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U.S.-China Economic and Security Review Commission

Monthly Summary of U.S.-China Trade Data **February 6, 2014**

Highlights of this month's edition

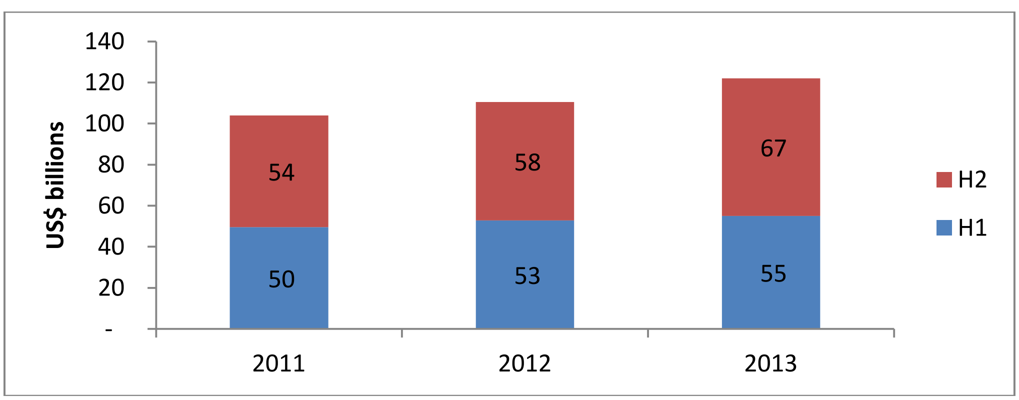
- **Bilateral trade:** 2013 trade deficit with China sets new record; U.S. exports perform well in second half; growth in bilateral trade continues to slow
- **Bilateral policy issues:** U.S. challenges China at WTO over noncompliance in GOES case; Lenovo bids for IBM servers and Motorola handsets; Qualcomm faces antitrust fines in China; SEC issues rulings in two cases involving Chinese units of U.S. auditors
- **Sector spotlight:** China's real estate boom raises risk of a bubble; housing becomes less affordable for China's poor; China's property developers begin to invest overseas
- **China's economy:** 7.7 percent GDP growth in the fourth quarter; external and internal imbalances worsen; leadership and CBRC unveil new leading groups to engineer reform

Strong Increase in U.S. Exports

The U.S. trade deficit with China totaled $318 billion in 2013, a record. U.S. exports to China increased by 10.4 percent year-on-year, while imports from China grew by 3.5 percent.[i] In 2012, imports had slightly outpaced exports. The bilateral trade deficit thus rose by only $3.3 billion from 2012, after growing by double-digits in the three previous years.

U.S. exports to China were particularly strong in the second half of the year (see figure 1), hitting a record $13 billion in October, and remaining at that level in November and December. According to China's customs data, the United States increased its share of China's total imports to 7.8 percent; in contrast, the European Union and Japan saw their share of China's imports decline. The improved bilateral trade balance, however, was still more attributable to the overall slowdown in bilateral trade (see figure 2).

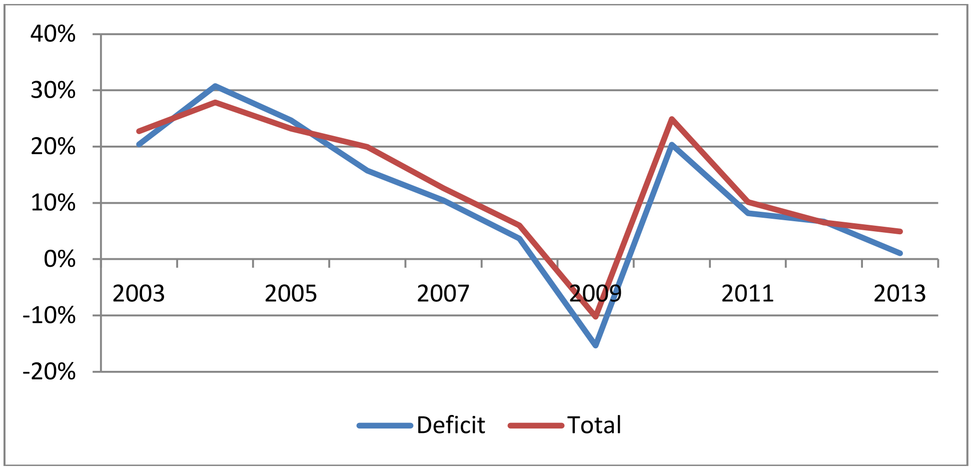
Figure 1: U.S. Exports to China, 2011-2013: First Half vs. Second Half of the Year
(US$ billions)



Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, February 2014). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

[i] This month's bulletin for the first time uses revisions to historical trade data undertaken by the U.S. Census in 2013. Prior trade bulletins used data published by the U.S. Census at year-end 2012.

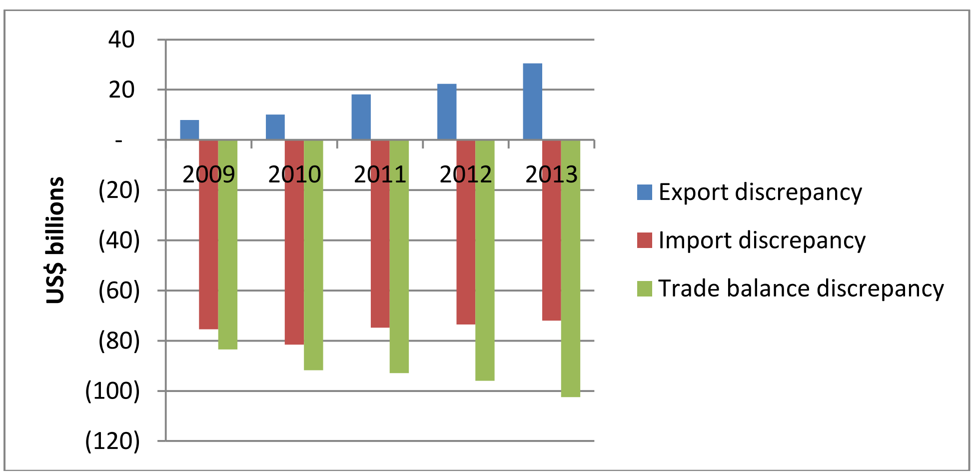
Figure 2: U.S. Trade with China: Annual Growth in Total Trade and the Deficit
(year-on-year, %)



Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, February 2014). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Trade data discrepancy remains a problem. Although both countries have agreed to jointly resolve this issue, the 2013 data still reveals large differences (see figure 3). According to data from the China General Administration of Customs, China's exports to the United States in 2013 totaled $368 billion – $72 billion less than the number recorded by the U.S. Census. By the same token, Chinese statistics show that China's imports from the United States totaled $152.5 billion – $31 billion greater than the number recorded by the U.S. Census. Taken together, China's data suggests that its trade surplus with the United States was only $216 billion, which is $102 billion lower than the number registered by the Census.[ii]

Figure 3: Trade Data Discrepancies: U.S. Trade with China
(US$ billions)



Source: China General Administration of Customs, via CEIC data; U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, February 2014). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

[ii] Annual calculations for China's trade are based on sums of monthly data published by China's customs agency.

Top Exports and Imports

Agricultural products topped the list of U.S. exports to China in December, but declined by 27 percent compared to the prior year, indicating reduced Chinese demand for U.S. crops, which are used as feedstock for China's livestock industry (see figure 4). Indeed, agricultural exports to China were only $19 billion in 2013, roughly $1 billion less than in 2012, according to U.S. census data.[iii] U.S. manufactures, on the other hand, registered strong gains, led by transportation equipment, computer and electronics, and machinery. On the import side, U.S. imports from China continued to be concentrated in computer and electronic products, which accounted for nearly four in every ten dollars paid by U.S. importers.

Figure 4: U.S. Trade with China: Top-Five Exports and Imports
(US$ millions)

U.S. Top-Five Exports to China	Exports	Share of total (%)	Change over Dec'12 (%)	**U.S. Top-Five Imports from China**	Imports	Share of total (%)	Change over Dec'12 (%)
Monthly (December 2013)				*Monthly (December 2013)*			
Agricultural Products	3,053.5	23.3%	-27.2%	Computer and Electronic Products	15,201.5	40.5%	-12.3%
Transportation Equipment	2,648.8	20.2%	32.4%	Miscellaneous Manufactured Commodities	2,965.4	7.9%	-21.5%
Computer and Electronic Products	1,438.4	11.0%	12.8%	Electrical Equipment, Appliances, and Component	2,664.8	7.1%	-5.4%
Chemicals	1,411.1	10.8%	7.4%	Apparel and Accessories	2,319.1	6.2%	-6.1%
Machinery, Except Electrical	1,087.6	8.3%	32.6%	Machinery, Except Electrical	1,969.9	5.2%	4.8%
Other	3,443.5	26.3%		Other	12,436.2	33.1%	
Total	**13,082.9**	**100.0%**		**Total**	**37,557.0**	**100.0%**	
Year-to-date (thru December 2013)				*Year-to-date (thru December 2013)*			
Transportation Equipment	23,387.0	19.2%		Computer and Electronic Products	163,068.8	37.0%	
Agricultural Products	19,287.9	15.8%		Miscellaneous Manufactured Commodities	36,633.1	8.3%	
Computer and Electronic Products	16,009.4	13.1%		Electrical Equipment, Appliances, and Component	33,623.8	7.6%	
Chemicals	13,720.6	11.2%		Apparel and Accessories	32,877.0	7.5%	
Machinery, Except Electrical	10,115.4	8.3%		Leather and Allied Products	24,648.0	5.6%	
Other	39,496.1	32.4%		Other	149,582.9	34.0%	
Total	**122,016.3**	**100.0%**		**Total**	**440,433.5**	**100.0%**	

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, February 2014). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Advanced Technology Products

In advanced technology products, the U.S. trade deficit with China in 2013 amounted to $117 billion, a decline of $2.2 billion from the previous year (see figure 5). The deficit fell despite a continual surge in U.S. imports of information and communications technology (ICT), by far the largest ATP item. The reduced deficit instead reflected improved U.S. exports of several other products, notably in aerospace and opto-electronics. Indeed, excluding ICT products, the U.S. registered an ATP trade surplus of $11.3 billion with China for the year, compared with $3.9 billion in 2012 and $1.4 billion in 2011.

[iii] Note that the USDA, which categorizes agricultural exports differently than the U.S. Census Bureau, calculated agricultural exports at $25.8 billion for 2013, roughly the same value as in 2012. It is also worth noting that record corn shipments from the United States to China in December were turned away by Chinese customs, owing to a dispute over presence of a genetically-modified strain that has not been approved by the Chinese government. It is unclear whether the U.S Census data has taken these rejected shipments into account.

Figure 5: Advanced Technology Product Trade through December 2013
(in US$ millions)

	Monthly			Year-end			
	Exports	Imports	Balance Dec'13	Exports	Imports	Balance 2013	Balance 2012
TOTAL	**3,158**	**13,683**	**-10,525**	**29,074**	**145,929**	**-116,855**	**-119,045**
(01) Biotechnology	38	8	30	400	77	323	216
(02) Life Science	312	196	116	3,011	2,040	971	724
(03) Opto-Electronics	75	507	-432	401	5,281	-4,880	-6,697
(04) Information & Communications	513	12,521	-12,008	4,680	132,866	-128,186	-123,016
(05) Electronics	395	271	124	4,840	3,379	1,461	906
(06) Flexible Manufacturing	371	84	287	2,650	951	1,699	1,138
(07) Advanced Materials	13	21	-8	181	243	-62	83
(08) Aerospace	1,433	63	1,370	12,668	789	11,879	7,741
(09) Weapons	0	12	-12	2	163	-161	-164
(10) Nuclear Technology	7	0	7	243	140	103	24

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, February 2014). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Bilateral Policy Issues

United States Challenges China's Non-compliance in WTO GOES Duties Dispute

U.S. Trade Representative Michael Froman announced on January 13, 2014 that the United States has requested consultations with China on Beijing's failure to comply with a 2012 Appellate Body decision, which found that China imposed duties on grain oriented flat-rolled electrical steel (GOES)[iv] in breach of WTO rules.[1] According to the Office of the USTR, U.S. exports of GOES amounted to more than $250 million a year, but fell to $3 million following China's imposition of duties.[2]

The original WTO challenge revolved around China's imposition of antidumping (AD) and countervailing duties (CVD) on GOES from the United States. AK Steel Corporation, based in Ohio, and Allegheny Ludlum, based in Pennsylvania, manufacture GOES. The United States initiated dispute settlement proceedings challenging China's imposition of these duties in September 2010. In a decision issued in June 2012, and later supported by the Appellate Body findings, the WTO found in favor of the United States. In particular, the Appellate Body upheld the Panel's determination that China's imposition of the duties failed to show injury to China's domestic industry.

China agreed to comply with the WTO ruling by July 31, 2013. On that date, China revised the amount of duties owed, but did not reverse its determination that the Chinese GOES industry was materially injured. In its original AD investigation, China found a dumping margin of 7.8 percent for AK Steel and 19.9 percent for Allegheny Ludlum; it imposed CVD rates of 11.7 percent and 12 percent for the two companies, respectively. Following the WTO case, China maintained the original AD margins for the respondents, but revised the CVD rates down to 3.4 percent for both firms, according to a USTR spokeswoman.[3] The United States and China are to hold consultations within 15 days of the request. Should China fail to sufficiently address U.S. complaints in the consultations, the United States will request a formal compliance panel under WTO.[4]

[iv] GOES is a high-tech, high-value magnetic specialty steel that is used primarily by the power generating industry in transformers, rectifiers, reactors, and large electric machines.

Although metals manufacturing in 2012 accounted for only 2.8 percent of U.S. exports to China and 1.0 percent of U.S. imports from China, steel has played an important role in bilateral trade disputes. China's first WTO case against the United States, brought in March 2002, challenged U.S. safeguards on certain steel products. The WTO panel decided in China's favor, and the United States removed the safeguards in November 2003.

Lenovo Makes IBM and Motorola Deals, Qualcomm Faces Antitrust Fines in China

Lenovo, a Chinese electronics company, announced back-to-back major acquisitions of U.S. assets in late January. First, it agreed to buy IBM's low-end x86 server business for $2.3 billion.[5] This was followed by a $2.91 billion purchase of Google's unprofitable Motorola Mobility handset business (Google paid $12.5 billion for Motorola in 2012). Under the terms of the deal with Lenovo, Google will keep the majority of Motorola patents, which are considered its prize assets. If it goes through, the Google deal will be the largest technology purchase by a Chinese firm to date.

These deals also mark the latest step in the evolution of Lenovo, once a tiny government-funded venture that is now the number-one PC maker in the world. Like the purchase of the IBM ThinkPad brand in 2005, the new deals provide Lenovo with a shortcut to credibility and market share in an intensely competitive industry. The deals are also characteristic of a trend among Chinese companies to purchase strong foreign brands in industries without home-grown capacity.[6] Lenovo will use the Motorola purchase to enter the lucrative smart phone market, particularly in the Americas. [7] Lenovo's current market share for smart phones in the United States is negligible, even as the company has become the world's fourth-largest smart phone maker by market share behind Samsung, Apple, and China's Huawei.[8]

Both the Google and the IBM deal are expected to be scrutinized by the Committee on Foreign Investment in the United States (CFIUS), an interagency body that screens foreign acquisitions of U.S. assets for national security threats. Chinese companies attempting entry into the U.S. telecommunications and internet infrastructure sectors have drawn CFIUS attention, particularly given the continued heavy involvement of the Chinese government in these sectors domestically. The widespread reports of Chinese hackers penetrating U.S. corporate and military networks also had a chilling effect on investment. Lenovo's 2005 purchase of IMB's PC business, which put it on the map and was a watershed moment for Chinese investment in the United States, generated controversy before it was ultimately cleared by CFIUS.

The two Lenovo deals come amidst a worsening climate for U.S. tech investors in China. Most recently, San Diego-based Qualcomm, the world's biggest cell phone chip maker, may be facing a $1 billion fine in a Chinese antitrust probe. China's National Development and Reform Commission (NDRC), the central economic planning agency, initiated an investigation into Qualcomm last year, alleging price-fixing, although details of specific allegations remain scarce.

Industry experts say the NDRC, which is trying to lower domestic costs of licensing fees for 4G mobile networks, may attempt to extract technology and licensing concessions from Qualcomm in exchange for more lenient treatment. Yee Wah Chin, a New York-based antitrust expert at law firm Ingram, Yuzek, Gainen, Carroll and Bertolotti has noted that the investigation into Qualcomm is "in some ways, a game of chicken. While the [fine] money may be very attractive to the NDRC, they would also be happy if Qualcomm were to make all sorts of commitments regarding its technology and the licensing of the technology."[9]

Qualcomm charges patent royalties to handset makers that use its chips, and dealings associated with that business have triggered antitrust cases in South Korea and Japan. The company is appealing adverse rulings in both countries.

SEC Issues Rulings in Two Cases Involving Chinese Units of the Big Four Accounting Firms

In a harshly-worded ruling, a Securities and Exchange Commission (SEC) administrative law judge said that the Chinese affiliates of the Big Four accounting firms (KPMG, Deloitte, PricewaterhouseCoopers and Ernst & Young) should be suspended from practicing in the United States or from appearing before the SEC for six months. The ruling also censured a fifth firm, Dahua, but did not impose a six-month suspension. The judge ruled that the companies "willfully" failed to give regulators audit papers of Chinese companies under investigation for announcing fraud.[10] The suspension will not go into effect until the appeals process is exhausted.

If the suspension does go into effect, the consequences could be significant for the auditors and firms involved. Paul Gillis, an expert on Chinese accounting, said that if the Big Four cannot audit U.S. listed companies during the suspension, their clients will not be able to file the required Form 20F due on April 30. "Under exchange rules, this should lead to the companies being suspended from trading since investors do not have the data they need to be able to trade."[11] Other experts suggested that the ruling might lead Chinese companies to engage the services of the Hong Kong affiliates of the Big Four, which are not affected or, in the longer term, to consider Hong Kong auditors.[12]

In a separate case, on January 27, 2014, the SEC said it would drop a federal lawsuit in which the commission had demanded documents from Deloitte's Chinese affiliate to help with its investigation of Longtop Financial Technologies, a U.S.-traded Chinese company. The SEC told the court that Chinese regulators have turned over many of the documents being sought, which made the enforcement of a subpoena unnecessary.[13] The U.S. regulators were able to obtain the documents because of the deal signed in July 2013 at the Strategic and Economic Dialogue meeting, where Chinese regulators agreed to turn over audit papers of some Chinese companies to the U.S. Public Company Accounting Oversight Board (PCAOB). However, no further progress has been made toward achieving a more general access to documents for U.S. regulators conducting investigations.[v]

The two cases mark the latest salvo in the clash between U.S. and Chinese regulators, with the accounting firms stuck in the middle. The SEC has been trying for years to gain access to audit work conducted by Chinese accounting firms for Chinese companies that list in the United States. Recent cases of fraud, coupled with the proliferation of Chinese company listings via reverse mergers,[vi] have made auditing a key bilateral issue. To date, the accounting firms have refused to produce the auditing documents, arguing that doing so would put them in violation of China's state secrets laws. Chinese authorities prohibit sharing accounting information with foreign regulators or removing audit papers from the country.[vii]

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[v] The deal falls short in many respects. For example, it does not include the SEC. Instead, the deal allows the PCAOB to share documents with the SEC after notifying the Chinese. Paul Gillis, "There's No Accounting for China's Accounting," *Wall Street Journal*, http://online.wsj.com/news/articles/SB10001424127887323855804578512270547620446.

[vi] A reverse merger takeover is the acquisition of a public company by a private company so that the private company can bypass the lengthy and complex process of going public. The transaction typically requires a financial reorganization of the acquiring company.

[vii] For further discussion of the U.S.-China tensions over auditing, see U.S.-China Economic and Security Review Commission, *2013 Annual Report to Congress* (Washington, DC: November 2013), pp. 137-141.

Senate Foreign Relations Committee Approves Baucus Nomination

As expected, on February 4 the Senate Foreign Relations Committee approved Senator Max Baucus (D-MT) as the next U.S. Ambassador to China. The full Senate is expected to confirm Sen. Baucus's nomination later this week. In his remarks and responses to question from the Committee members, Sen. Baucus said the United States should be "fair but firm" and "try to find common ground."[viii] His opening remarks touched upon the most pressing issues in the relationship, including cyber space, bilateral investment treaty negotiations, and geopolitical issues. Sen. Baucus said he will work to build a better economic relationship with China, and encourage China to "act responsibly in resolving international disputes, respecting human rights, and protecting the environment."[14] As is common practice with confirmation hearings, Sen. Baucus did not go into specifics, and avoided committing to any course of action beyond general engagement and cooperation.

Sector Spotlight: Real Estate

The real estate sector is central to the economies of the United States and China, undergirding (or threatening) the health of the financial sector, as well as creating demand for dozens of industries, from insurers to cement producers. Even as the U.S. real estate sector has struggled since the subprime crisis, real estate in China has scaled new heights. Real estate investment in China more than doubled in 2009-2013, from RMB 3.6 trillion ($590 billion) to RMB 8.6 trillion ($1.4 trillion). Beijing, Shanghai, Shenzhen, Guangzhou and Chongqing, each similar in population to metropolitan New York, are now each finishing one building that will top America's tallest building. China is home to 60 of the world's 100 tallest buildings now under construction.[15] By the government's count, 144 cities in 12 provinces are planning a total of 200 new towns.[16] The scale of construction is expected to grow since the new leadership made urbanization a core policy priority, calling it "the biggest development potential."[17]

The past year in China was particularly impressive. There was a resurgence in floor space sold, driven by a strong rebound in residential property, which accounts for around four-fifths of China's real estate sector (see figure 6). Assuming that each apartment unit in China averages 100 square meters (according to consulting firm Dragonomics), 13 million housing units were sold – double the number in 2008. The share of pre-sales also increased by 10 percentage points, to 76 percent (compared to 45 percent a decade ago), illustrating that more and more buyers are willing to invest in properties that have yet to finish construction, in order to get a leg up on other buyers.[ix] Indeed, much of China's real estate transactions are directly tied to the construction of new buildings. Only 20 percent of building sales in 2013 were existing property; the rest were new buildings sold in advance.

Figure 6: Growth in Floor Space Sold in China
(year-on-year, %)

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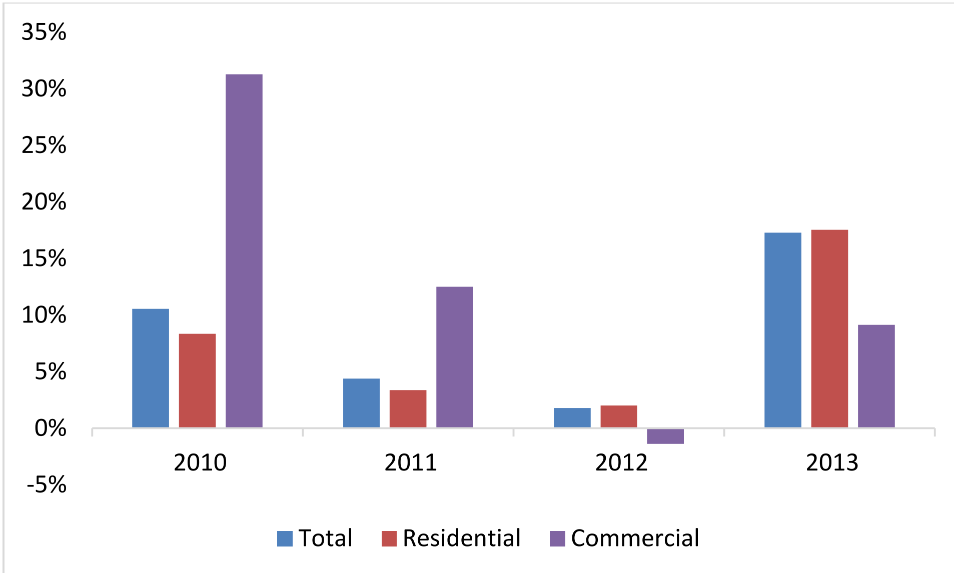
http://origin.www.uscc.gov/sites/default/files/Annual_Report/Chapters/Chapter%201%3B%20Section%203%20Governance%20and%20Accountability%20in%20China%27s%20Financial%20System.pdf.

[viii] Text of Sen. Baucus's speech and webcast of the hearing are available from the U.S. Senate Committee on Foreign Relations, http://www.foreign.senate.gov/hearings/nomination-01-28-2014.

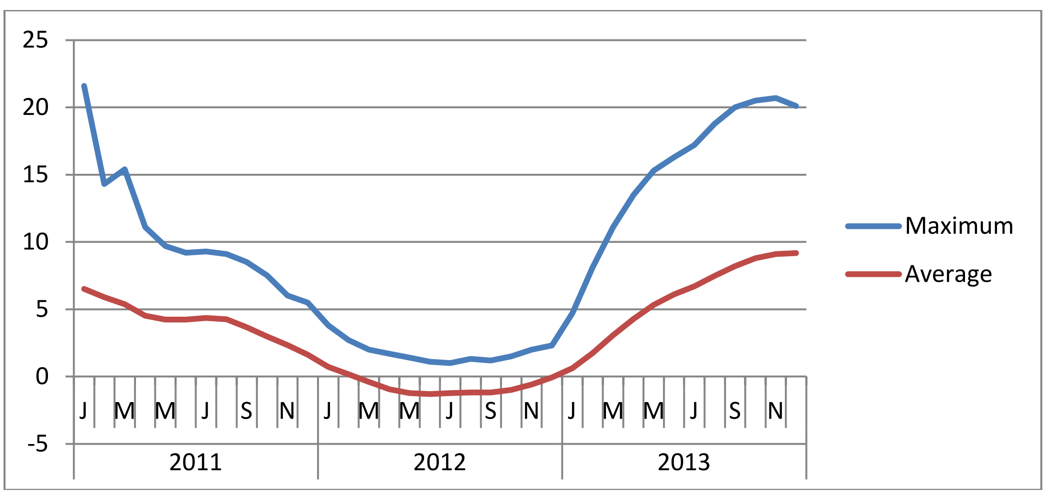
[ix] A pre-sale may be a home that hasn't even had a building permit issued, or it may already be in construction. Though purchasing through a presale offers the ability to secure the sale, there are risks involved, such as construction delays, code problems, and the mortgage coming due before the house is ready for move-in. Since the customer's money is already tied up in the presale purchase, which can prohibit him from walking away and buying elsewhere. It is important for the customer to be sure a problem clause is included in the contract that details remedies for delays.



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

In tandem with the increase in floor space sales, property prices increased in 69 out of 70 cities surveyed by China's National Bureau of Statistics, compared with just a dozen cities in 2012. Maximum values also increased, with the tier-1 cities, Guangzhou, Shanghai, and Beijing, experiencing the sharpest increases (see figure 7). After declining by 7 percent in 2012, floor space started also increased by 13 percent in 2013, an indication that rising prices are spurring more investment.

Figure 7: Change in China's Property Price (Sample of 70 Cities)
(year-on-year, %)



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

Some analysts argue that China can continue on its building boom, pointing to China's growing urban housing needs (China accounted for nearly one-third of global urbanization over the past decade and will contribute about a quarter of the increase in the global urban population over the next decade). Moreover, unlike the United States, where households take out large mortgages at low interest to buy their homes, households in China are less heavily leveraged, and are subject to higher mortgage rates and tougher down-payment requirements. Demand for residential property is particularly robust in wealthy tier-1 cities Beijing and Shanghai, suggesting that the building boom there is unlikely to outstrip demand.

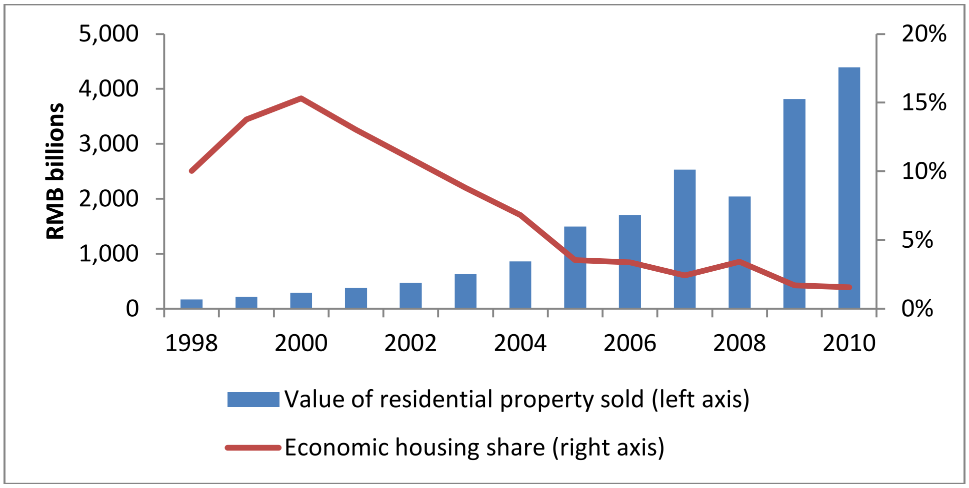
However, other factors suggest that real estate is far from stable. According to economist Nouriel Roubini, China is clearly overbuilding. Fundamental demand for urban housing has already begun to decline, as fewer people will become urban residents over the coming decade than over the past decade. Construction of new housing has outpaced demand by 60 million units since 2006. Further, China's share of global construction, in terms of the number of buildings and amount of cement and steel used, dwarfs its share of global housing demand. The share of China's GDP invested in real estate, in turn, is comparable to Spain in the lead-up to that country's property crash in 2008.[18] GaveKal, a consultancy, agrees with Roubini, calculating that after a decade of undersupply, China's housing market is now shifting to "structural oversupply".[19]

Over-investment in property is especially stark in tier-2 and tier-3 cities, where it quickly results in overcapacity and becomes a leading cause of debt among local governments and enterprises. Anne Stevenson-Yang of J Capital, a research firm, argues that a substantial share of new homes is being purchased not by individuals, who tend to have high savings rates, but by local governments, banks and state-owned enterprises, the same entities that borrow heavily to build property. Analysts at Bernstein, another consultancy, think the industry is at its most indebted for a decade and hence "highly vulnerable" to a downturn. [20] The fact that a lot of real estate investments are conducted through opaque local government financing vehicles, or unlisted subsidiaries of SOEs, may disguise the actual risks.

While the jury is out on how severe China's real estate bubble is, rising property values are no doubt exacerbating China's income inequalities. For some wealthy Chinese, trading in residential real estate can be extremely profitable. The *New York Times* recently described a young woman in Nanjing, in east-central China, who bought her first apartment seven years ago for $60,000, resold it at a 50 percent profit, traded up to a bigger apartment every year since then, and is now living in a 2,150-square-foot apartment for which she paid $985,000. But for most ordinary Chinese, such as Zheng Yilong, a 22-year-old college graduate paid just $575 a month in a low-level banking job in central China, purchasing a 540-square-foot apartment on the outer edge of town would cost him 14 years' pay.[21]

The government has promoted affordable housing units to reduce inequality. But according to the Beijing consulting firm Dragonomics, social housing schemes are not an important driver of housing supply.[22] Indeed, the Chinese government in2010 stopped publishing data on the value of "economic housing" sold. The latest data available showed that, of the RMB 4.4 trillion ($721 billion) worth of residential real estate sold in 2010, less than two percent was economic housing. A decade earlier, when the property market was much smaller, economic housing's share was 15 percent (figure 8).

Figure 8: Residential Property Sold and the Share of Economic Housing in China
(RMB billions; share, %)



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

The government has generally been fickle in its regulation of the real estate sector, because the housing market is a trusted source of dynamism when other parts of the economy slow down. As housing values flagged in the final quarter of 2011, dozens of cities made housing loans more easily available. But as signs of a bubble reappeared in early 2012, then-Premier Wen Jiabao ordered the central bank to raise down-payment requirements for second mortgages in cities with excessive price gains and told local governments with the biggest price pressures to tighten home-purchase limits.[23] Cities in the wealthy provinces of Zhejiang, Jiangsu and Guangdong increased minimum borrowing requirements, or capped the size of loans available to homebuyers tapping their local housing provident funds.[24] In March 2013, Beijing also introduced tougher measures, including a 20 percent tax on capital gains from property, a novel measure.[25]

However, as the economy showed signs of faltering in the second quarter, the government once again eased restrictions. In its meeting on China's economy in July, China's Politburo did not mention any steps to cool the property sector, instead pledging to promote its stable and healthy development. Xu Shaoshi, chairman of the National Development and Reform Commission, the country's top economic planning agency, also reaffirmed at the time that China would promote stable growth of property investment.[26]

And yet, this past month, the government showed signs of tightening the screws again, as the Ministry of Land and Resources announced plans to establish a national system for tracking real estate ownership and sales transactions. Optimists contend that these measures may represent real structural reforms. A nationwide real estate registration system could pave the way for levying a broad property tax in China for the first time, and also contribute to crack downs on corrupt officials who own multiple properties despite restrictions on ownership.[27]

Concerned by the possibility of a housing bubble, several of China's top property developers are now shifting to investments in real estate overseas. For example, in January 2014, Greenland, a major Chinese state-owned real-estate developer, announced that it was putting $2 billion into a brewery and a residential tower in downtown London. The announcement came just months after Greenland announced a $1 billion investment in downtown Los Angeles.[28] One of Greenland's rivals, Vanke, also broke out of its domestic shell in 2013 by announcing investments in Singaporeand the United States. The company's chairman predicts that a fifth of Vanke's investments may soon be made outside China.[29] Not least, a subsidiary of China's central bank, set up a special branch office in New York last year to invest in U.S. real estate, just months after the *Wall Street Journal* uncovered billions of dollars worth of real estate purchases by the subsidiary in the United Kingdom.[30]

China's Economy

Questions about Growth Targets for 2014

As China's factories wound down in January ahead of the Chinese New Year, new data provided a fuller picture of China's economy in 2013. The National Bureau of Statistics reported that China's GDP expanded by 7.7 percent in the fourth quarter of last year. That was down from 7.8 percent in the third quarter, but defied the pessimists who had pointed to downside risks, such as rising debt in the domestic economy, the prolonged recession in Europe, and the retreat of global investors from emerging markets.

An important question is what annual growth target Beijing will announce at the annual meeting of the National People's Congress in March. While the likely target is 7.5 percent, the same figure as in 2013, several provincial governments lowered their growth targets over the past month, suggesting that the leadership may opt for a target closer to 7 percent, the lowest in decades. According to the governor of Hebei, a province that lowered its target to 8 percent (from 9 percent in 2013), the goal was to focus this year on improving the quality of development and resolving "severe difficulties and contradictions". However, the seven provinces that lowered the targets are less developed and have pursued above-average growth rates; it is unclear whether the leadership will temper growth in areas such as Guangdong, Zhejiang, and Shanghai that account for more jobs and output.[31]

A related question is how the leadership will balance growth with its new reform agenda. In January, China's state radio announced that the Politburo would establish six leading groups to spearhead different areas of reforms unveiled at the Third Plenum in November. President Xi Jinping was appointed the head of the central leading group for comprehensive reforms that will oversee six teams. The six teams are the reform group for economic, ecological and civilization systems; the cultural reform group; the reform group for the democratic rule of law; the social reform group; the reform group for the institution of building the Communist Party; and the reform group for the system of discipline and checks. The establishment of these groups points to a long-term commitment to enact reforms, but timeline and implantation plans remain unclear.[32]

Growth at the Cost of Rebalancing

China's economic growth in 2013, well above the world average, was achieved amid mounting imbalances. Exports outpaced imports for a second year running, further expanding China's trade surplus. A sudden jump in exports in November caused China to register its largest monthly surplus on record. The trade surplus added to China's foreign exchange reserves, which rose by $324 billion in the second half of 2013. They now stand at over $3.8 trillion, nearly double the reserves of five years ago.[33] China stores the bulk of its reserves in U.S. treasuries.

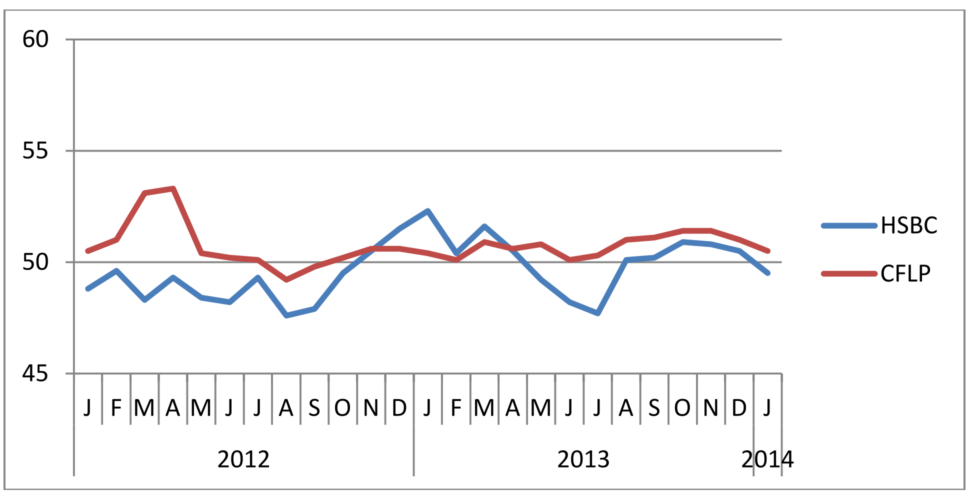
At the same time, China's annual exports rose by their lowest level since the financial crisis. While some analysts expected a strong push at year's end, as occurred in 2012, monthly export growth in December fell to 4.3 percent. Part of the decline was due to a government crackdown on the use by smugglers of phony export accounting: Over-invoicing of export receipts, a common tactic used by companies to circumvent China's capital controls. Producers surveyed in January expected export orders to contract rather than expand in the coming months.

Monthly growth in industrial output in 2013 averaged 9.7 percent, its lowest rate since the peak of the global financial crisis in 2008. Although output peaked in August at 10.4 percent, it decelerated throughout the fourth quarter. Optimism among producers, captured in the HSBC and CFLP purchasing managers' indices, also waned in recent months (see figure 9). Compounding weak export demand was a concerted effort by Beijing to reduce overcapacity, as many plants in aluminum, cement, shipbuilding, and other heavy industries were ordered in the summer to retire capacity by year's end.

One positive outcome of this decline in factory activity is that China's tertiary sector, which denotes service industries, increased its share of GDP by 1.4 percentage points. At 46.1 percent of nominal GDP, the tertiary sector is now slightly larger than the secondary sector, which denotes manufacturing industry.

Essential to China's growth has been fixed investment. According to the *Financial Times*, investment contributed 54 percent to GDP growth in 2013.[34] (As shown in this bulletin's Sector Focus, much of the investment went into the property market.) China's households are certainly spending more, resulting in retail sales growth well above the world average. Even so, consumption actually contributed 4 percentage points less to GDP growth than investment, forestalling China's transition to a consumer-based economy.[x] High levels of investment and economic growth would normally drive up consumer prices; yet China's inflation rate remained low throughout 2013. Volatile items such as food, energy, and rents saw only moderate price increases, offsetting the rapid increase in property values (see figure 10).

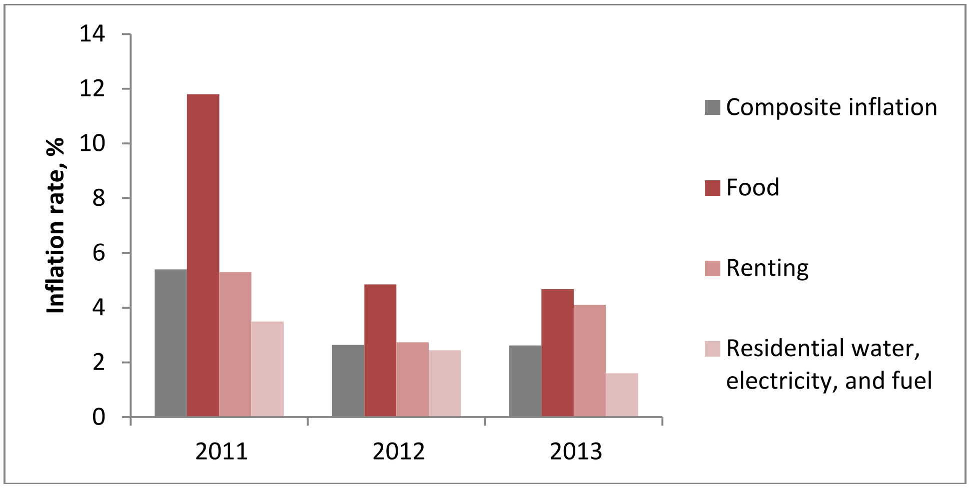
Figure 9: Purchasing Managers' Index through January 2014: HSBC and CFLP PMI compared
(<50 = contraction, >50 = expansion)



Source: China's National Bureau of Statistics, via CEIC data; HSBC Purchasing Managers' Index. http://www.hsbc.com/1/2/emerging-markets/em-index/purchasing-managers-index.

[x] Note that the contribution of net exports to GDP was negative.

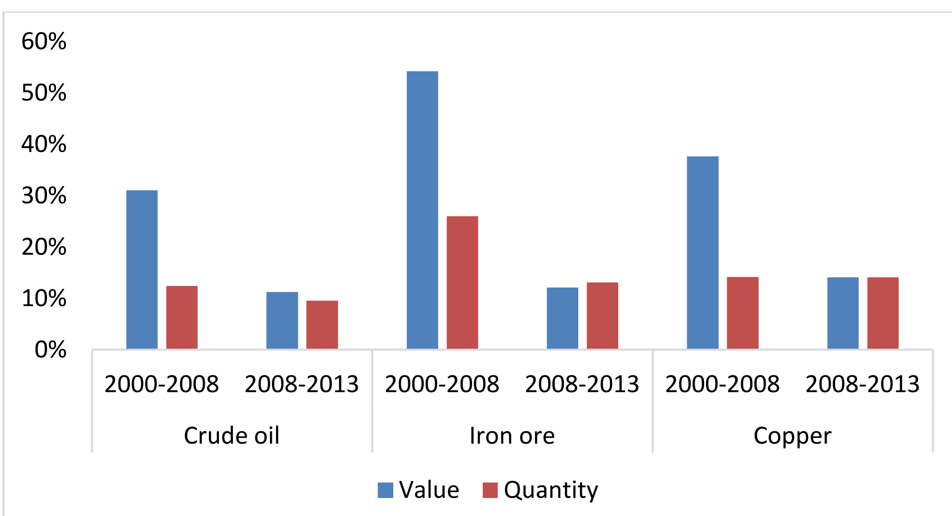
Figure 10: China's Consumer Inflation Rate
(year-on-year, %)



Source: China's National Bureau of Statistics, via CEIC data

The low cost of imports also helped to stabilize prices. While China's factories and property developers are less hungry for commodity imports, they are also benefitting from a precipitous fall in global commodity prices. For example, the value of China's crude oil, iron ore, and copper imports increased at a rate of up to 50 percent per year in the period 2000-2008, before the financial crisis. In 2009-2013, on the other hand, the value of those imports grew at only 10 to 15 percent. And yet, the growth in the tonnage of imports has remained fairly stable over the two periods (see figure 11). The cost of imports was also reduced, albeit to a lesser degree, by the moderate appreciation of the RMB, in a year when other emerging market currencies were sharply devalued.

Figure 11: Growth in China's Imports of Major Commodities: Value vs. Quantity of Imports
(Annualized, %)

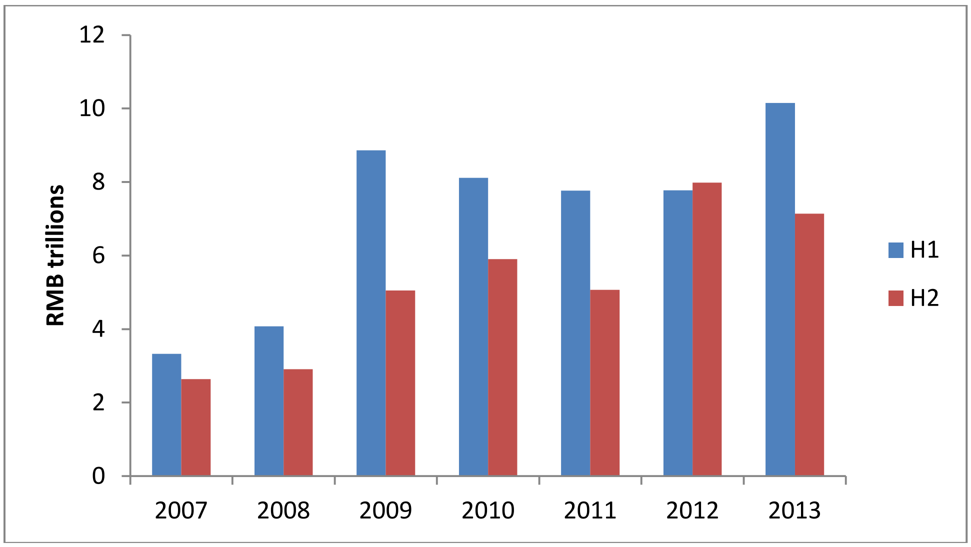


Source: China General Administration of Customs, via CEIC data.

Incipient Reforms in the Financial Sector

Counter to the doomsayers, China did not experience a major financial crisis in 2013. Like inflation, growth in the broad money supply (M2) was well contained, coming in at 13.6 percent in the fourth quarter, well below the 15.7 percent expansion that unsettled the markets in the first quarter. Chinese banks made RMB 482.5 billion ($79.1 billion) worth of new loans in December, lower than a forecast of RMB 600 billion ($98.3 billion).[35] Total social financing, a measure of aggregate credit growth, also declined sharply in the second half of the year, coming in at the lowest level since 2011 (see figure 12). The decline in financing can be led back to central bank austerity measures carried out in June.

Figure 12: Total Aggregate Credit in China
(RMB trillions)



Source: People's Bank of China, via CEIC data.

However, rising levels of debt, much of it in the "shadow banking" sector, is putting China's central bank in an increasingly untenable position. Fitch Ratings estimates China's aggregate debt now stands at 216 percent of GDP, up from 128 percent in 2008. Ordinary bank loans outside the shadow banking system accounted for just 55 percent of total credit in the economy in 2013, down from 88 percent a decade earlier.

Underlying these broad trends are complex supply and demand factors. On the one hand, China's households are increasingly seeking alternatives to depositing funds in low-yielding bank accounts. China's gold bullion imports doubled last year to over 1,000 tons, surpassing India as the biggest buyer, and prompting the government to extend import licenses to foreign banks in January.[36] Online investment platforms offering higher rates of return and flexible withdrawals are also attracting millions of users. [37] As depositors increasingly withdraw funds, banks have responded by offering higher-yielding wealth management products (WMP) to customers. But this unregulated and off-balance sheet practice puts banks in a bind when the WMPs come due before the underlying asset can be liquidated. At the end of 2013, banks borrowed heavily from one another, not only to meet year-end capital requirements, but also to pay off the WMP investors.

Banks are also experiencing an increase in non-performing loans that could grow worse in the coming months. Local governments, who have over-invested in residential and commercial property through financing vehicles, are heavily indebted. A new audit report of local government debt, released in early January, showed that many local governments will have a difficult time paying off debts that are coming due in the next 24 months. Due to China's slowing factory output, certain manufacturers are also seeking bailouts, especially in industries with overcapacity.

The central bank's efforts to deal with these issues in 2013 were extremely risky. Austerity measures in June and December twice incited spikes in interbank lending rates that threatened to crash financial markets. Over the past month, however, there have been signs that more earnest reforms are on the way. To rein in the shadow banking sector, the China Banking Regulatory Commission (CBRC) set up a leadership group on banking industry reform headed by its chairman Shang Fulin. According to CBRC Vice-Chairman Zhou Mubing, the Commission will come up with a reform plan in the first quarter, and preliminary results on these two focal points of reform should be evident by the end of June.[38] In addition, the CBRC said in a statement on its website that it had asked some large Chinese banks – those regarded as important to the financial system by the Financial Stability board – to disclose 12 indicators that measure their assets and obligations both on and off their balance sheets.[39]

If bank lending is indeed reined in, Beijing will need to find alternative sources of liquidity, or assets that are easily convertible to cash. One way of doing this is by attracting foreign capital. That may explain a recent decision to again accept initial public offerings (IPOs) to revive the country's moribund stock exchanges. IPOs were halted in late 2012 after a series of poor showings, but in the intervening year, the Shanghai exchange has dropped in value by 7.1 percent (in dollar terms). Only stock exchanges in emerging markets such as Turkey and India, which have suffered major currency devaluation over the past year, fared worse. For the time-being, however, IPO candidates in China will face a long waiting list to be approved for the country's exchanges. That will indirectly impact foreign investors such as private equity funds, which have been frustrated by China's restrictions on mergers and acquisitions, and view stock market listings as a favorable outcome of investment projects.[40]

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