Di-

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*Australia is China's top LNG supplier, followed by Qatar, and Malaysia. Clyde Russell, "China's Natural Gas Output, Imports Surge, Beating Target," Reuters, June 28, 2017.

†For more information about China's approval process for genetically modified products, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, July 6, 2017, 3–4.

‡The U.S.-China Strategic and Economic Dialogue (S&ED) was established by then President Barack Obama and then Chinese President Hu Jintao in April 2009. The S&ED was divided into two tracks. The economic track was headed by the secretary of the treasury and the security track by the secretary of state, but many other high-level officials from a variety of governmental departments also participated. The strategic track focused on bilateral relations, international security issues, global issues, and regional security issues. The economic track focused on promoting recovery and sustainable growth, market-oriented financial systems, trade and investment, and a more robust international financial architecture. House Foreign Affairs Committee, *U.S.-China*

alogue, which will be divided into four tracks: the Diplomatic and Security Dialogue, Comprehensive Economic Dialogue, Cyber and Law Enforcement Dialogue, and Social and People-to-People Exchange Dialogue.[137] The four dialogues will be scheduled at separate times; the S&ED, by contrast, was held over a two-day period.[138]

The inaugural Comprehensive Economic Dialogue, chaired by the U.S. Departments of Treasury and Commerce, was held on July 19. The meeting concluded with no joint statement, concrete agreements, or future agenda. The two news conferences United States and China were going to hold separately after the meetings were canceled.[139] A statement from U.S. Treasury Secretary Steven Mnuchin and U.S. Commerce Secretary Wilbur Ross said, "China acknowledged our shared objective to reduce the trade deficit which both sides will work cooperatively to achieve."[140] According to people familiar with the talks, China was unwilling to concede to U.S. demands for concrete plans, including numerical targets, for reducing the U.S. trade deficit and cutting steel capacity.[141]

USTR Launches an Investigation into China's Industrial Policies

On August 18, 2017, the Office of the U.S. Trade Representative (USTR) self-initiated an investigation under Section 301 of the U.S. Trade Act of 1974* to determine "whether acts, policies, and practices of the Government of China related to technology transfer, intellectual property, and innovation are unreasonable or discriminatory and burden or restrict U.S. commerce."[142] China's Ministry of Commerce quickly criticized the announcement stating, "China expresses strong dissatisfaction with the United States' unilateral protectionist action. We urge the U.S. side to respect the facts, … respect multilateral principles, and act prudently."[143]

The investigation will concentrate on the Chinese government's acts, policies, and practices in four main areas: (1) market access barriers such as opaque regulations and joint venture requirements; (2) imposition of non-market terms in licensing and technology-related contracts; (3) state-directed or state-facilitated investment in or acquisition of U.S. companies and assets; and (4) commercial cyberespionage.†[144] The USTR has one year to complete the investigation, consult with the Chinese government regarding problematic practices, and, if necessary, develop an action plan for President Trump.[145]

Relations: Maximizing the Effectiveness of the Strategic and Economic Dialogue, prepared statement of David Loevinger, U.S. Department of State, September 10, 2009; Bonnie Glaser, "Strategic & Economic Dialogue Sets Agenda for Cooperation," *E-Journal on East Asian Bilateral Relations* (October 2009): 2.

*Section 301 of the Trade Act of 1974 provides the United States with the authority to enforce trade agreements, resolve trade disputes, and open foreign markets to U.S. goods and services. It is a statutory authority under which the United States may impose trade sanctions on foreign countries that either violate trade agreements or engage in other unfair trade practices. When negotiations to remove the offending trade practice fail, the United States may take action to raise import duties on the foreign country's products as a means to rebalance lost concessions. U.S. Department of Commerce, International Trade Administration, "Section 301."

†For more information on China's commercial cyberespionage against U.S. firms, see U.S.-China Economic and Security Review Commission, Chapter 1, Section 4, "Commercial Cyber Espionage and Barriers to Digital Trade in China," in *2015 Annual Report to Congress*, November 2015.

For many years, the U.S. government has criticized China for its unfair market barriers and trade practices with limited success. The USTR's *2016 Report to Congress on China's WTO Compliance* outlined several major areas of ongoing concern including

> *serious problems with intellectual property rights enforcement in China, including in the area of trade secrets; the Chinese government's prolific use of industrial policies favoring state-owned enterprises and domestic national champions, including "secure and controllable" information and communications technology (ICT) policies, export restraints, subsidies, unique national standards and investment restrictions, among other policies; troubling agricultural policies that block U.S. market access; numerous continuing restrictions on services market access; and inadequate transparency.*[146]

If the USTR finds that Chinese government's acts, policies, and practices are "unreasonable or discriminatory," the USTR has the statutory authority to suspend existing trade agreement concessions, impose duties or other import restrictions on foreign goods and services, withdraw or suspend preferential duty treatments, and enter into binding agreements to address the elimination of problematic acts, policies, or practices.[147]

United States and China at the WTO

China's adherence to WTO principles remains mixed, giving rise to continued tensions with the United States over China's lack of compliance with its commitments. The United States continues to criticize China for its ongoing failure to notify its subsidies to the WTO. Over the last year, the United States brought WTO cases against China over its tariff rate quotas on certain agricultural goods, and subsidies to aluminum producers. At the same time, China has initiated a case against its trade partners for continuing to treat China as a nonmarket economy. Key developments in U.S.-China engagement at the WTO are discussed in the following subsections. Ongoing WTO cases between the United States and China are summarized in Addendum I.

China Brings Market Economy Status Dispute to the WTO

In December 2016, China launched a legal challenge at the WTO after the United States and EU maintained China's status as a nonmarket economy (NME).[148] Beijing believes its trade partners are obligated to grant it market economy status (MES) following the expiration of section 15(a)(ii) of its WTO Accession Protocol on December 11.[149] In China's 2001 WTO accession agreement, Beijing agreed to provisions allowing its trade partners to automatically treat it as an NME for the purposes of antidumping (AD) enforcement for 15 years.[150] This agreement allowed countries to use values from a third country in a similarly situated economic position—not Chinese prices or costs—for AD calculations, unless China could demonstrate market economy conditions prevailed in the relevant industry (the so-called "surrogate country" approach).[151] Beijing had hoped it would be recognized as a market economy following the provision's expiration, despite repeated instances of Chinese companies selling exports at prices below the cost of production—a practice known as "dumping."[152] If China is granted MES, its trading partners will no longer be able to determine the costs of Chinese goods using surrogate values, which many believe more accurately reflect what a market-based price of a Chinese product would be. This would likely result in a significant reduction of dumping margins on Chinese products to the detriment of U.S. companies and workers.*

On April 3, 2017, the WTO Dispute Settlement Body established a panel to review China's claim that the EU is violating its WTO commitments by treating China as an NME.[153] Despite requesting consultations with both the United States and the EU, at this stage China chose to pursue a case only against the EU—an indicator China may be using a "divide and conquer" strategy because it believes it has a better case against the EU.[154]

The United States applies a six-step statutory test† for determining whether a country or sector qualifies as a market economy. The Secretary of Commerce makes this determination. In contrast, current EU law names specific countries—including China—as NMEs.[155] At the time China lodged its complaint, the EU was considering legislation to remove the NME country list and make NME arguments against foreign countries on a sector-by-sector basis.‡ The EU has expressed frustration that China would bring its WTO case while the law is being considered, because if the law is adopted it would eliminate the measures China is challenging.[156] In a statement during a WTO meeting on March 21, 2017, the EU said China's case "is unnecessary and ultimately incapable of being fruitful," while also calling it an attack on the "ongoing internal legislative process of the European Union."[157]

The potential economic fallout of the EU granting China MES worries U.S. policymakers, with unnamed U.S. officials from the USTR and the U.S. Department of Commerce warning their EU counterparts in December 2015 that granting China MES would amount to "unilaterally disarming" Europe's trade defenses against China.[158] Six months later, a bipartisan group of 18 U.S. senators sent a letter to EU Trade Commissioner Cecilia Malmström urging the EU to rule against granting China MES. The letter stated that granting China MES would "thwart global efforts to secure China's compliance with its international trade obligations," and "could have a destabilizing impact in certain global sectors, including the steel industry."[159]

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*For more on China's MES, see U.S.-China Economic and Security Review Commission, "State-Owned Enterprises, Overcapacity, and China's Market Economy Status," in *2016 Annual Report to Congress*, November 2016, 114–119.

†These six factors are: (1) The extent to which the currency of the foreign country is convertible into the currency of other countries; (2) The extent to which wage rates in the foreign country are determined by free bargaining between labor and management; (3) The extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country; (4) The extent of government ownership or control of the means of production; (5) The extent of government control over the allocation of resources and over the price and output decisions of enterprises; and (6) Such other factors the administering authority considers appropriate. Tariff Act of 1930, Pub. L. No. 103–465, 1930, codified at 19 U.S.C. § 1677(18).

‡The EU agreed on a new AD methodology on October 3, 2017. The new rules will eliminate explicit differences between market and non-market economies, and instead consider a variety of factors to determine whether there are "significant market distortions, or a pervasive state's influence on the economy." Among the factors to be considered are "state policies and influence, the widespread presence of state-owned enterprises, discrimination in favour of domestic companies and the lack of independence of the financial sector." The European Commission, "Commission Welcomes Agreement on New Anti-Dumping Methodology," October 3, 2017.

United States Challenges Chinese Tariff Rate Quotas for Rice, Wheat, and Corn

On December 15, 2016, the United States brought a complaint against China's "opaque and unpredictable" management of tariff rate quotas (TRQs) for rice, wheat, and corn, which "breaches China's WTO commitments and undermines American farm exports."[160] In its WTO accession agreement, China agreed to apply low tariff rates to imports of grain until total imports have reached a specific quota (5.32 million metric tons for rice, 9.64 million metric tons for wheat, and 7.2 million metric tons for corn).[161] After the quota is reached, the imports are assessed a 65 percent tariff.[162] The USTR alleges "China's application criteria and procedures are unclear, and China does not provide meaningful information on how it actually administers the tariff-rate quotas."[163] The USTR also argues that China maintains "impermissible restrictions on importation, and [fails] to provide notice of the total quantities permitted to be imported and changes to the total quantity permitted to be imported," which prevents exporters from gaining fair access to China's market."[164]

China is an important market for U.S. agricultural exports, though these volumes would be much higher if China permitted imports in adherence to its WTO commitments. According to the U.S. Department of Agriculture, China's TRQs for wheat, rice, and corn "were worth over $7 billion in 2015. If the TRQs had been fully used, China would have imported as much as $3.5 billion worth of additional crops" in that year.[165]

In September 2016, the USTR brought a separate case against Chinese domestic subsidies for rice, wheat, and corn,* which the USTR estimates to be $100 billion in excess of China's WTO commitments.

United States and China Battle over Steel and Aluminum Industry Subsidies

Though steel and aluminum overcapacity are global issues, China accounts for most of the excess capacity† due to massive subsidies and other forms of support.‡ The United States challenged China's subsidization of its steel and aluminum firms at the WTO (though the challenge is currently suspended) and launched Section 232 investigations§ into the impact of imports on national security and U.S.-based aluminum and steel firms.

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*For more on this case, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, October 7, 2016.

†For example, an estimate from Duke University's Center on Globalization, Governance & Competitiveness shows in 2015 China was responsible for 46 percent of steel overcapacity. Lukas Brun, "Overcapacity in Steel: China's Role in a Global Problem," *Duke University*, September 2016.

‡For an in-depth assessment of the impact of Chinese overcapacity on U.S. economy and national security, see U.S.-China Economic and Security Review Commission, "State-Owned Enterprises, Overcapacity, and China's Market Economy Status," in *2016 Annual Report to Congress*, November 2016, 103–114.

§Section 232 of the Trade Expansion Act of 1962 (19 U.S.C. §1862) authorizes the Secretary of Commerce to conduct comprehensive investigations to determine the effects of imports of any article on the national security of the United States. The Secretary's report to the President, prepared within 270 days of initiation, focuses on whether the importation of the article in question is in such quantities or under such circumstances as to threaten to impair the national security. The President can concur or not with the Secretary's recommendations, and, if necessary, take action to "adjust the imports of an article and its derivatives." In addition, the Secretary can recommend, and the President can take, other lawful non-trade related actions necessary to address

The United States has long censured the Chinese government for not adhering to its WTO obligations by failing to report its subsidies to the WTO. Per the WTO Agreement on Subsidies and Countervailing Measures, member countries must report all of their subsidies each year.[166] In October 2015, China submitted a notification for national subsidies for 2009–2014, but this notification did not outline China's provincial and local subsidies, where most of China's government financial support is provided.[167] In January 2016, the USTR claimed this notification was incomplete and provided WTO members a list of China's subsidies for one of its largest steel firms and reported on the Chinese banking regulator's instructions to increase direct funding and loosen financing restrictions to the steel sector.[168] In October 2016, the USTR again raised its concerns about China's incomplete notification by laying out subsidy programs that China's notification did not mention and requesting additional clarification.[169]

On April 12, 2017, the United States and the EU jointly challenged China's steel subsidies before the WTO Committee on Subsidies and Countervailing Measures, identifying more than $1 billion in subsidies to Hebei Iron and Steel Company, Shougang Steel, Chongqing Steel, and Baoshan Iron and Steel in 2011–2014 for the Chinese government to explain.[170] The Chinese government responded to U.S. allegations by claiming yet again that its support for the steel industry is aimed at improving environmental protection, technological innovation, and industrial restructuring, and thus is not prohibited under the WTO.[171] The USTR has not yet challenged this latest response.

China has struck back against U.S. complaints by accusing the United States of failing to notify the WTO about alleged federal and state steel subsidy programs.[172] China claims these programs have de jure specificity—where a subsidy is clearly limited to a particular company, industry, group of industries, or geographic region—and thus is a violation of the WTO rules.[173] At the federal level, the Chinese government alleges $76.9 million in AD and countervailing duties (CVDs) paid out by U.S. Customs and Border Protection in 2008–2015 and $7.7 billion in pensions provided to retired U.S. workers by the U.S. Department of Labor's Pension Benefit Guaranty Group since 2003 are in fact subsidies.[174] China accuses U.S. Customs and Border Protection of subsidizing the U.S. steel industry by imposing CVDs to offset subsidized imports from China and other countries.[175] The WTO permits countries to enact ADs and CVDs after an investigation into the impact of subsidies on the importing countries' industries.[176] In addition, the Pension Benefit Guaranty Group—an independent government agency that guarantees pension benefits for private firms—is funded not by the federal government but by insurance premiums from private sector employers, assets held by pension funds it takes over, investment income, and bankruptcy assets from insolvent pension plans.[177] The USTR has yet to formally respond to these allegations.

In a separate action, in January 2017, the USTR requested consultations with China at the WTO regarding China's subsidies to

the threat. U.S. Department of Commerce, "Fact Sheet: Section 232 Investigations: The Effect of Imports on the National Security," April 20, 2017.

its primary aluminum producers since 2007.[178] The United States alleges the Chinese government has provided low-cost financing and inputs to its primary aluminum producers, which displaced and impeded U.S. imports of primary aluminum into China and the global market, suppressed global prices, and increased China's global market share.[179] (As of August 2017, the USTR appears to have put this case on hold and has not requested the WTO compose a panel.[180])

Beyond the WTO, in April 2017 President Trump directed the Department of Commerce to conduct investigations, under Section 232 of the Trade Expansion Act of 1962, into whether steel and aluminum imports are a threat to national security.[181] If the Department of Commerce determines these imports impair national security, the U.S. president would be able to "adjust imports" by imposing trade measures such as tariffs and quotas.[182] None of the nine steel-related cases the Department of Commerce has initiated have found a threat to national security.[183] In 2001, then President George W. Bush initiated this option to address iron ore and semifinished steel imports following the required Department of Commerce investigation; in that case, Section 232 was not applied because "there [was] no probative evidence that imports of iron ore or semifinished steel threaten to impair U.S. national security."[184]

Addendum I: WTO Cases

Ongoing WTO Cases Brought by the United States against China

No.	Title	Request for Consultations	Panel Report	Status
DS508	Export Duties on Certain Raw Materials	July 13, 2016	Panel established but not yet composed November 2016	The United States requested consultations with China over China's export subsidies on nine raw materials.*
DS511	Domestic Support for Agricultural Producers	September 13, 2016	Panel composed June 2017	The United States requested consultations with China over China's domestic support for rice, wheat, and corn in excess of its WTO commitments.
DS517	Tariff Rate Quotas for Certain Agricultural Products	December 15, 2016	Panel established but not yet composed September 2017	The United States argues China's tariff rate quota treatment for rice, wheat, and corn is nontransparent, unpredictable, and violates China's WTO commitments.
DS519	Subsidies to Producers of Primary Aluminum	January 12, 2017	In consultations; in August 2017 the USTR put this case on hold	The United States alleges China provides certain producers of primary aluminum with subsidies, including artificially cheap loans and artificially low-priced inputs for production, such as coal, electricity, and alumina.

Source: WTO; compiled by Commission staff. For a list of all U.S. WTO cases against China, see *https://www.uscc.gov/wto-cases*.

Ongoing WTO Cases Brought by China against the United States

No.	Title	Request for Consultations	Panel Report	Status
DS515	Measures Related to Price Comparison Methodologies	December 12, 2016	In consultations; panel not yet formed	China's complaint alleges the United States has failed to treat China as a market economy for the purposes of calculating antidumping duties.

Source: WTO; compiled by Commission staff. For a list of all Chinese WTO cases against the United States, see *https://www.uscc.gov/wto-cases*.

*The materials are antimony, cobalt, copper, graphite, lead, magnesia, talc, tantalum, and tin.

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