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U.S.-China Economic and Security Review Commission

Monthly Analysis of U.S.-China Trade Data **February 5, 2015**

Highlights of this month's edition

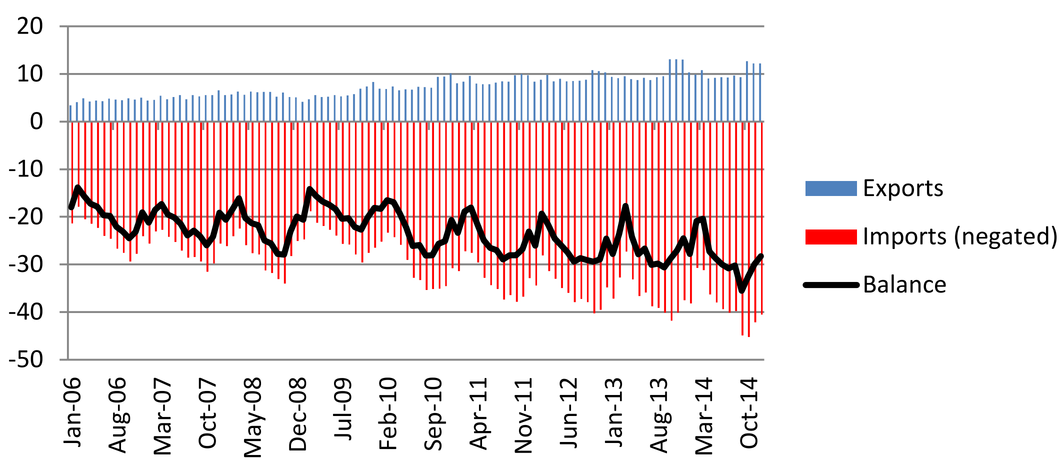
- **Bilateral trade:** U.S. goods deficit with China sets new record, imports outpace exports; U.S. maintains surplus in services despite weaker export growth; transport equipment shipments to China remain strong, farm goods shipments tail off
- **Quarterly review of China's economy:** China registers slowest growth in quarter-century; strong consumption and weak investment suggests some rebalancing; low inflation and "shadow" banking containment give central bank room for easing
- **Policy trends in China's economy:** Leadership's "new normal" principle likely to carry into 2015, emphasizing slower but higher quality growth
- **Sector focus—China's draft Foreign Investment Law:** Draft of new foreign investment law introduces "negative list" approach and codifies national treatment, but updated national security review could create additional market access barriers

Bilateral Goods Trade

U.S. Goods Trade Deficit with China Hits New Record

In 2014, the U.S. goods trade deficit with China increased by 7.5 percent year-on-year to $342.6 billion, a new record (see Figure 1). U.S. exports to China grew 1.9 percent year-on-year, while imports increased 6 percent. This stood in contrast to 2013, when U.S. exports to China rose by 10.2 percent, outpacing imports by 6.7 percentage points (ppt). In effect, after some progress in 2013, efforts to rebalance bilateral trade are retrogressing. In the second half of 2014, U.S. exports to China actually declined by 2.1 percent year-on-year, compared to 15.9 percent growth during the same period a year earlier.

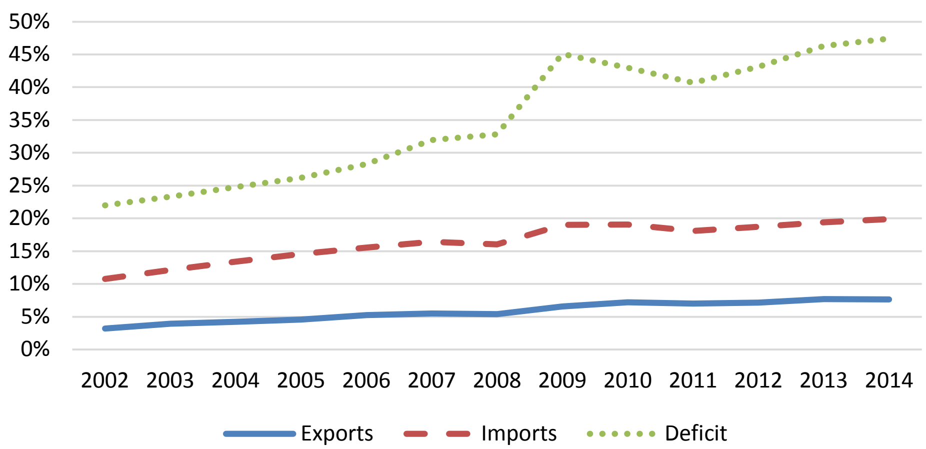
Figure 1: U.S.-China Goods Trade, 2006-2014
(US$ billions)



Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, February 2015). *http://www.census.gov/foreign-trade/balance/c5700.html.*

China's share of the U.S. goods deficit with the world also set a new record in 2014, reaching 47 percent (see Figure 2). The overall goods deficit for 2014 was $722.5 billion. U.S. exports to China also grew at a slower rate than U.S. exports to the world, counter to the prevailing trend of the past five years.

Figure 2: China's Share of U.S. Goods Exports, Imports, and Deficit



Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, February 2015). *http://www.census.gov/foreign-trade/balance/c0015.html; http://www.census.gov/foreign-trade/balance/c5700.html.*

Top Exports and Imports

In 2014, transportation equipment, primarily aerospace and automotive products, continued to lead U.S. exports to China. According to the Bureau of Economic Analysis, U.S. passenger car exports to China totaled $11.1 billion in 2014, ranking China second behind Canada ($14.6 billion) and ahead of Germany ($5.6 billion) and Mexico ($3.7 billion). At this rate, China will soon become the largest market for U.S. passenger vehicle exports, even as it imports almost no U.S. trucks or auto parts.[1]

Agricultural products topped the list of U.S. exports to China in December 2014, but declined 2.9 percent year-on-year (see Table 1), a reflection of overcapacity in China's meat industry, as much as China's restrictions on U.S. biotechnology crops. The restrictions were reduced in December at the Joint Committee on Commerce and Trade (JCCT) talks, which could allow crop exports to rebound in the new year.[2]

On the import side, computer and electronic products continued to dominate, accounting for 36 percent of U.S. purchases from China in 2014.

Table 1: 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'13 (%)	U.S. Top-Five Imports from China	Imports	Share of total (%)	Change over Dec'13 (%)
Monthly (December 2014)				*Monthly (December 2014)*			
Agricultural Products	2,818,168	23.0%	-2.9%	Computer and Electronic Products	16,410,893	40.5%	8.0%
Transportation Equipment	2,808,363	23.0%	5.9%	Electrical Equipment, Appliances, and Component	3,273,781	8.1%	23.4%
Computer and Electronic Products	1,553,152	12.7%	8.0%	Commodities	2,924,163	7.2%	-1.3%
Chemicals	1,161,335	9.5%	-22.9%	Machinery, Except Electrical	2,387,274	5.9%	21.8%
Machinery, Except Electrical	789,693	6.5%	-27.3%	Apparel and Accessories	2,261,166	5.6%	-2.4%
Other	3,100,699	25.4%	-	Other	13,274,206	32.8%	-
Total	12,231,410	**100.0%**		**Total**	40,531,483	**100.0%**	
Year-to-date (thru Dec'14)				*Year-to-date (thru Dec'14)*			
Transportation Equipment	26,410,072	21.3%		Computer and Electronic Products	167,965,977	36.0%	
Agricultural Products	18,613,928	15.0%		Electrical Equipment, Appliances, and Component	38,855,952	8.3%	
Computer and Electronic Products	16,367,749	13.2%		Commodities	37,621,273	8.1%	
Chemicals	13,802,421	11.1%		Apparel and Accessories	32,787,194	7.0%	
Machinery, Except Electrical	9,683,002	7.8%		Machinery, Except Electrical	29,569,338	6.3%	
Other	39,146,778	31.6%	-	Other	159,856,759	34.3%	-
Total	124,023,950	**100.0%**		**Total**	466,656,493	**100.0%**	

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, February 2015). *http://censtats.census.gov/naic3_6/naics3_6.shtml*.

Advanced Technology Products

The U.S. trade deficit with China in advanced technology products (ATP) reached $123.7 billion in 2014, an increase of $6.9 billion over 2013 (Table 2). As in years past, the deficit was largely caused by information and communication products (ICT). Excluding ICT products, the United States actually ran an $11 billion ATP surplus in 2014, buoyed by aerospace shipments.

Table 2: Advanced Technology Product Trade through December 2014
(US$ millions)

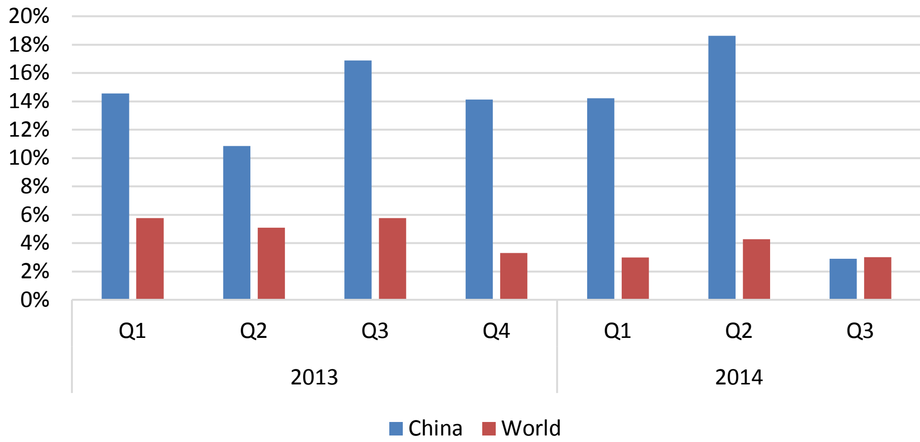
	Monthly			Cumulative year-to-date			
	Exports	Imports	Balance Dec'14	Exports	Imports	Balance 2014	Balance 2013
TOTAL	**3,369**	**15,280**	**-11,911**	**30,827**	**154,571**	**-123,744**	**-116,881**
(01) Biotechnology	40	12	28	497	104	393	322
(02) Life Science	315	229	86	3,111	2,243	868	975
(03) Opto-Electronics	32	566	-534	392	6,959	-6,567	-4,879
(04) Information & Communications	392	13,927	-13,535	4,619	139,411	-134,792	-128,185
(05) Electronics	571	297	274	5,549	3,364	2,185	1,461
(06) Flexible Manufacturing	182	87	95	2,436	997	1,439	1,697
(07) Advanced Materials	16	22	-6	177	271	-94	-61
(08) Aerospace	1,817	70	1,747	13,977	889	13,088	11,848
(09) Weapons	0	13	-13	1	145	-144	-162
(10) Nuclear Technology	3	57	-54	67	188	-121	103

Source: U.S. Census Bureau, U.S. Trade with China in Advanced Technology Products (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, February 2015). *http://www.census.gov/foreign-trade/statistics/product/atp/2014/12/ctryatp/atp5700.html*.

U.S.-China Trade in Services

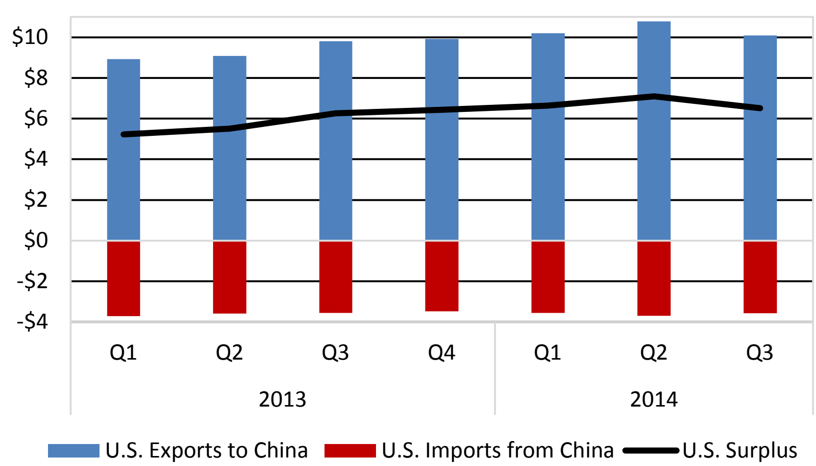
U.S. services exports to China grew by less than 3 percent in the third quarter of 2014, a sharp letdown from previous quarters (see Figure 3). China accounted for only 5.7 percent of U.S. services exports to the world, practically unchanged from its share in 2012 and 2013. The U.S. services trade surplus with China remained strong overall, with exports outpacing imports in the third quarter by 2.1 ppt. However, year-on-year surplus growth was a mere 4.1 percent, compared with 23.7 percent in the second quarter (see Figure 4).[3]

Figure 3: Growth in U.S. Services Exports to China and to the World
(year-on-year, %)



Source: U.S. Department of Commerce - Bureau of Economic Analysis, *U.S. Trade in Goods and Services by Selected Countries and Areas, 1992-present* (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, February 2015). *http://www.bea.gov/newsreleases/international/trade/tradnewsrelease.htm*.

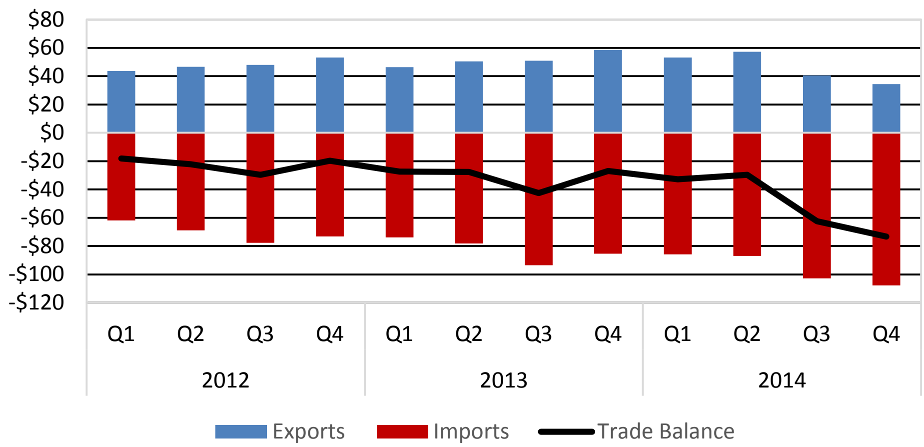
Figure 4: U.S.-China Trade in Services
(US$ billions)



Source: U.S. Department of Commerce - Bureau of Economic Analysis, *Table 3.2: International Trade in Services by Area and Country, Seasonally Adjusted*, December 17, 2014.

China's global trade deficit in services widened in 2013-2014, from $118.4 billion to $198 billion, a 67 percent increase.[4] In the fourth quarter alone, China's services deficit hit $73.3 billion, up 17.6 percent from $62.3 billion in the third quarter, with services imports more than three times the exports (see Figure 5). While this indicates China's services economy is opening up to more imports, it also signals China's lack of competitiveness in services trade.

Figure 5: China's Global Trade in Services
(US$ billions)

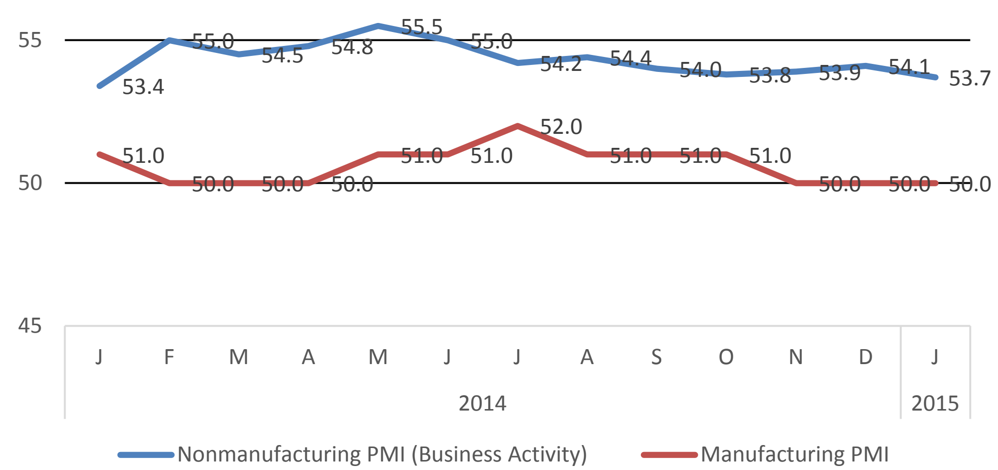


Source: China State Administration of Foreign Exchange, via CEIC.

China mainly relies on traditional industries such as tourism and transportation to support its services exports, but is looking to upgrade. On January 14, China's State Council announced a string of measures, including further opening up the finance, education, culture, and medical treatment sectors; accelerating service trade liberalization between the Mainland and Hong Kong and Macau; and encouraging domestic enterprises to invest in overseas service sector markets by establishing new ventures or acquiring local companies.[5]

China's domestic service industry is performing well at a time when the economy as a whole is slowing. China's fixed investment in the tertiary sector, excluding real estate, was 20.7 percent last year—4.4 ppt less than in 2013, but nearly twice the rate recorded for manufacturing investment.[6] The HSBC China Services Business Activity Index, a survey of services companies in China, posted 51.8 at the start of the year, down from 53.4 in December, but still above 50, which indicates that firms expect their orders to increase.[7] China's official purchasing managers' index (PMI) for services also indicates expansion (see Figure 6).

Figure 6: China's Official Purchasing Managers' Index
(>50 = Expansion; <50 = Contraction)



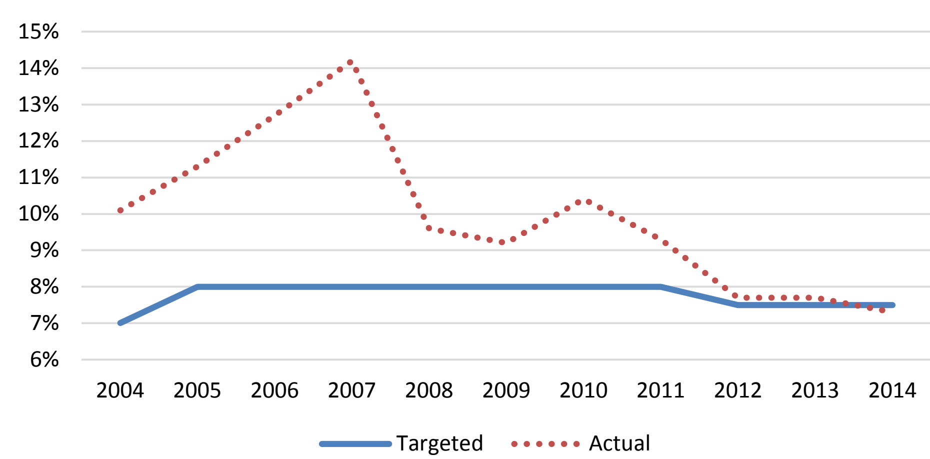
Source: China National Bureau of Statistics, via CEIC.

Quarterly Review of China's Economy

China's GDP Growth Slowest in 24 Years

China registered real gross domestic product (GDP) growth of 7.3 percent in 2014, its lowest annual rate since 1990.[8] It was also 0.2 ppt short of the official government target, the first time this has happened in over a decade (see Figure 7). GDP growth met the 7.5 percent target in the second quarter of last year, after which it decelerated to 7.3 percent in both the third and fourth quarters.[9] Deutsche Bank, normally bullish on China, expects the slowdown to continue, with GDP decelerating to 7 percent in 2015 and 6.7 percent in 2016.[10] The International Monetary Fund (IMF) goes a step further, projecting 6.8 percent growth for China in 2015 and 6.3 percent the year after.[11]

Figure 7: China's Actual and Targeted Real GDP Growth
(year-on-year, %)

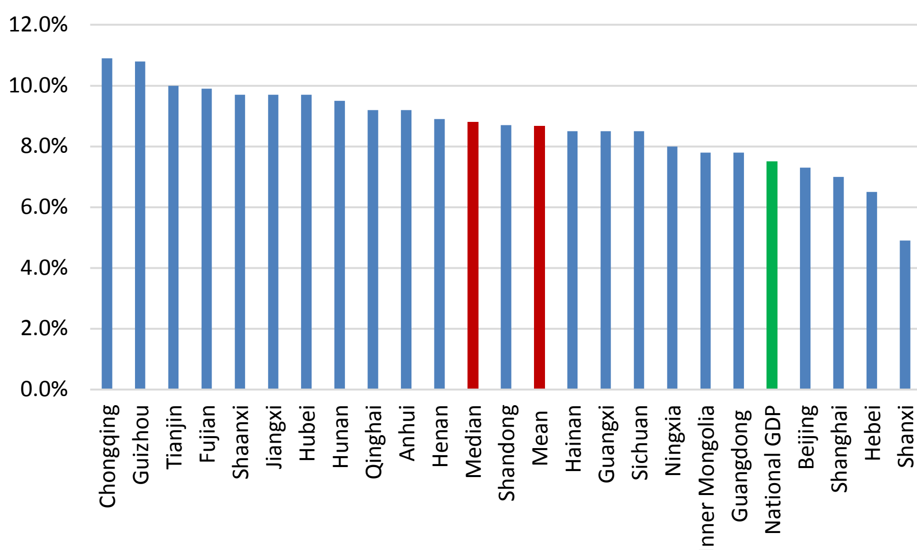


Source: World Bank; IMF; China National Bureau of Statistics.

While China remains a central driver of the world economy, forecasts suggest the growth gap between China and other countries will narrow. Global GDP growth in 2014 was 3.3 percent—less than half China's rate—but the IMF projects that number will improve to 3.5 percent and 3.7 percent in the next two years, despite China's slowdown.[12] The United States, the world's largest economy, is expected to grow by 3.6 percent (IMF) or 3.7 percent (Deutsche Bank) this year, bettering 2014 by about 1 ppt. India, the tenth-largest economy, could see accelerated growth as well, nearly matching China's rate by 2016.[13]

Oddly, China's slowdown is not apparent at the provincial level. Data from Deutsche Bank—which captures 22 out of China's 31 provinces, municipalities, and autonomous regions—shows only three territories with growth below 7.5 percent, and the mean and median are considerably higher (see Figure 8). China's largest province by GDP, Guangdong, recorded 7.8 percent growth. One explanation for the discrepancy between national- and provincial-level data is that key data are missing; three of China's top ten provinces by GDP (Zhejiang, Jiangsu, and Liaoning) are not included in the dataset. The methods used by China's National Bureau of Statistics (NBS) likely play a role as well. For example, the NBS often trims the provincial growth figures when making its aggregate calculation, in order to account for exaggerated reporting of output by local officials.*

Figure 8: China's Real GDP Growth by Province



Source: Deutsche Bank, "China's Provinces – Interactive Map."
https://www.dbresearch.com/servlet/reweb2.ReWEB;jsessionid=6A03903276EF312731A18F33F78443AD.srv-net-dbr-com?rwnode=DBR_INTERNET_EN-PROD$RMLCHPM&rwsite=DBR_INTERNET_EN-PROD.
Note: Includes only 22 out of China's 31 provinces, municipalities, autonomous regions.

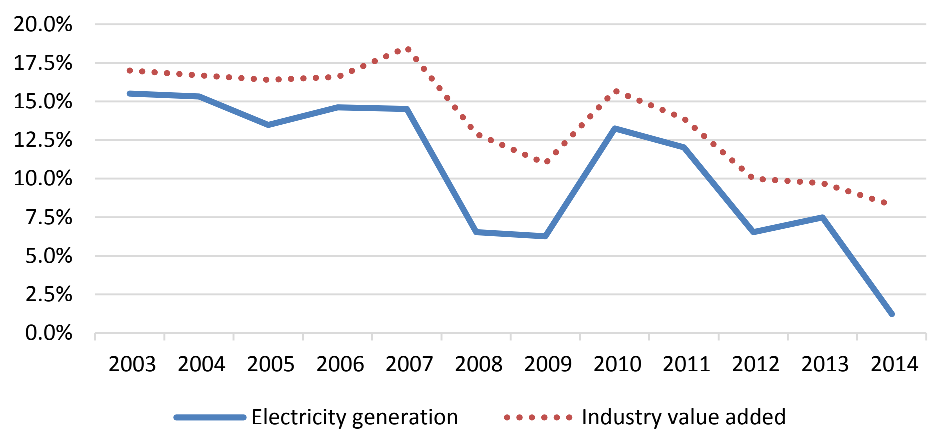
Moderate Rebalancing as Investment Slows and Consumption Booms

At the heart of China's slowdown is fixed investment, which accounts for almost half of China's GDP. At 13.3 percent for manufacturing and 11 percent for real estate, yearly investment growth was at its weakest in over a decade (non-adjusted for inflation). Investment in mining contracted by 0.5 percent year-on-year, likely precipitated by the drop in coal and metals prices.[14]

* For more information, see Iacob Koch-Weser, *The Reliability of China's Economic Data: An Analysis of National Output* (U.S.-China Economic and Security Review Commission, January 2013). *ttp://www.uscc.gov/research_economic?page=2#sthash.7Hip944N.dpuf.*

Like investment, manufacturing activity has been very subdued. About four-fifths of China's electricity is consumed by industry;[15] last year, electricity generation grew by just 1.5 percent (see Figure 9).[16] (This decline is so severe it challenges the validity of China's other growth statistics.) Industry value-added grew at an even lower rate than during the global financial crisis in 2007–2009. The HSBC PMI, a survey of manufacturers, registered 49.7 in January (seasonally adjusted), up only fractionally from 49.6 in December. When PMI is below 50, manufacturers expect their orders to decline. Job shedding at China's factories is already a reality; HSBC noted in a February 2 report that staffing levels were cut in January for the fifteenth successive month.[17]

Figure 9: Growth in China's Electricity Generation and Industry Value-Added



Source: China National Bureau of Statistics, via CEIC.

Several manufacturing sectors, including steel, cement, and glass, have suffered from the decline in China's housing market. The annual sales value of residential buildings, accounting for over four-fifths of the housing market, fell by 7.8 percent in 2013–2014.[18] This has also slowed property developers. Residential floor space under construction in China expanded by 3.6 percent last year, versus an average of 16.6 percent in the previous ten years.[19]

Anemic export growth has also hurt manufacturers. The value of China's goods exports rose by 6 percent year-on-year, less than total economic output, and a long way from the double-digit export boom of the 2000s.[20] An important factor is the recession-plagued eurozone, China's top export market, which grew by only 0.8 percent in 2014, and even less when discounting Germany.[21] China's perpetually export-oriented economy did achieve a record trade surplus of $380.1 billion, but that had much to do with weak import growth. In spite of the expanding market for foreign consumer goods, China's import demand is still determined chiefly by industry.[22]

Declines in investment and manufacturing could indicate rebalancing, but may also be symptoms of a cyclical downturn. Better indicators of rebalancing are gains in consumption, services, and household income:

- *Consumer growth strong.* At 12 percent year-on-year, China's retail sales last year outpaced industrial output and fixed investment. If correct, then China is indeed rebalancing. However, retail sales are a crude measure of total consumption, since they do not account for consumption of many services, such as healthcare, education, and insurance.[23]

- *Services growth moderate.* The tertiary sector, representing services, has grown at a faster rate than the secondary sector since 2012, but only marginally so, and primarily because of a manufacturing decline rather than a boom in services. [24] Investment in the non-real estate tertiary sector expanded by 20.7 percent, a faster rate than manufacturing investment, suggesting some rebalancing toward a service-oriented economy.[25]

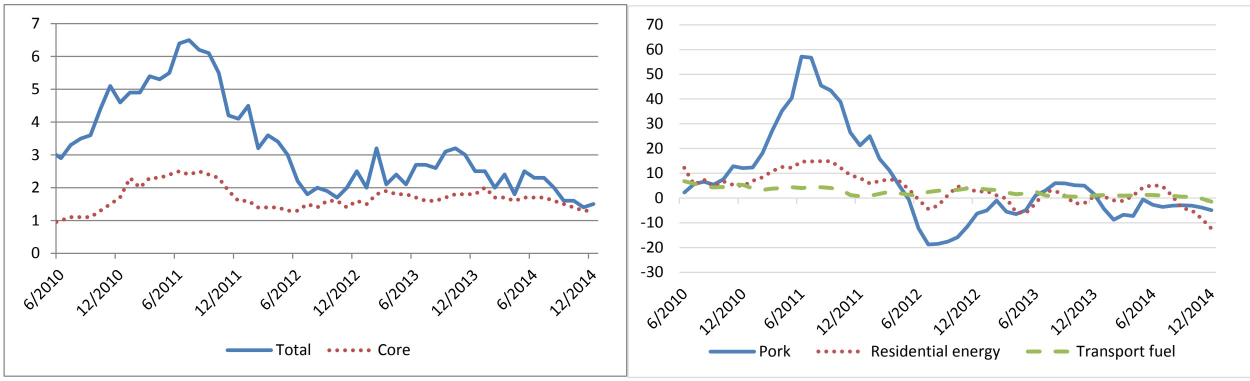
- *Income growth weak.* According to the latest data, available through the middle of 2014, urban disposable income is growing at a slower rate than nominal GDP. Disposable income gives a more realistic picture of spending power than nominal wages.[26]

Little Cause for Concern on Monetary Policy

While China's economy is slumping, the People's Bank of China (PBOC), its central bank, has less cause for concern. First, consumer price inflation (CPI) is moderate relative to China's GDP growth rates. At 2.1 percent in 2014, China's CPI was lower than Japan's (2.8 percent), and far lower than in fellow emerging markets Brazil (6.3 percent), Russia (7.7 percent), and India (7.2 percent)—all countries growing at a slower rate than China.[27] As Figure 10 shows, China's low inflation has resulted from a drop in non-core inflation, which represents energy and food prices. China in December paid around $30 less per barrel of imported crude oil than it did in July,[28] in conjunction with a sharp decline in global oil prices. This has contributed to a decline in prices for both residential and transport energy. Pork, a key component of CPI, has also become cheaper (see Figure 10).

Low inflation should give the PBOC some wiggle room to stimulate growth. Deutsche Bank expects cuts in China's benchmark interest rates in the second and third quarters of 2015.[29] Already on February 4, the PBOC cut the reserve requirement ratio, according the country's commercial banks more flexibility to issue loans.[30]

Figure 10: Consumer Inflation in China
(Percent)

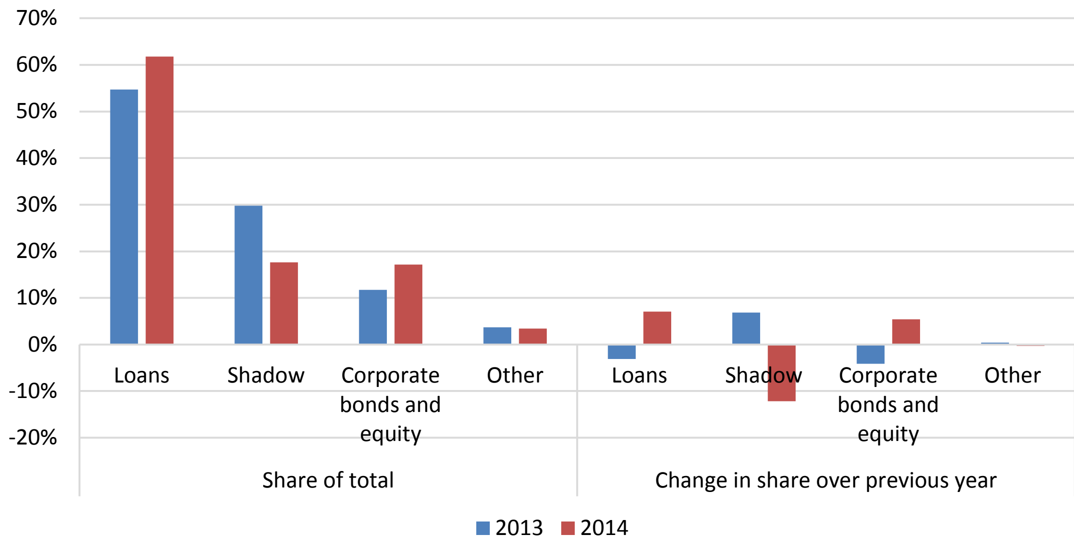


Source: China National Bureau of Statistics, via CEIC.

Furthermore, the "shadow banking" sector is unwinding, a process that began in the latter half of 2013. As Figure 11 illustrates, ordinary bank loans and corporate bonds and equity have increased as a share of aggregate financing, while credit issued through shadow banking instruments (trust loans, entrusted loans, and banker's acceptance bills) has receded. Online banking poses some new risks, but China's bank regulators appear to be tackling the problem head-on by endorsing certain forms of online banking over others.

Internet conglomerate Tencent Holdings launched China's first Internet-based bank in early January with direct support from Premier Li Keqiang.*

Figure 11: The Composition of Aggregate Financing in China
(Share %)



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

A persistent concern is the status of local government debt. The decline in the housing market has translated into reduced land sales, the primary source of revenue for municipal governments. The central government's recent policies add to these woes. Financial regulators are cracking down on local government financing vehicles (LGFVs), private entities used to raise public funds in lieu of government bonds. In September 2014, the Ministry of Finance loosened its 20-year ban on bond issuances by local governments, but only did so for provincial governments, which must also seek central-level approval.†

The Ministry of Finance is also phasing out the local business (or turnover) tax that has burdened companies in the services sector. Although this is a progressive move, it has deprived local governments of key revenue. One strategy to overcome this fiscal gap is to increase local taxes on polluting and energy-intensive goods. In early December, for example, China shifted from a volume-based to a price-based consumption tax on coal.[31,‡]

Policy Trends in China's Economy

"New Normal" Principle Starts to Hit Home

In 2014, as China registered its slowest economic growth in 24 years,[32] the senior leadership began to promote the "new normal" principle. Its core tenets are:

- To transition from high-speed growth to medium-high-speed growth;
- To optimize and upgrade the economic structure; and

* For more information, see the January 2015 edition of the *USCC Monthly Trade Bulletin*.
† For more information, see Iacob Koch-Weser, *China Fiscal Policy Revamp Faces Hurdles*. Staff paper. (U.S.-China Economic and Security Review Commission, September 30, 2014).
‡ For more information see the *USCC Chinese Media Digest No.4*, January 30, 2015.

- To transition from a factor- and investment-driven economy to an innovation-driven economy. [33]

Donna Kwok, a senior economist at UBS, told CNBC:

> *[What the "new normal" for China] essentially means is that new changes in China's domestic demand and external circumstances [have led] to a situation whereby the government can no longer focus only on growth support. They also have to make sure they contain financial and economic risks already embedded in the system, and they also have to see through reforms. So they try to [achieve] all three goals at the same time when they deliver any kind of support to the economy.*[34]

The "new normal" principle reinforces China's long-held objectives—stated repeatedly since the 11th Five-Year Plan (2006-2010)—to focus on the quality of growth and rebalance the economy toward consumption, services, and high-tech manufacturing. Several reform initiatives over the past year arguably contributed to this agenda:

- *Mini-stimulus rather than large-scale stimulus measures.* By openly accepting a slower economic outlook, the "new normal" represents a significant departure from the growth-centric policies of former presidents Hu Jintao and Jiang Zemin.[35] In January 2015, Shanghai municipality became the first local government in China to eliminate its annual GDP growth target. It explicitly cited the "new normal" as its guiding policy, in conjunction with pledges to create jobs, raise research and development (R&D) spending, and generate more innovative patents.[36] Kwok told CNBC:

  > *We think the [central] government will try to restrain and hold back from any wholesale easing, so any type of traditional flushing the system with liquidity or massive fiscal support. However, we do expect them to not shy away from providing infrastructure support and also targeted selective monetary easing measures where needed […] We think the government will step up support in a trickle-through manner.* [37]

- *Reforming the household registration system.* By making it difficult for urban migrants to access basic amenities, China's antiquated system of household registration exacerbates China's urban-rural divide and hampers the rise of a new urban consumer class. To remedy this situation, the State Council, China's cabinet, set out guidelines in August 2014 that give cities greater leeway to set their own residency requirements, beyond traditional criteria such as stable accommodation and a steady job. Cities can now vet applicants based what type of job they perform and how long they have paid into the local social-insurance system.[38]

- *Fiscal reform and local government budget transparency*. The government is cracking down on the use of LGFVs and encouraging local governments to raise funds through indirect taxes and bond issuances. According to Fitch, the rating agency, local government bonds have the added benefit of making fiscal budgets transparent, since fewer funds will be raised "off-budget."[39] It will also help to reign in oversupply in the property and construction sectors, since local governments rely excessively on land sales (for discussion, see economic trends section above).

These initial steps could set the stage for far-reaching reforms this year, especially in the financial and corporate sectors. However, China's leadership continues to face a delicate balancing act between instituting reforms that sustain growth in the long run and maintaining sufficient growth in the short term to prevent financial defaults and labor unrest.[40,*] While Chinese officials talked up the 13 million new jobs created last year in the face of a slowing economy, maintaining such employment growth will prove increasingly difficult.[41] The Chinese government also faces stiff resistance from vested interests in state-owned and export-driven sectors.

Sector Focus: China's Draft Foreign Investment Law

On January 19, China's Ministry of Commerce (MOFCOM) published a draft of its proposed Foreign Investment Law.[42] The draft law introduces some key reforms, including the "negative list approach" to foreign investment as well as a streamlined process for initiating new foreign investment projects. However, the draft law's national security review process could create additional market access barriers for U.S.-based and other foreign invested enterprises (FIEs) in China.

In addition, proposed regulations on variable interest entity (VIE)-structured firms would give MOFCOM discretion to favor China-based businesses that use the structure to obtain foreign financing, usually by listing on U.S. exchanges, while continuing to closely scrutinize or ban foreign-based firms that use the VIE structure as a means of entering the China market.[43] The draft law is available for public comment until February 17, after which it will navigate the Chinese legislative process for an undefined period of time.[44] On January 28, the U.S.-China Economic and Security Commission held a hearing on China's foreign investment climate that included expert testimony regarding the draft law.[†]

National Treatment and the "Negative List" Approach

A key reform introduced by MOFCOM's draft Foreign Investment Law is the adoption of national treatment toward foreign investment. Under the current system, China maintains catalogues that outline those sectors approved for foreign investment by the National Development and Reform Commission (NDRC) and MOFCOM; FIEs in sectors not included are subject to an extensive and often time-consuming government review process. Under the prospective law, in order to implement a national treatment policy, China will shift to a negative list approach for foreign investment projects, meaning all sectors will be open to foreign investment unless specifically excluded by the negative list.[45]

The draft law does not specify which Chinese sectors will be included in the negative list, but it is expected that politically sensitive sectors or sectors with a large state-owned presence, such as telecommunications, Internet, press, and publications, will remain restricted.[46] As a result of this national treatment approach, all FIEs in sectors not restricted by the negative list will be treated equally to domestic firms. In other words, in lieu of applying for approval from MOFCOM as a prerequisite for market entry, FIEs in unrestricted sectors would be able to establish businesses in China in the same way as domestic firms, namely by applying directly to the State Administration for Industry and Commerce.[47] Meanwhile, FIEs in restricted sectors would still face numerous market access barriers such as foreign equity caps, geographic limitations, and local hiring minimums, as well as the current MOFCOM review and approval process.

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[*] For an in-depth analysis, see Tom Orlik, Zhang Ming, et al., *China's Transition: The Third Plenum – One Year On*. Bloomberg Brief, October 2014. *http://www.bloombergbriefs.com/content/uploads/sites/2/2014/10/China-Plenum-opt.pdf*; Knowledge @ Wharton, "China in 2015: Gauging the New Normal," January 20, 2015. *http://knowledge.wharton.upenn.edu/article/gaging-the-new-normal-in-china/*.

[†] Witness testimony is available on the Commission's website, *http://www.uscc.gov/Hearings/hearing-foreign-investment-climate-china-present-challenges-and-potential-reform*.

National Security Review

Although the above reforms would be a positive development for U.S.-based and other FIEs in China, some changes proposed in the draft Foreign Investment Law could worsen the foreign investment climate in China. For example, the current Chinese regulations for review of foreign investment projects for national security risks have been moderately well-defined in scope. Specifically, current Chinese law allows for a national security review for mergers and acquisitions with foreign firms in military industrial enterprises or related supporting businesses as well as government-designated key sectors such as agriculture, energy, infrastructure, technology, etc., in which foreign entities could obtain control over the business. The new draft law broadens the scope extensively to include "any foreign investment which damages or may damage the national security of China."[48] Such a broad and arbitrary scope of the national security clause would grant MOFCOM a high degree of discretion in determining which foreign investment projects may be subject to the national security review.[49]

Moreover, the draft law stipulates there will be no judicial review of cases reviewed for national security purposes. According to the draft, cases reviewed for national security purposes will "not be subject to challenge under any administrative review or administrative litigation."[50] Although MOFCOM revisions to the national security clause of the draft law were borrowed from other "relevant countries," the judicial immunity of the national security review process contrasts with the U.S. approach under which a foreign firm may sue the U.S. government if the foreign firm contests a determination by the Committee on Foreign Investment in the United States (CFIUS).[51] For example, in 2012, Ralls Corporation, a Delaware-based affiliate of the Chinese firm Sany Group Co., filed a lawsuit against President Obama after he denied its request to build a wind farm.[52] Such judicial oversight is explicitly banned in China's draft law.

VIE Structures

The draft Foreign Investment Law also addresses the long-standing ambiguous legal status of VIE-structured companies. VIE-structured companies are typically firms in restricted industries, such as the Internet sector, that face foreign equity caps in China. To circumvent these regulations, such firms adopt a complex transnational corporate structure bound by myriad legal contracts to access foreign capital. Major Chinese companies listed on U.S. stock exchanges, such as Alibaba and Baidu, use the VIE structure to obtain foreign financing. Non-Chinese companies often use the VIE structure as a means of entering restricted sectors in the China market, though this is less common because of the legal ambiguity of the structure in China. The structure allows foreign-based firms or Chinese firms with majority foreign financing to disguise themselves as domestic Chinese firms, although People's Republic of China (PRC) law thus far has been ambiguous about their legality.[53]

The draft Foreign Investment Law appears to be the first time China would definitively classify VIE-structured firms as foreign firms. The draft defines foreign investors as "individuals who are not Chinese citizens, any enterprise incorporated under foreign laws, any organ of a foreign government, international institutions, and any domestic entity which is controlled by any of these."[54] The last of these would include VIE-structured firms that are legally domestic entities, but whose controlling investor stake is foreign.

This clarification on VIEs as foreign entities has led some legal experts to declare the end of the VIE structure in China and to predict that existing VIEs, which are not registered as foreign firms, will become illegal in China.[55] Specifically, the draft rules imply that VIE-structured companies listed on U.S. stock exchanges, such as Alibaba, would be reclassified as foreign (non-Chinese) firms and would, therefore, face the same restrictions and market access barriers as U.S. Internet firms operating or seeking to invest in China.

However, other experts believe it is highly unlikely MOFCOM would implement any reforms that would cause damage to China's thriving Internet sector, the main beneficiary of the VIE structure.[56] To that effect, the draft law introduces a control test to determine if a VIE-structured firm is ultimately Chinese-controlled or foreign-controlled. First, grandfather clauses are included in the draft law to allow VIEs that were already established in China to continue operations.[57] For newly established VIE-structured companies, the draft law includes an exception clause that will allow VIE firms to request to be classified as domestic companies based on "de facto control" by Chinese citizens. In other words, MOFCOM would have the discretion to determine de facto Chinese control even if the majority of shareholders are foreign, as is the case for most Chinese companies listed on U.S. stock exchanges. In sum, the draft law provides greater clarification on the VIE structure, but in a way that seemingly favors Chinese firms while continuing to restrict or ban foreign firms from restricted sectors.[58]

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