

# CHAPTER 1

## U.S.-CHINA TRADE AND ECONOMIC RELATIONS

### SECTION 1: YEAR IN REVIEW: ECONOMICS AND TRADE

#### Introduction

Supported by government stimulus, China sustained economic growth at or near its official target rate of 7.5 percent through the first three quarters of 2014. China's gross domestic product (GDP) growth has been under 8 percent for ten consecutive quarters, with Chinese government leaders calling current growth rates the "new normal" for China.<sup>1</sup> Responding to signs of an imminent economic slowdown, China's government used various policy tools to intervene in the economy and try to achieve its official growth target for 2014.<sup>2</sup> Branded as a "mini-stimulus," fiscal spending increased by 25 percent year-on-year in May as the government accelerated subsidization of large infrastructure and housing projects.<sup>3</sup> A continuing policy of Chinese government intervention in international currency markets supported China's exports in the first half of the year by maintaining an undervalued renminbi (RMB).

Chinese President Xi Jinping laid out a sweeping economic reform agenda during the 2013 Third Plenum of the Chinese Communist Party (CCP) to address many of China's underlying economic problems. Xi's proposed reforms range from a revised tax system, to financial liberalization, to partial reform of restrictions on imports and inbound foreign investment.\* However, President Xi's government made minimal progress in implementing these reforms in 2014. Instead, President Xi and his leadership team focused on a broad anticorruption campaign while using the stimulus to avoid further economic slowdown. It remains unclear if the Xi-led government will accelerate reform in 2015.

Although China prevented further deceleration of growth in 2014 through stimulus, the government failed to address underlying structural problems, such as oversupply, overcapacity, mounting local government debt, and asset bubbles that put its economy at

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\*China has traditionally used catalogs to denote which products, services, and investments are approved for market access. Sectors not specifically listed in the catalogs are restricted from foreign competition. The system more widely used globally is a "negative list" approach which denotes only those sectors which face market access restrictions; sectors not listed are considered open.

risk of a sharp slowdown or “hard landing.”\* Excessive levels of investment in property and heavy industries such as steel, which fueled China’s growth since the 1990s, have caused these underlying structural problems. Although market forces have been forcing prices downward, China’s government continues to use subsidized fixed investment and exports to bolster its economy to levels of growth that ensure low unemployment and reduce the risk of social unrest. While disposable income and consumption have increased relative to savings, China has not yet weaned itself from its traditional investment and export-based growth model, and thus continues to struggle with large internal imbalances.<sup>4</sup>

Imbalances in China’s trade and investment relationship with the United States and other countries worsened in 2014. In the first eight months of 2014, the U.S.-China trade deficit increased by 4.1 percent year-on-year to a total of \$216 billion. Despite its economic slowdown, China’s exports continued to grow and it sustained a global trade surplus. Chinese direct investment into the United States exceeded U.S. investment into China in 2014 for the first time as foreign firms faced an increasingly hostile investment climate in China. China accelerated its 2001 “Go Out” policy, which encourages Chinese firms to expand their global presence.<sup>5</sup> China’s nontransparent policy-making processes frustrated trading partners and obstructed progress in key trade negotiations, such as the Information Technology Agreement (ITA). China’s confrontational behavior in addressing contentious territorial disputes with neighboring countries has also harmed economic and trade relations in the Asia Pacific. Such behavior has economic implications for the United States because of the large volumes of U.S. trade that flow through these disputed waters as well as the presence of potentially vast natural resources, including oil, natural gas, and other mineral deposits.

## **China’s Economic Slowdown and Stimulus**

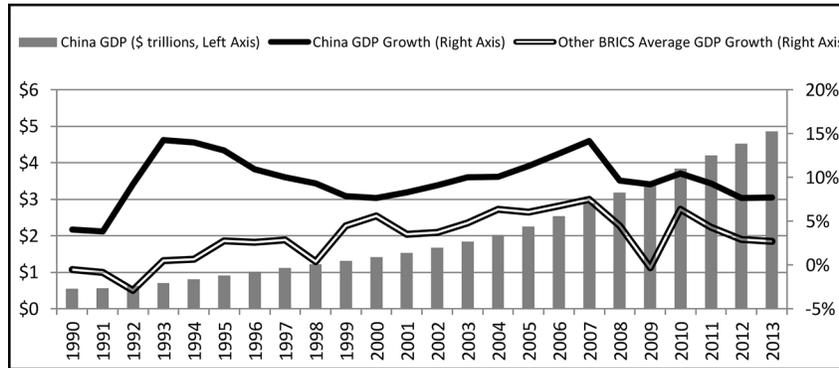
### ***Slowdown—Causes and Symptoms***

In the first three quarters of 2014, China reported an average growth rate of 7.4 percent, just below its official growth target of 7.5 percent, as the economy was bolstered through government stimulus. Throughout 2014, Chinese government leaders said lower growth rates would become the norm as the country seeks to transition from an investment and export-led economy to a consumption-based growth model. For example, Chinese Premier Li Keqiang said that China’s economy must grow at a “proper rate” expected at around 7.5 percent, which he described as “slower than the past, but normal.” Li indicated that the Chinese government was “adjusting its economic operations” to ensure that growth did not fall below 7.5 percent, a rate determined to maintain job creation.<sup>6</sup> Li also pledged that there would be “no hard landing” for China’s economy.<sup>7</sup> In summation, China conceded to a slower growth rate in 2014 but ensured intervention through stimulus whenever growth decelerated below the official target rate of 7.5 percent.

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\*A hard landing is a scenario in which an economy slows sharply toward or into recession after a period of growth.

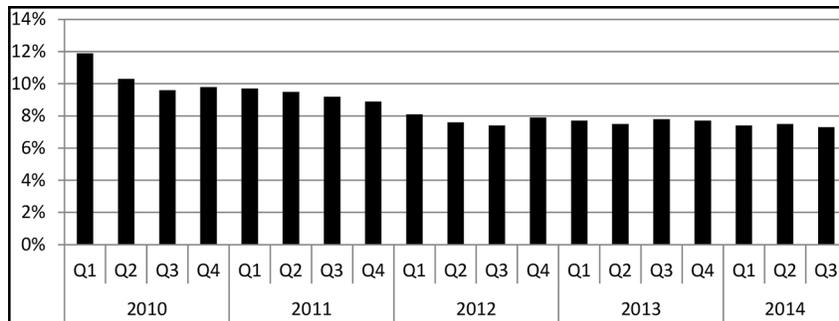
**Figure 1: China's Annual GDP and GDP Growth**



Source: World Bank Development Indicators. "Other BRICS Average GDP Growth" is an average of the GDP growth rates of Brazil, Russia, India, and South Africa.

Figure 1 shows China's annual GDP and GDP growth rates since 1990. Over this 23-year period, China's annual GDP increased from \$200 billion to \$4.8 trillion. Although annual growth rates declined somewhat from the peaks of the 1990s and early 2000s, they continue to remain consistently high, even in comparison to other large emerging economies. As shown in Figure 2, quarterly GDP growth rates declined slightly in 2010 and 2011, but have generally hovered in the 7.4 to 8 percent range since 2012. In the absence of sustained government stimulus, economists generally agree that China's GDP growth would have continued to decelerate below its official target in 2014.<sup>8</sup>

**Figure 2: China's Quarterly GDP Growth Rates**

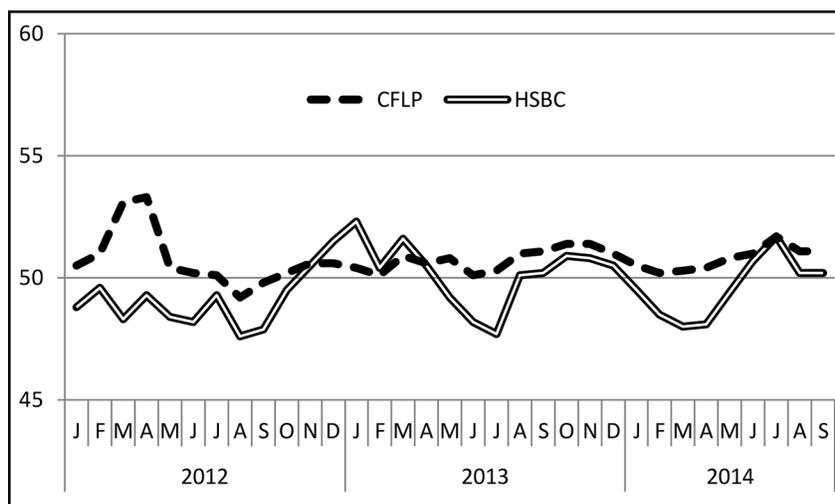


Source: Trading Economics.

China's Purchasing Managers' Index (PMI), an indicator of economic expansion and a proxy for industrial utilization, reveals how expanding government stimulus in 2014 may have mitigated China's economic slowdown. As shown in Figure 3, in the first half of the year, China's PMI remained under 50, the threshold for contraction in the economy. However, by June, as China's stimulus began to expand and take effect, China's PMI rose above 50, indicating evidence of increased production.<sup>9</sup>

**Figure 3: Purchasing Managers' Index**

(&gt;50 = expansion; &lt;50 = contraction)



Source: China Federation of Logistics and Purchasing (CFLP), via CEIC data; HSBC.

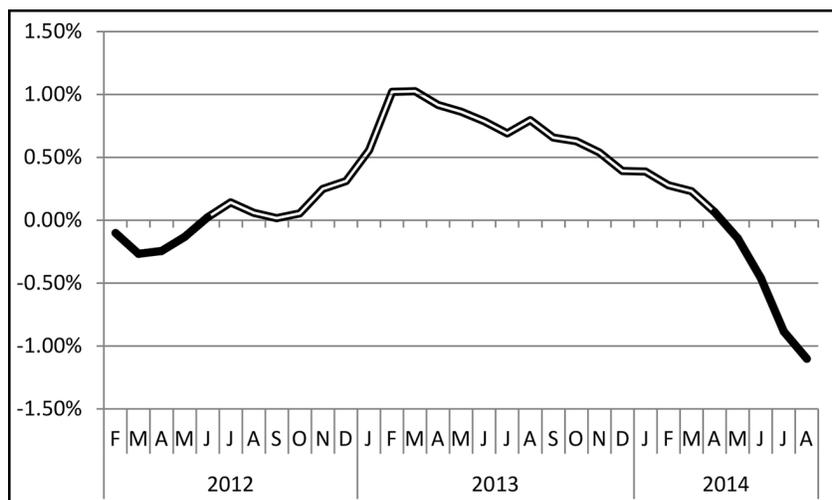
Although China's economy avoided a "hard landing" in 2014, several underlying structural problems combined to jeopardize growth: a worsening property market, persistent industrial overcapacity, and increasing debt levels. According to the International Monetary Fund (IMF), China's "growth has relied too heavily on investment and credit, a pattern that is not sustainable and [is] resulting in rising vulnerabilities."<sup>10</sup> High levels of investment, especially in the property sector and related heavy industries, have been a central driver of economic growth and job creation in China since the 1990s.<sup>11</sup> Real estate and construction make up about 14 percent of urban employment in China, and local governments have financed construction-intensive projects as an easy means of job creation.<sup>12</sup> As slowing growth threatens to raise unemployment in China, local governments may continue to subsidize these industries to sustain employment levels and prevent the risk of domestic instability.

Historically, China's dynamic property sector has bolstered demand for steel, cement, and construction—the same industries that now face the most severe overcapacity problems. Such investment in traditional industries has often been spurred indirectly through local government subsidization of infrastructure projects that increased China's debt to the highest levels ever. Thus, the interdependence of China's property market, subsidized overcapacity of traditional industries, and rising local government debt has resulted in a vicious cycle that continues to put China's economy at risk of further slowdown.

*Property Slump:* In 2014, China's residential property prices fell for the first time in two years, sparking fears of an imminent crisis. As shown in Figure 4, price increases of newly constructed residential properties in 70 Chinese cities began to slow in March 2013 and continued to decelerate throughout that year.<sup>13</sup> In May 2014,

prices began to decline and continued to do so into the third quarter. In July, 64 of 70 cities surveyed in China reported declining property prices, the largest proportion of cities showing a monthly decline since 2005. On average, property prices fell 0.9 percent between June and July.<sup>14</sup>

**Figure 4: Change in Price of New Residential Construction**  
(Average of 70 Surveyed Chinese Cities)



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

According to UBS Bank, “the risk of a more persistent and sharper downturn in the property sector is now the biggest risk facing China’s economy in 2014 and 2015.”<sup>15</sup> As a pillar of China’s growth, the property sector affects a multitude of other key sectors, such as construction and steel production. Moody’s Analytics estimates that, including construction and home renovation, property sales account for nearly one-quarter of China’s GDP.<sup>16</sup>

*Overcapacity:* China’s chronic problem of overcapacity and excess investment continued to plague the economy. Chinese policymakers have been trying to pare down industrial overcapacity since 2005; yet after nearly a decade of efforts, economists believe that the problem has actually worsened.<sup>17</sup> Traditionally, China’s overcapacity has been concentrated in certain sectors, such as steel, solar panels (photovoltaics), plate glass, cement, construction, and shipbuilding.<sup>18</sup> Official data indicate that the average industrial utilization rate was 78 percent in the first half of 2013, while steel and plate glass had the lowest utilization rates at 72 percent, a level that would be considered recessionary in a capitalist system.\*<sup>19</sup> In the aluminum sector, overcapacity has increased with

\*The utilization rate is a measurement of industrial capacity and is the rate at which the potential output levels are being met or used. Normal utilization rates in the United States tend to average around 80 percent.

approximately three million tons of new smelter space established since 2013.<sup>20</sup>

China's steel sector also suffers from serious overcapacity.<sup>21</sup> Local governments amplify this problem by relying on steel mill expansion as an easy way to increase local output and employment.<sup>22</sup> Chinese government subsidization of steel, even when domestic demand is low, has resulted in the selling of Chinese steel exports in global markets at below-market rates. As a result, the U.S. Commerce Department announced in July a preliminary decision to impose countervailing duties on certain Chinese steel imports; a final decision will be announced in November.<sup>23</sup>

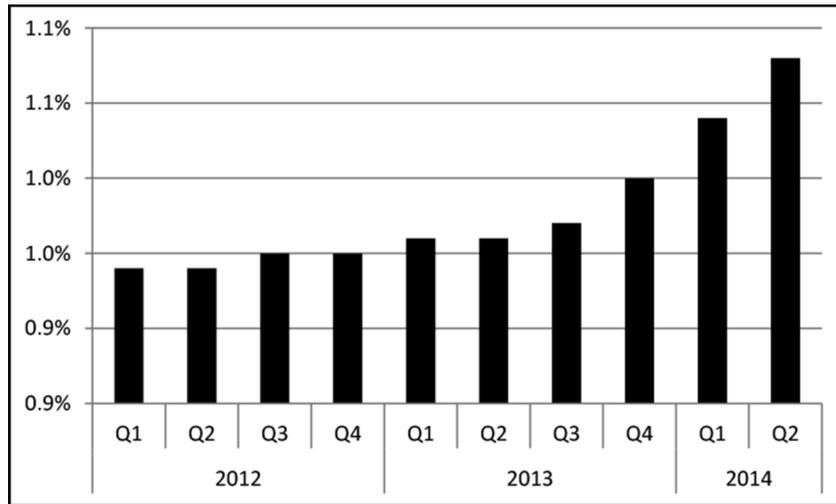
Economists estimate that for China to meet its 2014 target growth rate without enhanced stimulus, it would have to reduce excess capacity by 56.3 percent in steel, 38.9 percent in plate glass, and 11.4 percent in cement.<sup>24</sup> Although necessary in the long-term to reduce inefficiencies, the Chinese government appears to have adopted the view that reducing overcapacity during a time of economic slowdown would exacerbate the decline. For example, China's Minister of Industry and Information Technology, Miao Wei—who is charged with reducing industrial overcapacity—admitted to the difficulty of addressing the problem while the economy is under downward pressure.<sup>25</sup> The government did request that banks not lend to industries suffering from overcapacity; however, easy access to credit through the shadow banking sector has negated any effect from the official but widely ignored policy.<sup>26</sup>

*Rising Debt Levels:* In 2014, China's debt levels rose at record rates, imposing another underlying threat to China's economic stability. Standard Chartered estimated that China's total debt-to-GDP ratio surpassed 250 percent in 2014,<sup>27</sup> a level well above most emerging economies and on par with Australia, South Korea, France, and Italy.\* By comparison, the U.S. total debt-to-GDP ratio in 2013 was estimated at 270 percent. While economists do not consider the ratio itself to be dangerously high, they are concerned about the rate at which China's debt levels are increasing. By July 2014, China's debt-to-GDP ratio had already increased 20 percent over the previous year.<sup>28</sup> In the first half of 2014, China's total social financing, a more robust measurement of credit beyond traditional bank lending, increased 23.7 percent year-on-year.<sup>29</sup> China's rising debt levels are accompanied by a growing number and value of non-performing loans (NPL), which are loans upon which the borrower has not made payments for at least 90 days.<sup>30</sup> NPLs in China have been rapidly rising since late 2013, as shown in Figure 5. In addition, in 2014, China experienced its first corporate bond default since the establishment of its bond market in the early 1990s.<sup>31</sup> If this trend continues, it could have negative consequences on the financial sector, as well as the broader economy.<sup>32</sup>

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\* Standard Chartered's estimate of total debt is more comprehensive than China's official debt statistics and includes both domestic and foreign lending, as well as some types of lending that are often referred to as shadow banking. These include trust loans and entrusted loans, but do not include lending by underground banks, guarantee companies, online lending firms, and pawn brokers, which Standard Chartered considers to be very small compared to overall credit estimates. Some analysts estimate these forms of lending not included in Standard Chartered's calculation to be as high as 8 percent, in which case China's total debt-to-GDP ratio would be about 258 percent.

**Figure 5: Chinese Non-Performing Loans**  
(as percentage of commercial bank loans)



Source: China Banking Regulatory Commission, via CEIC database.

Local governments are a major contributor to China's rising debt levels. Excessive investment in China's property sector and overcapacity-laden industries has largely been supported through local government financing.<sup>33</sup> In an effort to bolster local economic growth in a given Chinese town or province, local governments borrow to finance infrastructure projects that artificially boost demand for construction services and building materials. Consequently, local government debt is raising China's overall debt-to-GDP ratio at record rates and introducing another vulnerability to China's economic growth. In December 2013, a report issued by China's National Audit Office (NAO) revealed that "three provincial governments, 99 cities, 195 county-level administrations, and 3,465 townships had local public debt exceeding 100 percent" of their local economic activity.<sup>34</sup> In total, the NAO report disclosed that China's local governments held nearly \$3 trillion in debt, approximately one-third of China's GDP in 2013.<sup>35</sup>

In recent years, China's central government has tried to rein in rising local government debt to lessen the oversupply of property and industrial overcapacity; however, Beijing's efforts have been largely inconsequential. Local governments have simply circumvented central government restrictions by borrowing from the large shadow banking sector.<sup>36</sup> The shadow banking system can be broadly defined as "lending that falls outside of the official banking system," and includes lending products such as entrusted loans, investment trusts, wealth management products, credit guarantees, and certain forms of microlending.<sup>37</sup> This year, the China Banking Regulatory Commission revealed that China's shadow banking sector reached about \$5.29 trillion, or 57 percent, of GDP in 2013.<sup>38</sup> Beijing has attempted to rein in the prominent shadow banking sector. For example, in May, the People's Bank of China (PBOC),

China's central bank, instructed commercial banks to limit inter-bank lending and lending to other financial institutions—both of which are important financing mechanisms for shadow bank lending. According to analysts, by limiting lending between banks and financial institutions, the government can curb risk-laden debt across the economy.<sup>39</sup> The government's efforts seem to have slowed shadow bank lending, which declined since 2013 as a share of aggregate credit; however, borrowing has simply shifted to the bond market, nullifying any net effect on overall debt.<sup>40</sup> (For more analysis of China's shadow banking sector, see the U.S.-China Economic and Security Review Commission's *2013 Annual Report to Congress*, Chapter 1, Section 3, "Governance and Accountability in China's Financial System.")

### ***Stimulus—Scale and Effectiveness***

Setting aside the structural reforms promised in the 2013 Third Plenary Session of the 18th CCP Central Committee (hereafter, "Third Plenum"), the Chinese government in 2014 resorted instead to economic stimulus to mitigate the slowdown. Although the Chinese government promised not to employ large-scale stimulus in 2014, Beijing implemented expansionary fiscal initiatives throughout the year to bolster the economy and maintain a growth rate at or near the official 7.5 percent target. Chinese Premier Li Keqiang stated that the government would only rely on "smart and targeted regulation" rather than strong stimulus.<sup>41</sup> The government was wary of increasing already high debt levels, particularly among local governments.<sup>42</sup>

Unofficially referred to as a "mini-stimulus," fiscal initiatives announced in July 2013 included expanded investment in railways and public housing, as well as reductions in the Required Reserve Ratios (RRRs) for banks, tax breaks for small businesses, and incentives for homebuyers.<sup>43</sup> Economists estimated that these fiscal initiatives, initially modest in volume, would have been insufficient to offset the effects of the slowing property market on economic growth.<sup>44</sup> Indeed, following the announcement of 7.4 percent GDP growth in the first quarter of 2014, the Chinese government steadily added to the initial "mini-stimulus," steering growth back toward the official target rate of 7.5 percent. For example, in September 2014, the PBOC provided \$81 billion in low-interest loans to China's five major state-owned banks as growth estimates declined in the third quarter of the year.<sup>45</sup> In July, the IMF called on China to lower its economic growth targets for 2015 and refrain from continued stimulus in favor of a "safer and more sustainable growth path."<sup>46</sup>

*Fiscal Spending:* China's overall fiscal spending increased and accelerated throughout 2014 as the government increased stimulus. New central government spending, which increased 15.8 percent year-on-year in May, continued to support railway expansion, but also included other large infrastructure projects such as highways, oil and gas distribution, and storage facilities.<sup>47</sup> By mid-2014, the government had raised railway spending to \$128 billion, an increase of about 25 percent from 2013.<sup>48</sup> The China Railway Corporation (formerly, the Ministry of Railways) announced that it would be constructing 4,350 miles of new tracks in 2014.<sup>49</sup> Some

analysts claim that China's rail system does not suffer from the overcapacity found in other sectors and is, therefore, ripe for enhanced investment.<sup>50</sup> However, others argue that government subsidization of freight rail and investment in rail infrastructure serve as an indirect subsidy to China's export-oriented industries.\*<sup>51</sup>

Despite high debt levels, Beijing urged local governments to boost fiscal spending. Fiscal spending accelerated throughout 2014 reaching a year-on-year increase of 26.1 percent in June.<sup>52</sup> While the value of these fiscal initiatives paled in comparison to the \$640 billion stimulus implemented during the 2008–2009 global economic slowdown, the steady expansion of the stimulus over the year illustrated the Chinese government's commitment to bolstering the economy to avert rising unemployment and possible social instability.

As the decline of China's property market became the main risk to its economy in 2014, the government made policy adjustments to increase demand for housing. For example, the PBOC encouraged the country's largest banks to accelerate mortgage approvals.<sup>53</sup> Banks began offering low down-payment options to help first-time homebuyers.<sup>54</sup> Local governments also provided incentives to home buyers, such as tax breaks<sup>55</sup> and local household registration,† or *hukou*, to residents from other Chinese provinces.<sup>56</sup> On the supply side, the government also reduced reserve requirements of banks to allow property developers to obtain easier financing.<sup>57</sup> To boost lending, Chinese regulators redefined how loan-to-deposit ratios are calculated; the maneuver freed up new credit for small businesses.<sup>58</sup>

### **Building Megaregions with Mini-Stimulus**

The government's increased infrastructure expenditure under the mini-stimulus is accelerating the Chinese government's plans to integrate cities into megaregions. According to the McKinsey Global Institute, China is currently integrating cities into 22 clusters, seven of which can be characterized as megaregions.<sup>59</sup> The megaregions are Guangzhou, Shenzhen, Hangzhou, Shanghai, Nanjing, the Shandong Byland, and the Jing-Jin-Ji cluster, which includes Beijing, Tianjin, and parts of Hebei province.

However, the government's efforts to build megaregions have also come under criticism for contradicting Xi Jinping's pledge to let the market play a decisive role in the economy. While 2014 stimulus spending was small compared to the 2008 package, economists are concerned that China continues to resort to investment spending to boost the economy, exacerbating the overcapacity problem, and elevating the risk of an impending debt crisis. As one analyst remarked, "There are only so many 'ghost cities' and 'high-speed rail lines to nowhere' [Xi's] government can build."<sup>60</sup>

\* In the United States, the freight railway operators own the vast majority of rail tracks and self-finance new rail infrastructure investment.

† The location of one's household registration in China is the basis for eligibility to receive a variety of government services, such as education. It has traditionally been very difficult to change the location of one's household registration in China.

### **Building Megaregions with Mini-Stimulus—Continued**

Furthermore, many urban planners argue that China’s megaregions are not being built in a way that would maximize the advantages of large urban clusters. Specifically, China’s megaregions are built around a single urban core with concentric circles of commuters extending out from the center.<sup>61</sup> Some urban planning experts say that this model worsens traffic and pollution because residents will ultimately gravitate toward the megaregion’s core for work and city services.<sup>62</sup> For example, Jan Wampler, a Massachusetts Institute of Technology (MIT) architect, criticized the Jing-Jin-Ji megaregion as simply an expansion of Beijing by building out more commuter ring roads.\* Wampler said, “You can’t continue to build ring roads. It’s got to stop sometime.”<sup>63</sup> Instead, planning experts believe that the integration of cities only works when multiple urban cores are maintained, such as the U.S. Northeast corridor stretching from Washington, DC, to Boston, MA.<sup>64</sup>

Supporters of the megaregion concept respond that these urban clusters are at less risk of becoming ghost towns since they build upon the economic momentum of China’s major cities. For example, in the case of the Jing-Jin-Ji cluster, advocates argue that the integration of the nearby but lesser developed Hebei region into the Beijing-centric megalopolis will reduce pressure on Beijing’s housing market, migrant flow, and water scarcity.<sup>65</sup>

### **Status of China’s Economic Reform Agenda**

In 2014, China’s government made minimal progress on the economic reforms it pledged to implement during the 2013 Third Plenum.<sup>66</sup> At the Third Plenum, Chinese President Xi Jinping announced an ambitious and comprehensive economic reform plan. In an oft-cited speech from that event, Xi stated the following:

*A proper relationship between the market and government remains the core of China’s economic reform. To build such a relationship is to settle whether the market or government plays a decisive role, and the market has proven to be the most effective.*<sup>67</sup>

Xi’s comments articulate a clear guiding principle that the market should play a “decisive role” as China implements reforms.<sup>68</sup> However, in the same speech, Xi emphasized that the state would continue to play a key role in the economy, seemingly contradicting the so-called “decisive role” of the market. Critics noted that Xi’s comments should therefore not be misinterpreted to mean that the CCP would relinquish any power over China’s economy; on the contrary, the reforms have the potential to strengthen the CCP’s influence by clarifying the role of the state and consolidating its

\*A ring road is a circumferential highway that surrounds a city, similar to the Capital Beltway (I-495) around Washington, DC, I-695 around Baltimore and I-285 around Atlanta (285). European cities, such as Stockholm, London, and Rome also have ring roads surrounding a city center.

power.<sup>69</sup> As The Brookings Institution scholar Arthur Kroeber said, “The respective roles of state and market need to be clarified, but the state role will remain very large.”<sup>70</sup> However, the IMF noted in a July 2014 country report on China that its reform blueprint “has not been followed up with details on the specific reforms or timetables.”<sup>71</sup> In lieu of implementing substantive economic reforms, Xi and his economic reform leadership team spent the better part of 2014 consolidating political power and executing a vast anticorruption campaign.<sup>72</sup>

### ***Reform Leadership and Power Consolidation***

In 2013, the Chinese government underwent a once-in-a-decade leadership transition that brought in Xi Jinping as president and altered the membership of the Politburo and other Party organs.\* Initially, the transition sparked uncertainty about who would guide China’s future economic policies. Many analysts believed a broad consensus in China’s government supported comprehensive reform, highlighted by the November 2013 Third Plenum. At the National People’s Congress (NPC) meetings in March, the annual work reports issued by the Premier, the Ministry of Finance, and the National Development and Reform Commission (NDRC) were more detailed than previous reports, and appeared to build on the Third Plenum agenda.†

However, in 2014, President Xi took control over key Party organs, suggesting that he believes centralization of power is necessary to implement his reform agenda. For example, Xi has reorganized the CCP’s Central Committee’s small leading groups and now personally chairs more than half of them, including the powerful Comprehensive Deepening Reform, State Security, and Internet Security and Informationization groups.<sup>73</sup> The government’s justification for creating the Reform Group is that the Third Plenum reforms would be hard to implement through existing institutions, which represent local and sectoral interests, and do not coordinate sufficiently.<sup>74</sup> Attacking “vested interests” may present a pretext for Xi to target rivals, particularly in state-dominated sectors.<sup>75</sup>

#### **Some Key Economic Officials in Xi’s Cabinet**

*Lou Jiwei (Minister of Finance):* Lou Jiwei is one of the most frequently quoted Chinese officials. In response to concerns about China’s economic slowdown, Lou argued that job creation is more important than GDP growth, and that a weaker role for manufacturing will help to relieve overcapacity and pollution.<sup>76</sup>

\* For more information, see Chapter 1, Section 1, of the U.S.-China Economic and Security Review Commission, *2013 Annual Report to Congress*, November 2013.

† For details, see Nargiza Salidjanova and Iacob Koch-Weser, *China’s 2014 Government Work Report: Taking Stock of Reforms* (U.S.-China Economic and Security Review Commission, April 1, 2014). [http://origin.www.uscc.gov/sites/default/files/Research/USCC%20Backgrounder\\_NPC%20scorecard.pdf](http://origin.www.uscc.gov/sites/default/files/Research/USCC%20Backgrounder_NPC%20scorecard.pdf).

### **Some Key Economic Officials in Xi's Cabinet—Continued**

He has also called on China to shift its tax base from production to consumption, with a focus on luxury goods, property, and energy-intensive products.<sup>77</sup> In an unusual move, Lou acknowledged in June 2014 that “persistent downside pressures in economic growth” could force the government to miss its fiscal revenue target, even as President Xi stated that there was “no way” China would miss its 2014 GDP growth target.<sup>78</sup> In China’s power structure, Lou likely has less influence than long-serving central bank head Zhou Xiaochuan, who was allowed to retain his post after the leadership transition.<sup>79</sup> The Xi administration recently criticized mismanagement at China’s sovereign wealth fund China Investment Corporation, where Lou served as chairman from 2007 to 2013.<sup>80</sup>

*Zhou Xiaochuan (PBOC Governor):* Following the extension of his term as PBOC governor in March 2013, Zhou Xiaochuan now stands as China’s longest serving central banker.<sup>81</sup> The extension of his tenure following last year’s leadership transition is likely related to his reformist views on interest rates and China’s exchange rate regime. Zhou is credited with overseeing the transition away from a fixed exchange rate to the current “managed float” system that designates a limited daily trading band within which the RMB can change value vis-à-vis the U.S. dollar.<sup>82</sup> He is also known for recruiting U.S. educated economists into key PBOC posts, which is further evidence of his reformist views on economics.<sup>83</sup> Under Zhou’s leadership, the PBOC has taken marginal steps to address China’s growing credit crisis, such as by limiting lending within the shadow banking sector. However, given that the PBOC is not an independent government entity like the U.S. Federal Reserve, it is unlikely the Zhou-led PBOC will have the same power as the Federal Reserve in implementing broader economic reforms.

*Zhang Gaoli (Executive Vice Premier):* Considered to be a close ally of Xi Jinping, Zhang Gaoli holds multiple high-level titles that imply he is a key economic figure in Xi’s cabinet; however, analysts say that his “low-profile approach” makes it difficult to determine which economic issues are more important to him and how influential he is in Xi’s decision-making.<sup>84</sup> Zhang is not only a member of the Politburo Standing Committee and the executive vice premier; he also holds one of the four positions on the leading small group on reform, along with Xi Jinping, Li Keqiang, and Liu Yunshan. However, Zhang holds no other key positions on any other leading small groups.<sup>85</sup> Some analysts argue that Zhang’s leadership experience in some of China’s most developed regions, including Shenzhen, Shandong, and Tianjin, is evidence of Zhang’s support for economic reform.<sup>86</sup> However, Zhang’s alleged persecution of Falun Gong followers when he was Party secretary in Shandong province and his tight grip on the media when serving as Party secretary in Tianjin are evidence of his opposition to political reform.<sup>87</sup>

### **Some Key Economic Officials in Xi's Cabinet—Continued**

*Wang Yang (Vice Premier):* Prior to the leadership transition, Wang Yang served as Party secretary of Guangdong province, and was known as a particularly liberal reformer. He failed to secure a seat on the Politburo Standing Committee, giving him less authority than Zhang Gaoli. That is also reflected in the Central Reform Leading Group, where Wang Yang is an ordinary member, whereas Zhang co-heads the Group.<sup>88</sup> Nonetheless, Wang Yang is actively engaged in China's economic policy. He has inherited many functions of Wang Qishan, the former vice premier who now spearheads Xi's anticorruption campaign. Wang Yang is lead negotiator in China's Strategic and Economic Dialogue (S&ED) and Joint Commission on Commerce and Trade (JCCT) talks with the United States, where he has emphasized the importance of the Third Plenum reform agenda.<sup>89</sup> He frequently serves as interlocutor for foreign companies and commercial delegations, and has emphasized the importance of improving intellectual property protection and developing e-commerce.<sup>90</sup>

*Xu Shaoshi (Director of the NDRC):* The NDRC, the powerful supra-ministry that formulates industrial policies, issues approvals, and sets prices, has arguably been relegated to secondary status under the new leadership.<sup>91</sup> No one from the NDRC is represented in the Central Leading Reform Group, and the agency's former Deputy Director Liu Tienan was indicted on corruption charges in June 2014.<sup>92</sup> However, the NDRC's current director Xu Shaoshi appears keen to adapt the agency to the reform agenda of the new leadership. Xu has called for increasing private sector investment in financial services, energy, and utilities, a departure from the NDRC's historic protection of domestic industry.<sup>93</sup> He told the NPC in March that the focus on industrial growth was restraining efforts to cut emissions and energy use.<sup>94</sup> Xu is also heading a new coordinating body, established by the State Council in May, which will seek ways to reduce income inequality.<sup>95</sup> On July 8, Xu published a lengthy opinion piece in the *People's Daily*, the Party-controlled paper, in which he praised "Comrade Xi Jinping's" "brilliant" speeches on market reform since the 18th Party Congress.<sup>96</sup>

### ***Xi Jinping's Anticorruption Campaign***

In 2014, Xi Jinping accelerated his anticorruption campaign to address a major source of public dissatisfaction and eliminate his political opponents while further consolidating his power.<sup>97</sup> However, some analysts believe that the elimination of other political factions, namely former Politburo Standing Committee member Zhou Yongkang and his supporters as well as former President Jiang Zemin's lingering loyalists in the Shanghai region, is Xi's method for laying the groundwork for wider economic reforms.<sup>98</sup> The 2013 Third Plenum called for internal Party reform and reform of the CCP's disciplinary system in its blueprint for China's economic reforms. Xi and his likeminded reform leaders argued that

the government must eliminate the long-standing incentives that entice officials—especially local officials—to engage in corrupt practices.<sup>99</sup> For example, in September 2013, executives of China’s largest oil and gas company PetroChina were forced out when the government launched a corruption campaign.<sup>100</sup> As one of China’s three big oil companies, PetroChina has control over domestic fuel prices and oil supply in the Chinese energy market. Some analysts predict that Xi’s pro-reform government initiated the corruption probe into PetroChina as a means of breaking the state-owned enterprise (SOE) into smaller companies, thereby allowing for some privatization of the oil sector. The logic is that if Xi is able to remove high-level officials with vested interests in SOEs such as PetroChina on the basis of corruption, he can more swiftly implement other SOE-related reforms.<sup>101</sup>

Because President Xi’s ten-year term is in its beginning, the impact of Xi’s broad-sweeping housecleaning on his economic reform aspirations is not yet clear. Some analysts believe that if the anticorruption campaign continues to gain momentum, Xi risks intimidating the broad majority of Chinese officials into isolation, rendering them unwilling to govern effectively.<sup>102</sup> Moreover, if Xi fails to implement other economic reforms in a timely manner because of a prolonged anticorruption purge, it is likely that China’s economic growth will continue to slow and imbalances will worsen.<sup>103</sup> (For more analysis of Xi’s anticorruption campaign, see Chapter 2, Section 3, “China’s Domestic Stability.”)

### ***Stagnant Implementation of Economic Reform***

China made minimal progress in 2014 toward implementing the economic reforms laid out in the 2013 Third Plenum.<sup>104</sup> The government stopped short of fulfilling its reform promises despite its slowing economy and ongoing dependence on export and investment-led growth. In July, the IMF urged China to expedite its economic reform agenda stating that it was “increasingly urgent” and that the current growth model was “not sustainable and is raising vulnerabilities.”<sup>105</sup> U.S. Treasury Secretary Jacob Lew called on China “to speed up” its reforms, reduce reliance on exports, adopt a consumption-led growth model, and contribute to a level playing field in global trade.<sup>106</sup> The U.S.-China Business Council reported that only six out of 59 reform policy announcements have a “significant impact” on foreign investment; of these, four were described as “largely aspirational.”<sup>107</sup>

*Shanghai Free Trade Zone (FTZ):* Launched in September 2013, the Shanghai FTZ was lauded as one of China’s major reform initiatives.<sup>108</sup> However, the FTZ has achieved minimal progress in 2014 as businesses and legal advisers struggle to find any notable benefit from operating in the trade zone rather than elsewhere in China.<sup>109</sup> Incremental trade-related reforms, such as lifting a ban on foreign video game consoles, have benefited some niche industries; however, analysts compare these reforms to those of a traditional Chinese special economic zone, such as Shenzhen, noting that the Shanghai FTZ was intended to be far more comprehensive in its liberalization.<sup>110</sup> Regarding foreign investment, the Shanghai FTZ adopted a negative list approach to regulating which sectors

face restrictions on foreign investment.\* The FTZ came under criticism, though, when the negative list was revealed to include 190 sectors with foreign investment restrictions. In what was probably the most notable advance in the FTZ thus far, China reduced that number to 139 sectors in July, granting greater foreign investment access in industries such as finance, health care, and entertainment.<sup>111</sup>

Monetary reforms were also intended to be a defining characteristic of the Shanghai FTZ; but these have been largely inconsequential, and economists have criticized some of the more aggressive reforms as infeasible. In one ostensible reform, the Chinese government informed foreign companies that by holding bank accounts in the Shanghai FTZ, they can more easily transfer excess local currency in and out of China; however, FTZ officials were reported saying that the process can already be done nationwide, based on regulations outside of the FTZ.<sup>112</sup> The government has also promised liberalized interest rates and full currency convertibility within the FTZ. Neither of these reforms has yet to be launched, and economists argue that it is nearly impossible to liberalize interest rates and adjust monetary policy within only a small region of the country.<sup>113</sup> Economists believe that liberalized rates within the FTZ alone would not be a meaningful test of the economic reforms Beijing purports to launch nationally. Similarly, currency convertibility confined to the FTZ would require “a strong firewall,” which economists argue is challenging and would fail to accurately test the reforms on a nationwide basis.<sup>114</sup>

*State-Owned Enterprise (SOE) Reform:* Reform of China’s SOEs largely stalled in 2014, though some limited SOE reform did take place. For example, Sinopec launched a hybrid ownership structure that permits private investors to purchase company shares, and PetroChina privatized some of its pipeline business as well.<sup>115</sup> On the policy side, the U.S.-China Business Council (USCBC) tracked three new official policies on SOE reform, including a Shanghai municipal government announcement that accelerates SOE reform, but only for Shanghai-based SOEs; a China Securities Regulatory Commission (CSRC) notice that requires SOEs to provide a portion of their revenues back to the government; and a State-Owned Assets Supervision and Administration Commission (SASAC) statement calling on SOEs to improve efficiency by using economic value-added (EVA) to measure performance.<sup>116</sup> In addition, the anticorruption campaign is considered to be contributing partially to SOE reform by eliminating vested interests of government officials and incentives to engage in corruption.<sup>117</sup>

*Financial Reforms:* On financial reform, China made very limited progress toward liberalizing interest rates and reforming its government-managed exchange rate system that has allowed it to undervalue and manipulate its currency.<sup>118</sup> China’s economy has been under increasing pressure to liberalize interest rates as risk-

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\* China has traditionally used purchasing catalogs to denote which products, services, and investments are approved for market access. Sectors not specifically listed in the catalogs are restricted from foreign competition. The system more widely used globally is a “negative list” approach which denotes only those sectors which face market access restrictions; sectors not listed are considered open.

ridden shadow banking and unregulated wealth managed products have flourished in circumvention of financial regulations.<sup>119</sup> The shadow banking sector poses risks because it does not provide adequate disclosures of risk-related information to investors.<sup>120</sup> While China's regulators may understand that deregulation of interest rates is the best solution to reining in the massive shadow-banking sector and addressing China's growing debt problem, they lack the political clout to implement such a reform.<sup>121</sup> In addition, the government has long touted the need for a bank deposit insurance system, but to date, has not implemented one.<sup>122</sup> Although the World Bank, IMF, and U.S. government have called on China to implement these reforms in a timely manner, PBOC Governor Zhou Xiaochuan said the timing would depend on "good conditions" in the Chinese and global economies, and estimated that liberalization would take two years.<sup>123</sup>

China made few reform moves toward a more flexible market-based exchange rate system. The United States has repeatedly called on China to adopt a floating exchange rate policy and cease undervaluing its currency; a policy that makes Chinese products cheaper and, therefore, serves as an export subsidy. Secretary Lew said that China needs to speed up floating its currency, a measure that will be a "crucial step" for the economy. However, during the 2014 U.S.-China Strategic and Economic Dialogue, Chinese Vice Premier Wang Yang warned against China moving too fast in exchange rate reform.<sup>124</sup> PBOC Governor Zhou Xiaochuan said that while China will "eventually" move toward a market-determined exchange rate regime, money flows were too unstable to do so now.<sup>125</sup> Despite the government's often stated intention of floating its currency, China has never tried to achieve this goal, nor has it announced any timeline for doing so.

*Foreign Investment Reform:* China's government has made minimal progress in liberalizing restrictions on foreign investment. In September 2013, the PBOC issued a "Notice on Relevant Matters Regarding RMB Settlement of Foreign Investors Investing in Domestic Financial Institutions," which allows foreign investors to use local currency for a broad range of domestic financial transactions that can support their expansion within China.<sup>126</sup> This was the only reform related to foreign investment that the USCBC reported as having a "significant impact" on foreign companies operating in China.<sup>127</sup> USCBC considered other reform initiatives that streamline certain administrative processes for foreign firms in China to have only moderate or limited impact.<sup>128</sup> Many sectors remain fully or partially closed to foreign investment in China, but the government has reformed foreign ownership restrictions in some niche sectors, such as hospitals.<sup>129</sup>

*Administrative and Procedural Reforms:* Administrative reforms—specifically regarding how companies are incorporated and obtain licenses in China—were one area where the government took some positive, though still incremental, steps forward. In February, China's State Council issued a "Notice on Registered Capital Registration System Reform," which reduced capital requirements for establishing new businesses and streamlined incorporation processes.<sup>130</sup> According to legal analysts, the reforms should apply

to both domestic and foreign-invested businesses.<sup>131</sup> The USCBC rated the measure as having “significant impact” on the operation of foreign firms in China. Other measures adopted by the State Council simplified procedures for obtaining administrative licensing, and began laying the groundwork for reviewing new investment projects based on a negative list approach to restricting foreign investment.<sup>132</sup>

*Internal Reforms:* China made moderate progress in planning for certain internal reforms in areas such as the tax system, household registration or *hukou* system, and urbanization. Xi Jinping said, “Now the Chinese economy is too complex; [China] must first build the institutions of economic governance in which the market will operate.”<sup>133</sup> According to former World Bank president and U.S. Trade Representative Robert Zoellick, this implies that internal reforms such as the tax and household registration system are priorities for Xi.<sup>134</sup> Concrete timelines set out by the government in these areas indicate that the reform leadership considers these time-sensitive areas of reform. For example, the Ministry of Finance announced in July that a reform of China’s tax system, which includes a phased shift toward greater dependence on a value-added tax (VAT), will be completed by 2016.<sup>135</sup> In 2014, China announced multiple reforms to its household registration system that currently blocks many migrant workers in China’s largest cities from access to basic social services, such as education.<sup>136</sup> The reforms should allow for migrants from other provinces to apply for local *hukou* registration in the city they have migrated to, though initially the reforms are restricted to medium-size cities.<sup>137</sup> Analysts in China are optimistic that, with Beijing leading *hukou* reform, the effort may be “substantive” and “systematic.”\*<sup>138</sup> (For more analysis of the *hukou* system, see Chapter 2, Section 3, “China’s Domestic Stability.”)

### **China’s Economic Rebalancing**

In the absence of substantive reforms, China’s economic imbalances—both external and internal—continue to plague its economy and burden the U.S. and global economies. Externally, China’s dependence on exports for growth, which is supported by an undervalued currency, as well as large volumes of foreign currency reserves, contributes to major global trade imbalances. Internally, the government’s failure to shift the economy toward a consumption-based growth model sustains China’s overdependence on investment and limits opportunities for U.S. exports to China.

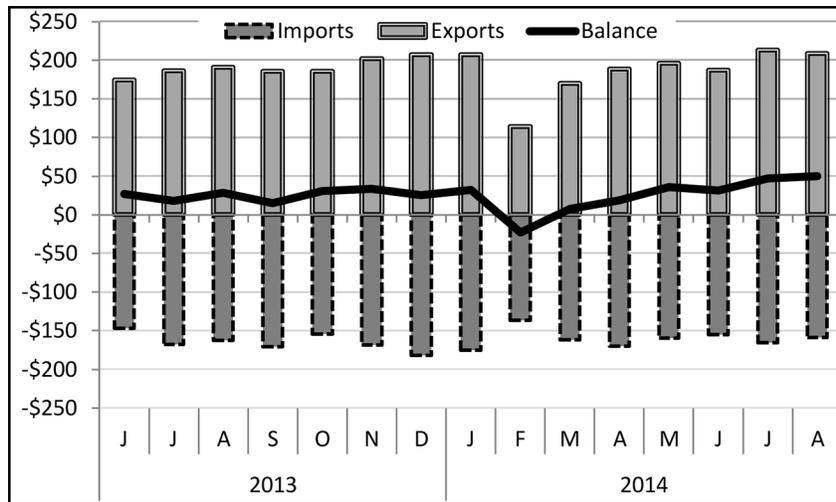
#### ***External Rebalancing***

*Global Trade Imbalances:* In 2014, China maintained a global trade surplus, a hallmark feature of its export-oriented growth model. As of June, China’s trade surplus was approximately \$31.5 billion, a year-on-year increase of 16 percent. China’s expanding current account surplus was driven by increased exports, which rose by 7 percent year-on-year. Imports into China increased 5 percent year-on-year, but the higher rate of increase of exports was sufficient to sustain China’s surplus. As depicted in Figure 6, Chinese exports recovered in the first half of 2014 from a seasonal

drop in February. Thus, despite slowing economic growth, China's global trade surplus, including export levels, continued to rise as the government injected stimulus into the economy and maintained an undervalued currency. The IMF indicated that a reduction in China's current account surplus as a percentage of its GDP to 1.9 percent in 2013 was a positive sign toward external rebalancing; however, the change was due largely to weak global demand and increasing investment boosted by the stimulus.<sup>139</sup>

**Figure 6: China's Global Trade Flows**

(US\$ billions)

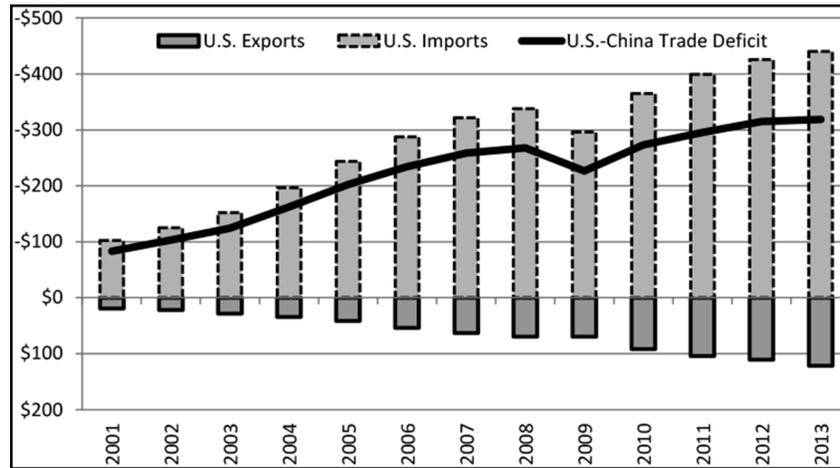


Source: China General Administration of Customs, via CEIC database.

Figure 7 shows the trend in the U.S.-China trade balance since 2001, when China joined the World Trade Organization (WTO). In the first eight months of 2014, the U.S.-China trade deficit in goods was over \$216 billion, an increase of 4.1 percent from the same period in 2013, according to data from the U.S. Census Bureau. In the first half of 2014, U.S. exports to China grew 6.2 percent year-on-year, while Chinese imports increased by only 4.6 percent.\* The U.S.-China trade deficit in Advanced Technology Products (ATP) was \$72.6 billion in the first eight months of 2014, an increase of less than 1 percent year-on-year.<sup>140</sup> Tables 1 and 2 outline the top five U.S. exports to China and U.S. imports from China in the first half of 2014, respectively. The United States continued to register a trade surplus with China in services, which totaled \$13.5 billion in the first half of 2014, an increase of 25 percent year-on-year.<sup>141</sup> (For further analysis of the challenges of the U.S.-China economic and trade relationship, see Section 2, “U.S.-China Bilateral Trade and Economic Challenges.”)

\*This calculation is based on the value of U.S. exports to China year-to-date from January to May 2014. The year-on-year comparison refers to the same period in 2013.

**Figure 7: U.S. Trade Deficit with China**  
(US\$ billions)



Source: U.S. Bureau of Economic Analysis.

**Table 1: Top Five U.S. Exports to China**

Product Type	2014 H1 (US\$ billions)	Percent Change (year-on-year)
Transportation Equipment	12.2	21.6%
Computer and Electronic Products	7.8	-0.7%
Agricultural Products	7.3	10.2%
Chemicals	6.9	6.0%
Machinery (Except Electrical)	4.9	-3.2%

Source: U.S. Census Bureau.

**Table 2: Top Five U.S. Imports from China**

Product Type	2014 H1 (US\$ billions)	Percent Change (year-on-year)
Computer and Electronic Products	74.6	-0.3%
Electrical Equipment, Appliances & Components	17.7	17.0%
Miscellaneous Manufactured Commodities	15.2	4.9%
Machinery (Except Electrical)	15.1	26.1%
Apparel and Accessories	13.7	0.4%

Source: U.S. Census Bureau.

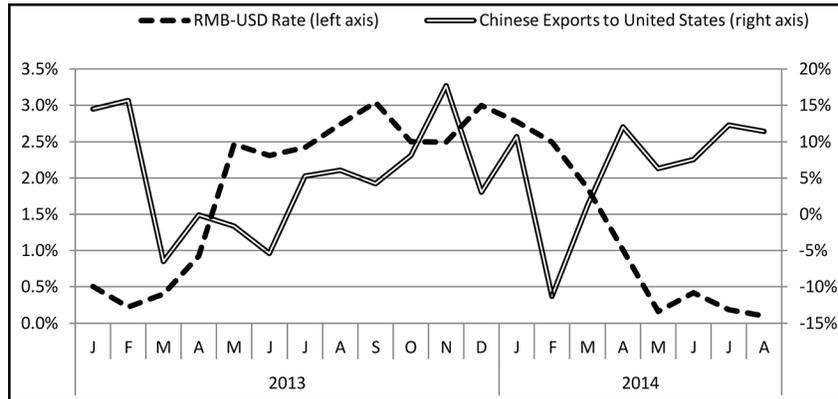
*Monetary Policy Issues:* Undervaluation of the RMB continues to serve as a subsidy to Chinese exports. In March 2014, the PBOC

doubled the RMB's trading band with the U.S. dollar (USD) to  $\pm 2$  percent each day.<sup>142</sup> However, the Chinese government retained the power to set a new value for the RMB-dollar exchange rate each new trading day, even while allowing greater fluctuations in intra-day trading. While China's trade surplus should have caused the RMB to increase in value, the opposite happened as China continued to intervene massively in currency markets to lower the value of the RMB. The PBOC's confusing policy change was followed by an immediate weakening of the RMB against the USD by 7.7 percent from January to June. In its mid-year report to Congress released in April, the Treasury Department associated the expanded daily trading band with greater flexibility for China to intervene in its currency. The report states:

*In the month prior to the band widening, the PBOC took measures, including reported heavy intervention, to significantly weaken the RMB and push it away from the most appreciated edge of the previous band. The RMB has seen periods of depreciation before, such as mid-2012 when the RMB fell 1.5 percent against the dollar over a three-month period. However, the pace and the size of the recent decline were unprecedented.*<sup>152</sup>

For the 20th consecutive year, the Treasury Department stopped short of officially accusing China of currency "manipulation"; however, a comparison of changes in the RMB-USD exchange rate against increases in Chinese exports demonstrates that the PBOC purposefully undervalued the RMB as a means of subsidizing Chinese exports during the first quarter of 2014, just as China fell short of reaching its 7.5 percent official growth target. As shown in Figure 8, the year-on-year change in the RMB value relative to the dollar, which had been gradually appreciating since 2005, suddenly declined sharply to almost no year-on-year appreciation by May. During that same period, year-on-year changes in Chinese exports to the United States, which were declining from November 2013 to February 2014 as China's economy slowed, suddenly spiked. In February, at the time of the PBOC band increase, Chinese exports to the United States were down about 11 percent year-on-year. By April, exports were increasing by over 12 percent year-on-year. Nonetheless, PBOC officials called the weakening of the RMB as falling within a "normal scope."<sup>144</sup>

**Figure 8: RMB Undervaluation as Export Subsidy**  
(Year-on-Year Change)

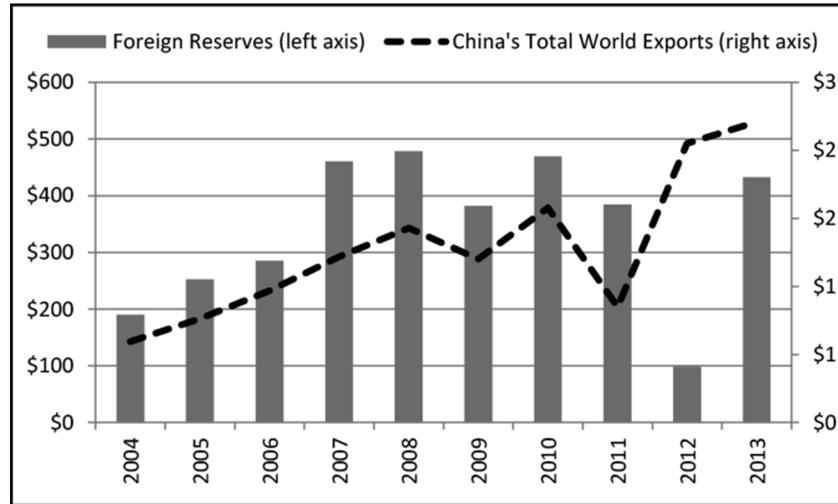


Source: People's Bank of China and General Administration of Customs, via CEIC data.

*Foreign Exchange Reserves:* Accumulation of foreign exchange reserves is further evidence of China undervaluing its currency and using monetary policy to subsidize exports. In the first quarter of 2014, China's foreign exchange reserves increased sharply by about \$140 billion bringing its total foreign reserve assets to nearly \$4 trillion. The foreign exchange reserve data from 2014 confirms that China's weakening RMB is due to "intensive intervention" by the PBOC.<sup>145</sup> Economists infer that China's increasing foreign reserves while maintaining a trade surplus is convincing evidence of heavy intervention in currency markets.<sup>146</sup> Figure 9 shows a direct correlation between China's exports and the purchase of foreign reserve assets from 2004 to 2011. Following a sharp drop in new foreign reserves in 2012, exports increased again as China resumed large-scale accumulation of foreign reserves in 2013. Preliminary data from 2014 indicates that this trend will continue. By May, Chinese exports began to increase again following the PBOC's massive interventionist policies in the first quarter.

**Figure 9: China's Annual Acquisition of Foreign Reserves**

(Left Axis: US\$ billions; Right Axis: US\$ trillions)



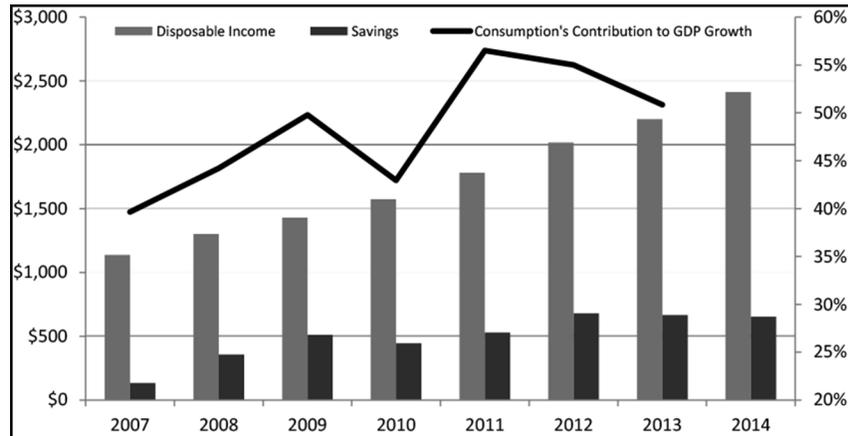
Source: China State Administration of Foreign Exchange and General Administration of Customs, via CEIC data.

### ***Internal Rebalancing***

The Chinese government's official narrative in 2014 was that its economy made progress toward a greater reliance on domestic sources rather than exports for growth by reducing wasteful investment.<sup>147</sup> China's growth model, which has been driven by high levels of investment in manufacturing capacity and infrastructure, is not sustainable and China needs to shift to a primarily consumption-driven growth model.<sup>148</sup> China's leadership has stated it accepts this view, which is also held by several Western governments, the World Bank, and the IMF. Analysis by the Peterson Institute for International Economics (PIIE) shows that in the first quarter of 2014, China's GDP growth and the growth rate of disposable income—a proxy for consumption capacity—expanded at nearly the same rate with a gap of only -0.2 percent.<sup>149</sup> PIIE economist Nicholas Borst said that the increase in Chinese disposable income, even during a time of slow growth, is the best sign for internal rebalancing in China since 2012.<sup>150</sup>

Analysts continue to debate whether the positive trends in China's disposable income figures during 2014 reflect true internal rebalancing toward a sustainable consumption-led growth model. Figure 10 shows a comparison of annual per capita disposable income and savings with the contribution of consumption to GDP growth. Since 2012, per capita savings has remained constant, while per capita disposable income increased nearly 20 percent, an indicator of increasing consumption. However, with 2013 and 2014 government stimulus focusing on infrastructure investment and credit loosening—which tends to boost investment rather than consumption—the contribution of consumption to GDP growth declined from 2012 to 2013.

**Figure 10: Per Capita Disposable Income and Savings in China**  
(Left Axis: US\$)



Source: China National Bureau of Statistics and People's Bank of China, via CEIC data. The data for disposable income and savings compare year-to-date data in June of each year. The consumption contribution to GDP data is annual.

Official data on the first half of 2014 indicates that consumption's contribution to GDP surpassed the contribution of gross capital formation this year.<sup>151</sup> In addition, China's retail sales increased by 10.8 percent in the first half of 2014, which may also support this analysis.<sup>152</sup> Analysts view both as positive signs of progress toward internal rebalancing; however, it remains to be seen if this trend toward greater consumption can be sustained in the absence of government stimulus and without increasing China's debt levels, which already account for 250 percent of GDP.<sup>153</sup>

## U.S.-China Bilateral Trade and Investment Issues

### *Bilateral Investment Issues*

For the first time, Chinese foreign direct investment (FDI) flows into the United States are surpassing U.S. FDI into China.<sup>154</sup> This shift in the bilateral investment relationship occurs in an increasingly hostile investment climate for foreign firms operating in China.

*Foreign Investment Climate in China:* U.S. and other FDI flows into China continued a steady deceleration in 2014 as new investment opportunities dwindled and foreign firms faced hostile or discriminatory treatment by Chinese regulators (see Figure 11).<sup>155</sup> According to data from China's Ministry of Commerce, FDI into China declined 1.8 percent in the first eight months of 2014 compared to the same period last year.<sup>156</sup> According to University of North Carolina Finance Professor Christian Lundblad, the "low-hanging fruit" that foreign investors have enjoyed in China for years have been harvested, leaving opportunities only in the sectors where regulatory complications make investment very difficult or even impossible.<sup>157</sup> These include sectors dominated by Chinese SOEs, or in areas deemed sensitive or strategically important, such

as telecommunications, media, and financial services. In most of these sectors, foreign investment is either banned or restricted to joint ventures with Chinese partners.<sup>158</sup> Localization requirements—such as China-based research and development, technology transfer, and network servers—are also costly and inefficient for foreign businesses, especially those in the information and communication technology (ICT) sector.<sup>159</sup>

Chinese regulators and state media have disproportionately targeted foreign firms operating in China with accusations ranging from monopolistic behavior to exploitation of Chinese consumers.<sup>160</sup> In 2014, China ramped up use of its Anti-Monopoly Law (AML) against foreign firms in what appears to be unequal enforcement in order to create favorable market conditions for Chinese competitors.<sup>161</sup> This year, China used the AML to investigate foreign firms in sectors designated by the government as “strategic and emerging,” including automobiles and information technology. Four foreign industry associations including the U.S. Chamber of Commerce, the U.S.-China Business Council, the American Chamber of Commerce in China, and the European Union Chamber of Commerce in China issued reports in 2014 accusing China of unfair enforcement of the AML.<sup>162</sup> The U.S. Chamber of Commerce said that “in many cases involving foreign companies, China’s anti-monopoly enforcement agencies have skewed the implementation of the AML and related statutes to support China’s industrial policy goals through discrimination and protectionism.”<sup>163</sup> The U.S.-China Business Council reported that 86 percent of respondents to its 2014 member company survey said that they were “at least somewhat concerned about China’s evolving competition regime.”<sup>164</sup> The European Union (EU) Chamber of Commerce said that the lack of transparency in China’s enforcement of the AML leaves speculation about the government’s intentions with the law.<sup>165</sup>

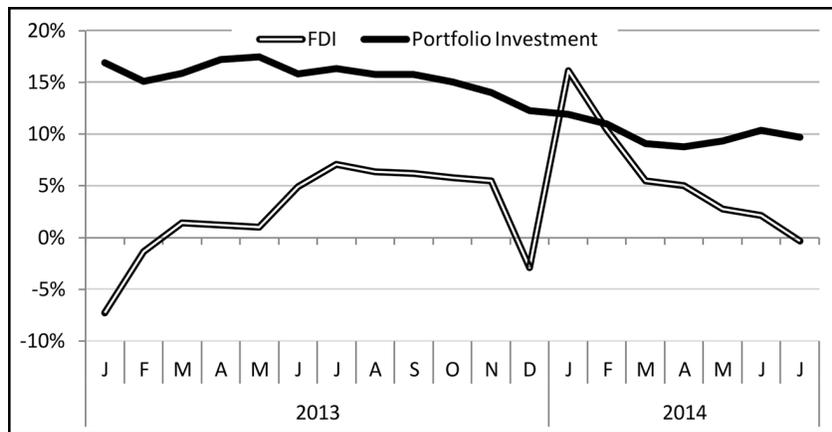
The U.S. Chamber of Commerce added that China disproportionately uses the AML against foreign firms to protect domestic industries and support national champions. The U.S. Chamber further argued that such unequal enforcement could violate China’s WTO obligations.<sup>166</sup> China’s NDRC, one of the enforcement agencies of the AML, refuted the industry groups’ accusations and claimed that in an NDRC review of 300 AML cases, only 10 percent were of foreign firms.<sup>167</sup> However, the NDRC failed to disclose the time frame of the 300 cases or how they were chosen for the review.

The Chinese government also uses procurement rules, state-media, and anticorruption laws to target foreign-invested firms disproportionately. For example, in May 2014, China banned the procurement of new government computers equipped with Microsoft’s Windows 8 operating system.<sup>168</sup> Two months later, under the auspices of an antimonopoly investigation, China’s State Administration for Industry and Commerce (SAIC) raided Microsoft’s offices in Beijing, Shanghai, Guangzhou, and Chengdu, seizing documents and computers.<sup>169</sup> In addition, in June 2014, Chinese state media called U.S. technology firms, such as Google and Apple, “pawns of the U.S. Government,” accusing them of espionage and cyber-theft in China.<sup>170</sup> Historically, China has disproportionately targeted foreign firms in corruption investigations, with one estimate indicating that of approximately 500,000 corruption investigations in

China between 2000 and 2009, 64 percent were of foreign-based firms.<sup>171</sup> There also appears to be a coordinated effort by the Chinese government to promote domestic industries, while state-run media attack foreign competitors. For example, in 2010, after China announced plans to boost domestic-made car sales to control the majority of the Chinese auto market, state-run China Central Television (CCTV) launched a media campaign against Volkswagen that resulted in a recall of 640,000 vehicles.<sup>172</sup>

In 2013, the USCBC described U.S. industry’s attitude toward investment in China as “tempered optimism.”<sup>173</sup> In its annual survey of the Chinese business environment, USCBC’s members agreed that nine of the ten most pressing challenges they face in China—which include uneven enforcement of Chinese laws, transparency issues, and discriminatory practices toward foreign firms—did not improve at all from the previous year.<sup>174</sup>

**Figure 11: Foreign Investment in China**  
(percent change year-on-year)



Source: FDI from China Ministry of Commerce and Portfolio Investment from China PBOC, via CEIC database.

Despite the growing hostility to foreign investment in China, foreigners continue to invest there, though the year-on-year rate has declined steadily through the first half of 2014 (see Figure 11). Commensurate with the leadership transition in early 2013, China’s FDI inflows remained generally positive with an upward spike in early 2014, perhaps in conjunction with enhanced government stimulus. However, as China’s government has generally stalled implementation of economic reforms, year-on-year increases in FDI inflows have decelerated to a rate of 2.2 percent in June 2014.<sup>175</sup> Likewise, portfolio investment into China has been decelerating almost continuously since September 2013.

*Inbound Chinese Investment:* While U.S. FDI into China is slowing, Chinese investment in the United States has grown dramatically. According to analysis by Rhodium Group, the stock of Chinese FDI in the United States grew from \$1.9 billion in 2007 to

over \$17 billion in 2012.<sup>176</sup> From 2011 to 2012, the number of Chinese investments—mergers and acquisitions and greenfield projects combined—nearly doubled from below 40 to about 70. Rhodium Group estimated there were 82 new investments in 2013. The increase in inbound Chinese FDI has occurred simultaneously with Executive Branch efforts to attract more foreign investment into the United States, particularly with hopes of spurring job creation. Rhodium Group estimates that in 2013, Chinese-owned firms employed more than 70,000 U.S. citizens.<sup>177</sup> In recent years, the Obama Administration began more targeted efforts to attract FDI, including FDI from China, by, for example, expanding the Department of Commerce’s investment promotion function in 2012.<sup>178,179</sup>

### **China’s Share of U.S. Housing Market Grows**

According to the National Association of Realtors (NAR), Chinese buyers ranked as the largest foreign purchasers of U.S. real estate by dollar value in 2014.\*<sup>180</sup> Chinese buyers also constitute the fastest growing segment of foreign buyers.<sup>181</sup> In the first three months of the year, Chinese buyers spent \$22 billion on U.S. homes, more than any other nationality, and an increase of 72 percent from the same period in 2013.<sup>182</sup> Over 75 percent of buyers from China pay cash for U.S. homes, and the median home price among Chinese buyers was \$523,148, more than twice the median price of existing home sales.<sup>183</sup> With this growing demand, the online real estate listing company Zillow Inc. established a Chinese language search portal in 2014 to link more effectively with potential Chinese buyers.<sup>184</sup>

The motivation of Chinese buyers to purchase U.S. homes is varied. Chinese buyers view purchasing U.S. homes as a cheap, but reliable, investment with strong rent potential.<sup>185</sup> In addition, by purchasing U.S. real estate as a limited liability corporation (LLC) or through other “creative corporate structuring,” the U.S. property market is a convenient way to store money overseas anonymously.<sup>186</sup> Perhaps the most cited reason for Chinese buyers to purchase a home in the United States is because their children are enrolled, or hope to enroll, in U.S. schools and universities. One survey of wealthy Chinese shows that 85 percent want to send their children overseas for school.<sup>187</sup> Real estate brokers report that Chinese buyers prefer property near major educational institutions; one New York broker said that many Chinese clients purchase in Manhattan in hopes of sending their children to Columbia or New York University.<sup>188</sup>

In light of a \$50,000 cap on the amount of money an individual can take out of China per year, the methods some Chinese buyers use to acquire property in the United States raise questions

\*The NAR includes buyers from Taiwan and Hong Kong in their classification of “Chinese.” However, the NAR confirmed that only about 1 percent of “Chinese buyers” surveyed were from Taiwan or Hong Kong with the remaining 99 percent reportedly from mainland China.

**China's Share of U.S. Housing Market Grows—Continued**

of legality, transparency, and money laundering. Because 76 percent of Chinese buyers are offering cash on U.S. homes averaging well over \$500,000, money must be wired or physically carried as currency or valuables into the country.<sup>189</sup> University of California Los Angeles economist William Yu says that wealthy Chinese find creative ways to circumvent the \$50,000 restriction, including laundering money through Macau casinos and “cooking the books” of import-export firms.<sup>190,191</sup> Potential buyers can also set up LLCs or other corporate entities to make the property ownership “untraceable.”<sup>192</sup>

According to the International Consortium of Investigative Journalists, this practice has allowed many U.S. real estate deals linked to Chinese financial and political corruption scandals to take place.<sup>193</sup> For example, the 2011 investigation of former Chinese Minister of Railways Zhang Shuguang revealed that he purchased an \$860,000 home in a suburb of Los Angeles in 2002 while his government salary was less than \$400 per month.<sup>194</sup> Weeks prior to the start of the investigation, Zhang transferred full ownership of the property to his wife. The investigation is reportedly continuing, and some analysts predict that the property may be seized as President Xi Jinping's anti-corruption drive begins to target the overseas assets of corrupt officials.<sup>195</sup>

*Bilateral Investment Treaty (BIT):* Claimed by the Administration as a major breakthrough following the 2013 U.S.-China Strategic and Economic Dialogue, negotiations resumed with China on BIT in 2013 and continued throughout 2014.<sup>196</sup> The talks are divided into two phases, focusing first on the core text of the treaty and then on a so-called negative list of sectors that the parties would deem off limits or restricted to foreign investment.<sup>197</sup> During the 2014 U.S.-China Strategic and Economic Dialogue, the two sides committed to reach agreement on the core text by the end of 2014 and to start discussions on their respective negative lists early in 2015.<sup>198</sup> U.S. Treasury Secretary Lew estimated that a treaty—if one is ultimately agreed upon—would not be finalized until 2016 at the earliest.<sup>199</sup> Uncertainty remains about what China's negative list for the BIT will look like. U.S.-China Business Council Vice President Erin Ennis said that getting China to commit to a “commercially significant negative list could be a battle,” citing the Chinese government's sluggish approach to liberalization in the Shanghai FTZ.<sup>200</sup> American Enterprise Institute expert Derek Scissors believes that given the increasingly hostile foreign investment climate in China, the United States should suspend the BIT negotiations, arguing that under current conditions, Chinese investors in the United States have much more to gain from an agreement than U.S. investors in China.<sup>201</sup>

***Bilateral Trade Issues***

Trade tensions between the United States and China escalated in 2014 as key WTO cases advanced or were concluded and the

U.S. Department of Justice filed indictments against five People's Liberation Army (PLA) soldiers for engaging in state-sponsored, cyber-enabled theft of commercial property. Three key sectors of dispute included rare earths, auto parts, and Chinese subsidization of solar panels.

*Rare Earths:* In a March 26, 2014 decision, the WTO Dispute Settlement Panel ruled that China's export quotas on rare earths violated its WTO obligations.<sup>202</sup> Rare earths are crucial to many U.S. industries, especially clean energy and advanced electronics.<sup>203</sup> The *Rare Earths* case was initiated in 2012 by the United States, the European Union, and Japan in response to China's restrictions on the exports of rare earths.<sup>204</sup> The WTO Dispute Settlement Panel found that China failed to justify its restrictions as legitimate conservation or environmental protection measures, saying the export quotas were "designed to achieve industrial policy goals rather than conservation." China appealed the decision, but the WTO Appellate Body rejected its appeal in August.\*<sup>205</sup> Rare earths are one of many raw materials upon which China imposes export restraints. Trade law analysts estimate that China imposed export duties on 346 items in 2014, only 103 of which are permitted under China's WTO accession agreement.<sup>206</sup> Even if China lifts all of the export restraints deemed unlawful in the WTO ruling on rare earths, 162 items will still be subject to export duties.<sup>207</sup>

*Automobiles and Auto Parts:* In another WTO Dispute Settlement Panel ruling, the United States was successful in its complaint regarding China's application of antidumping (AD) and countervailing duties (CVD) on U.S. cars and sport utility vehicles with an engine capacity of 2.5 liters or larger.<sup>208</sup> China alleged that certain U.S. cars were being subsidized or "dumped" in its markets, citing two programs under the U.S. government's Troubled Asset Relief Program (TARP), which provided loans to General Motors (GM) and Chrysler.<sup>209</sup> The U.S. defense focused on the failure by the Chinese Ministry of Commerce (MOFCOM) to demonstrate that the duties caused economic injury.<sup>210</sup> The Panel agreed with the U.S. defense and further found MOFCOM failed to disclose to U.S. respondents the essential facts that formed the basis of its decision to impose duties. China's duties affected an estimated \$5.1 billion worth of auto exports in 2013.<sup>211</sup> Still pending before the WTO is another auto-related case, challenging Chinese subsidization of auto and auto parts producers located in designated regions known as "export bases."<sup>212</sup> According to the U.S. Trade Representative (USTR), consultations last took place on the auto parts dispute in November 2012, and the United States and China have been "engaging in further discussions" since then.<sup>213</sup> There is no public information of further progress in the case.

*Solar Panels:* In 2014, the U.S. Department of Commerce announced preliminary determinations in CVD and AD investigations of imports of certain types of Chinese solar panels.<sup>214</sup> U.S. Customs will begin collecting the duties—which range from 18.56 percent to

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\* Following China's appeal, the United States also filed an appeal because of concerns related to the Panel's decision to reject certain exhibits issued in support of its case.

35.21 percent in CVDs and 26.33 percent and 165.04 percent in ADs.<sup>215</sup> The recent duties build upon CVD and AD duties ranging from 24 percent to 36 percent imposed by the Commerce Department in 2012 on other types of solar panel products imported from China.<sup>216</sup> Chinese manufacturers responded to those duties by buying solar cells from Taiwan and elsewhere, which allowed them to avoid most of the duties. The U.S. solar industry is divided about the duties, with many companies opposed to the Commerce Department's determination.\*<sup>217</sup> Some U.S. solar panel manufacturers support the duties arguing that Chinese dumping of solar panels has harmed U.S. manufacturing and employment and that duties will help "level the playing field."<sup>218</sup> However, companies developing solar-power projects have criticized the duties arguing that they will result in more expensive equipment, thereby inhibiting innovation and growth in the solar energy sector. (For further discussion of clean energy issues, please refer to Chapter 1, Section 4, "U.S.-China Clean Energy Cooperation.")

Table 3 summarizes recent cases brought by the United States against China at the WTO. Table 4 lists recent cases by China against the United States. Addendum I provides a more comprehensive summary of unresolved or uncontested trade disputes with China, many of which have no public record of progress made in 2014.

**Table 3: Recent WTO Cases Brought against China by the United States**

No.	Title	Request for Consultations	Panel Report	Status
DS414	Measures Imposing Countervailing and Antidumping Duties on Grain-Oriented Flat-Rolled Electrical Steel (GOES)	September 15, 2010	June 15, 2012 (Appellate Body Report, October 18, 2012)	The Panel upheld U.S. claims, and the Appellate Body upheld the Panel decision; China agreed to implement the ruling by July 31, 2013. In January 2014, the United States requested consultations with China regarding China's failure to implement WTO ruling.
DS427	Antidumping and Countervailing Duty Measures on Broiler Products from the United States	September 20, 2011	August 2, 2013	The Panel upheld most U.S. claims. In July 2014, China informed the WTO that it had fully implemented the Panel's decision. The United States disagreed with China's assertion that it had fully complied.

\*SolarWorld Industries America Inc. filed the AD and CVD petitions with the U.S. Department of Commerce and received support from the Coalition for American Solar Manufacturing, an industry association with 255 U.S. solar manufacturer members. The Coalition for Affordable Solar Energy, an association of 94 U.S. solar energy firms, is opposed to the duties. <http://origin.www.uscc.gov/sites/default/files/Research/June%202014%20Trade%20Bulletin.pdf>.

**Table 3: Recent WTO Cases Brought against China by the United States—  
Continued**

No.	Title	Request for Consultations	Panel Report	Status
DS431	Measures Related to the Exportation of Rare Earths, Tungsten and Molybdenum	March 13, 2012	March 26, 2014 (Appellate Body Report, April 8, 2014)	The Panel upheld U.S. claims. In April 2014, both parties to the dispute appealed certain issues of law covered in the panel report. The Appellate Body rejected China's appeal, and did not rule on the U.S. appeal.
DS440	Antidumping and Countervailing Duties on Certain Automobiles from the United States	July 5, 2012	May 23, 2014	The Panel agreed with the United States that China's imposition of antidumping and countervailing duties on U.S.-made cars and SUVs violated China's obligations under the WTO.
DS450	Certain Measures Affecting the Automobile and Automobile-Parts Industries	September 17, 2012	In consultations; panel not yet formed	The United States requested consultations with China concerning export-contingent provisions of certain subsidies and other incentives to automobile and automobile-parts enterprises in China.

Source: WTO; compiled by Commission staff.

**Table 4: Recent WTO Cases Brought against the United States by China**

No.	Title	Request for Consultations	Panel Report	Status
DS437	Countervailing Duty Measures on Certain Products from China *	May 25, 2012	July 14, 2014	The Panel issued a mixed ruling, rejecting some of China's claims, but finding that the United States acted inconsistently with some of its obligations under the WTO. China appealed the decision.

**Table 4: Recent WTO Cases Brought against the United States by China—  
Continued**

No.	Title	Request for Consultations	Panel Report	Status
DS449	Countervailing and Anti-dumping Measures on Certain Products from China <sup>219</sup>	September 17, 2012	March 27, 2014	The Panel upheld U.S. Public Law (PL) 112–99 entitled “An act to apply the countervailing duty provisions of the U.S. Tariff Act of 1930 to nonmarket economy countries, and for other purposes,” but found that the United States acted inconsistently with its obligations in failing to investigate whether “double remedies” arose in proceedings at issue.
DS471	Antidumping Methodologies	December 3, 2013	Panel established March 26, 2014; report pending.	China requested consultations with the United States regarding the use of certain methodologies in antidumping investigations involving Chinese products.

\*The Chinese products concerned by these investigations consist of solar panels; wind towers; thermal paper; coated paper; tow behind lawn groomers; kitchen shelving; steel sinks; citric acid; magnesia carbon bricks; pressure pipe; line pipe; seamless pipe; steel cylinders; drill pipe; oil country tubular goods; wire strand; and aluminum extrusions.

Source: WTO; compiled by Commission staff.

### **Chinese State-Sponsored Cyber Theft**

Cyber-enabled theft of intellectual property (IP) and commercial espionage are among the biggest risks facing U.S. companies today. In the United States, the annual cost of cyber crime and cyber espionage is estimated to account for between \$24 billion and \$120 billion (or 0.2 to 0.8 percent of GDP), and results in the loss of as many as 200,000 U.S. jobs annually.<sup>220</sup> The Chinese government's engagement in cyber espionage for commercial advantage was exposed on May 19, 2014, when the U.S. Department of Justice charged five PLA officers for cyber-enabled theft and other related offenses committed against six U.S. victims, including Westinghouse Electric Co. (Westinghouse), U.S. subsidiaries of SolarWorld AG (SolarWorld), United States Steel Corp. (U.S. Steel), Allegheny Technologies Inc. (ATI), Alcoa Inc., and the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial and Service Workers International Union (USW or Steelworkers Union).<sup>221</sup> According to the indictment, PLA Unit 61398 \*<sup>222</sup> officers Wang Dong, Sun Kailiang, Wen Xinyu, Huang Zhenyu, and Gu Chunhui hacked, or attempted to hack, into the victims' computers to steal information that would be useful to competitors in China, including SOEs.<sup>223</sup> One victim, SolarWorld, subsequently petitioned the U.S. Department of Commerce to investigate the allegations made in the indictment as they directly related to SolarWorld's ongoing trade dispute over imports of solar products from China.<sup>224</sup>

The Chinese government strongly denied what it called the "fabricated" allegations,<sup>225</sup> and within days of the indictment, China retaliated both economically and politically against the United States. The Chinese government suspended participation in a U.S.-China Cyber Working Group, which was established in 2013 as a bilateral dialogue on cyber security.<sup>226</sup> China also announced that its government offices were forbidden from using Microsoft's Windows 8 operating system and ordered security checks on foreign IT products and services seemingly directed at U.S. companies, including Cisco Systems.<sup>227</sup> Likewise, the PBOC and the Chinese Ministry of Finance asked banks to replace IBM servers with those produced by domestic brands to protect financial security.<sup>228</sup> In the same week, the Chinese government instructed SOEs to sever ties with U.S. consulting companies, including McKinsey, Boston Consulting Group, Bain & Company, and Strategy & Co. (formerly known as Booz & Co.), and urged SOEs to establish teams of domestic consultants out of fears that U.S. consultants are government spies.<sup>229</sup>

\*In 2013, U.S. cybersecurity firm Mandiant issued a report that identified one of the "most prolific cyber espionage groups in terms of the sheer quantity of information stolen" as Shanghai-based Unit 61398 of China's PLA, confirming that it is highly likely that China engages in state-sponsored, cyber-enabled economic espionage of U.S. companies, including large-scale theft of IP and confidential business information.

### **Chinese State-Sponsored Cyber Theft—*Continued***

Chinese entities have long been engaging in cyber-enabled theft against U.S. companies for commercial gain; however, the May 19 indictment represents the “first ever charges against known state actors for infiltrating U.S. commercial targets by cyber means.”<sup>230</sup> In addition, the indictment states that “Chinese firms hired the same PLA Unit where the defendants worked to provide information technology services.”<sup>231</sup> This established a channel through which the Chinese firms could issue tasking orders to the PLA defendants to engage in cyber theft and commercial espionage. For example, in one case, according to the indictment, a Chinese SOE hired the PLA Unit “to build a ‘secret’ database to hold corporate ‘intelligence.’”<sup>232</sup>

Of the 141 organizations allegedly compromised by PLA Unit 61398 since 2006, 81 percent were located or headquartered in the United States.<sup>233</sup> In June 2013, the U.S. Department of Justice indicted Chinese energy firm Sinovel for cyber-enabled IP theft committed against Massachusetts-based American Superconductor (AMSC).<sup>\*</sup> Florida-based biofuel company Algenol, which is developing technology that converts algae into fuels while decreasing greenhouse gas emissions, fell victim to more than 39 million hacking attempts since mid-2013.<sup>234</sup> According to Algenol’s technology chief, 63,000 hacking attempts came from China, of which 6,653 attempts came from IP addresses identified by cyber security firm Mandiant as belonging to PLA Unit 61398.<sup>235</sup> Algenol’s investigation also identified Alibaba’s cloud computing subsidiary Aliyun as an originator of hacking attempts, though Alibaba claimed that Algenol mischaracterized ordinary Internet traffic as hacking attempts.<sup>236</sup>

## **China’s Multilateral Trade and Investment Issues**

### ***China’s Role in the Global Trade System***

China’s engagement in the multilateral trade arena continued to reflect its protectionist policies and its lack of regulatory transparency. Concerns about China’s opaque policies were raised during China’s fifth mandatory WTO trade policy review, and were again raised in response to China’s obstructive behavior in the Information Technology Agreement (ITA) negotiations, which further demonstrated its efforts to insulate domestic industries from competition.

*China’s WTO Trade Policy Review:* In 2014, China underwent its fifth WTO Trade Policy Review (TPR) since its 2001 WTO accession. While the official WTO report was mostly neutral in its description of China’s trade and investment policies, some statements within the TPR reflect several WTO members’ concerns about Chi-

<sup>\*</sup>AMSC continues to seek compensation from Sinovel through lawsuits in China. U.S.-China Economic and Security Review Commission, *2013 Annual Report to Congress*, November 2013, p. 248.

na's lack of transparency in forming and implementing trade-related policies. For example, the TPR was critical of the complexity and inconsistency of trade and investment catalogs, which China uses to specify those sectors that are eligible for preferential treatment in trade or are open to foreign investment.\* The TPR said:

*It is not always clear how the different Catalogues should be read, as they sometimes overlap and even conflict, reflecting the different agendas at the different levels [of government]. The different layers of regulation add an additional level of difficulty when trying to unravel specific policy measures in China.*<sup>237</sup>

The TPR also stated that it is unclear how China subsidizes agricultural exports “since China has failed to notify [the WTO of] any agricultural support provided after 2008.”<sup>238</sup> The review went on to say that “China retains a large number of support programs aimed at achieving its economic and social goals, but the WTO could not identify the full scope of these policies because they were often the result of “internal administrative measures.”<sup>239</sup>

During China's TPR proceedings, the United States was highly critical of China's lack of transparency in trade and investment-related policymaking. The United States described China's trade and investment practices as shrouded in a “systemic web of secrecy.”<sup>240</sup> The United States accused China of failing to meet the transparency obligations that it agreed to upon accession to the WTO in 2001. Specifically, the Chinese government was inconsistent in notifying the WTO in advance of newly enacted policies that affect or distort trade, a requirement for WTO members.<sup>241</sup> The United States called China's subsidization of its domestic industries “widespread and massive.”<sup>242</sup> China did not respond directly to the United States' accusations, but said it would work to reply to questions as soon as possible.<sup>243</sup>

*Information Technology Agreement (ITA):* China continued to obstruct efforts to conclude a revised ITA in the WTO this year. During the latest negotiating round in June 2014, China failed to table a promised new offer amenable to the United States and other participants.<sup>244</sup> Originally slated for conclusion last year, the ITA negotiations have stalled due to China's unwillingness to include key products such as multicomponent integrated circuits (MCOs) and flat-panel displays, and its insistence on lengthy tariff phase-out periods for other products.<sup>245</sup> An updated ITA is considered an important component of early-harvest outcomes in the WTO Doha Round.<sup>246</sup> The next meeting of the ITA Committee was scheduled for October 31, 2014, and the hope is still to reach an agreement by the end of the year.<sup>247</sup>

*Trade in Services Agreement (TiSA):* In September 2013, China asked to join multilateral negotiations toward a Trade in Services Agreement (TiSA), which began in May 2013 and have been spearheaded by the United States and EU Member states.<sup>248</sup> In the

\*China's “catalog” system is the opposite of the more widely used “negative list” approach, which only includes the sectors where foreign products or investors face restrictions.

aftermath of China's disruption in the ITA talks, some analysts speculate that allowing China to join the TiSA talks would be akin to inviting in a Trojan horse.<sup>249</sup> The EU and Australia have welcomed China's bid to join the TiSA talks, arguing that liberalization of China's relatively small services sector would open more opportunities for trade and investment.<sup>250</sup> However, China's procrastination in unilaterally liberalizing its services sector—a reform pledge it made in the Third Plenum—may be a signal that it is not committed to actual liberalization of services. Many of China's service industries are either highly consolidated into large SOEs, such as telecommunications, or highly fragmented and uncompetitive globally, such as logistics.<sup>251</sup> Information services, such as digitally transferable services, are heavily restricted because of China's control and censorship over the Internet. Only select service sectors in China, such as construction and shipping, are expected to be competitive globally.<sup>252</sup> These factors, combined with China's nontransparent political processes, raise serious concerns about including China in the TiSA talks.

### ***Economic Aspects of China's Territorial Disputes***

Territorial disputes between China and its neighbors have harmed commercial activity in the Asia Pacific and put at risk key U.S. interests in the region. In 2014, rising tensions surrounding these disputes have attracted global attention due to the large economic assets that are at stake around some of the territories, including key global trade routes, large oil and gas reserves, and fisheries. (Further analysis of China's territorial disputes is discussed in Chapter 2, Section 1, "Year in Review: Security and Foreign Affairs" and Chapter 3, Section 1, "China and Asia's Evolving Security Architecture.")

The locations of China's most sensitive territorial disputes are of strategic economic importance globally and to the United States. By the estimates of the U.S. Energy Information Administration (EIA), approximately 11 billion barrels of oil reserves and 190 trillion cubic feet of natural gas reserves lie in proved and probable reserves in the South China Sea.<sup>253</sup> This equates to an approximate \$1.14 trillion in oil reserves and \$833 billion in natural gas reserves in the South China Sea.<sup>254</sup> In addition, the EIA estimates that the East China Sea likely has approximately 200 million barrels of oil reserves and between 1 trillion and 2 trillion cubic feet in natural gas reserves, which equates to \$20.8 billion in oil reserves and between \$4.39 billion and \$8.77 billion in natural gas reserves.\*<sup>255,256</sup> Some Chinese sources claim undiscovered resources can run as high as 70 billion to 160 billion barrels of oil across the East China Sea.†

The South and East China Seas are also home to vast fisheries. The Food and Agriculture Organization of the United Nations esti-

\*Calculations for oil reserves are based on a price of \$103.93 per barrel and for natural gas are based on \$4.27 per million British Thermal Units, MMBtu.

†Expert testimony delivered to the U.S.-China Economic and Security Review Commission in 2013 cast doubt on the feasibility of exploring and extracting these proven and probable reserves from the South and East China seas. For details, see the U.S.-China Economic and Security Review Commission's *2013 Annual Report to Congress*, Chapter 2, Section 3, "China's Maritime Disputes."

mates that the South China Sea produces 1.7 billion tons of fish, which accounts for over 10 percent of global fisheries production. The region is considered a key supply source for the fisheries sectors of Southeast Asian economies, a large portion of which are U.S.-bound exports.<sup>257</sup>

The South China Sea is also a key trading route. One hundred and seventy-two ports are located around the perimeter of the South China Sea, and approximately \$5 trillion of ship-borne trade (or nearly 30 percent of global trade) passes through the South China Sea every year.<sup>258</sup> Annual U.S. trade through the South China Sea is valued at about \$1.2 trillion, which is nearly a quarter of overall U.S. trade.<sup>259,260</sup> Should a crisis occur, the diversion of cargo ships to other routes would harm the global economy due to higher transport costs and longer shipping times.

### **Implications for the United States**

China's preoccupation in 2014 with stimulating its economy to reach official GDP growth targets has been detrimental to the U.S. economy. China's "mini-stimulus," which continued to grow throughout the year, is causing investment to increase in sectors where overcapacity and oversupply are already problematic, such as steel. These subsidies encourage China to dump excess supply in overseas markets at below-market rates, putting U.S. manufacturers at a disadvantage.

Slow implementation of substantive economic reform has also been harmful to the United States. For example, U.S. businesses continue to face high market access barriers, including those for U.S. exports and investment. Separately, failure to transition to a floating exchange rate regime allows China to continue undervaluing its currency, thereby subsidizing Chinese exports, raising the cost of imports from the United States, and increasing the U.S.-China trade deficit. In addition, failure to accelerate privatization of sectors dominated by SOEs allows these companies, which are heavily subsidized by the government, to enjoy an unfair competitive advantage globally. China's slow path toward internal rebalancing and adopting a consumption-based growth model is also harmful to the United States. High levels of investment and savings rather than consumption by the Chinese keeps U.S. exports to China relatively low, which expands the U.S.-China trade deficit.

China's increasingly hostile foreign investment climate is also harming U.S. business interests. Beijing is using multiple tools—including its Anti-Monopoly Law and state-run media attacks—to discriminate against foreign invested firms. In addition, state-sponsored cyber theft of commercial IP and trade secrets has harmed U.S. businesses and the economy. China's obstructionist behavior in key multilateral trade negotiations, such as the Information Technology Agreement, has also inhibited the U.S. trade agenda.

### **Conclusions**

- Despite U.S. exports to China growing by 6.2 percent, imbalances in the U.S.-China trade relationship increased in the first eight months of 2014 as the trade deficit grew by 4.1 percent. China stalled on liberalizing key sectors in which the United States is

competitive globally, such as services. Chinese foreign direct investment (FDI) flows into the United States grew, while U.S. FDI into China fell as foreign firms faced an increasingly hostile investment climate in China.

- Supported by government stimulus, China sustained economic growth at or near its official target rate of 7.5 percent through the first three quarters of 2014. Underlying economic problems in China, including oversupply of property and industrial overcapacity, continue to put economic growth at risk of further deceleration.
- China's chronic overcapacity, especially in sectors such as steel and solar panels, continued to harm U.S. manufacturing and exports by dumping excess supply into global markets.
- China's government made little to no progress this year in implementing the economic reforms designated by its leadership during the 2013 Third Plenum. Instead, Chinese President Xi Jinping and his leadership team focused on a broad anti-corruption campaign, while using stimulus to avoid further economic slowdown.
- While disposable income and consumption have increased relative to savings, China has not yet weaned itself off its traditional investment and export-based growth model, and continues to struggle with large internal imbalances.
- China's nontransparent policymaking came under criticism at the World Trade Organization, and China obstructed progress in key trade negotiations, such as the Information Technology Agreement. China's confrontational behavior in addressing contentious territorial disputes with neighboring countries also harmed economic and trade relations in the Asia Pacific.

**Addendum I: Unresolved Trade Disputes with China**

<b>Issue</b>	<b>Last Action Taken</b>	<b>Summary of Dispute</b>
China's Failure to Notify the WTO on Subsidies	The United States requested notification on Chinese subsidy programs in 2012 and 2014. There is no public record of China responding to the requests.	As noted in China's Fifth Trade Policy Review, China has a history of failing to report subsidies to the WTO, a requirement for all WTO members. China notified the WTO twice of subsidies in 2006 and 2011. In the latter case, the notification was made only after the United States issued a counter notification; however, China's notification only covered 93 subsidy programs from 2005 to 2008. The United States submitted requests for notification of Chinese subsidies in 2012 and 2014, but there is no public record of China responding to the requests.
Chinese Protectionist Measures on Auto Parts	The United States and China held consultations in November 2012 and are "engaging in further discussions." There is no public record of progress on the dispute since that time.	In 2012, the United States held consultations with China regarding auto parts export subsidies that appear to violate China's WTO obligations. The United States also accused China of failing to notify the WTO of the subsidies and failing to publish the measures as well as to provide translations in an official WTO language. There is no public record of further progress on the case or efforts to escalate the case to a Dispute Settlement Panel.
Subsidies to Chinese "Famous Brands"	In 2009, the United States and China came to an agreement in which China would eliminate a subsidy program to Chinese "famous brands."	In 2008, the United States and other WTO Member States challenged China for subsidies to producers of so-called Chinese "famous export brands." In December 2009, China agreed to eliminate the subsidy programs; however, Chinese "famous brands" subsidies have subsequently been reported, such as the one to a Chinese shrimp producer which became the basis of a 2013 U.S. countervailing duty.
Chinese Export Restraints	In April 2014, the United States won a case against China for export restraints on rare earths. Other export restraints have not yet been disputed.	Although prohibited by the WTO with limited exceptions, China maintains export restraints on several products, especially those deemed as strategic and emerging industries. In 2009, the United States and other WTO Member States lodged a dispute on export restraints of rare earths. In 2014, the WTO Dispute Settlement Body ruled against China; and an Appellate Body upheld the ruling. However, industry analysts report Chinese export duties on a broad range of other products which have yet to be disputed at the WTO.

**Addendum I: Unresolved Trade Disputes with China—Continued**

<b>Issue</b>	<b>Last Action Taken</b>	<b>Summary of Dispute</b>
Export Credits from China's Export-Import Bank	In 2012, the United States and China agreed to form a working group to establish guidelines on export financing by 2014.	Following U.S. industry complaints that China's Export-Import Bank provided export credits at below-market rates, the United States raised the issue of export financing with China in the 2011 U.S.-China Strategic and Economic Dialogue. Both sides agreed to form a working group to establish guidelines on export credits by 2014; however, reports from the European Union indicate that the scope of negotiations have been narrow, focusing on ships and medical equipment. To date, a dispute on Chinese export credits has not been raised at the WTO.
Localization Requirements	The USTR reports on-going discussions with China regarding localization requirements, such as of servers in the information and communication technology (ICT) sector.	China imposes localization requirements on several strategic and emerging industries as a means of acquiring foreign technology. For example, Internet companies that wish to provide services in China must establish a local presence, including servers, with a Chinese joint-venture partner. The USTR states in its annual report on China to Congress that it continues to discuss these localization requirements with China. To date, no formal dispute has been raised against China at the WTO.
Barriers to Trade in Digitally Distributable Services	In 2009, the WTO ruled partially in favor of the United States in a landmark dispute on trade in certain audiovisual services. China has yet to come into full conformity with the ruling.	The United States raised a case against Chinese barriers to the import of certain audio-visual services, and the WTO Dispute Settlement Panel ruled in favor of the United States in 2009. While China has come into partial compliance by permitting more imports of foreign-made movies, opaque Internet regulations in China continue to severely limit access for digitally distributable exports to China. The USTR submitted questions to China on its Internet censorship regulations in 2011, but the WTO has not published any response from China and a dispute settlement case has not been raised.
Market Access for Foreign Electronic Payment Services	China agreed to grant access to foreign suppliers of electronic payment services by July 2013, following a dispute panel decision that China's regulations were not WTO-compliant. To date, China has failed to grant market access.	In 2010, the United States raised a case against Chinese regulations that banned foreign suppliers of electronic payment services which are used to process credit card payments and other transfers among financial institutions. In 2012, the Dispute Settlement Panel found Chinese restrictions to be noncompliant, and China agreed to implement the Panel's recommendations by July 2013. To date, China has yet to authorize access to foreign suppliers, and there is no public record of further action on the dispute.

Source: WTO and USTR; compiled by Commission staff.

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