U.S.-China Economic and Security Review Commission

Economics and Trade Bulletin

August 5, 2019

Highlights of This Month's Edition

- **Bilateral trade:** U.S. goods deficit with China reached $87 billion in Q2 2019, down 8 percent year-on-year; U.S. Q1 2019 services trade surplus with China fell for the first time since 2006.
- **Bilateral policy issues:** President Trump announced new tariffs on Chinese goods effective September 1, citing China's failure to make large purchases of U.S. agricultural goods and curb the flow of fentanyl to the United States; the WTO issued a mixed ruling on China's challenge of U.S. calculation of tariffs on certain Chinese goods; the Trump Administration issued a memorandum calling out WTO standards on developing country status for China and others.
- **Quarterly review of China's economy:** China's gross domestic product (GDP) grew 6.2 percent in Q2 2019 as stimulus deployed earlier in the year wore off; escalating trade tensions also hurt industrial profits as export growth collapsed, prompting fears about employment stability.
- **Policy trends in China:** In an approach different from the recent takeover of Baoshang Bank, China's financial regulators assisted the struggling Bank of Jinzhou by facilitating investment from three state-run investment firms; trading began on China's new technology trading platform, but performance has been uneven.

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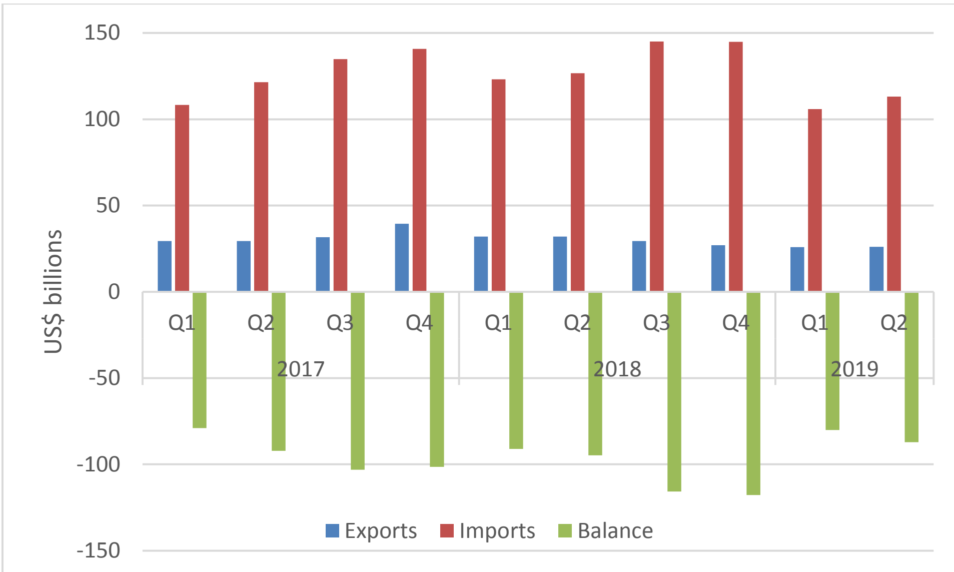
Bilateral Trade

U.S. Goods Exports and Imports Down in Q2 2019

The U.S. goods trade deficit with China reached $87 billion in the second quarter of 2019, a decline of 8 percent from the second quarter of 2018 (see Figure 1). A sustained fall in exports and imports contributed to the decline, with U.S. exports to China reaching $26 billion (down 18.7 percent year-on-year) and U.S. imports totaling $113 billion (down 10.7 percent year-on-year) as reciprocal tariff actions continued to impact bilateral trading patterns and narrow the U.S. goods trade deficit with China. In the first six months of 2019, the U.S. goods trade deficit with China was $167 billion, down 10.1 percent from the same period in 2018.

Figure 1: Quarterly Trade with China, Q1 2017 – Q2 2019



Source: U.S. Census Bureau, *Trade in Goods with China*, August 5, 2019. *https://www.census.gov/foreign-trade/balance/c5700.html.*

Transportation Equipment Exports Fall, Electronics Imports Sustain Decline

U.S. exports of transportation equipment—the top U.S. export to China in 2018—fell 36.4 percent year-on-year (see Table 1). U.S. exports of agricultural products—targeted by Chinese retaliatory tariffs—were up 55.7 percent year-on-year from a low base in the second quarter of 2019 as Chinese state grain buyers made modest goodwill purchases of U.S. soybeans against the backdrop of trade negotiations.[1] Computer and electronic products still accounted for nearly a third of all U.S. imports from China, but imports of this product category continued to decline year-on-year, falling by 15.7 percent relative to the second quarter of 2018.

Table 1: U.S. Trade with China: Top Five Exports and Imports, Q2 2019

U.S. Trade with China, June 2019

U.S. Top-Five Exports to China	Exports (in US$ millions)	Share of total (%)	Change over Q2'18 (%)	**U.S. Top-Five Imports from China**	Imports (in US$ millions)	Share of total (%)	Change over Q2'18 (%)
Quarter 2 (Apr-June'19)				*Quarter 2 (Apr-June'19)*			
Computer & Electronic Products	$4,671.03	18.0%	6.8%	Computer & Electronic Products	$37,155.71	32.9%	-15.7%
Transportation Equipment	$4,094.26	15.7%	-36.4%	Electrical Equipment, Appliances & Components	$10,881.13	9.6%	-8.4%
Chemicals	$3,808.58	14.6%	-11.9%	Miscellaneous Manufactured Commodities	$9,096.69	8.0%	4.9%
				Machinery, Except Electrical	$8,544.74	7.6%	-15.6%
Machinery, Except Electrical	$3,123.26	12.0%	-4.0%				
Agricultural Products	$1,848.37	7.1%	55.7%	Apparel & Accessories	$6,061.13	5.4%	1.0%
Other	$8,460.75	32.5%		Other	$41,331	36.6%	
Total	$26,006.26	**100.0%**		**Total**	$113,070.36	**100.0%**	

Source: U.S. Census Bureau, USA Trade Online, August 5, 2019. *https://usatrade.census.gov/*.

Advanced Technology Deficit Continues to Narrow

The U.S. trade deficit with China in advanced technology products (ATP) declined by 17.4 percent year-on-year to $26.5 billion in the second quarter of 2019 (see Table 2). ATP imports totaled $34.5 billion, down from $41 billion in the second quarter of 2018. A sustained fall in imports of information and communications technology (the largest U.S. ATP import from China) drove the overall decline in U.S. ATP imports. U.S. exports of electronics to China grew by nearly 50 percent year-on-year in the first six months of 2019, as U.S. exporters rushed to complete sales prior to tightened U.S. export controls on select technology products.

Table 2: U.S. Trade with China in ATP, Q2 2019
(US$ millions)

	Exports	Imports	Balance Q2'2019	Balance Q2'2018	Balance YOY
TOTAL	**$8,004**	**$34,499**	**-$26,495**	**-$32,087**	**-17.4%**
(01) Biotechnology	$255	$50	$205	$159	29.2%
(02) Life Science	$960	$628	$332	$288	15.3%
(03) Opto-Electronics	$160	$1,081	-$921	-$755	21.9%
(04) Information & Communications	$827	$31,349	-$30,522	-$35,983	-15.2%
(05) Electronics	$2,156	$791	$1,365	$171	697.7%
(06) Flexible Manufacturing	$1,268	$217	$1,051	$872	20.6%
(07) Advanced Materials	$65	$72	-$7	-$55	-87.3%
(08) Aerospace	$2,276	$278	$1,998	$3,228	-38.1%
(09) Weapons	$0	$31	-$31	-$27	12.8%
(10) Nuclear Technology	$37	$2	$35	$17	104.7%

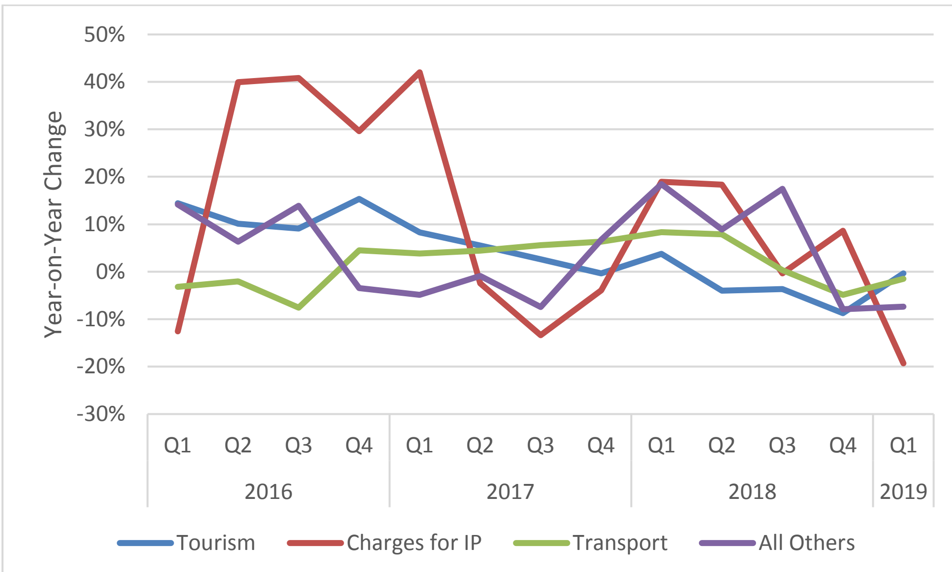
Source: U.S. Census Bureau, U.S. Trade with China in Advanced Technology Products, August 5, 2019. *https://www.census.gov/foreign-trade/statistics/product/atp/2019/06/ctryatp/atp5700.html*

U.S. First Quarter Services Trade Surplus Falls for First Time in 13 Years

In the first quarter* of 2019, U.S. services exports to China were $16.6 billion, down 4.2 percent from a record high of $17.3 billion in the first quarter of 2018. This marks the first year-on-year contraction in first quarter services exports to China since 2004.[2] In contrast, U.S. imports of Chinese services grew 6.6 percent to $4.6 billion.[3] While the United States maintained a trade surplus in services with China, reaching $12 billion in the first quarter of 2019, the surplus declined year-on-year for the first time since 2006, shrinking 7.7 percent from a high of 13 billion in the first quarter of 2018.[4]

Overall, services exports to China decreased slightly across the board in the first quarter of 2019 (see Figure 2). At $10.7 billion, Chinese tourism to the United States (including for education) accounted for 64.2 percent of exports, decreasing only 0.3 percent year-on-year.[5]

Figure 2: U.S. Year-on-Year Change in Service Exports to China, Q1 2016 – Q1 2019



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, June 6, 2019.

The steady growth of U.S. services trade surplus with China faltered chiefly due to a 31 percent year-on-year decrease in the balance of trade in intellectual property (IP) charges,† the United States' second largest services export to China. U.S. imports of IP from China nearly quadrupled year-on-year from $65 million to $320 million, while exports decreased from $2.3 billion to $1.9 billion.[6] According to balance of payments data from China's State Administration of Foreign Exchange (SAFE), rapid growth of China's global IP exports are foremost in the manufacturing sector and driven by software licensing fees.[7] Data were not available for the composition of IP trade with the United States; however, SAFE's statistics indicate China's global imports of IP charges also decreased in the first quarter of 2019, but only at about half the rate as imports of IP from the United States.[8]

* The Economics and Trade Bulletin uses data on trade in services from the Bureau of Economic Analysis that has not been adjusted to account for seasonal variations. Because of predictable seasonal fluctuations, it is more meaningful to compare the year-on-year change between quarters rather than quarter-on-quarter changes in the services trade balance. 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, June 6, 2019; U.S. Department of Commerce – Bureau of Economic Analysis, "Seasonal Adjustment of Trade in Goods and Services by Selected Countries and World Areas: Frequently Asked Questions," May 2017. *https://www.bea.gov/system/files/2017-05/trad_geo_FAQs.pdf*.

† Charges for the use of intellectual property (not included in other categories) include licensing fees for use of patents, trademarks, and copyrights, as well as software, various media, marketing, and prototypes. World Trade Organization, "Goods and services – What is Being Traded?" *World Trade Statistical Review 2018*, July 10, 2018, 52-53. *https://www.wto.org/english/res_e/statis_e/wts2018_e/wts2018chapter04_e.pdf*.

The United States' trade deficit with China in "other business services"[*] increased from $429 in the first quarter of 2018 to $511 million in the first quarter of 2019.[9] The United States' $1.3 billion in other business services imports constituted 29 percent of total services imports from China, and is the only category in which the United States maintains a persistent services trade deficit with China.[10] The overall balance across other categories of services trade stayed relatively constant.

While the shift in composition of services trade with China is driven primarily by changes at the margin, the general trend points to a decrease in export of knowledge-intensive services and an increase in imports of these same services from China. The outsized contribution of tourism exports buoys the U.S. services surplus, but could also mask substantial decreases in a critical export market for other U.S. services. Given the Chinese government's drive to decrease dependence on foreign technology and tightening of internet regulations, U.S. technology firms that license IP to Chinese manufacturers or export digital services to China are particularly at risk.[11]

Bilateral Policy Issues

United States to Impose More Tariffs as China Trade Talks Drag

On August 1, President Donald Trump announced the United States will impose 10 percent tariffs on an additional $300 billion in U.S. imports from China starting on September 1, 2019, citing China's failure to meet its commitments to make large purchases of U.S. agricultural goods and curb the flow of fentanyl to the United States.[†][12] The new tariffs would come on top of the 25 percent tariffs the United States has already imposed on $250 billion worth of Chinese goods, and cover nearly all Chinese exports to the United States. In contrast to the existing tariffs,[‡] the new tariffs would cover a broad swath of consumer goods.[13] China has threatened to retaliate if new tariffs are implemented.[14] On August 5, China's central bank allowed the renminbi (RMB) to weaken past the psychologically important threshold of 7 RMB to the U.S. dollar for the first time in more than a decade, linking the depreciation to market forces produced by "unilateralism, protectionist trade measures and expectations of tariffs against China."[15]

President Trump's decision came a day after U.S. Treasury Secretary Steven Mnuchin and U.S. Trade Representative Robert Lighthizer concluded two days of talks with their Chinese counterparts, with both sides agreeing to resume negotiations in September. The White House statement said the meetings were "constructive," noting the two sides discussed topics "such as forced technology transfer, intellectual property rights, services, non-tariff barriers, and agriculture" and that the "Chinese side confirmed their commitment to increase purchases of United States agricultural exports."[16] Chinese state-run news service Xinhua reported the two sides "discussed the increased purchase of U.S. agricultural products by China according to its own domestic needs."[17]

The meetings marked resumption of talks after negotiations collapsed in May 2019, with the United States accusing China of reneging from key commitments under a draft deal. Both sides agreed to restart talks after a meeting between President Trump and Chinese President and General Secretary of the Chinese Communist Party Xi Jinping on the sidelines of the G20 summit in June 2019. There, President Trump said he would allow U.S. companies to

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[*] Other business services includes legal, accounting, engineering, design, architectural, research and development, and additional professional services not included in other categories. Rachel F. Fefer, "U.S. Trade in Services: Trends and Policy Issues," *Congressional Research Service*, January 26, 2018, 6-7. *https://fas.org/sgp/crs/misc/R43291.pdf*.

[†] For more on fentanyl flows from China to the United States, see Sean O'Connor, "Fentanyl Flows from China: An Update Since 2017," *U.S.-China Economic and Security Review Commission*, November 26, 2018. *https://www.uscc.gov/sites/default/files/Research/Fentanyl%20Flows%20from%20China.pdf*.

[‡] In July and August 2018, the United States imposed 25 percent tariffs on $50 billion worth of industrial technology imports from China, which included autos, aircraft parts, intermediate electronics components, semiconductors, and machinery, as part of the Office of the U.S. Trade Representative's Section 301 investigation into China's intellectual property practices. In September 2018, the United States imposed a 10 percent tariff on $200 billion worth of Chinese goods, including computer modems and routers, printed circuit boards, chemicals, building materials, and furniture; the United States increased tariffs on these products to 25 percent in May 2019. David Lawder, Simon Webb, and Chris Prentice, "Tariff Wars: Duties Imposed by Trump and U.S. Trading Partners," *Reuters*, August 1, 2019. *https://www.reuters.com/article/us-usa-trade-tariffs-factbox/tariff-wars-duties-imposed-by-trump-and-u-s-trading-partners-idUSKCN1UR5YD*.

resume sales of technology to Huawei that do not pose a national security risk in return for China "immediately" making major purchases of U.S. agricultural products.[18]

At a press briefing on July 31, a Chinese Ministry of Commerce spokesperson said that "some Chinese firms, including both state-owned enterprises and private enterprises, have inquired with U.S. suppliers about new purchases of U.S. farm produce including soybeans, cotton, pork, and sorghum since July 19."[19] According to media reports, in the days leading up to the resumption of the talks, the Chinese government granted five companies tariff waivers for up to 3 million tons of soybeans as a goodwill gesture toward the United States.[20] However, following President Trump's tariff announcement, *Bloomberg* reported the Chinese government has ordered state-owned buyers to halt purchases of U.S. agricultural products.[21] U.S. soybean exports to China plunged to almost zero toward the end of 2018 after China imposed 25 percent tariffs on U.S. soybeans in July 2018 and have yet to pick up significantly.[22]

Beijing views restrictions on the sale of U.S. technology to Huawei[*] as a significant hurdle to reaching a trade deal.[23] The Trump Administration is preparing to make a decision on whether to grant special licenses to U.S. companies to sell to Huawei; U.S. Commerce Secretary Wilbur Ross noted on July 30 that a decision on the licenses was "forthcoming" and that the Department of Commerce received more than 50 applications for such licenses.[24]

Beyond retaliatory tariffs on U.S. goods, China has also tightened the screws on U.S. companies operating in China. On July 26, Xinhua reported that Chinese authorities investigating U.S. international courier FedEx suspect the company had illegally held back "more than 100 Huawei packages entering China" as well as uncovered "clues to other violations."[25] FedEx said in a statement, "These shipments in question were handled while we were trying to comply with the U.S. [Department of Commerce Bureau of Industry and Security] order which was unclear and resulted in considerable complexity for our operations."[26] Chinese authorities opened an inquiry into FedEx in June 2019 after Huawei said the company had diverted packages intended for the company.[27]

Appellate Body Decides on U.S.-China Case; United States Pushes for WTO Rule Change on Self-Identified Developing Countries

July saw two major movements in U.S.-China relations within the context of the World Trade Organization (WTO). On July 16, the WTO ruled on China's 2012 challenge of U.S. tariff investigations between 2007 and 2012.[28] The Appellate Body backed the United States' claim of unfair subsidies by state-owned enterprises, but ruled that the United States must accept Chinese pricing of inputs rather than rely on the methodology developed by the Department of Commerce when calculating appropriate tariffs.[29] China was granted permission to impose retaliatory tariffs, and future U.S. tariffs would have to use Chinese prices to measure subsidies.[30] In a statement, the Office of the U.S. Trade Representative (USTR) contended that the Appellate Body had overstepped its authority in the ruling[31]

Separately, in a memorandum issued on July 26, President Trump argued nearly two-thirds of WTO members have designated themselves as developing countries, which affords them special treatment, including taking on weaker commitments, regardless of their actual stage of development or economic strength.[32] The memorandum explicitly names China as one such nation no longer meeting the standards for a "developing country" designation. China has the world's second-highest gross domestic product (GDP) (after the United States), is a leader in outbound and inbound foreign direct investment (FDI), and is a major high-tech exporter.[33] The memorandum names other economies, including Singapore, Qatar, South Korea, Mexico, and Turkey, as being among the world's wealthiest countries that also claim developing country status.[34]

Longstanding practice carried over from the WTO's predecessor, the General Agreement on Tariffs and Trade (GATT), has allowed members to self-declare as "developing" and benefit from special and differential treatment, the specific terms of which are defined by each country's ascension protocols but often include preferential market access, exceptions to WTO commitments, or technical assistance.[35] The July memorandum instructs the USTR to advocate for changes at the WTO to prevent self-declared developing countries from holding to lower WTO

[*] In May 2019, the Department of Commerce added Huawei and its affiliates to the Bureau of Industry and Security's Entity List, which restricts U.S. firms from selling technology to the company.

standards. If substantial progress is not made within 90 days (by October 24), the USTR will, with the consultation of the Trade Policy Committee and the National Security and Economic Councils, determine which countries the United States will no longer treat as developing.[36] In February 2019, the USTR passed to the WTO general council a request to adjust and update WTO rules to prohibit the following from availing themselves of special and differential treatment: (1) countries that have applied to be members of, or are already members of the Organization for Economic Cooperation and Development (OECD); (2) members of the Group of 20 (G20); (3) countries that are classified as "high income" by the World Bank; or (4) countries that account for no less than 0.5 percent of global merchandise trade (imports and exports).[37]

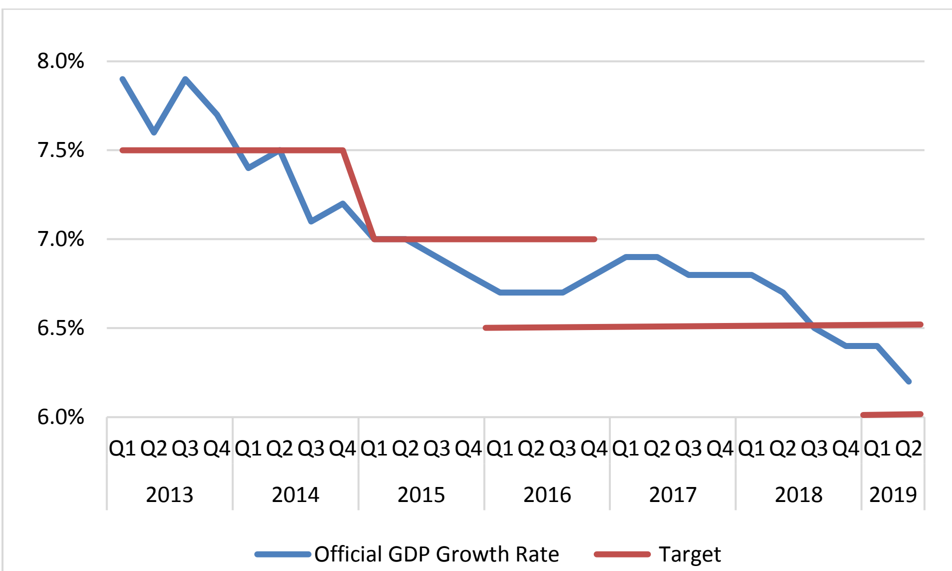
China's Ministry of Foreign Affairs responded by describing the U.S. request as "arrogant and selfish," arguing the rules of the WTO are not determined by a single country or small group of countries, and that China would advocate to protect the rights of all developing countries.[38]

Quarterly Review of China's Economy

China's GDP Grows at Slowest Rate in Nearly Three Decades

In the second quarter of 2019, China posted an official GDP growth rate of 6.2 percent, down slightly from 6.4 percent in the first quarter (see Figure 3).[39] While still within Beijing's target range of between 6 and 6.5 percent, this is the slowest growth rate ever recorded since China began publishing quarterly data in 1992.[40] The slowdown was primarily driven by Beijing's deleveraging campaign, which suppressed domestic demand, but was also exacerbated by a weakening external environment amid escalating U.S.-China trade tensions. The government has deployed significant stimulus measures since December 2018, including $190 billion in new infrastructure spending and $170 billion in cuts to business taxes and fees, in an effort to stabilize the economy.[41] While these stimulus policies forestalled an even sharper deceleration, they have not halted the slowdown.

Figure 3: China's Official GDP Growth, 2013–Q2 2019
(year-on-year)

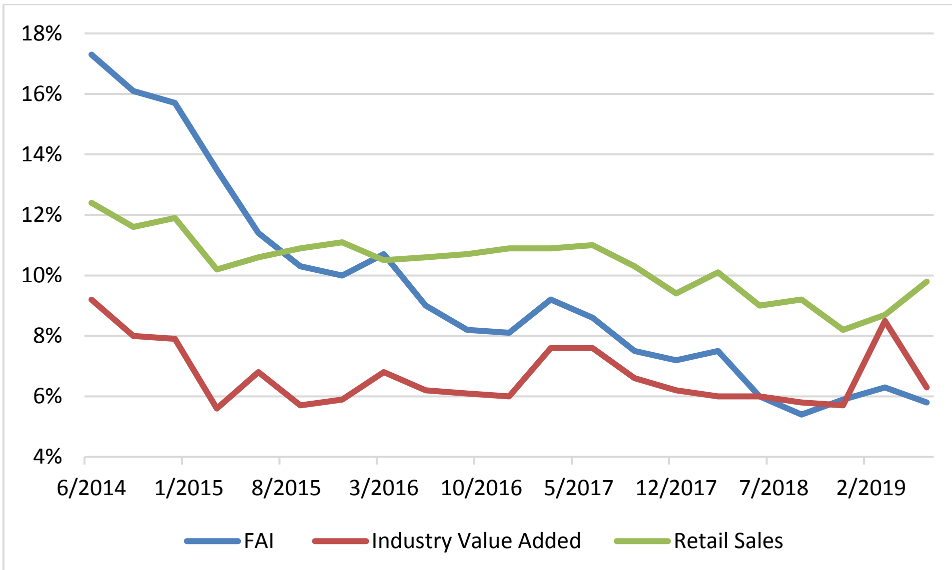


Note: In 2016, the target was set at a range of 6.5–7.0 percent GDP growth. In 2019, the target is set at a range of 6.0–6.5 percent.
Source: China's National Bureau of Statistics via CEIC database.

Key drivers of China's economy—like fixed-asset investment (FAI) and industrial output—resumed their deceleration in the second quarter of 2019, after experiencing a temporary stimulus-fueled boost in the first quarter of the year (see Figure 4).[42] FAI—a traditional driver of China's economy that measures investment in physical assets such as buildings, machinery, and equipment—rose 5.8 percent in the first half of 2019, down slightly from

5.9 percent in all of 2018.[43] Industrial output, meanwhile, grew 6 percent in the first half of the year, compared with 6.2 percent in all of 2018.[44] Retail sales growth (an indicator of consumer demand), on the other hand, showed signs of a resurgence during the second quarter. Retail sales grew 8.4 percent in the first half of 2019, lower than 9 percent growth in all of 2018, but spiked to a 16-month high of 9.8 percent in June 2019.[45] This, however, does not indicate a broader recovery in consumer demand. Continued softness in domestic demand is visible in the 7.3 percent year-on-year drop in imports during the same month.[46] Instead, June's retail sales data were driven almost entirely by auto sales, which surged as dealers offered steep discounts to offload inventory that did not meet new vehicle emissions standards that took effect on July 1.[47]

Figure 4: Key Indicators of China's Economy, 2014–Q2 2019
(year-on-year)

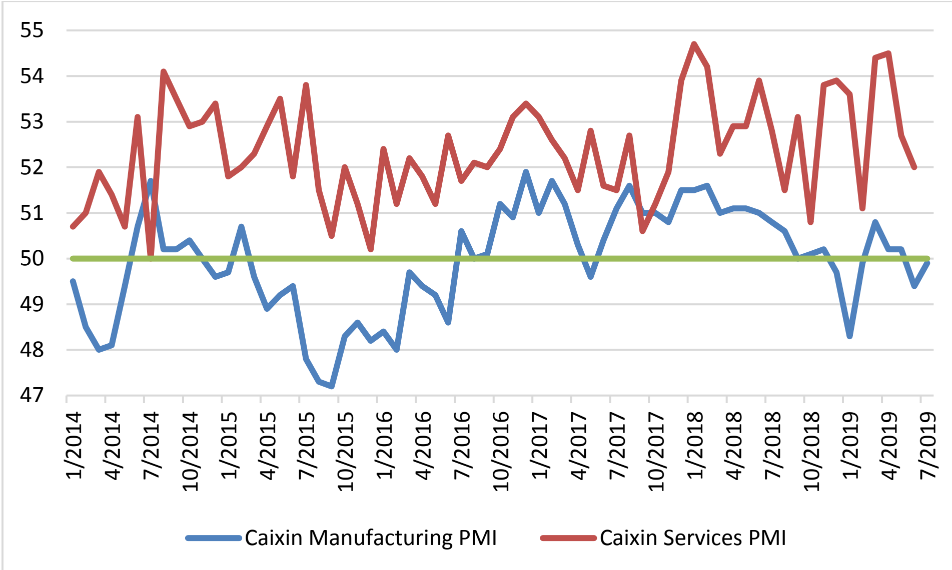


Source: China's National Bureau of Statistics via CEIC database.

Unofficial estimates by the Chinese financial media firm Caixin found China's manufacturing Purchasing Managers' Index (PMI)* was 49.9 in July, up from a three-year low in January but still indicating contraction (see Figure 5).[48] According to Iris Pang, economist for Greater China at the Dutch bank ING Group, China's recent PMI data reflect a divergence within the manufacturing sector between industries linked to building and infrastructure that have benefited from the Beijing's fiscal stimulus, and export-oriented industries harmed by global trade tensions.[49] This is borne out in a recent study of 1700 Chinese companies conducted by Nikkei, which found that while overall manufacturing profits fell 2.4 percent in the first half of 2019 (down from 10.3 percent growth in all of 2018), construction equipment and materials suppliers maintained higher profitability than consumer-product manufacturers and industries with greater exposure to export markets.[50] China's services sector—which accounts for more than half of China's economy—continued growing though the services PMI reading came in at 52 in June 2019, down from a 15-month high of 54.5 in April.[51]

* 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.

Figure 5: Caixin Services and Manufacturing PMIs, 2014–Q2 2019



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, 2019. *https://www.markiteconomics.com/Public/Home/PressRelease/c777ba6bdb9249529adea78034658761*; Caixin and IHS Markit, "Caixin China General Services PMI," *Markit Economics*, July 3, 2019. *https://www.markiteconomics.com/Public/Home/PressRelease/0b31d26dbe4a41a4afeb9d9d8175b0b0*.

Industrial Slowdown Sparks Employment Concerns

Falling industrial profits due to weakness in China's domestic economy as well as softening external demand have raised concerns about employment stability, especially as the United States prepares to impose 10 percent tariffs on an additional $300 billion in Chinese imports.[52] Growth of Chinese exports fell to just 0.1 percent in the first half of 2019, down from 9.9 percent in all of 2018, and a contraction in the second half of the year would put further pressure on employment.[53]

Measuring the U.S.-China trade dispute's impact on employment is difficult, as China's official unemployment rate—currently 5.1 percent—is widely considered to be chronically underestimated due to its political sensitivity.[54] However, other official and unofficial evidence suggests employment has come under significant pressure in the first half of 2019. The employment sub-index of China's official PMI, for example, fell from 48.0 in December 2018 to a ten-year low of 46.9 in June 2019, indicating that the manufacturing employment continued to contract.[55] Data from Zhaopin, a popular online recruiter, also pointed to a tougher job market, with the ratio of job vacancies to job seekers falling from 2.38 in the fourth quarter of 2018 to 1.89 in the second quarter of 2019.[56] Additionally, China International Capital Corporation, a major Chinese investment bank and financial services company, estimated that China's industrial sector shed 5 million jobs—3.4 percent of total employment—over the last year.[57]

Party leaders in Beijing, concerned that factory layoffs may pose a risk to social stability, are signaling they are worried about the employment outlook. In his annual Government Work Report, delivered before the National People's Congress in March 2019, Premier Li Keqiang predicted that "the pressure on aggregate job creation will continue unabated" in the near term and consequently declared an "employment-first policy."[58] To oversee Premier Li's policy, the State Council replaced an Interdepartmental Joint Conference on Employment Work with a newly created—and much more powerful—Leading Small Group for Employment Work in May 2019. The new leading small group is headed by Vice Premier Hu Chunhua and convenes representatives from more than 20 ministries and government agencies.[59]

Policy Trends in China

Bank of Jinzhou Receives Different Treatment from Baoshang

On July 29, 2019, three Chinese state-owned asset managers confirmed strategic investments to shore up the struggling regional Bank of Jinzhou.[60] This restructuring differed from the Baoshang takeover in late May 2019,[*] prompting analysts to debate the reason behind the two different approaches. Chinese financial regulators' response to Bank of Jinzhou's troubles may indicate their attempt to balance maintaining interbank stability and open credit channels with the desire to force investors to take responsibility for managing financial risk.

The government completely took over Baoshang; in Jinzhou's case, three state-owned investment firms stepped in to support it through strategic investments. Under the guidance of local People's Bank of China (PBOC) branch officials, China Great Wall Asset Management Co., Industrial and Commerce Bank of China (ICBC) Financial Asset Co., and Cinda Investment Co. invested in the struggling bank, taking a total equity stake of between 17 and 25 percent of the bank's shares.[61] Notably, unlike the Baoshang takeover, Bank of Jinzhou interbank and corporate depositors reportedly suffered no losses in this process.[62] The PBOC and financial regulator China Banking and Insurance Regulatory Commission have attempted to explain the Baoshang takeover by emphasizing Baoshang's particular circumstances: the founder of its former largest shareholder, tycoon Xiao Jianhua, was reportedly detained in 2017.[†]

Observers believe the different approach to resolving the Bank of Jinzhou crisis demonstrates regulators' concern about the market reaction to Baoshang investors' losses. Michael Pettis, senior associate at the Carnegie Endowment for International Peace, stated the interbank reaction demonstrated Chinese investors found the takeover "very significant," given the "surge in interbank interest rates" and quick measures by the PBOC to shore up the interbank market and continue the flow of credit.[63] As another indication of new difficulties borrowing in the interbank market, sales of interbank negotiated certificates of deposit (NCDs)—an asset commonly sold by banks in return for short-term financing—fell by close to 90 percent in the week after the Baoshang takeover.[64] This represents a significant drop in funding: Logan Wright of Rhodium Group noted that many banks rely on NCDs for financing, with NCDs accounting for more than 20 percent of their total liabilities.[65] If they cannot issue new NCDs, small and regional banks do not have large reserves of deposits to fall back on when their current NCDs mature.[‡]

Other regional banks may now also face challenges obtaining funding. UBS Group Executive Director of Asian Financials Research Jason Bedford identified 24 banks with lending and funding structures similar to Baoshang and Bank of Jinzhou (e.g., lending repackaged as investments, a low share of deposits to liabilities, and overreliance on now-flighty interbank funding).[66] These banks' distressed assets total $349 billion (RMB 2.4 trillion).[67] The Chinese government will have limited ability to deal with all of them: Dr. Wright noted few Chinese banks are large enough to assume the burden of a troubled regional bank.[68] In an environment where larger banks now fear lending to risky regional counterparties, regulators may have sought to protect interbank lending channels by preventing investors from suffering another loss.

This different treatment—particularly the move to spare investors—may be counterproductive. Analysts agree the PBOC is correct to begin forcing market participants to accurately price and accept financial risk, as in the case of Baoshang.[§] The regulatory challenge is how to ease participants into this practice, thus reining in increasingly risky credit growth, without prompting market turmoil.[69]

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[*] For more on the Baoshang Bank takeover, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, July 3, 2019, 6. *https://www.uscc.gov/sites/default/files/trade_bulletins/July%202019%20Trade%20Bulletin.pdf*.

[†] Billionaire Xiao Jianhua was abducted by Chinese agents from Hong Kong in January 2017, and taken across the border to mainland China, where he was reported as detained as of June 2018. For further details, see U.S.-China Economic and Security Review Commission, Chapter 3, Section 4, "China and Hong Kong," in *2017 Annual Report to Congress*, November 2017, 426-427.

[‡] Dr. Wright identified 11 small banks that only sold 25 percent or less of the NCDs they sought to issue in the two weeks after the Baoshang takeover. Logan Wright, "The Next Domino Falls," *Rhodium Group China Markets Research*, July 26, 2019, 4.

[§] In its financial stability assessment in December 2017, the International Monetary Fund highlighted the danger of government "implicit guarantees": market actors have come to expect the Chinese government to bail them out for losses they incur, which leads to "excessive risk taking" across the economy, and this expectation must be gradually removed by "allowing non-viable firms to fail and investors to

After a Stellar Debut, China's STAR Market Stumbles

On July 22, trading began on China's new Science and Technology Innovation Board, also known as the STAR Market. Originally proposed by General Secretary Xi in November 2018, the STAR Market—which has drawn comparisons to Nasdaq—seeks to encourage Chinese companies in technology and other strategic sectors to list their shares domestically rather than on foreign stock exchanges.[*] Compared with other mainland Chinese exchanges, the STAR Market is more liberal in several key respects, including the initial public offering (IPO) process, eligibility for loss-making companies, and the elimination of a cap on trading during the first week.[†] [70]

Twenty-five stocks are currently trading on the board, with three more expected to begin trading soon.[71] More than 120 companies have pending applications.[72] Expectations were high ahead of the first day of trading, with IPOs of the 25 listed companies 1,690 times oversubscribed.[‡] The first day of trading lived up to the hype: the 25 stocks posted an average gain of 140 percent, with price increases as high as 520 percent in the most extreme case, raising a total of nearly $5.4 billion (RMB 37 billion) across the 25 listed stocks.[73]

Since its blockbuster debut, however, the STAR Market's performance has been less impressive. On the second day of trading, 21 of the 25 stocks saw their prices decline, and the total value of shares traded was less than half that of the previous trading session. After the first week of trading, at which point caps on daily gains or losses of 20 percent took effect, activity has slowed markedly. On the first trading session with limits, only one stock hit the 20 percent cap.[74]

Moreover, the STAR Market's attempts to limit the volatility that has plagued other Chinese equity markets have not been entirely successful. The STAR Market has a minimum capital requirement of nearly $72,500 (RMB 500,000) for retail investors. In theory, this should limit the influence of such investors, whose widespread speculative behavior has given China's equity markets a reputation being like "casinos" due to their extreme volatility.[75] However, after the first several days of trading, retail investors still accounted for 90 percent of all purchases on the STAR Market.[76]

The STAR Market represents China's third attempt to launch a rival to Nasdaq. ChiNext, launched in Shenzhen in 2009, saw its 28 stocks increase an average of 106 percent on the first day of trading. However, it subsequently saw trading dwindle, as did the New Third Board (officially known as the New Equities Exchange and Quotations), an over-the-counter market launched in Beijing in 2013.[77]

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[†] For more on the establishment and key features of the STAR Market, please see "New Hi-Tech Board on the Shanghai Stock Exchange" in U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, May 2019. *https://www.uscc.gov/sites/default/files/Research/May%202019%20TB.pdf*.

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