U.S.-China Economic and Security Review Commission

Economics and Trade Bulletin

August 6, 2018

Highlights of This Month's Edition

- **Bilateral trade:** In the first half of 2018, the U.S. goods trade deficit with China reached $185.7 billion, up about 9 percent year-on-year; in the month of June, U.S. agricultural exports to China declined 34.4 percent and livestock declined 39.2 percent year-on-year; in services, the United States reached a record high trade surplus with China in Q1 2018, but exports of travel—the main driver of U.S. service exports to China—slowed to their lowest year-on-year growth in 14 years.

- **Bilateral policy issues:** Following tariffs imposed July 6, the United States initiated WTO cases against five trade partners, and published a list of tariffs on $200 billion worth of additional Chinese imports, as China threatens retaliation; Chinese regulators fail to approve Qualcomm's proposed acquisition of NXP.

- **Quarterly review of China's economy:** China's officially-reported GDP growth slowed to 6.7 percent year-on-year in Q2 2018 as fixed asset investment, industrial output, and retail sales lose steam; Chinese policymakers implement measures to increase credit growth and spur economic activity despite pledges to focus on deleveraging; the RMB's value falls due to trade tensions and signs of an economic slowdown in China, raising concerns Beijing could use currency devaluations to offset the impact of U.S. tariffs.

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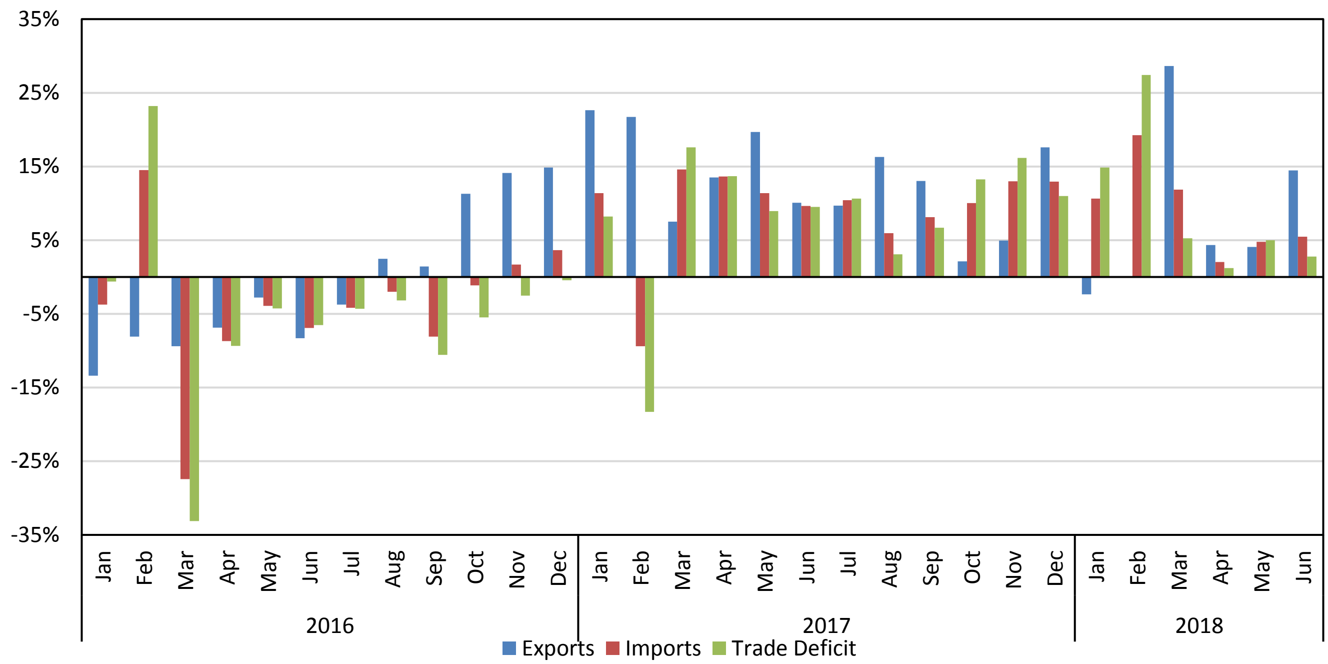
Bilateral Trade

U.S. Goods Deficit with China Expands on Stronger Imports in Q2 2018

In June 2018, the U.S. deficit in goods with China reached $33.5 billion, up 2.8 percent year-on-year; U.S. exports to China were $11.1 billion, up 14.5 percent year-on-year, and imports from China were $44.6 billion, a 5.5 percent increase year-on-year (see Figure 1). This month, U.S. exports increased primarily in aircraft and associated parts, and crude oil, while U.S. imports from China increased in clothing, toys, games and sporting goods, and cell phones.[1] Notably, in June U.S. agricultural exports to China fell 34.4 percent relative to the previous year. In addition, though U.S. farmers saw a surge in soybean exports, as sellers tried to get ahead of Chinese retaliatory tariffs, April and May agricultural exports to China also declined year-on-year.[2]

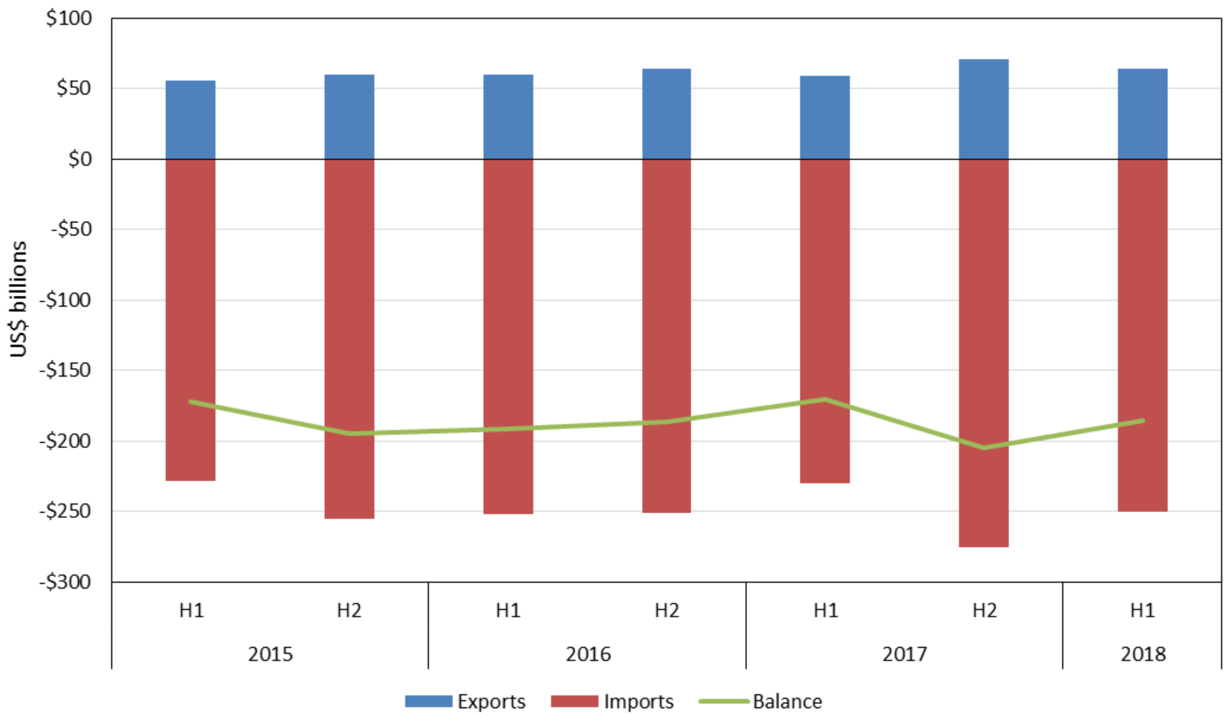
Figure 1: Monthly Goods Trade with China, June 2016–June 2018



Source: U.S. Census Bureau, Trade in Goods with China, August 3, 2018. *https://www.census.gov/foreign-trade/balance/c5700.html*.

In the first six months of 2018, U.S. imports from and exports to China increased by between 8 and 9 percent year-on-year (see Figure 2). The goods trade deficit for the first half of 2018 also increased about 9 percent—to $185.7 billion—relative to the first half of 2017. As shown in Figure 2, trade with China is marked by seasonal variation: greater export and import volumes typically occur in the second half of the year.

Figure 2: Goods Trade with China, January 2015–June 2018



Source: U.S. Census Bureau, Trade in Goods with China, August 3, 2018. *https://www.census.gov/foreign-trade/balance/c5700.html*.

U.S. Agriculture Exports to China Fall 14 Percent in Q2 2018

A review of the top five U.S. exports to and imports from China shows that transportation equipment comprises the largest share—about a fifth—of U.S. exports to China, while computers and electronic products make up about a third of U.S. imports from China (see Table 1). Notably, agricultural products—which are usually ranked into the top five—experienced a significant decline: 4.5 percent in April, 9.6 percent in May, and 34.4 percent in June relative to 2017, leading to an overall decline of 14.0 percent for Q2 2018. Exports of livestock and livestock products fell by 39.2 percent relative to the second quarter of 2017. U.S. agricultural exports to China usually pick up in late summer, but with Chinese retaliatory tariffs on U.S. agriculture in force, the coming months provide a window to examine their impact. Finally, waste and scrap exports remain impacted by the Chinese ban on imports of waste and scrap: exports fell 30.3 percent relative to 2017.*

Though transportation equipment maintained its place as the largest U.S. export to China, the value of transportation equipment's exports declined about 10 percent over the same period in 2017. Conversely, oil and gas exports continued to increase in the second quarter, with a 129 percent increase year-on-year.

* See "Sector Focus: China Ends Waste and Scrap Imports," in U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, October 5, 2017, 8. *https://www.uscc.gov/sites/default/files/Research/October%202017%20Trade%20Bulletin_0.pdf*.

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

U.S. Top-Five Exports to China

	Exports (in US$ millions)	Share of total (%)	Change over Q2'17 (%)
Quarter 2 (Apr-June'18)			
Transportation Equipment	6,441	20.1%	-10.7%
Computer and Electronic Products	4,378	13.7%	2.6%
Chemicals	4,342	13.6%	14.8%
Machinery, Except Electrical	3,258	10.2%	30.9%
Oil and Gas	2,787	8.7%	129.4%
Other	10,789	33.7%	-
Total	31,994	**100.0%**	
2018 Year-to-Date			
Transportation Equipment	12,495	19.5%	
Computer and Electronic Products	8,502	13.3%	
Chemicals	8,264	12.9%	
Machinery, Except Electrical	5,610	8.8%	
Oil and Gas	5,430	8.5%	
Other	23,716	37.0%	
Total	64,018	**100.0%**	

U.S. Top-Five Imports from China

	Imports (in US$ millions)	Share of total (%)	Change over Q2'17 (%)
Quarter 2 (Apr-June'18)			
Computer and Electronic Products	44,187	34.9%	3.1%
Electrical Equipment, Appliances, and Component	11,812	9.3%	7.8%
Machinery, Except Electrical	10,114	8.0%	10.2%
Miscellaneous Manufactured Commodities	8,679	6.9%	0.9%
Furniture and Fixtures	6,425	5.1%	2.4%
Other	45,410	35.9%	-
Total	126,627	**100.0%**	
2018 Year-to-Date			
Computer and Electronic Products	86,566	34.7%	
Electrical Equipment, Appliances, and Component	22,802	9.1%	
Machinery, Except Electrical	19,839	7.9%	
Miscellaneous Manufactured Commodities	17,669	7.1%	
Furniture and Fixtures	12,585	5.0%	
Other	90,278	36.1%	
Total	249,739	**100.0%**	

Source: U.S. Census Bureau, USA Trade Online, August 3, 2018. *https://usatrade.census.gov/*.

Advanced Technology Products Deficit Increases

The U.S. trade deficit with China in advanced technological products (ATP) stood at about $32.1 billion in the second quarter of 2018, up 3.7 percent over the second quarter of 2017 (see Table 2).

Table 2: ATP Trade through June 2018

(US$ millions)

Quarter 2	Quarterly					Cumulative year-to-date			
	Exports	Imports	Balance Q2'2018	Balance Q2'2017	Balance YOY	Exports	Imports	Balance 2018	Balance 2017
TOTAL	**8,887**	**40,973**	**-32,086**	**-30,954**	**3.7%**	**16,888**	**80,668**	**-63,780**	**-57,896**
(01) Biotechnology	226	68	158	170	-6.6%	445	125	320	381
(02) Life Science	1,016	728	288	318	-9.5%	1,882	1,374	509	504
(03) Opto-Electronics	247	1,001	-755	-851	-11.3%	375	1,899	-1,524	-1,462
(04) Information & Communications	1,007	36,990	-35,983	-34,795	3.4%	1,951	73,056	-71,104	-64,501
(05) Electronics	1,514	1,343	171	263	-34.7%	3,112	2,597	515	737
(06) Flexible Manufacturing	1,263	391	872	535	63.0%	2,055	763	1,293	997
(07) Advanced Materials	72	127	-55	-48	15.5%	140	229	-89	-45
(08) Aerospace	3,521	293	3,228	3,467	-6.9%	6,882	567	6,315	5,350
(09) Weapons	1	28	-28	-31	-11.0%	1	53	-52	-55
(10) Nuclear Technology	21	4	17	19	-6.6%	45	6	39	198

Source: U.S. Census Bureau (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, August 2018). *http://www.census.gov/foreign-trade/statistics/product/atp/2017/12/ctryatp/atp5700.html*.

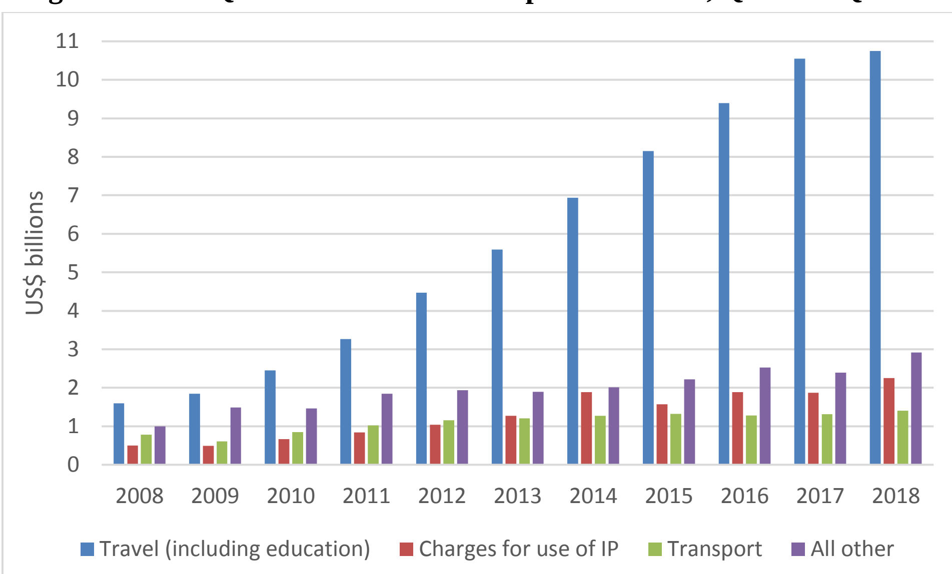
Information and communication technology (ICT) remained the greatest contributor to the deficit, with $37.0 billion in imports from China compared to $1.0 million exports from the United States to China. The ICT deficit increased about 10.2 percent year-on-year in the first half of 2018. The United States' largest ATP export to China, aerospace technology, decreased about 18 percent in the first half of 2018 compared to the first half of 2017.

U.S. Service Trade Surplus with China Reaches Record High in Q1 2018

In the first quarter of 2018, strong export growth drove the U.S. services surplus with China to reach a record high of $12.9 billion, a 6.4 percent year-on-year increase.[3] Services now account for 35 percent of total U.S. exports to China and 3.5 percent of total U.S. imports from China, up from 19.7 percent and 2.9 percent, respectively, in the first quarter of 2013.[4]

U.S. services exports to China in Q1 2018 increased 16 percent year-on-year to reach their highest level yet, at $17.3 billion, due to high levels of U.S. travel exports and strong growth in U.S. exports of intellectual property (IP) charges.[5] U.S. exports of travel, which include Chinese students coming to the United States to study,[*] dominate U.S. services trade with China, accounting for 62 percent of total U.S. services exports to China in the first quarter of 2018 (see Figure 3).[6] Growth in travel exports slowed to 1.8 percent year-on-year—their slowest first quarter growth since 2004—to reach $10.7 billion.[7] U.S. exports of IP charges, the second-largest category, grew 20.7 percent year-on-year to reach $2.3 billion; transportation totaled $1.4 billion, a 6.8 percent year-on-year increase.[8] While only accounting for 1.5 percent of total U.S. services exports, telecommunications, computer, and information services exports to China saw 60 percent year-on-year growth, a record, to reach $256 million.[9]

Figure 3: First Quarter U.S. Services Exports to China, Q1 2008–Q1 2018



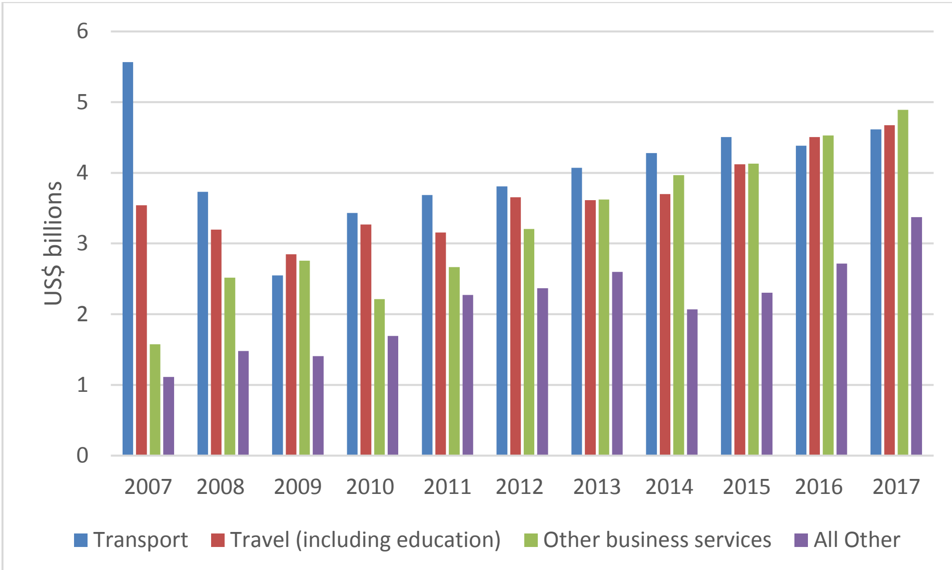
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *U.S. International Transaction, Expanded Detail by Area and Country*, U.S. Department of Commerce, Foreign Trade Division, June 20, 2018.

U.S. imports of Chinese services grew 10.3 percent year-on-year to reach $4.4 billion.[10] Transportation, travel (including for education), and other business services accounted for 79.2 percent of U.S. services imports from China (see Figure 4).[11] Transportation grew 7.8 percent year-on-year to reach $1.2 billion; travel (including for

[*] 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*.

education) increased 10.4 percent to reach $1.1 billion; and other business services increased 8 percent year-on-year to reach $1.1 billion.[12] U.S. imports of IP charges, government goods and services, and telecommunications, computer, and information services saw strong year-on-year growth in the first quarter of 2018, increasing 53.3 percent, 23.8 percent, and 21.4 percent, respectively.[13]

Figure 4: First Quarter U.S. Services Imports from China, Q1 2008–Q1 2018



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *U.S. International Transaction, Expanded Detail by Area and Country*, U.S. Department of Commerce, Foreign Trade Division, June 20, 2018.

Bilateral Policy Issues

The United States and China Manage Tariffs' Impact

Following the recent imposition of tariffs, both the United States and China moved to shield their economies while taking retaliatory action. According to U.S. Trade Representative Robert Lighthizer, U.S.-China trade tensions will "take time" to resolve.[14]

In the wake of the Section 301 investigation into China's practices on technology transfer, IP infringement, and licensing, the United States imposed 25 percent tariffs on $34 billion worth of Chinese imports. China retaliated with equivalent tariffs on U.S. imports, and both sets of tariffs went into force on July 6. The Trump Administration took measures to confront and ameliorate the effect of Chinese trade retaliation on the United States, including: (1) launching five cases at the World Trade Organization (WTO); (2) scheduling retaliatory tariffs on an additional $200 billion of Chinese imports; and (3) announcing an emergency relief package to protect U.S. farmers from retaliatory tariffs abroad. Similarly, Chinese officials have moved to respond to U.S. trade challenges with nontariff measures and additional tariffs while softening the impact of U.S. tariffs.

Following China's retaliatory tariffs, prices for key U.S. agricultural exports have declined. Some examples include:

- *Soy:* China accounted for about 57 percent of U.S. soy exports in 2017.* Thus far, Chinese soy importers have "accounted for only 17 percent of all advanced purchases," and prices of U.S. soy have hit their lowest point in nearly ten years.[15]
- *Pork:* In 2018, falling prices for U.S. hog farmers due to tariffs abroad has coincided with a surge in U.S. hog supply. Iowa State University economist Dermot Hayes stated that hog futures fell by $18 per animal, leading to a projected "$2.2 billion loss on an annualized basis."[16] U.S. pork production is on track to "reach an all-time high" in 2018, but U.S. demand has not kept pace.[17] The National Pork Producers Council calculated China and Mexico have imposed retaliatory tariffs on about "40 percent of American pork exports."[18]
- *Almonds:* Almond prices have fallen by more than 10 percent since May; China's tariff adds a 50 percent tax.[19] The Almond Board of California found that export volume commitments declined 26 percent in June 2018 relative to the prior year.[20] A senior marketing director at Stewart & Jasper Orchards noted: "No one wants to take an advance position on contract because they're afraid that there will be another tariff down the line."[21]

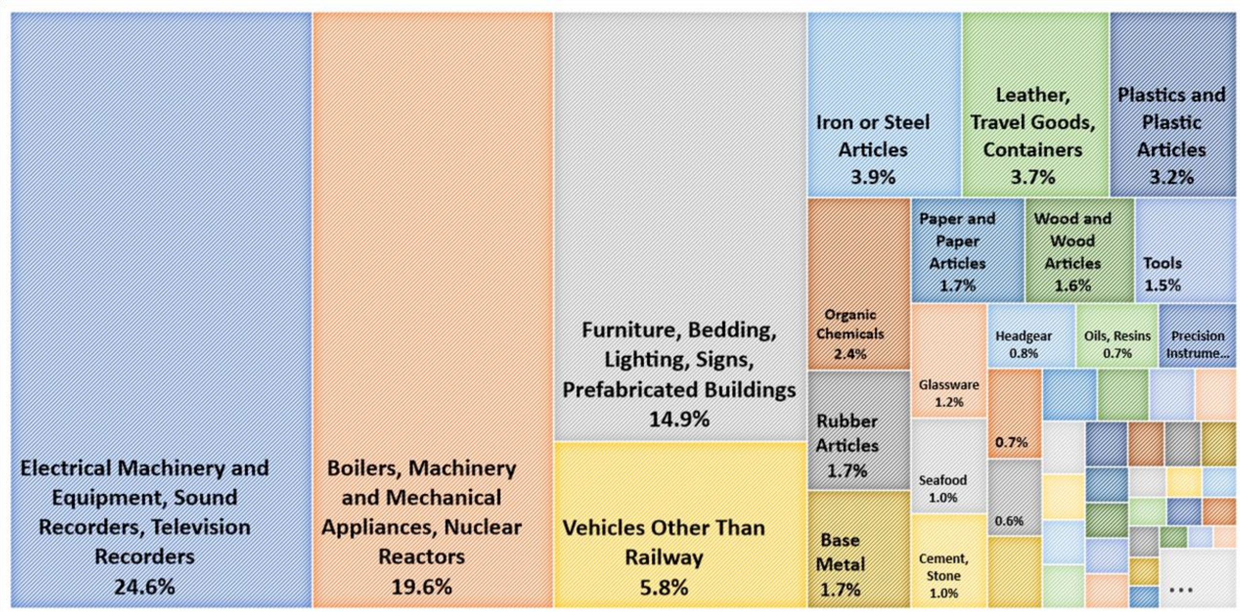
To address retaliation from China and other trade partners, the Trump Administration has taken three steps:

1. *WTO cases:* On July 16, the United States requested five separate consultations—the first step to launching a WTO case—with China, the EU, Canada, Mexico, and Turkey.[22] Each case contests a trading partner's tariffs imposed in retaliation for U.S. tariffs on its steel and aluminum exports.[23] The Office of the U.S. Trade Representative (USTR) said U.S. steel and aluminum tariffs imposed are allowed under international agreements, while retaliatory tariffs "are completely without justification under the WTO."[24]
2. *Retaliatory tariffs on Chinese imports:* On July 10, the USTR released an additional list of U.S. imports from China subject to a 10 percent tariff (which was raised to 25 percent on August 1), estimated to affect $200 billion in imports (see Figure 5).[25] The USTR noted the additional tariffs were being imposed, "As a result of China's retaliation and failure to change its practices."[26] Though the published list includes over 6,000 tariff lines, 52 tariff lines capture about half of these imports' 2017 trade value.[27] According to 2017 data from the U.S. International Trade Commission, about half of this import value falls broadly into several industries: telephones and related phone parts; machinery, parts, and accessories for calculation and automatic data processing; office equipment; seats; motor vehicles and auto parts; lighting; trunks, bags, and cases; electric transformers; insulated wire; and valves and equipment for pipes.[28] As in the prior two tariff lists published by the USTR, this product list will undergo a public comment period through August 17, and a hearing is scheduled for August 20–23.[29]

* For more information, see "China Imposes Wide-Ranging Tariffs on U.S. Products, Takes Steps to Lessen Impact of U.S. Tariffs" in U.S.-China Economic and Security Review Commission, *Economic and Trade Bulletin*, July 9, 2018. *https://www.uscc.gov/sites/default/files/trade_bulletins/July%202018.pdf*.

Figure 5: U.S. Imports from China Affected by Proposed Tariffs on $200 Billion Worth of Products

(by product category; 2017 trade value)



Source: Staff calculations using 2017 trade values from the U.S. International Trade Commission Dataweb and HTS2 product codes; Office of the U.S. Trade Representative, Docket Number USTR-2018-0026: Request for Comments Concerning Proposed Modification of Action Pursuant to Section 301: China's Acts, Policies, and Practices related to Technology Transfer, Intellectual Property, and Innovation, July 10, 2018. *https://ustr.gov/sites/default/files/301/2018-0026%20China%20FRN%207-10-2018_0.pdf*.

3. *Relief for U.S. farmers:* On July 24, U.S. Secretary of Agriculture Sonny Perdue announced a $12 billion relief package to support U.S. farmers impacted by retaliatory tariffs abroad.[30] This package would issue incremental payments to soybean, sorghum, corn, wheat, cotton, dairy, and hog farmers, while allowing the U.S. Department of Agriculture to purchase "unexpected surplus" of products like "fruit, nuts, rice, legumes, beef, pork, and milk," providing a buyer for those products.[31] In testimony before the Senate Committee on Appropriations, Ambassador Lighthizer stated: "It is the view of the Administration that agriculture has been particularly targeted by [trade] retaliation."[32] No relief packages were announced for other industries affected by retaliatory tariffs.

For China, increased tension with the United States comes at a difficult time. The government's efforts to control credit expansion have led to increased regulation of "shadow banking," or more risky, off-balance-sheet debt.[33] While many financial observers agree such a move was overdue, it has impacted corporate financing.[34] (See "Beijing's Commitment to Debt and Deleveraging Efforts in Doubt.") Tariff actions have not helped this climate. After peaking in mid-January, the Shanghai Composite Index fell to a two-year low ahead of tariffs imposed on July 6.[35] In July, China's Purchasing Managers' Index (PMI) fell to a five-month low, though it still indicates an expansion of activity.[36] Data from the National Bureau of Statistics (NBS) showed new export orders slowing for the second month, and the first decline in imports in five months.[37] (See "Investment, Industrial Output, and Retail Sales Lose Steam.")

Chinese government officials likewise took measures to address U.S. trade pressures. As China imports less from the United States than it exports to the United States, its retaliation actions include nontariff measures:

1. *NXP-Qualcomm deal failure:* On July 26, Qualcomm announced it would end its $44 billion bid to acquire NXP Semiconductors N.V. after 21 months.[38] Many observers see the failed NXP-Qualcomm deal as a casualty of rising trade tensions, though China's Ministry of Commerce denied that the Chinese

government's failure to approve the deal was politically motivated.[39] According to Cornell University economist Eswar Prasad, the deal's collapse "is a strong signal that China is going to use every available lever [in responding to economic frictions]."[40]

2. *People's Bank of China (PBOC) policy:* Given China's economic headwinds, analysts have watched the PBOC for any stimulus: the reserve requirement ratio* and the value of China's currency, the renminbi (RMB). The PBOC has already cut the reserve requirement ratio for specific banks three times in 2018.[41] These moves lower the cash deposits some banks must keep on hand, allowing them to disperse more credit.[42] In addition, the value of the RMB declined against the dollar; while the decline may not be in direct response to tariff actions, it may provide a cushion for Chinese exports.[43] (See "RMB Value Falls, Raising Concerns of Currency Manipulation.")

3. *Retaliatory tariffs on U.S. imports:* China's State Council announced it would impose a series of retaliatory tariffs on $60 billion worth of U.S. exports to China if the United States applies additional tariffs on Chinese products.[44] Proposed Chinese tariffs would range from 5 to 25 percent and affect 5,207 types of U.S. goods.[45] An implementation date is pending and contingent on U.S. action, and the State Council said, "China reserves the right to introduce other countermeasures."[46]

Quarterly Review of China's Economy

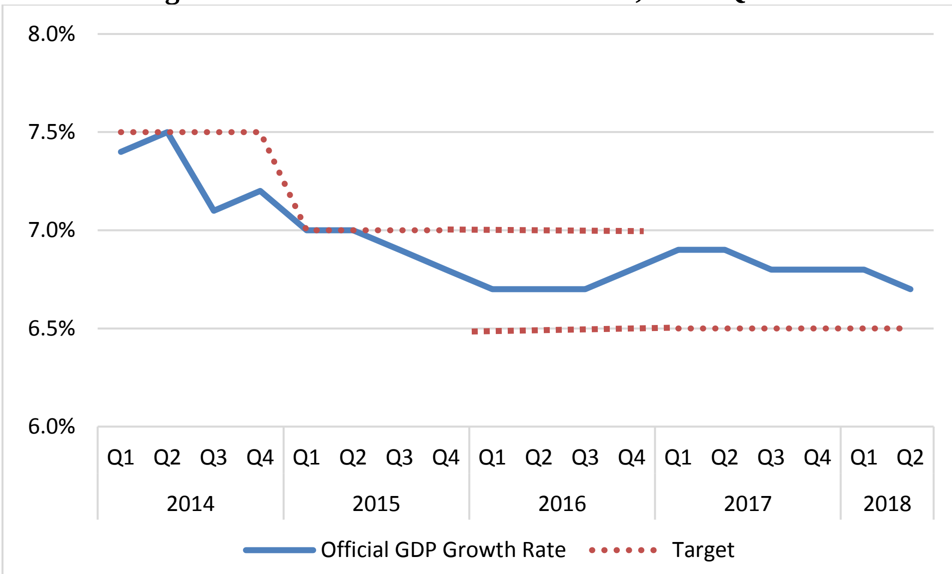
China's Gross Domestic Product Growth Slows to 6.7 Percent in Q2 2018

China's officially reported gross domestic product (GDP) grew 6.7 percent year-on-year in the second quarter of 2018, a slight decline from the first quarter's 6.8 percent growth, but still above Beijing's annual target of "around 6.5 percent" (see Figure 6). The deceleration in China's economy comes as Beijing's ongoing deleveraging campaign weighed on domestic demand and raised corporate borrowing costs.[47]

The impact of China's trade conflict with the United States is not yet apparent in Chinese trade data (see "Bilateral Trade").[48] In the first half of 2018, growth in Chinese exports increased by 4.9 percent year-on-year, while Chinese imports grew 11.5 percent year-on-year; China's overall trade surplus shrank by 26.7 percent year-on-year.[49] China's exports grew at a solid pace in June—increasing 11.3 percent from a year earlier—although analysts believe this may have been boosted by exporters front-loading shipments to get ahead of expected tariffs.[50]

* The reserve requirement ratio regulates how much funds a depository institute (e.g., bank) must hold in reserve against the money it holds for its customers. This ratio is typically set by a country's central bank governors. See Board of Governors of the Federal Reserve System, *Reserve Requirements*. *https://www.federalreserve.gov/monetarypolicy/reservereq.htm*.

Figure 6: China's Official GDP Growth, 2014–Q2 2018



Note: In 2016, the GDP growth target was set at a range of 6.5–7.0 percent.
Source: China's National Bureau of Statistics via CEIC database; Li Keqiang, *Report on the Work of the Government* (First Session of the 13th National People's Congress, Beijing, China, March 5, 2018), 20.

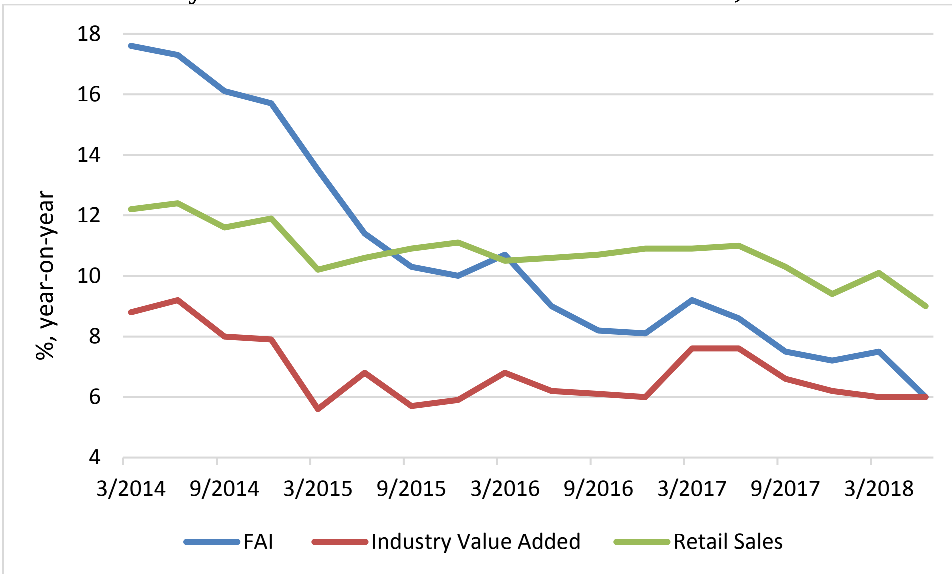
The intensifying trade conflict is expected to dampen China's export growth and economic growth more broadly in the second half of 2018, after the United States and China both imposed $34 billion in tariffs that went into effect on July 6, 2018 (with more tariffs expected at a later date).[51] Economists estimate China's trade conflict with the United States could reduce China's GDP growth by 0.2 to 0.5 percentage points over the next 12 months.[52] China's National Bureau of Statistics spokesman Mao Shengyong said that "external uncertainties are increasing while domestic structural adjustment is [going through a] crucial stage," but maintained the impact of a trade war on China's economy "should be limited."[53] At the July 31 meeting of the Chinese Communist Party (CCP) Politburo, China's top leadership highlighted that China's economy faced new challenges due to "obvious changes in the external environment" and pledged to maintain economic stability in the second half of 2018 through "a proactive fiscal policy and prudent monetary policy."[54] The official statement released after the meeting sought to mitigate concerns that Beijing might retaliate against U.S. trade actions by targeting U.S. firms, noting the "legitimate rights of foreign-funded companies in China will be protected."[55]

Investment, Industrial Output, and Retail Sales Lose Steam

In the first half of 2018, fixed asset investment (FAI),* a traditional engine of China's growth, slowed to 6 percent year-on-year, down from 8.6 percent year-on-year in the first half of 2017—the slowest pace of expansion on record (see Figure 7).[56] Growth in infrastructure investment—a key contributor to FAI growth—tumbled to 7.3 percent in the first half of 2018, compared to 21.1 percent a year ago, due to tighter scrutiny on investment projects to curb debt risks.[57] Private investment growth outpaced that of state-owned enterprises (SOEs): private sector investment increased 8.4 percent year-on-year in the first half of 2018, up from 7.2 percent year-on-year in the first half of 2017, while SOEs' investment fell to 3 percent year-on-year in the first half of 2018, down from 12 percent during the same period a year ago.[58]

* FAI 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 7: China's Key Economic Indicators Point to a Slowdown, March 2014–June 2018



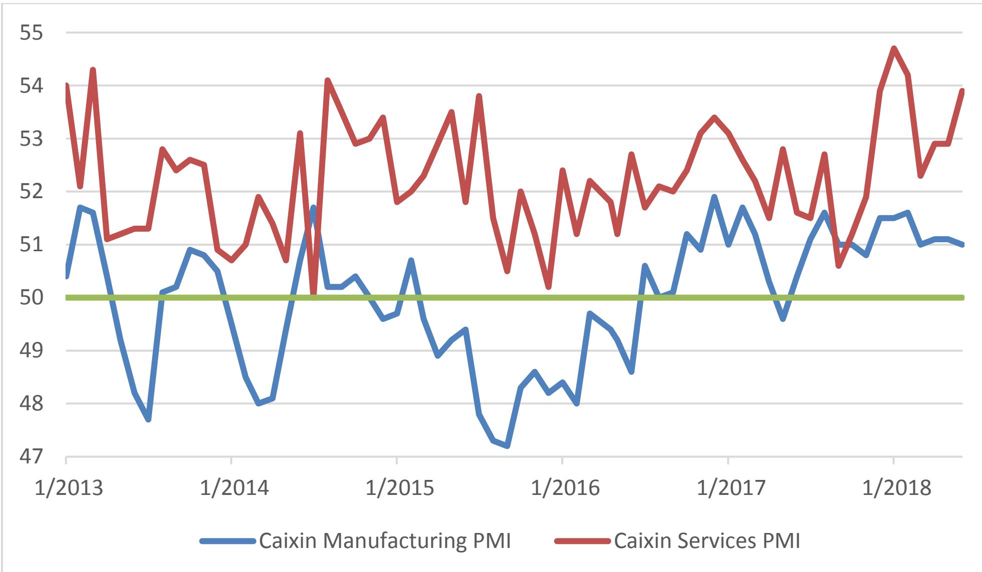
Source: China's National Bureau of Statistics via CEIC database.

China's industrial output slowed in June 2018, growing 6 percent year-on-year in June after increasing 6.8 percent in May and 7 percent in April.[59] Unofficial estimates by the Chinese financial media firm Caixin found China's manufacturing PMI,[*] a measure of economic expansion and industrial utilization, declined slightly to 51 in June 2018 from May's 51.1, as Chinese companies face rising input prices and a decline in export orders amid a growing trade dispute with the United States (see Figure 8).[60] Growth in China's services sector was more robust. According to Caixin, China's services PMI rose to 53.9 in June 2018 from 52.9 in May, marking a fourth-month high as new orders and employment at services companies strengthened.[61]

Consumption is an increasingly important contributor to China's economy, accounting for 78.5 percent of the country's economic growth in the first half of 2018, compared to 58.8 percent in full-year 2017.[62] However, retail sales of consumer goods—a proxy for overall consumption—were lackluster, growing 9 percent year-on-year in June from a year ago, compared with 8.5 percent in May and 9.4 percent in April.[63] Investment in China's real estate sector, another major driver for the economy, also saw slower growth in the first half of 2017, due in part to increased curbs on buyers and higher borrowing costs.[64] Investment in China's property market increased 9.7 percent year-on-year, slightly slower than the 10.2 percent expansion during the first five months of 2018.[65]

[*] The PMI measures the production level, new orders, inventories, supplier deliveries, and employment level to gauge the economic activity level in the services and manufacturing sector. The global financial information services provider Markit Economics compiles the Caixin-Markit China services and manufacturing PMI from monthly questionnaires answered by more than 400 purchasing executives (including small and medium-sized enterprises). By comparison, China's official manufacturing PMI tracks larger state-owned companies, generally leading to a stronger reading than private PMIs.

Figure 8: Caixin Services and Manufacturing PMIs, 2013–Q2 2018



Note: A reading above 50 indicates expansion; a reading below 50 shows contraction.
Source: Caixin and IHS Markit, "Caixin China General Services PMI," *Markit Economics*, July 4, 2018. *https://www.markiteconomics.com/Survey/PressRelease.mvc/f3def1f2fa794521a71c09853d7b057e*; Caixin and IHS Markit, "Caixin China General Manufacturing PMI," *Markit Economics*, July 2, 2018. *https://news.ihsmarkit.com/press-release/financial-markets/caixin-china-general-manufacturing-pmi-final-data*.

Beijing's Commitment to Debt and Deleveraging Efforts in Doubt

Slowing economic growth threatens to derail Chinese government efforts to reduce corporate and local government debt. At a December 2017 economic conference in Beijing, Chinese policymakers agreed that excessive leverage poses a threat to long-term economic stability. A statement from the conference read, "Prudent monetary policy should be kept neutral, the floodgates of monetary supply should be controlled, and credit and social financing should see reasonable growth."[66] To this end, policymakers announced new measures to slow—and eventually reverse—China's debt growth, including enhancing enforcement of existing financial rules, increasing punishments for violators of those rules, and engaging in preventative measures (e.g., reducing growth in speculative banking assets).[67]

In 2017 and the first quarter of 2018, Beijing focused on ending credit growth in unproductive industries and reducing interbank lending in an effort to slow debt accumulation without impacting overall economic growth.[68] In 2017, Beijing cut off new debt to upstream material industries like steel, aluminum, and mining, with leverage growth in these industries dropping to nearly zero, down from 17 percent a year earlier.[*] In September 2017, the PBOC also announced a ban on issuing long-term interbank deposits, which had surged in recent years as small lenders began relying on them as a funding source.[69] These long-term deposits created artificial asset growth without adding any value to the economy, as Chinese banks (both state-owned and private) began buying each other's bonds.[70] Efforts to crack down on these sources of credit proved successful, as China's nonfinancial sector leverage ratio growth increased just 0.4 percentage points, down from 12.1 percentage points in 2016.[71]

[*] According to Gene Ma, chief China economist at the Institute of International Finance, China's upstream industries are largely unproductive and contribute little to the country's economic growth; mining industries (except mining equipment industries) experienced value-added growth of -0.9 percent in 2017, meaning they detracted from economic growth. Gene Ma, "China's Credit Risks," *Center for Strategic and International Studies*, May 14, 2018. *https://www.csis.org/events/xis-three-battles-chinas-credit-risks*; China's National Bureau of Statistics via CEIC database.

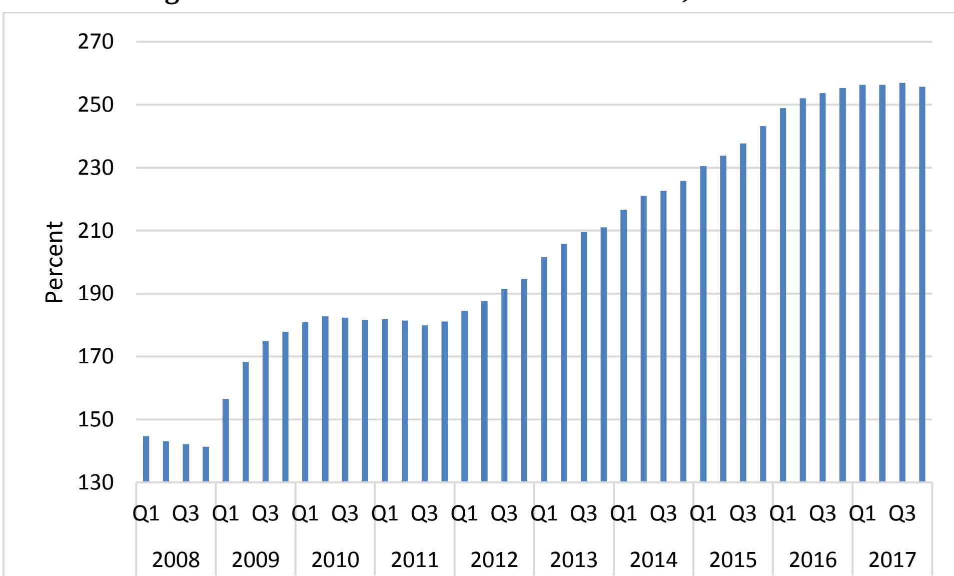
However, escalating trade tensions with the United States, coupled with signs of slowing growth across several of China's leading economic indicators, have raised questions about the country's economic stability.[72] In June 2018, a leaked report from the National Institute of Finance and Development, a Chinese government-backed think tank, concluded that "China is currently extremely likely to experience a financial panic" due to a combination of trade tensions, RMB depreciation, tight liquidity, and bond defaults, among other factors.[73]

Faced with these economic concerns, Beijing appears to be suspending deleveraging efforts in favor of supporting GDP growth. In June 2018, the PBOC cut banks' reserve requirement ratio—the third time it has done so in 2018—freeing up around $108 billion in hopes of spurring new lending and investment.[74] The next month, it lent more than $73 billion to commercial banks in an effort to boost their liquidity, the largest capital injection of this kind since 2014.[75] A government statement also called for increased government spending on infrastructure projects and to keep credit liquidity conditions "reasonable and adequate," a sign that banks will begin loosening their credit restrictions.[76] Despite this recent policy shift, Chinese policymakers reiterated in a July 2018 statement that their focus remains on reducing debt and creating jobs in the second half of 2018.[77]

Chinese Debt-to-GDP Ratio Continues to Climb

According to data from the Bank for International Settlements, China's total debt (government and private) reached 255.7 percent of GDP—or $32.5 trillion—in the fourth quarter of 2017, up from 141.3 percent of GDP at the end of 2008 (see Figure 9).* While China's corporate debt-to-GDP ratio fell 6 percent in 2017 compared to 2016 levels, household debt (up 4 percent) and government debt (up 2.5 percent) both increased as a percentage of GDP.[78]

Figure 9: China's Total Debt-to-GDP Ratio, 2008–2017



Source: Bank for International Settlements, "Long Series on Total Credit to the Non-Financial Sectors," June 5, 2018.

A 2018 International Monetary Fund (IMF) report on China's economic development indicated the rise in Chinese government and household debt is driven by increased state investment and a surge in mortgage and consumer loans.[79] The report urged Chinese policymakers to "stay the course on tightening macro-financial settings to continue to rein in credit growth," which may require the government to deemphasize growth targets and resist loosening credit if growth falls.[80]

* In comparison, the United States' total debt reached $48.3 trillion, or 249.2 percent of GDP, in the fourth quarter of 2017. Bank for International Settlements, "Long Series on Total Credit to the Non-Financial Sectors," June 5, 2018.

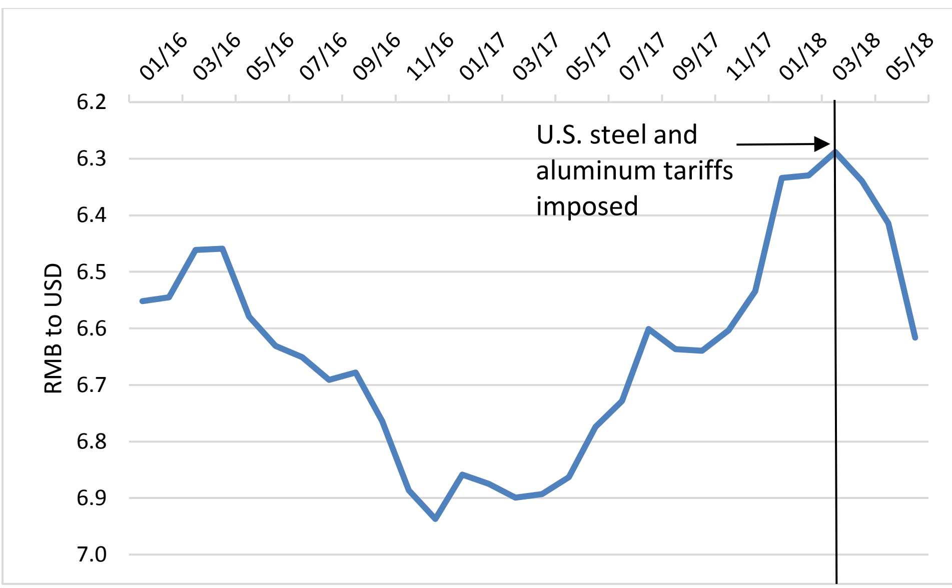
The largest category of debt is held by nonfinancial corporations, comprising nearly two-thirds of China's total debt.[81] Corporate debt reached 160.3 percent of GDP in the fourth quarter of 2017, down from its peak of 166.9 percent in the second quarter of 2016.[82] China's corporate debt largely consists of loans made to SOEs by state-owned banks; SOEs continue to enjoy privileged access to bank loans in return for delivering investments and public services in line with Chinese government interests.[83] According to estimates from the IMF, SOEs account for around 55 percent of corporate debt.[84]

Economists are particularly concerned about the growth of household debt, which increased from 38.8 percent of GDP in the fourth quarter of 2015 to 48.4 percent in the fourth quarter of 2017.[85] The rapid accumulation of household debt is the result of Chinese government policies aimed at encouraging increased borrowing and spending—particularly on cars and real estate—to boost consumption and investment, as well as rising housing prices.[86] Because the average Chinese households rely on limited incomes, economists fear they will not be able to pay off their debts and instead dry up liquidity in China's financial system over the long term.[87]

RMB Value Falls, Bringing Back Concerns of Currency Manipulation

In January 2018, the PBOC took steps to reduce its control over the exchange rate, removing a banking mechanism that was introduced last year to support the RMB's value against the U.S. dollar and push back against capital flight.* The change signaled that Chinese policymakers had become more confident in the RMB's trajectory after the currency's value strengthened relative to the U.S. dollar for the first time in four years in 2017.[88] However, increased economic uncertainty in China and escalating trade tensions with the United States led the RMB to depreciate 5.2 percent between March and June 2018 (see Figure 10).[89] The RMB's value against the dollar is now back at a level similar to where it was pegged in 2008–2010.[90] The significant currency depreciation has alarmed some global investors, who fear the Chinese government is intentionally allowing its currency to weaken in order to support exports.[91]

Figure 10: RMB to U.S. Dollar Exchange Rate, January 2016–June 2018



Source: People's Bank of China via CEIC database.

* The PBOC reduced its control over the "counter-cyclical factor" mechanism, which allowed the bank to set the daily midpoint of the RMB's dollar exchange rate. The mechanism had effectively lessened the impact of market forces in determining the RMB exchange rate. *Bloomberg News*, "China Changes the Way It Manages Yuan after Currency's Jump," January 8, 2018. *https://www.bloomberg.com/news/articles/2018-01-09/china-is-said-to-shift-way-it-manages-yuan-after-currency-s-jump*.

Chinese policymakers believe managing the RMB's exchange rate is necessary for preventing significant depreciation and reassuring global and domestic investors about the stability of China's economy.[92] However, Beijing's control over the exchange rate also presents a potential tool for responding to U.S. trade enforcement actions. If China's economic growth begins to slow as a result of U.S. tariffs, Chinese policymakers could weaken the RMB, increasing demand for Chinese products abroad.[93] According to Brad Setser, senior fellow for international economics at the Council on Foreign Relations, a 10 percent currency depreciation against a basket of currencies generally raises net exports by about 1.5 percentage points of GDP, potentially offsetting any economic slowdown from U.S. tariffs.[94] However, using RMB devaluations as a tool to offset the impact of trade tensions is risky; significant currency devaluations could spark increased capital outflows as investors seek to move their money out of China.[95] If capital outflows do surge, the PBOC would likely buy RMB with its foreign reserves to artificially create demand and support the RMB's value, much like it did in 2015 and 2016.[*]

Chinese policymakers have pledged not to use the RMB as a tool in trade conflicts, with PBOC Governor Yi Gang saying China will "keep the yuan exchange rate basically stable at reasonable and balanced level."[96] If Beijing wants to keep its currency's value stable, it seemingly has the ability to do so; the PBOC maintains around $3.1 trillion in foreign reserves that it could sell off to support the RMB's value, while China's state banks have a net foreign asset position of over $500 billion and the China Investment Corporation (CIC, a sovereign wealth fund) has $270 billion in its foreign portfolio.[97]

[*] China's foreign reserves fell $980 billion from their $3.98 trillion peak in June 2014 to $3 trillion in January 2017. People's Bank of China via CEIC database; Brad Setser, "Devaluation Risk Makes China's Balance of Payments Interesting (Again)," *Follow the Money* (Council on Foreign Relations Blog), July 2, 2018. *https://www.cfr.org/blog/devaluation-risk-makes-chinas-balance-payments-interesting-again*.

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