U.S.-China Economic and Security Review Commission

Economics and Trade Bulletin

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Highlights of This Month's Edition

- **Bilateral trade:** In the first six months of 2017, U.S. goods trade deficit grew to $171 billion, up 6 percent year-on-year; U.S. deficit in advanced technology products increases 124 percent year-on-year in the second quarter of 2017 as Chinese telecommunications exports soar and U.S. aerospace exports decline; U.S. services exports to China reach a new record, driven by increases in tourism, financial services, and intellectual property payments.

- **Bilateral policy issues:** The inaugural Comprehensive Economic Dialogue concludes with no concrete agreements; China clamps down on the use of VPNs, threatening free flow of data and business operations.

- **Policy trends in China's economy:** China's National Financial Work Conference produces modest outcomes; faced with mounting corporate debt and capital flight, the Chinese government introduces new regulations limiting large overseas investments, leading to the withdrawal of several high-profile deals in the United States.

- **Quarterly review of China's economy:** China's economy grew 6.9 percent year-on-year in the second quarter of 2017, fueled primarily by surging industrial activity, property investment, and credit growth.

- **Sector focus – Rice:** U.S. rice producers gain access to China's market, but challenges remain.

Contents

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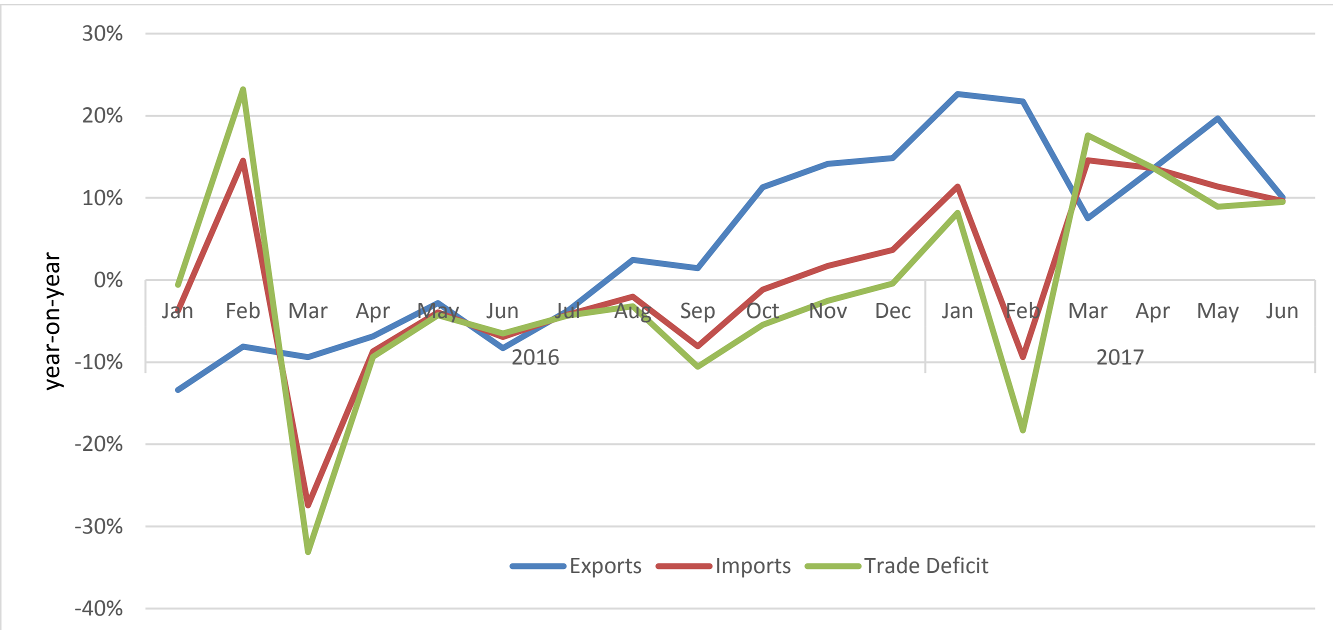
Bilateral Trade

The U.S. trade deficit in goods with China totaled $32.6 billion in June 2017, its highest monthly level since August 2016 and a 9.5 percent increase year-on-year (see Figure 1). U.S. exports to China continued to increase, growing 10.1 percent year-on-year to $9.7 billion. U.S. imports from China grew 9.6 percent year-on-year to $42.3 billion. Month-on-month, U.S. exports fell 4.7 percent mostly due to a decrease in passenger cars and pharmaceutical products while U.S. imports from China increased 1.2 percent due to higher computer and apparel imports.[1]

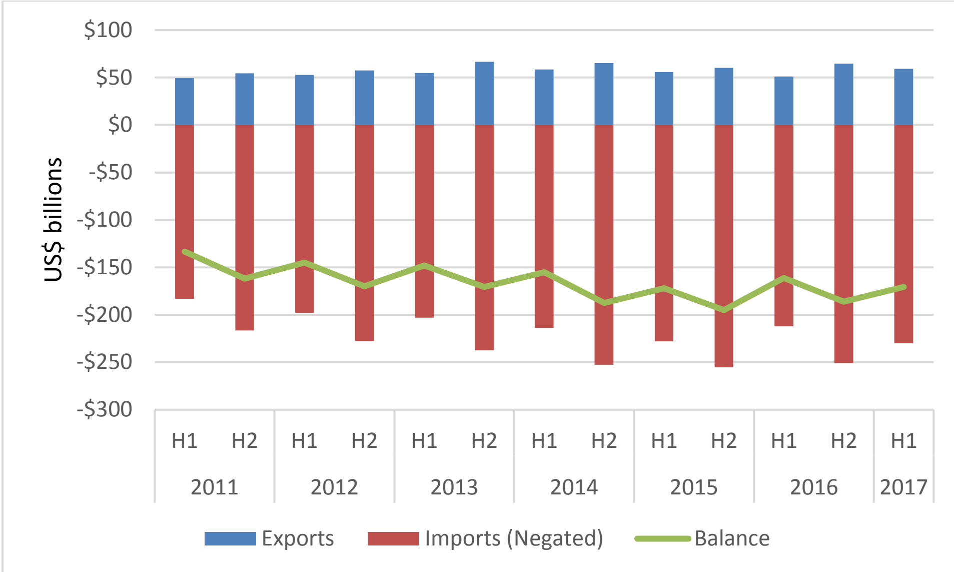
Figure 1: U.S. Exports, Imports, and the Trade Deficit with China, January 2016–June 2017



Source: U.S. Census Bureau, *Trade in Goods with China*, August 4, 2017. *https://www.census.gov/foreign-trade/balance/c5700.html*.

In the first six months of 2017, U.S. imports to and exports from China both reached a record high for this period of the year. As seen in Figure 2, U.S. goods trade with China is seasonal, decreasing in the first half of the year and increasing in the second half. For the first half of 2017, U.S. exports grew 15.7 percent year-on-year to $59 billion and imports from China grew 8.3 percent year-on-year to $230 billion, with the overall goods trade deficit increasing 6 percent year-on-year to $171 billion. In terms of total trade, China was the United States' second largest trading partner in the first half of 2017, roughly $1 billion behind Canada ($290 billion in total trade with Canada versus $289 billion for China).[2]

Figure 2: Goods Trade with China, 2011–2017



Source: U.S. Census Bureau, *Trade in Goods with China*, August 4, 2017. *https://www.census.gov/foreign-trade/balance/c5700.html.*

Top U.S. Imports from China Grow

U.S. imports of four out of the top five product categories from China increased in the second quarter of 2017 (see Table 1). Imports of Chinese consumer and electronic products and miscellaneous manufactured commodities showed considerable growth, increasing 31.8 percent and 61.7 percent year-on-year respectively. Together these two categories accounted for 50.9 percent of all U.S. good imports from China in the second quarter of 2017. Imports of Chinese electrical equipment and apparel and accessories increased 21.6 percent and 29.9 percent respectively year-on-year. Non-electrical machinery declined 8.4 percent year-on-year.

Table 1: U.S. Trade with China Top Five Exports and Imports

U.S. Trade with China, August 2017

U.S. Top-Five Exports to China	Exports	Share of total (%)	Change over Q2'16 (%)	**U.S. Top-Five Imports from China**	Imports	Share of total (%)	Change over Q2'16 (%)
Quarter 2 (Apr-Jun'17)				*Quarter 2 (Apr-Jun'17)*			
Transportation Equipment	7,536.6	25.3%	2.9%	Computer and Electronic Products	48,787.05	40.2%	31.8%
Computer & Electronic Products	4,271.7	14.4%	1.0%	Miscellaneous Manufactured Commodities	12,961.9	10.7%	61.7%
Chemicals	3,789.3	12.7%	12.1%	Electrical Equipment	10,983.1	9.1%	21.6%
Machinery, Except Electrical	2,471.5	8.3%	15.8%	Apparel and Accessories	8,314.1	6.9%	29.9%
Waste And Scrap	1,375.1	4.6%	6.0%	Machinery, Except Electrical	7,300.9	6.0%	-8.4%
Other	10,298.9	34.6%	-	Other	32,874	27.1%	-
Total	**29,743.3**	**100.0%**		**Total**	**121,221.25**	**100.0%**	
2017 Year-to-date				*2017 Year-to-date*			
Transportation Equipment	12,647.5	21.4%		Computer and Electronic Products	79,880.6	34.8%	
Computer & Electronic Products	8,156.8	13.8%		Electrical Equipment, Appliances, and Component	19,809.4	8.6%	
Chemicals	7,505.9	12.7%		Machinery, Except Electrical	17,481.4	7.6%	
Agricultural Products	5,870.4	9.9%		Miscellaneous Manufactured Commodities	16,865.9	7.4%	
Oil & Gas	2,701.0	4.6%		Apparel & Accessories	12,469.1	5.4%	
Other	22,357.2	37.7%		Other	82,888	36.1%	
Total	**59,238.9**	**100.0%**		**Total**	**229,394.5**	**100.0%**	

Source: U.S. Census Bureau, *USA Trade Online*, August 4, 2017. *https://usatrade.census.gov/.*

Top five U.S. exports to China registered moderate-to-high growth. Exports of chemicals and non-electrical machinery grew 12.1 and 15.8 percent year-on-year. The United States' largest export to China, transportation equipment, grew 2.9 percent year-on-year in the second quarter. Exports of waste and scrap edged out agricultural products for the last slot among the top 5 exports for the first time since August 2016.[3]

Advanced Technology Products

The U.S. trade deficit with China in advanced technology products reached nearly $58 billion in the first half of 2017, a 51 percent increase compared to the same period in 2016 (see Table 2). This increase was driven by a spike in China's largest ATP export to the United States, information and communications equipment, which increased 20 percent year-on-year to $36 billion in Q2 2017. At the same time, sales of aerospace goods, the largest U.S. ATP export to China, fell to $3.7 billion, a 21 percent decrease year-on-year.[4]

Table 2: ATP Trade Q2 2017

Quarter 2	Quarterly					Cumulative year-to-date			
	Exports	Imports	Balance Q2'17	Balance Q2'16	Balance YOY	Exports	Imports	Balance 2017	Balance 2016
TOTAL	**8,609**	**39,517**	**-30,908**	**-13,803**	**123.9%**	**15,403**	**73,224**	**-57,821**	**-38,206**
(01) Biotechnology	222	52	170	198	-14.1%	479	99	380	323
(02) Life Science	952	630	322	233	38.2%	1,768	1,259	509	435
(03) Opto-Electronics	158	1,008	-850	-1,353	-37.2%	290	1,751	-1,461	-2,584
(04) Information & Communications	1,223	35,974	-34,751	-28,892	20.3%	2,272	66,705	-64,433	-55,109
(05) Electronics	1,387	1,127	260	504	-48.4%	2,808	2,073	735	1,013
(06) Flexible Manufacturing	871	338	533	661	-19.4%	1,608	612	996	1,156
(07) Advanced Materials	55	104	-49	-33	48.5%	153	200	-47	-50
(08) Aerospace	3,718	251	3,467	4,498	-22.9%	5,816	466	5,350	6,067
(09) Weapons	0	32	-32	-32	0.0%	0	57	-57	-58
(10) Nuclear Technology	21	2	19	14	35.7%	203	5	198	200

Source: U.S. Census Bureau. (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, August 2017). *http://www.census.gov/foreign-trade/statistics/product/atp/2016/06/ctryatp/atp5700.html.*

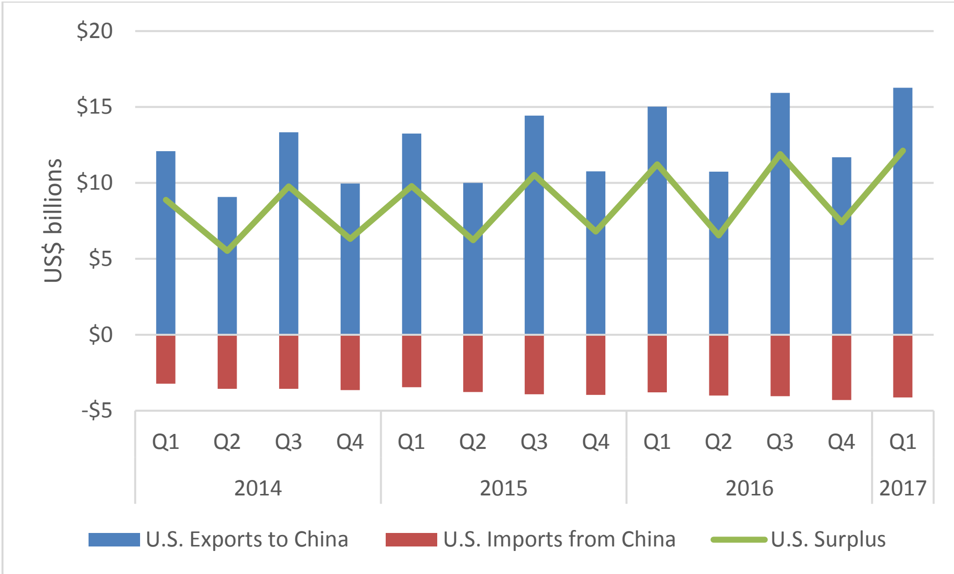
U.S. Services Trade with China

In the first quarter of 2017, U.S. services hit a record high of $16.3 billion, up from $15 billion over the same period in 2016, an 8.2 percent increase (Figure 3). This growth in exports drove the U.S. trade surplus in services to its highest level yet, at $12.1 billion—up 8 percent from $11.2 billion year-on-year. Chinese services exports to the United States grew to $4.1 billion from $3.8 in 2016 for 8.7 percent growth year-on-year.[5]

Tourism continues to be the United States' top services export to China, accounting for 63 percent of all U.S. services exports to China in the first quarter of 2017.* Chinese tourism to the United States continues to rise, growing $411 million in the first quarter of 2017 year-on-year. U.S. exports of transportation, financial services, and intellectual property charges increased significantly in the first quarter, growing 11 percent, 27 percent, and 38 percent, respectively, year-on-year. U.S. telecommunications, information, and computer services exports dropped 20 percent year-on-year in the first quarter, from $179 million to $143 million.[6]

* The U.S. government classifies tuition payments as tourism and travel exports. For more on Chinese tourism in the United States, see Matt Snyder, "Chinese Tourism and Hospitality Investment in the United States," *U.S.-China Economic and Security Review Commission*, July 25, 2016. *http://www.uscc.gov/Research/chinese-tourism-and-hospitalityinvestment-united-states*.

Figure 3: U.S.-China Trade in Services, Q1 2014–Q1 2017



Source: U.S. Department of Commerce – Bureau of Economic Analysis, *U.S. Trade in Goods and Services by Selected Countries and Areas, 1999-Present*, U.S. Department of Commerce, Foreign Trade Division, July 27, 2017.

Bilateral Policy Issues

The U.S.-China Comprehensive Dialogue

The Comprehensive Economic Dialogue—one of four dialogue tracks created by President Donald Trump and Chinese President and General Secretary of the Chinese Communist Party Xi Jinping at their Mar-a-Lago summit—held its inaugural meeting on July 19.* The meeting concluded with no joint statement, concrete agreements, or future agenda. The two news conferences the United States and China planned to hold separately after the meeting were cancelled.[7] A statement from U.S. Treasury Secretary Steven Mnuchin and U.S. Commerce Secretary Wilbur Ross said, "China acknowledged our shared objective to reduce the trade deficit which both sides will work cooperatively to achieve."[8] According to people familiar with the talks, China was unwilling to concede to U.S. demands for concrete plans—including numerical targets—for reducing the U.S. trade deficit and cutting steel capacity.[9]

The 100-day plan to address trade and investment issues between the United States and China—another outcome of the Mar-a-Lago summit—included promises by China to increase market access for U.S. agricultural products and financial services,† but progress has been mixed (most of the items had a deadline of July 16, 2017):

- **Beef and poultry:** China and the United States finalized technical standards for U.S. beef exports to China, lifting a 13-year ban;[10] however, only 15 percent of U.S. producers participate in the voluntary beef traceability system required by the agreement, which limits gains for U.S. exporters hoping to reach the Chinese market.[11] U.S. producers also face steep competition from other exporters, such as Australia and Brazil, which did not have any restrictions on their ability to sell to China and which produce beef without additives banned by the Chinese government but widely used by U.S. producers.[12] In return for gaining

*At the Mar-a-Lago meeting, President Trump and President Xi agreed to restructure the Strategic and Economic Dialogue (S&ED) creating the United States-China Comprehensive Dialogue, which will be divided into four tracks: the Diplomatic and Security Dialogue, Comprehensive Economic Dialogue, Cyber and Law Enforcement Dialogue, and Social and People-to-People Exchange Dialogue.
† For a review of the 100-day plan agreements, see U.S.-China Economic and Security Review Commission, *Economic and Trade Bulletin*, June 2, 2017, 2–4. *https://www.uscc.gov/sites/default/files/trade_bulletins/June%202017%20Trade%20Bulletin.pdf*.

market access for U.S. beef, the United States will allow imports of Chinese cooked poultry;[13] meanwhile, U.S. poultry exports to China have been banned since 2015 after bird flu was discovered in a wild duck.*

- **Financial services:** China agreed to issue guidelines to allow U.S.-owned suppliers of electronic payment services to "begin the licensing process" in a sector that has been dominated by UnionPay, China's state-owned payments network.[14] U.S. companies hoped for speedy access to the Chinese bank card payments market, which, according to the People's Bank of China (PBOC), reached $8.4 trillion in 2015 and is projected to become the world's largest by 2020.[15] Instead, the guidelines released by the PBOC on July 12 lay out a two-step licensing process, possibly with a national security review provision, which means U.S. companies would have to wait two or more years before they can participate in the Chinese market.[16]
- **Biotechnology:** China promised "to conduct science-based evaluations of all eight pending U.S. biotechnology product applications to assess the safety of the products for their intended use,"[17] which would make these goods eligible for export to China. In June 2017, China approved two genetically modified (GM) strains of soybeans and corn developed by Monsanto and Dow Chemical, respectively, for import into its market.[18] Approval for two more GM corn types, from Syngenta and Monsanto, followed in July.[19] However, four more products await approval, leading U.S. companies to complain about the lack of transparency in China's review process.† [20] Beijing has blocked imports of genetically modified seeds from U.S. companies like Monsanto, DuPont, and Dow Chemical, citing safety concerns, but U.S. industry analysts believe these policies are aimed at protecting China's domestic biotechnology industry from foreign competition.[21]

China Cracks Down on the Use of Virtual Private Networks

The Chinese government has intensified its crackdown on virtual private networks (VPNs), which are used by individuals and businesses to circumvent China's extensive censorship apparatus (often referred to as the "Great Firewall"). Under Chinese law, use of VPNs for cross-border business purposes is illegal without government approval.[22] In January 2017, China's Ministry of Industry and Information Technology (MIIT) stepped up enforcement of this provision by enlisting Chinese Internet providers to remove customers using VPNs without government approval, and holding Internet providers accountable for failing to do so.[23] In July, China ordered its state-run telecommunications firms to bar individuals from using VPNs by February 2018.[24] At the end of July, Apple announced it was taking down all VPN services from its app store in compliance with the law.[25] Amazon quickly followed suit, saying its Web Services operations in China will not allow customers to use VPNs to circumvent China's online restrictions.[26]

China's crackdown on VPNs will negatively affect U.S. firms as Chinese customers rely on VPNs to access U.S. websites, such as the *New York Times*, that are blocked by Chinese censors.[27] According to Jake Parker, vice president of the U.S. China Business Council, if the ban is expanded to apply to U.S. businesses it may prompt firms to close or reduce operations in China because U.S. businesses rely on VPNs for secure communication and access to important tools blocked by China, such as Google Docs.[28] Companies also use VPNs to ensure "speed and efficiency as they migrate more services to the cloud," which will become problematic if they are unable to use VPNs.[29] Lester Ross, chairman of the American Chamber of Commerce in China (AmCham China) said, "The success of our members is dependent upon instantaneous access to information on a world-wide basis as well as the ability to freely communicate with their affiliates, suppliers and customers around the world."[30]

In a survey conducted by AmCham China, 92 percent of participating firms were negatively affected by Chinese restrictions preventing the use of online tools in 2016, a significant increase from 56 percent of respondents in 2015.[31] Chinese Internet policies also widely affect U.S. companies: 87 percent of U.S. companies responding to

* For more on China's restrictions on U.S. poultry, see U.S.-China Economic and Security Review Commission, *Economic and Trade Bulletin*, June 3, 2016, 9–11. *https://www.uscc.gov/sites/default/files/trade_bulletins/June%202016%20Trade%20Bulletin.pdf*.

† For more information about China's approval process for GM products, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, July 6, 2017, 3–4. *https://www.uscc.gov/sites/default/files/trade_bulletins/July%202017%20Trade%20Bulletin.pdf*.

an AmCham China survey in 2016 reported being affected by Chinese regulations regarding online censorship, and 77 percent reported being affected by regulations on data localization.[32]

The VPN crackdown in the latest salvo in China's attack on unobstructed Internet access and data flows. In June, the Chinese government implemented a cybersecurity law that gives the government the ability to restrict data transfers out of China and demand data localization, forcing businesses operating in "critical industries"—a broad and vaguely defined category—to store data in China and require government permission before moving it offshore.[33] While some observers believe this clampdown reflects the government's heightened sensitivity ahead of the leadership transition scheduled to take place during the 19th Party Congress this fall, others are more skeptical there will be a thaw after the meeting. For example, Zhang Lifan, a Beijing-based historian, said the restrictions are "a one-way track with no way back."[34]

Policy Trends in China's Economy

National Financial Work Conference Produces Modest Outcomes

On July 15, China concluded the National Financial Work Conference, a high-level meeting held every five years that sets the tone for financial reforms.[35] President Xi chaired the conference—which is traditionally led by the premier—underscoring the government's prioritization of financial stability ahead of the 19th Party Congress.[36] In his remarks, President Xi described financial security as "an important part of national security" and said the government would take stronger measures to limit systemic risk across the financial sector and reduce state-owned enterprise (SOE) leverage.[37] President Xi said the PBOC will play a stronger role in guarding against systemic risk in the financial system; however, no details were provided on how the PBOC's role will be strengthened.[38] He also called for greater accountability for financial regulators, noting it would be a "breach of duty" if regulators fail to detect risks in time and "dereliction of duty" if they fail to report and address identified risks.[39] "The heavy emphasis on risk prevention will put a damper on much-needed reform in the financial market. With the wording on holding regulators [accountable] for any signs of instability, they will definitely err on the side of caution," said Victor Shih, a professor at the University of California in San Diego.[40]

The meeting's sole tangible outcome was the establishment of the Financial Stability and Development Committee, a cabinet-level body tasked with coordinating financial regulation and oversight.[41] Because China has separate regulatory bodies for the banking, insurance, and securities industries, no single regulator has a complete picture of the entire financial system, leading to gaps in oversight, particularly as China's financial system has become increasingly complex.[42] China's financial regulators have at times acted in isolation and even at odds with one another.[43] For example, the financial regulators' poorly coordinated response to China's stock market crash in 2015 led to significant scrutiny of their competence, prompting criticism from Premier Li Keqiang.[44]

Details on the new committee are scant, but observers are skeptical it will have much impact, noting the committee lacks formal power and a similar structure already exists.[45] China's State Council established a financial coordination mechanism in 2013 that includes the heads of the PBOC, China Banking Regulatory Commission, China Securities Regulatory Commission, China Insurance Regulatory Commission, and State Administration of Foreign Exchange.[46]

Beijing Seeks to Curb Large Overseas Investments amid Mounting Debt Fears

The Chinese government is increasing regulatory scrutiny on large investments abroad as part of a government effort to limit capital outflows and fend off risks from mounting corporate debt.[47] The new regulations include barring state-owned banks from making loans to large private firms investing overseas, a decision that was approved in June 2017 by President Xi.[48] The China Banking Regulatory Commission is also taking the lead on investigating whether companies used high-interest financial products and overseas loans to finance foreign deals.[49] These efforts seek to crack down on investments deemed to pose systemic risks to the country's financial stability.[50] According to a Chinese official involved in the decision, large Chinese companies "have borrowed a lot to fund their deals overseas, and that means risks to Chinese banks if the deals go bad."[51]

Since 2015, four Chinese corporations—Dalian Wanda Group, Anbang Insurance Group, HNA Group, and Fosun International—have invested a combined $55 billion overseas, 18 percent of total Chinese outbound foreign direct investment over that period.[52] Many of these deals relied on funding from state banks, support from overseas lenders, and proceeds from financial products to finance multi-billion-dollar acquisitions. For example, Wanda's $3.5 billion acquisition of Legendary Entertainment in January 2016 was financed using state loans, with the firms' onshore assets used as collateral.[53] In December 2016, Standard & Poor's rating agency lowered Wanda's corporate credit rating one notch, citing the firm's high leverage and increased capital expenditure.[54] The following month, Wanda withdrew a $1 billion bid to acquire Dick Clark Studios due to pressure from Chinese regulators to nix the deal.[55] Now, Chinese banking officials are saying overseas acquisitions will no longer be permitted if they rely on state loans.[56] To reduce the firm's debt, Wanda's founder Wang Jianlin is pursuing what he describes as an "asset-light" strategy, selling off properties that require loans to operate; in June 2017, Wanda sold off 13 of its China theme parks to the real estate firm Sunac China for $6.5 billion and 77 of its hotels to the Chinese property developer R&F Properties for $3 billion.[57]

Chinese regulators have also ordered state banks to scrutinize their loans to Anbang.[58] Anbang attracted international attention in 2016 for its ultimately unsuccessful $14 billion bid to acquire Starwood Hotels & Resorts Worldwide Inc. To finance the deal, Anbang would have relied in large part on funding from its insurance plans, using retail investors' savings as the underlying collateral for loans.[59] The Chinese government is cracking down on these practices, with the China Insurance Regulatory Commission banning Anbang from selling new products for three months and reportedly reviewing the firm's financial filings and records of past deals.[60] There is speculation Anbang may be forced to sell overseas assets—including the U.S. Waldorf Astoria hotel, which it bought for $2 billion in 2014—that were acquired using proceeds from the firm's insurance products.[61] This past June, regulators investigating Anbang's deal making also detained Anbang's chairman, Wu Xiaohui, for questioning. Mr. Wu has not made a public appearance since being detained.[62]

According to Keith Pogson, a senior partner for financial services at Ernst & Young, Beijing is seeking to send "a clear message to the market that [regulators are] going to make it difficult for companies to finance overseas deals."[63] However, the Chinese government has indicated overseas investments will be permitted strategically based on the industries or companies being targeted.[64] Gao Feng, a spokesperson for the Ministry of Commerce, identified specific industries as the primary targets of the Chinese government's investment crackdown, including real estate, hotels, cinemas, entertainment, and sports clubs.[65] Meanwhile, investments in support of government initiatives, including "One Belt, One Road" projects and other strategic foreign investments that support government policies and goals, will not be subjected to the same stringent review processes or regulations.[66]

The Chinese government's efforts to curb foreign deal making comes in response to China's growing debt levels and capital outflows.[67] According to the Bank for International Settlements (BIS), China's total debt reached $27.5 trillion (or 257 percent of gross domestic product [GDP]) in the fourth quarter of 2016, up from 141 percent at the end of 2008.[68] According to BIS data, China's credit-to-GDP gap,[*] a measure of debt buildup, was 24.6 percent in the fourth quarter of 2016.[69] Historically, a credit-to-GDP gap above 10 percent signals excessive credit growth and is a robust early warning indicator for banking crises.[70] Two-thirds of China's total debt is held by nonfinancial corporations, consisting largely of loans made to SOEs by state-owned banks.[71] Corporate debt reached 166 percent of GDP in the fourth quarter of 2016, up from 96 percent in the fourth quarter of 2008.[72] Meanwhile, China's State Administration of Foreign Exchange indicated that Chinese capital outflows totaled around $640 billion in 2015 and $650 billion in 2016, up from $130 billion in 2014.[73]

Quarterly Review of China's Economy

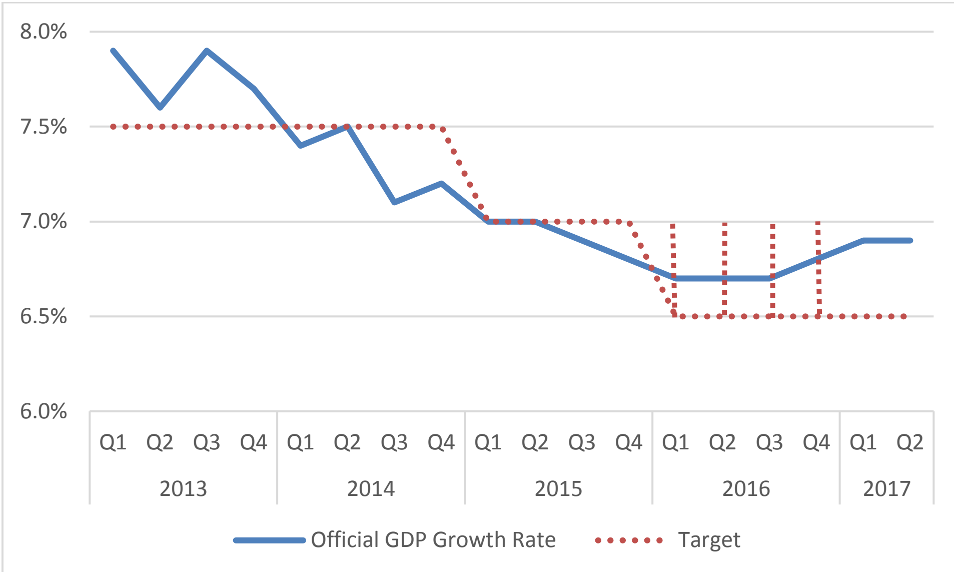
China's GDP Growth Exceeds Expectations

In the second quarter of 2017, China's real GDP grew 6.9 percent year-on-year, ensuring China's economy will exceed the official 6.5 percent target this year (Figure 4).[74] Electricity consumption (6.5 percent increase year-on-

[*] According to BIS, a credit-to-GDP gap is the difference between the credit-to-GDP ratio and its long-term trend. Bank for International Settlements, "Credit-to-GDP Gaps," December 11, 2016. *http://www.bis.org/statistics/c_gaps.htm*.

year), rail freight (10 percent increase year-on-year), and retail sales (10.4 percent increase year-on-year)—unofficial proxies for economic growth—all saw strong growth in the first half of the year.[75] This stronger-than-expected growth led the International Monetary Fund (IMF) to revise its initial forecasts for China's GDP growth in 2017 from 6.5 percent to 6.7 percent.[76] But as China's property sector cools and financing costs rise, GDP growth in the next two quarters is expected to slow.[77]

Figure 4: China's Official GDP Growth, Q1 2013–Q2 2017

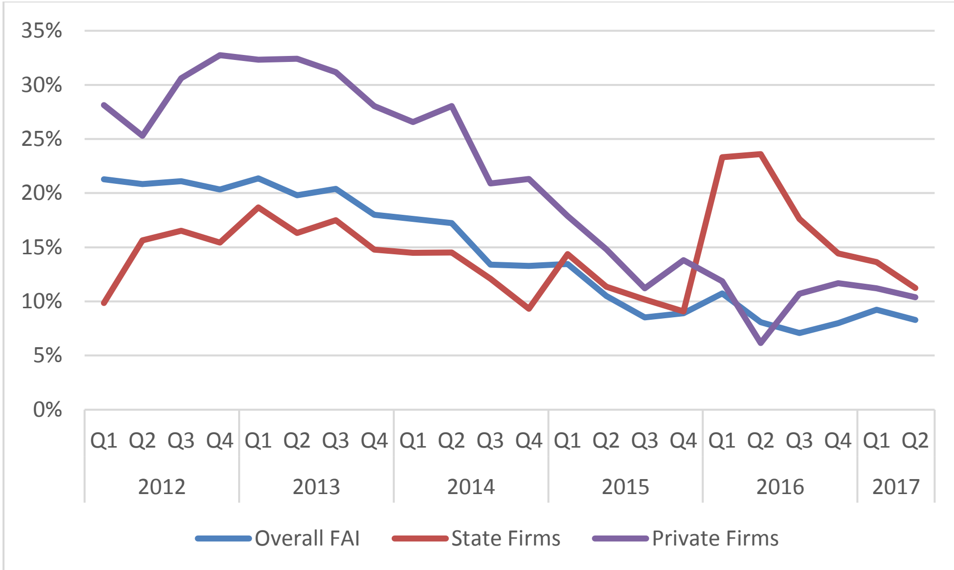


Note: In 2016, the target was set at a range of 6.5–7.0 percent GDP growth.
Source: China's National Bureau of Statistics via CEIC database.

State-led investment, higher industrial output, and greater domestic consumption contributed to China's high economic growth in the first half of 2017.[78] Fixed asset investment*—a traditional driver of China's growth—continues to expand, but its contributions are weakening as the returns from these investments slow. Growth in China's fixed asset investment slowed to 8.6 percent year-on-year in the first half of 2017 compared to 9 percent year-on-year in the first half of 2016 (see Figure 5).[79] Government infrastructure spending largely fueled growth in fixed asset investment, accounting for 36.4 percent of total fixed asset investments in the first half of 2017.[80] SOEs' investment continued to outpace the private sector, increasing 12 percent year-on-year in the first half of 2017 compared with private firms' investments at 10.7 percent year-on-year.[81]

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

Figure 5: Growth in Fixed Asset Investment, Q1 2012–Q2 2017
(quarterly; year-on-year)



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

Property Market Remains Strong

China's property market remains strong, with continued growth in real estate investment (primarily composed of residential construction), sales, and property prices, driving demand for industrial manufacturing goods such as steel, aluminum, cement, and glass.[82] To prevent a property bubble, the Chinese government since mid-2016 moderated property price growth by increasing mortgage interest rates, and attempted to slow new development through restricting access to capital for real estate developments.[83] These measures slowed growth in average residential property prices, the value of residential buildings sold, and the amount of residential floor space sold (see Figure 6).[84] But government efforts to rein in residential real estate investment were unsuccessful.[85] In the first half of 2017, China's residential building sales increased 17.9 percent year-on-year by value—a slowdown from the 44.4 percent year-on-year growth seen in the first half of 2016.[86] Similarly, growth in residential floor space sold slowed to 13.5 percent year-on-year in the first half of 2017, down from 28.6 percent year-on-year growth in the first half of 2016.[87] Growth in average residential property prices also decelerated to 3.9 percent year-on-year in the first half of 2017 compared with the 12.3 percent jump in the first half of 2016.[88] But residential real estate investment increased 10.2 percent year-on-year in the first half of 2017 compared with 5.6 percent year-on-year growth in the first half of 2016, largely due to an uptick in investment in the first quarter.[89]

Figure 6: Growth in China's Residential Property Sector, Q1 2012–Q2 2017

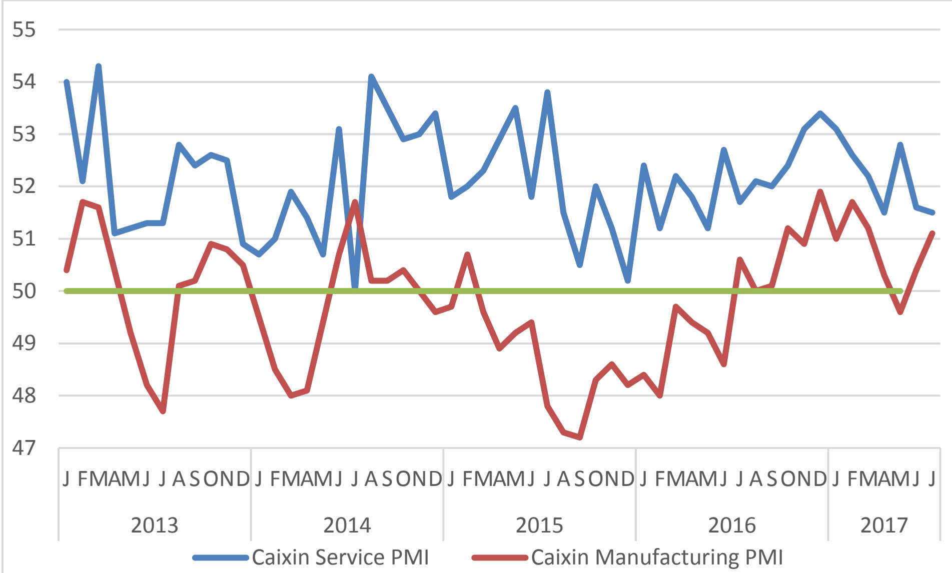
Source: China's National Bureau of Statistics via CEIC database.

Manufacturing and Exports Rebound

In the first half of 2017, China's manufacturing and industry production continued to recover from a slowdown in 2015 and early 2016 in part due to a rebound in the property market and global growth.[90] Value-added industrial growth—a market indicator for economic growth—expanded 6.9 percent year-on-year in the first half of 2017.[91] Unofficial estimates by the Chinese financial media firm Caixin found China's manufacturing Purchasing Managers' Index (PMI),* a measure of economic expansion and industrial utilization, improved over the last year to reach 50.4 in June 2017 (see Figure 7).[92] Services have continued to expand, with Caixin's service PMI remaining above 50 since mid-2014.[93] In July 2017, Caixin' estimates of PMI continued to remain strong with manufacturing PMI reaching 51.1 and service PMI slowing slightly to 51.5.[94] The pickup in global growth contributed in part to the recovery. Exports, which had been falling year-on-year since the second quarter of 2016, rebounded in the second quarter of 2017, increasing 16.9 percent year-on-year.[95]

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

Figure 7: Monthly Caixin Service and Manufacturing PMIs, January 2013–July 2017



Note: A reading above 50 indicates expansion; a reading below 50 shows contraction.
Source: Caixin and IHS Markit, "Caixin China General Manufacturing PMI," *Markit Economics*, August 1, 2017. *https://www.markiteconomics.com/Survey/PressRelease.mvc/6d85656c03274a8884edbe3a4205eaf5*; Caixin and IHS Markit, "Caixin China General Services PMI," August 3, 2017. *https://www.markiteconomics.com/Survey/PressRelease.mvc/e205c2b485654fe0b7d59b2655ce168b*.

Domestic Consumption and Services Continue to Grow

Strong services sector growth and retail sales reflect China's transition to a more consumption- and services-driven economy. In the first half of 2017, services continued their upward trend, growing 11.4 percent year-on-year.[96] Retail sales of consumer goods—a proxy for overall consumption—showed steady growth increasing 10.5 percent year-on-year in 2016 and 10.4 percent year-on-year in the first half of 2017.[97] Online sales largely drove this increase, growing 30.9 percent year-on-year in goods and 73.4 percent year-on-year in services.[98] But China's household consumption—a critical driver of China's new economic growth model—is not keeping pace with income growth.[99] As the economy rebounded in the first half of 2017, growth of national disposable income per capita accelerated with an 8.8 percent year-on-year increase.[100] Consumption expenditure per capita slowed to 7.6 percent year-on-year growth in the first half of 2017 compared with 8.8 percent year-on-year growth in the first half of 2016.[101] This shift is likely due to the fact that Chinese households are lowering their spending to save for ever-more expensive housing—a popular investment for Chinese households that lack access to other options.[102]

Sector Focus: United States Gains Access to Chinese Rice Market

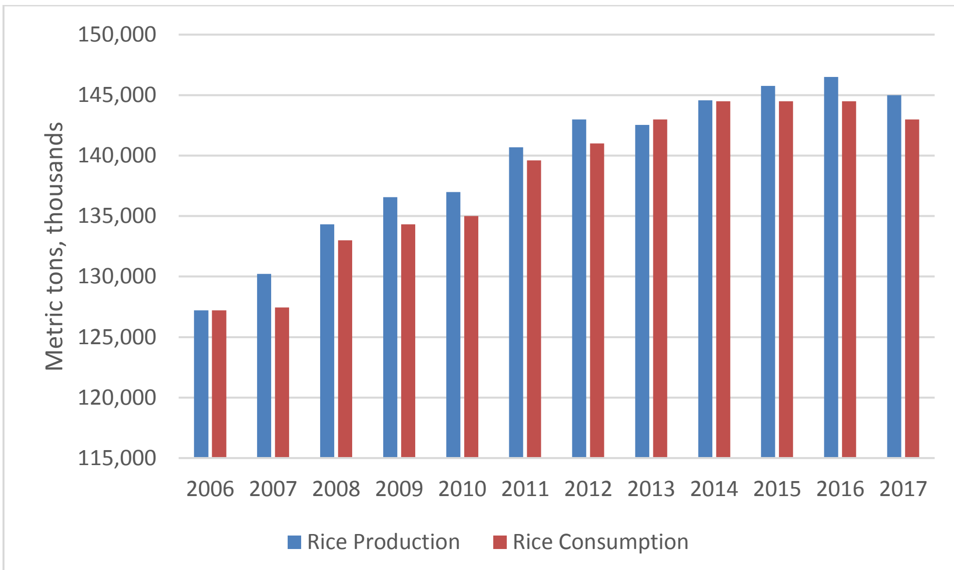
On July 20, Secretary of Agriculture Sonny Perdue announced an agreement that would allow the United States to export rice to China.[*] [103] The agreement marks the finalization of a phytosanitary protocol after over a decade of deliberations by both sides in which the United States was unwilling to accept China's demands that it adhere to standards for mills and export facilities that were in excess of international norms.[104] Before rice shipments can begin, the U.S. government must submit a list of rice exporters to Chinese authorities for approval, and fumigate

[*] Obstacles hampering the ability of U.S. exporters of rice, wheat, and corn to access China's market are also a subject of two ongoing WTO cases. In the first case, the United States challenged Chinese subsidies to domestic producers, in the second, China's "opaque and unpredictable" management of tariff rate quotas for rice, wheat, and corn. For more details on these cases, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, October 7, 2016. *https://www.uscc.gov/sites/default/files/Research/Oct%202016%20Trade%20Bulletin.pdf*; and U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, January 9, 2017. *https://www.uscc.gov/sites/default/files/Research/January%202017%20Trade%20Bulletin_0.pdf*.

rice from qualified exporters using Chinese-approved methods. Subsequently, China's General Administration of Quality Supervision, Inspection, and Quarantine will conduct an audit of U.S. mills and export facilities.[105] USA Rice President and Chief Executive Officer Betsy Ward has called the agreement "a shot in the arm for our industry [that] couldn't come at a better time."[106] While the timetable and details for the start of U.S. rice exports to China remains unclear, USA Rice and the USDA are seeking Chinese inspections of U.S. facilities to begin in September.[107] According to USA Rice, shipments of rice could begin in 2018.[108]

China consumes more rice than any other country in the world,[109] making it an attractive market for U.S. exporters. In 2016, China consumed 144 million metric tons of rice, of which 4.6 million tons were imports.[110] Even though Chinese rice consumption has stagnated in recent years[*] (Figure 8), rice imports have continued to increase (Figure 9), showing a growing preference for imported rice.[111] Cambodia, Pakistan, Thailand, and Vietnam together accounted for 95.9 percent of all Chinese rice imports in 2016 (Figure 10), primarily due to freight advantage resulting from their proximity to China and their lower prices in comparison to domestic price floors (Table 3).[†] [112]

Figure 8: Chinese Rice Production and Consumption, 2006–2017

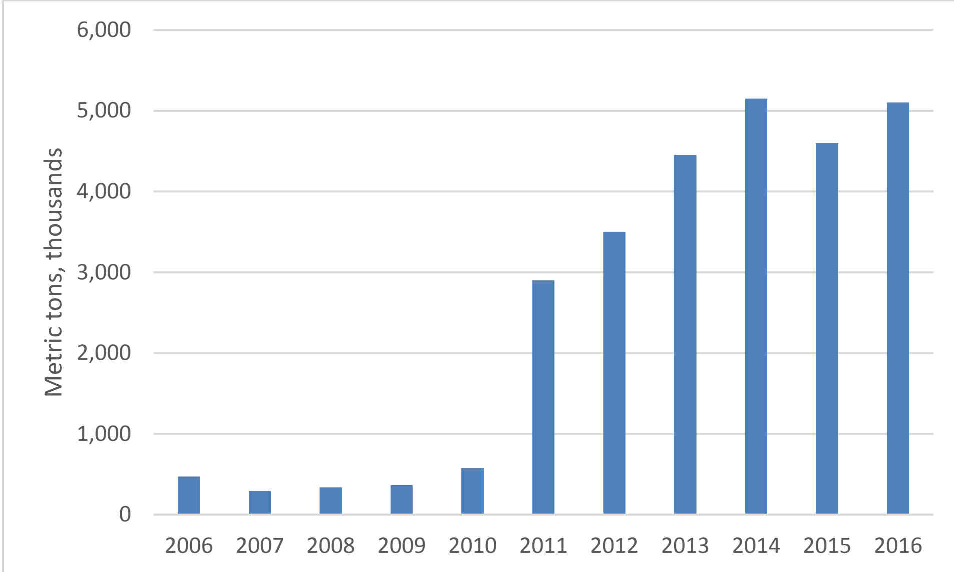


Source: United States Department of Agriculture Foreign Agricultural Service, *Production, Supply, and Distribution Online*. *http://apps.fas.usda.gov/psdonline/psdquery.aspx*.

[*] The decline in rice consumption is unequal across China's urban-rural divide. Urban residents consume far less grain than their rural counterparts. In 2015, urban Chinese consumed 112.6 kilograms of rice per year, compared with 159.5 kilograms for rural residents. As China continues to urbanize, the per capita consumption of rice will continue to decline and be replaced with a diet increasingly focused on animal products. Australia's Department of Agriculture, Fisheries and Forestry, *Food Consumption Trends in China*, April 2012, 37.

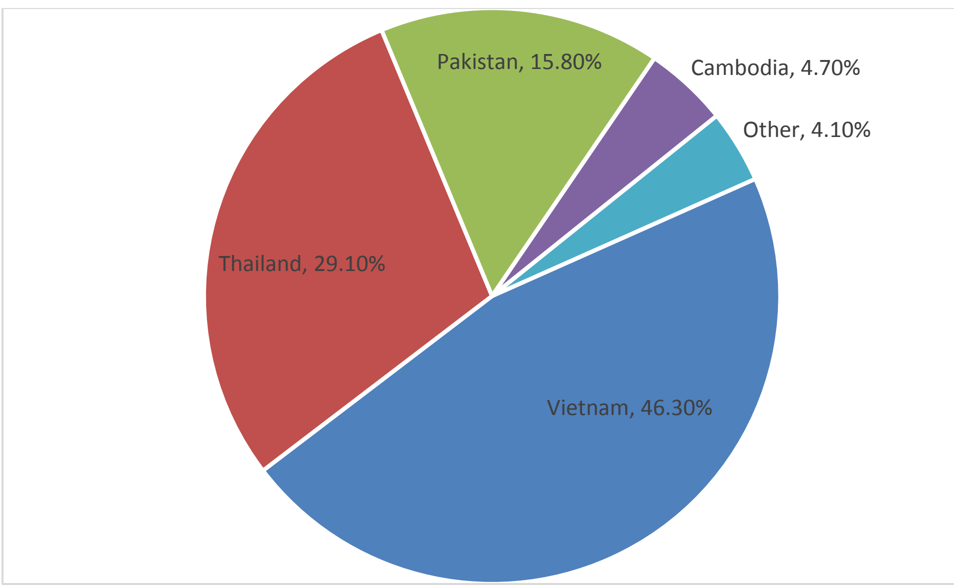
[†] Price floors establishes a minimum price for a product, which means it cannot be sold below that price regardless of market forces. The Chinese government uses domestic price floors (see Table 3) to support its domestic rice industry and ensure the country produces enough rice to be self-sufficient.

Figure 9: Chinese Rice Imports, 2006–2016



Source: United States Department of Agriculture Foreign Agricultural Service, *Production, Supply, and Distribution Online*. *http://apps.fas.usda.gov/psdonline/psdquery.aspx*.

Figure 10: Chinese Rice Imports Market Share, 2016



Source: International Trade Centre, "Trade Map." *http://www.trademap.org/Country_SelProductCountry.aspx?nvpm=1|156||||1006|||4|1|1|1|1|1|2|1|1*.

China may be using rice imports to gain favorability with key states in the Indo Pacific region. In 2016, China committed to importing 200,000 tons of rice from Cambodia, a key ally in the region, with China's Ministry of Agriculture Fisheries and Forestry selecting "28 rice millers who have demonstrated competence to meet the requirements for exporting rice into China."[113] China National Cereals, Oils, and Foodstuffs Corporation (COFCO), a state-owned enterprise, additionally approved 18 mills to begin exporting rice to China following an agreement with the Cambodian Rice Federation.[114] These moves came in the wake of new EU regulations that decreased Cambodian rice exports to Europe, signifying that China seeks to bridge the gap and increase its economic influence.[115] In August 2015, China agreed to buy one million tons of rice from Thailand, easing accumulated stocks after a previous deal failed due to scrutiny from Thailand's Anti-Corruption Commission.* [116] This development improved China's relationship with the new military government in Thailand, which came to power in late 2014. Facing lower rice prices from regional producers (see Table 3) and a lack of preferred status by the government, U.S. producers may find it difficult to gain a sizable foothold in the Chinese market.

Table 3: International Rice Prices, 2016

Country	Price per ton (US$)
China (Floor price long-grain)	389
China (Floor price medium-grain)	453
Vietnam (5% broken)	346
Thailand (100% Grade B ≤4.5% broken)	381
Pakistan (5% broken)	359
India (5% broken)	368
USA (Southern long-grain ≤4% broken)	464
USA (California medium-grain ≤4% broken)	599

Source: Data for Thailand, Vietnam, Pakistan, and India from USDA Economic Research Service, *Export Prices Thailand, Vietnam, India and Pakistan*; data for United States from USDA Economic Research Service, *U.S. Rough and Milled Rice Prices, Monthly and Marketing Year*; data for China from USDA Foreign Agriculture Service, *China Annual Grain and Feed Report*.

Despite these challenges, China's growing appetite for imported rice means gaining even a small foothold in the Chinese market would be a great boon for the U.S. rice industry. In 2016, the United States exported 3.4 million tons of rice.[117] According to USA Rice, exports to China may be low in the first year as U.S. exporters and Chinese importers establish a market; however, exports could reach 50,000 metric tons in the second year, and 250,000 metric tons in five years.[118] USA Rice expects japonica varieties, also known as medium and short grain rice, to initially dominate U.S. exports because China's quota-fill rate for japonica varieties is relatively low, while the fill rate for long grain indica varieties is nearly at 100 percent.[119] Representatives from USA Rice have already met with COFCO during the June HOFEX† conference in Hong Kong, establishing a relationship with China's largest purchaser of foodstuffs.[120] Additionally, according to Greg Yielding, director for emerging markets at the U.S. Rice Producer's Association, Chinese consumers have demonstrated an interest in purchasing "high quality U.S. rice."[121] With increasing incomes and a number of food safety incidents occurring in recent years—including a 2013 report by the Guangdong provincial government that 44 percent of all tested rice and rice products contained excess levels of cadmium[122]—Chinese consumers have continuously increased their consumption of imported food.[123] In addition, U.S. producers may capitalize on China's emerging niche markets. China already has the fourth-largest organic food market in the world, valued at $5.6 billion in 2016 and growing quickly (in 2016, it grew an estimated 20 percent year-on-year).[124] With 58,994 tons of organic rice produced in the United States in 2015,[125] there are possibilities for expanded organic rice exports with little competition from China's more established rice sources.

* In February 2014, the Chinese Ministry of Commerce announced it was pulling out of a deal to purchase 1.2 million metric tons of rice from Thailand after Thailand's Anti-Corruption Commission began investigating then Prime Minister Yingluck Shinawatra's rice program due to a lack of transparency.

† HOFEX is an annual Asian food and hospitality trade show.

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