U.S.-China Economic and Security Review Commission

Economics and Trade Bulletin

February 5, 2016

Highlights of this Month's Edition

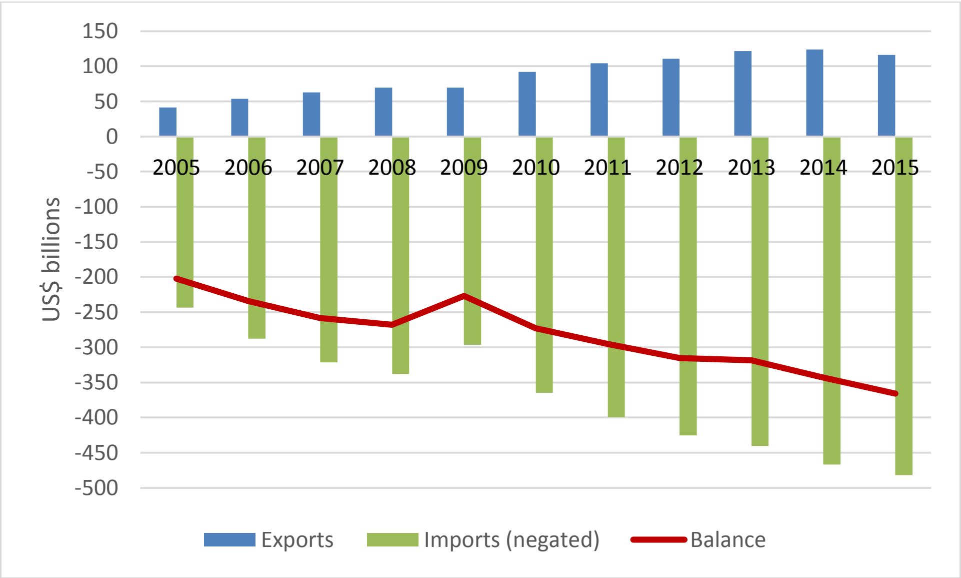
- **Bilateral trade:** At $365.7 billion, U.S. goods deficit with China hits new record; U.S. services exports expanded to a record high in Q3 2015 driven by high Chinese travel to the United States.
- **Bilateral policy issues:** U.S. firms rate Chinese interpretation of law as top concern and report lower profitability and future growth in China's economy in American Chamber of Commerce survey.
- **Quarterly review of China's economy:** GDP growth slows to 6.9 percent on manufacturing deceleration; Beijing pursues new "supply-side" reforms; stock market volatility continues; the $500 billion surge in Chinese capital outflows places the Chinese government on the horns of a dilemma.
- **Sector focus – Real estate:** The slowdown in China's real estate sector remains a drag on GDP growth; government attempts to boost the sector have failed to halt the market's decline.

Bilateral Goods Trade

U.S. Goods Trade Deficit in 2015 Sets a New Record

In 2015, the U.S. goods trade deficit with China increased by 6.7 percent year-on-year to $365.7 billion, a new record (see Figure 1). U.S. exports to China declined 6.3 percent year-on-year, while imports increased 3.3 percent.

Figure 1: U.S.-China Goods Trade, 2005-2015

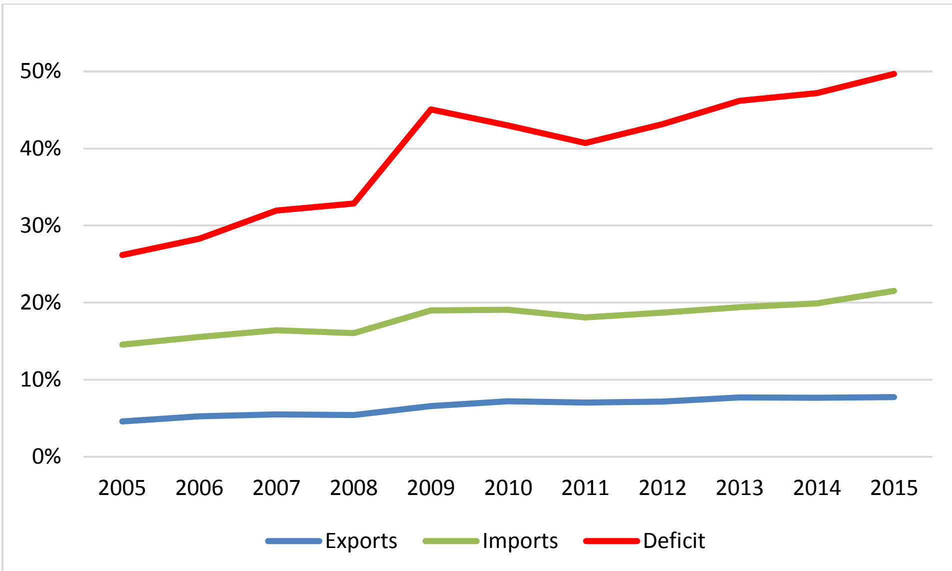


Source: U.S. Census Bureau. *http://www.census.gov/foreign-trade/balance/c5700.html.*

While the pace of U.S. export growth to China has never been very high (U.S. exports grew 1.9 percent in 2014), the actually decline in exports this year makes for a disappointing new development. The only previous time this happened was at the height of the global financial crisis, when exports fell from $69.7 billion in 2008 to an even more tepid $69.5 in 2009, before staging a quick recovering in subsequent years.

China's share of the U.S. goods deficit with the world also set a grim new record in 2015, hitting 50 percent (see Figure 2). The overall goods deficit for 2015 was $736.2 billion. U.S. exports to China also remain flat for the third year in a row at 8 percent of the total U.S. exports.

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



Source: U.S. Census Bureau. *http://www.census.gov/foreign-trade/balance/c0015.html* and *http://www.census.gov/foreign-trade/balance/c5700.html*.

Top Exports and Imports

In 2015, transportation equipment continued to lead U.S. exports to China, accounting for nearly 22.5 percent of all exports (see Table 1). On the import side, computer and electronic products continue their perennial reign, accounting for 35.3 percent of all U.S. purchases from China. Year-on-year, the value of top U.S. imports from China increased marginally in 2015, with imports of computer and electrical products increasing 1.4 percent while electrical equipment and appliances, the second-most imported product from China, increased 7.6 percent.[1]

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'14 (%)	U.S. Top-Five Imports from China	Imports	Share of total (%)	Change over Dec'14 (%)
Monthly (Dec'15)				*Monthly (Dec'15)*			
Transportation Equipment	2,294,529	22.7%	-18.2%	Computer and Electronic Products	14,323,883	37.7%	-12.4%
Agricultural Products	1,697,905	16.8%	-39.0%	Electrical Equipment, Appliances, and Component	3,107,840	8.2%	-4.1%
Computer and Electronic Products	1,685,388	16.6%	8.6%	Commodities	2,910,501	7.7%	0.5%
Chemicals	1,038,869	10.3%	-10.5%	Apparel and Accessories	2,330,199	6.1%	3.4%
Machinery, Except Electrical	734,986	7.3%	-6.7%	Machinery, Except Electrical	2,289,728	6.0%	-3.5%
Other	2,675,730	26.4%	-	Other	13,053,180	34.3%	-
Total	10,127,407	**100.0%**		**Total**	38,015,331	**100.0%**	
Year-to-date (thru Dec'15)				*Year-to-date (thru Dec'15)*			
Transportation Equipment	26,113,734	22.5%		Computer and Electronic Products	170,246,702	35.3%	
Computer and Electronic Products	17,413,485	15.0%		Electrical Equipment, Appliances, and Component	41,791,051	8.7%	
Agricultural Products	14,885,588	12.8%		Commodities	40,043,966	8.3%	
Chemicals	13,515,112	11.6%		Apparel and Accessories	33,443,829	6.9%	
Machinery, Except Electrical	9,199,044	7.9%		Machinery, Except Electrical	30,621,290	6.4%	
Other	35,059,299	30.2%	-	Other	165,733,925	34.4%	-
Total	116,186,262	**100.0%**		**Total**	481,880,763	**100.0%**	

Source: U.S. Census Bureau. *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 $120.7 billion in 2015, a $3 billion decline form 2014 (see Table 2). An in the previous years, imports of information and communication products (ICT) were the main contributor to the deficit. Excluding ICT, the United States ran a $13 billion ATP surplus on the strength of aerospace exports.

Table 2: ATP Trade through December 2015

(US$ millions)

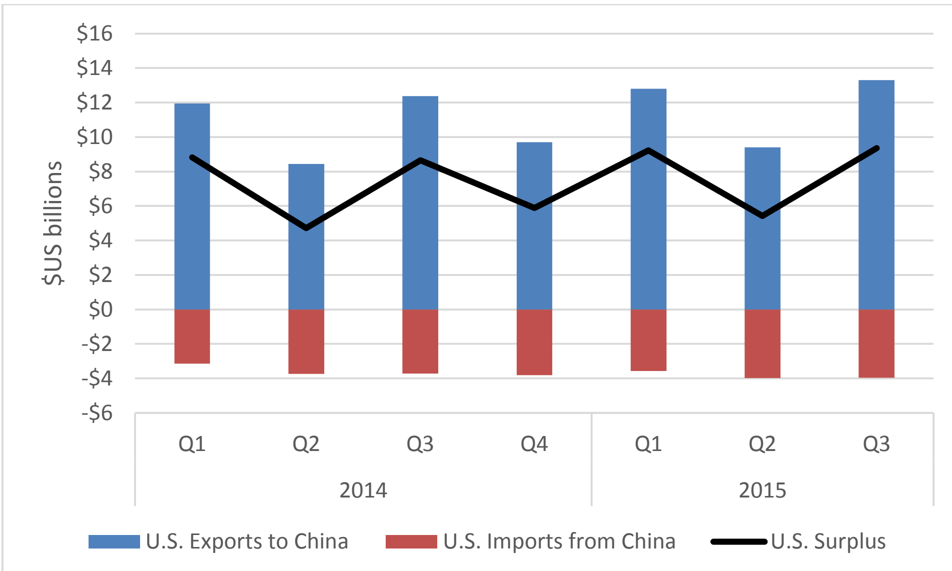
	Monthly			Cumulative year-to-date			
	Exports	Imports	Balance Dec'15	Exports	Imports	Balance 2015	Balance 2014
TOTAL	**3,376**	**13,111**	**-9,735**	**34,228**	**154,946**	**-120,718**	**-123,764**
(01) Biotechnology	70	13	57	796	124	672	393
(02) Life Science	338	233	105	3,316	2,446	870	868
(03) Opto-Electronics	45	535	-490	465	7,058	-6,593	-6,570
(04) Information & Communications	490	11,835	-11,345	5,178	139,325	-134,147	-134,842
(05) Electronics	557	284	273	6,023	3,552	2,471	2,200
(06) Flexible Manufacturing	188	82	106	2,541	952	1,589	1,460
(07) Advanced Materials	23	27	-4	211	407	-196	-94
(08) Aerospace	1,648	89	1,559	15,481	881	14,600	13,087
(09) Weapons	0	13	-13	2	156	-154	-144
(10) Nuclear Technology	18	0	18	215	45	170	-121

Source: U.S. Census Bureau. *http://www.census.gov/foreign-trade/statistics/product/atp/2015/12/ctryatp/atp5700.html*.

U.S.-China Trade in Services

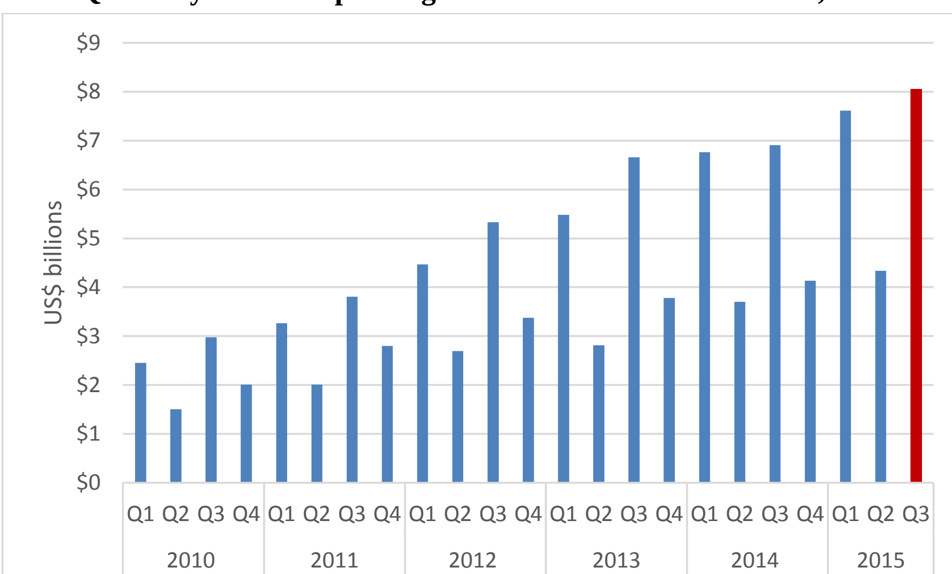
In the third quarter of 2015, U.S. service exports to China grew 41 percent quarter-on-quarter (from $9.4 billion to $13.3 billion), leading to a $9.35 billion surplus (a 72 percent increase over the second quarter) (Figure 3). Growth in U.S. exports was driven primarily by an 86 percent quarter-on-quarter increase in Chinese travel* to the United States; expenditures by Chinese tourists grew from $4.3 billion to $8 billion. This upsurge in travel accounted for 95 percent of the quarter-on-quarter growth in U.S. service exports. As Figure 4 shows, the third quarter of 2015 saw the highest quarterly Chinese expenditures on U.S. travel to date. The cyclical increase in the first and third quarters could be caused by travel and tuition payments of Chinese students which tend to fall in these quarters. China is the largest source of international students and education spending to the United States—in 2013 (latest available) Chinese students spent more than $8 billion in the United States.[2] U.S. imports of services from China remained largely flat in the third quarter of 2015, with a quarter-on-quarter decrease of 0.6 percent from $3.98 billion to $3.95 billion.

Figure 3: U.S.-China Trade in Services, 2014–2015 Q3



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, February 2016.

Figure 4: Quarterly Chinese Spending on Travel to the United States, 2010–2015 Q3



* Under U.S. statistics, travel service expenditures include travel for the purposes of education.

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, February 2016.

Bilateral Policy Issues

U.S. Companies Report Inconsistent Interpretation of Chinese Laws, Less Welcome Environment, and Decreased Profitability in China

The American Chamber of Commerce in China (AmCham) released its 2016 Business Climate Survey, which highlighted growing concerns among U.S. businesses regarding inconsistent interpretation of Chinese laws by the regulatory authorities. For the first time since 2010, surveyed U.S. firms reported that "inconsistent regulatory interpretation and unclear laws" presented the greatest challenge to doing business in China.[3] As Table 3 shows, this year 57 percent of U.S. firms reported unclear laws and regulatory inconsistency as their top business challenge in China.[4] This issue has been consistently reported as a concern for U.S. business—from 2012 to 2015 it was the second-most reported challenge in AmCham surveys.[5] U.S. businesses have previously expressed concerns that Chinese regulations are more frequently and severely applied to foreign firms. For example, in 2014 the U.S. Chamber of Commerce stated that China's antimonopoly law was enforced "disproportionately against foreign companies to achieve industrial policy goals" and found that anticompetition fines were higher for foreign firms than for Chinese businesses (on average 3.3 percent of the previous year's sales for foreign firms versus 2.5 percent for Chinese firms).[6,*] Alongside these regulatory concerns, difficulties in obtaining Chinese licenses rose to the third most frequently cited challenge, with 29 percent of respondents identifying it as a top concern in 2016.[7] Industry overcapacity—a new addition to the survey in 2016—was the fifth most cited challenge for U.S. firms.[8] This year AmCham reported the results of 496 surveyed U.S. businesses operating in China.[9]

Table 3: Top Five Business Challenges in China for U.S. Firms, 2012–2016

2012	2013	2014	2015	2016
Shortage of qualified management: 43%	Labor costs: 44%	Labor costs: 61%	Labor costs: 61%	**Inconsistent regulatory interpretation and unclear laws: 57%**
Inconsistent regulatory interpretation and unclear laws: 37%	**Inconsistent regulatory interpretation and unclear laws: 38%**	**Inconsistent regulatory interpretation and unclear laws: 39%**	**Inconsistent regulatory interpretation and unclear laws: 47%**	Labor costs: 54%
Shortage of qualified employees: 29%	Shortage of qualified employees: 35%	Shortage of qualified employees: 37%	Shortage of qualified employees: 42%	Obtaining required licenses: 29%
Obtaining required licenses: 26%	Corruption: 30%	Shortage of qualified management: 31%	Shortage of qualified management: 32%	Shortage of qualified employees: 29%

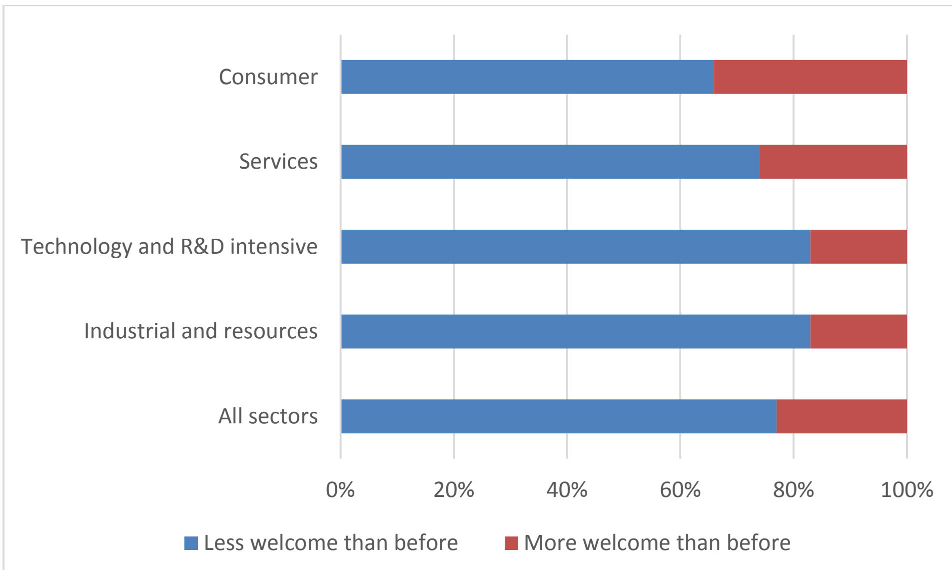
* For more analysis on business conditions in China, see U.S.-China Economic and Security Review Commission, Chapter 1, Section 2, "Foreign Investment Climate in China," in *2015 Annual Report to Congress*, November 2015, 72–139. *http://1.usa.gov/1Jcwf3h*.

Corruption: 26%	Shortage of qualified management: 30%	Obtaining required licenses: 31%	Increasing Chinese protectionism: 30%	**Industry overcapacity: 29%**

Source: American Chamber of Commerce in the People's Republic of China, "2016 China Business Climate Survey Report." *http://www.amchamchina.org/policy-advocacy/business-climate-survey/*.

A majority of U.S. companies—71 percent—reported they felt foreign businesses are less welcome in China than before (see Figure 5).[10] The share is even higher in select industries. For example, 81 percent of tech, research and development (R&D), industrial, and resource firms reported China to be less welcoming.[11] This presents a dramatic increase over survey results in previous years. In 2015 and 2014, 47 and 44 percent of U.S. businesses, respectively, stated that China was less welcoming.[12]

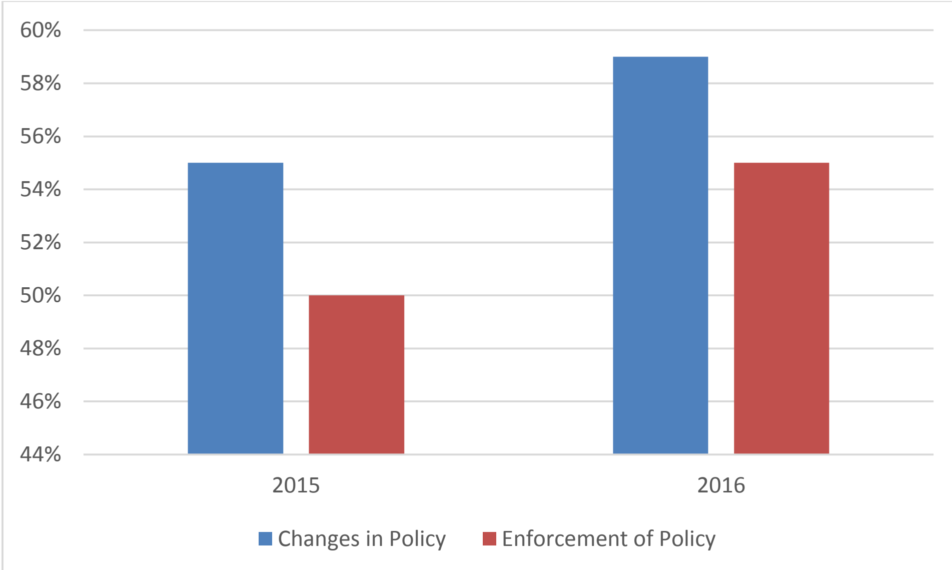
Figure 5: Percent of U.S. Business Reporting China More or Less Welcoming to Foreign Business by Sector, 2016



Source: American Chamber of Commerce in the People's Republic of China, "2016 China Business Climate Survey Report." *http://www.amchamchina.org/policy-advocacy/business-climate-survey/*.

Despite concern over inconsistent interpretation of rules and perceptions of a less welcoming environment, this year 59 percent of U.S. businesses reported that changes in Chinese policies had improved business conditions (up from 55 percent in 2015), and 55 percent of businesses reported improvements to the business environment due to Chinese enforcement of rules and regulations (see Figure 6).[13] Strong progress in intellectual property rights protection was reported, with 91 percent of U.S. businesses stating that China's enforcement of intellectual property rights had improved over the past five years (compared to 86 percent in 2015).[14]

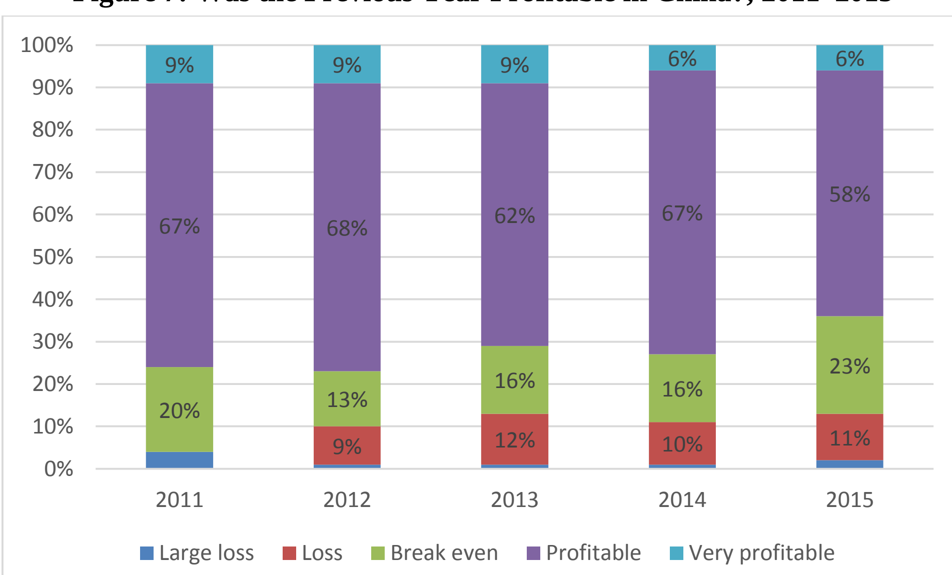
Figure 6: Percentage of U.S. Businesses Reporting Improved Business Conditions due to Chinese Policy Changes and Enforcement, 2015–2016



Source: American Chamber of Commerce in the People's Republic of China, "2016 China Business Climate Survey Report." *http://www.amchamchina.org/policy-advocacy/business-climate-survey/*; American Chamber of Commerce in the People's Republic of China, "2015 China Business Climate Survey Report." *http://www.amchamchina.org/policy-advocacy/business-climate-survey/2015-business-climate-survey*.

A decreasing number of firms responded that they had a profitable year in 2015. Overall, a majority (64 percent) of U.S. businesses reported that the past year was either profitable or very profitable.[15] However, this was the lowest share of firms reporting profitability in the past five years (Figure 7). The survey concluded that a mix of slower economic growth and inconsistent application of laws are impacting U.S. companies. Eighty-three percent of U.S. businesses predict that China's growth in 2016 will be below 6.75 percent, with nearly half of survey respondents anticipating Chinese growth below 6.25 percent.[16]

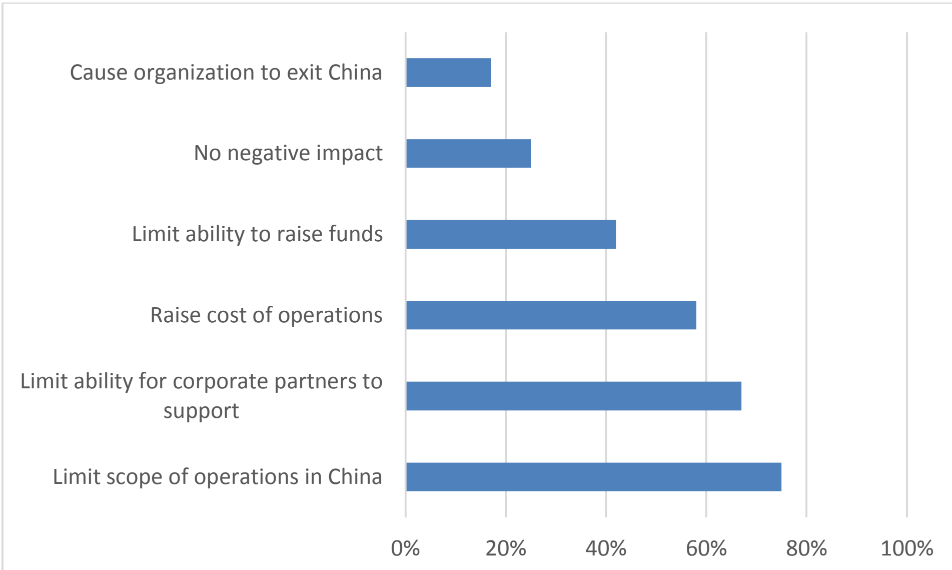
Figure 7: Was the Previous Year Profitable in China?, 2011–2015



Source: American Chamber of Commerce in the People's Republic of China, "2016 China Business Climate Survey Report." *http://www.amchamchina.org/policy-advocacy/business-climate-survey/*.

Finally, there is widespread concern about the potential impact of the draft Foreign Nongovernmental Organization (NGO) Management law on the ability of U.S. NGOs to operate in China. China is considering draft legislation that gives Chinese security agencies broad powers to monitor, inspect, and terminate foreign NGOs operating in China.[17] The law is written broadly enough to possibly include many business associations, foreign universities, and legal and professional societies.[18] Seventy-five percent of U.S. NGOs responding to the survey reported that the law would limit the scope of their operations in China and 17 percent stated it would cause them to exit the country (Figure 8). Only 25 percent foresee no negative consequences.[19]

Figure 8: How Draft NGO Law Would Affect U.S. NGOs



Source: American Chamber of Commerce in the People's Republic of China, "2016 China Business Climate Survey Report." *http://www.amchamchina.org/policy-advocacy/business-climate-survey/*.

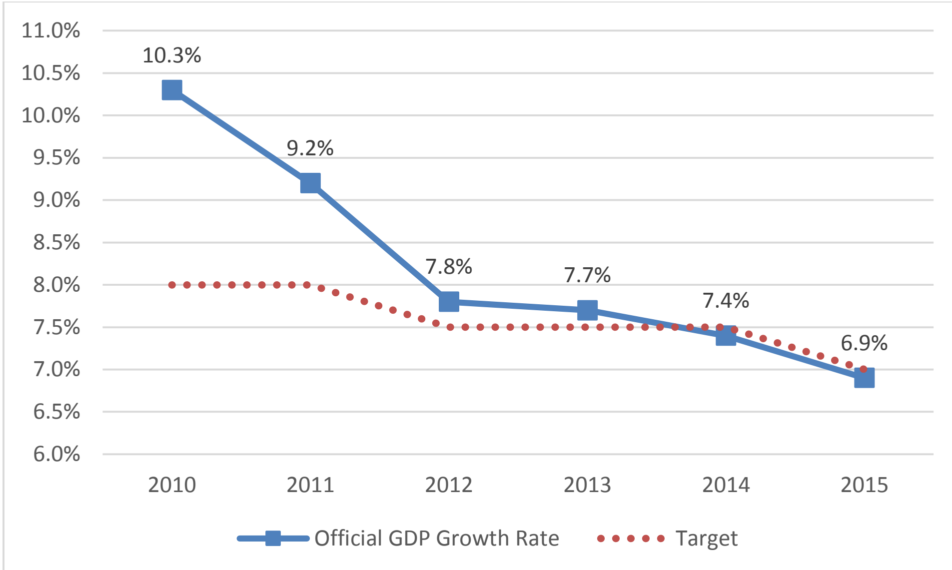
Quarterly Review of China's Economy

Growth Hits 25-Year Low

According to official data released by China's National Bureau of Statistics, China's gross domestic product (GDP) growth fell to 6.9 percent in 2015—a 25-year low—in line with the target of "around 7 percent" cited by Premier Li Keqiang (see Figure 9).[20] In the fourth quarter of 2015, China's GDP grew 6.8 percent year-on-year, marking the lowest quarterly performance of the year from a high of 7 percent in the first and second quarters.[21] Doubts over the accuracy and reliability of China's official figures, however, have led some economists to look to other indicators, including electricity, rail freight, supply of raw materials, and retail sales, as proxies for measuring China's GDP.[22] Based on these indicators, which are less sensitive to political pressures, many estimate China's actual growth rate to range from 4 to 6 percent.[23]

Figure 9: China's GDP Growth, 2010–2015

(year-on-year)



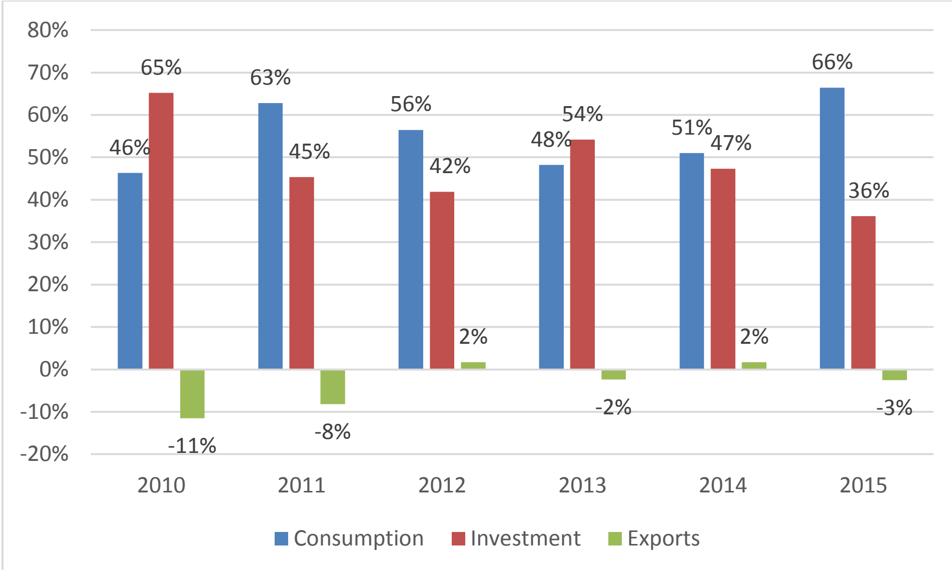
Source: Sina (China), "National Bureau of Statistics: China's 2015 GDP Increased 6.9 Percent," January 19, 2016. Staff translation. *http://finance.sina.com.cn/china/gncj/2016-01-19/doc-ifxnqriy3132067.shtml*; CNN, "China's Economy Grew 10.3 Percent in 2010," January 20, 2011. *http://edition.cnn.com/2011/BUSINESS/01/19/china.gdp.growth/*; Neil Gough, "China Lowers Official Economic Growth Target," *New York Times*, March 4, 2015. *http://www.nytimes.com/2015/03/05/business/china-lowers-official-economic-growth-target.html*.

On February 3, 2016, the Chinese government announced the GDP growth goal for 2016 will be between 6.5 percent and 7 percent, slightly lower than the 2015 target.[24] The International Monetary Fund's (IMF) forecasts for China were 6.3 percent for 2016 and 6 percent for 2017—below the Chinese government's target.[25] The IMF cut the global growth outlook for 2016 by 0.2 percentage points to 3.4 percent in light of the economic turmoil in China and weak performance in other emerging markets.[26]

Consumption, Services Rise as Manufacturing Slides

China's growth appears to conform to the Chinese Communist Party (CCP) leadership's pledge to rebalance the economy away from its reliance on investment and exports and toward consumption-led growth. As seen in Figure 10, consumption's contribution to GDP growth in 2015 has continued to increase, accounting for about two-thirds of growth in 2015 compared with 51 percent in 2014. The investment's share of GDP growth continued an overall downward trend, falling from 47 percent of GDP growth in 2014 to 36 percent in 2015.[27] China's net exports were a drag on the growth in 2015: official data show December exports fell 1.4 percent year-on-year, while imports fell 7.6 percent over the same period.[28]

Figure 10: Share of GDP Growth, 2010–2015

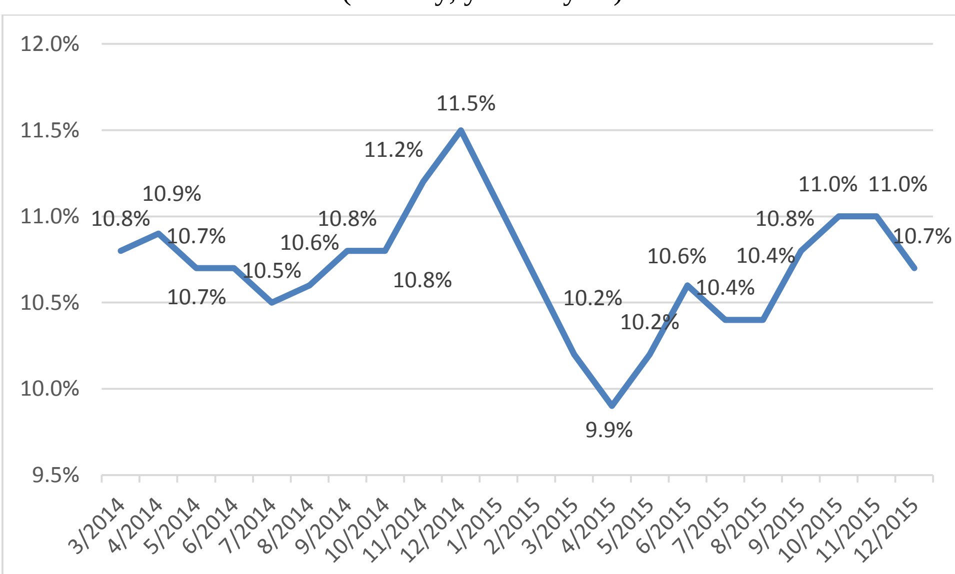


Source: China's National Bureau of Statistics via CEIC.

Though consumption appeared to be a main component of growth in 2015, retail sales growth data suggest consumption played a smaller role than in 2014. Retail sales of consumer goods—a crude measure of total consumption—grew 10.7 percent year-on-year in December 2015, compared with 11.5 percent in December 2014 (see Figure 11). Because China's retail sales figure includes spending not just by households but also by government departments and business-to-business sales, however, the household consumption component of GDP expenditure can be a more accurate indicator of household spending.[29] As shown in Figure 12, the 2015 decline in retail sales could be due to the decline in the government component of GDP expenditure, given the household component's year-on-year increase in 2014 (official data for 2015 components of GDP expenditure were not available at the time of writing).

Figure 11: Growth in Retail Sales of Consumer Goods, March 2014– December 2015

(monthly, year-on-year)



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

Figure 12: Retail Sales versus Consumer Spending, 2005–2015

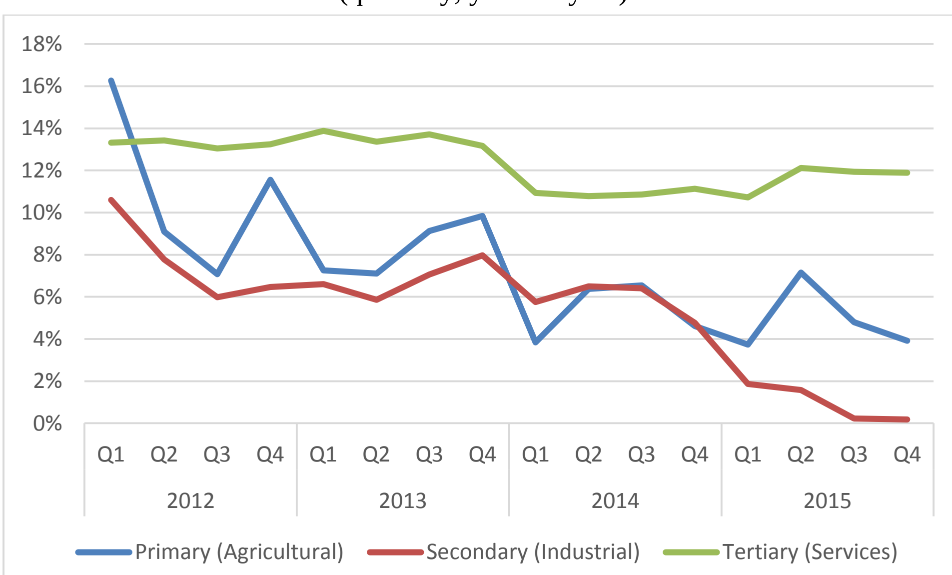
(year-on-year)

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

Economic restructuring efforts appeared to accelerate in 2015. China's tertiary sector—predominantly services—grew nearly 12 percent year-on-year in the fourth quarter of 2015, outpacing secondary industries (mining, heavy industry, manufacturing, and utilities)—China's former growth engine—which nearly flat-lined (see Figure 13). Primary industry (agriculture) grew 3.9 percent year-on-year.[30] Official data show the services sector contributed 48.1 percent of China's GDP in the fourth quarter, while construction and manufacturing contributed 40.4 percent and agriculture contributed 11.6 percent.[31] Given the sizable contribution of the industrial sector to GDP, a significant slowdown in heavy industry growth is a major contributor to the overall economic deceleration.

Figure 13: GDP Growth by Sector, 2012–2015

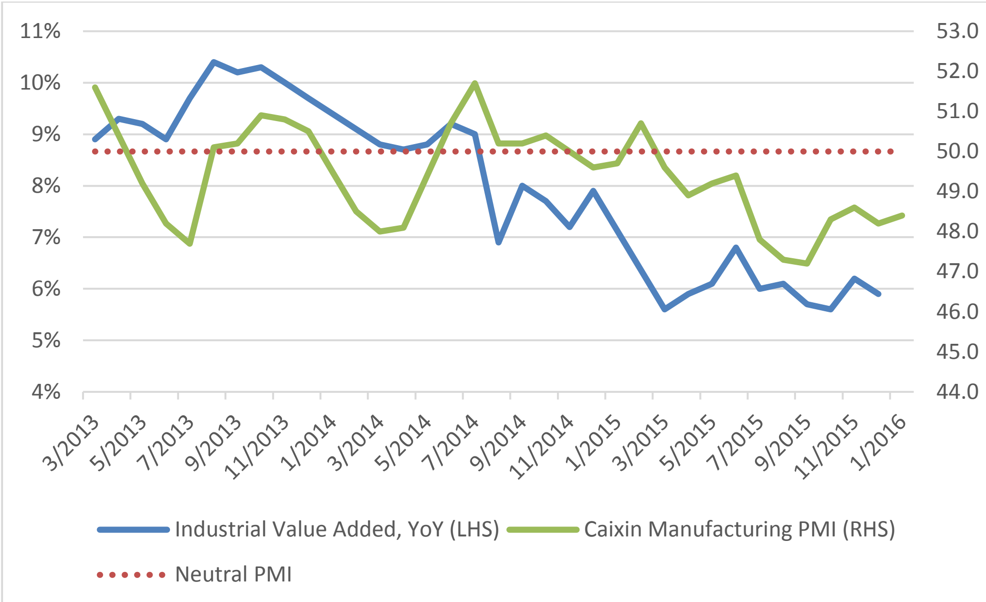
(quarterly, year-on-year)



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

Deterioration of conditions in China's manufacturing sector—denoted by a Purchasing Managers' Index (PMI) reading below 50—continued through the end of 2015. The Caixin unofficial estimate of China's manufacturing PMI registered at 48.2 in December 2015, an improvement from the 2015 low of 47.2 in September but down from 49.6 in December 2014 (see Figure 14). Industrial value-added growth—viewed by markets as a proxy for overall growth in China—has also slowed markedly, slumping from 7.9 percent year-on-year in December 2014 to 5.9 percent in December 2015.[32] Both indicators show that industrial output—a main component of China's GDP growth—is continuing an overall downward trend.

Figure 14: China's Declining Manufacturing Sector, March 2013–January 2016



Source: China's National Bureau of Statistics via CEIC; "China Caixin Manufacturing PMI."*http://www.investing.com/economic-calendar/chinese-caixin-manufacturing-pmi-753*.

Beijing Highlights "Supply-Side" Reforms

As rebalancing efforts take effect, policymakers in Beijing are having to modify the reform agenda to minimize economic adjustment costs and reduce the risk of a debt-related disruption.[33] According to explanations published by Chinese state-run media outlets, Beijing is backing away from so-called "demand-side reforms"—including measures like adjusting banking regulations and interest rates and exports—acknowledging these measures have "not been very successful" in stimulating investment or consumption.[34] Instead, the government announced it will pursue "supply-side reforms," which are aimed at boosting productivity and effective use of production factors including resources, skilled workers, and technology.[35] Michael Pettis, a Beijing-based economist and professor of finance at Guanghua School of Management at Peking University, interpreted the new emphasis on supply-side reforms to include the following key objectives:

1. *Reducing overcapacity*. This will involve encouraging mergers and acquisitions and allowing unproductive firms to close without risking a level of unemployment that is destabilizing.
2. *Reducing real estate inventory*. The boom in real estate construction to promote Beijing's massive urbanization initiative has created an oversupply of inventory. Further liberalizing the household registration system should help create demand for housing in lower-tier cities and reduce excess inventory.
3. *Deleveraging and otherwise strengthening balance sheets*. Zombie firms—heavily indebted, nonproductive companies, often state-owned—are dragging down growth while banks are pressured to extend loans to such firms so as not to cause a disruptive bankruptcy. Potential supply-side reforms would focus on making debt-servicing costs more manageable for such firms and addressing the pressures to loan to them.

4. *Fiscal expansion, including tax cuts.* With the goal of boosting demand, tax cuts will be designed and implemented to improve business efficiency.

5. *Lowering corporate costs directly and by reducing government bureaucracy.* This will involve reducing institutional transaction costs for businesses to generate higher economic productivity and improve firms' competitiveness.[36]

According to Mr. Pettis, the announcement of these supply-side reforms more or less constitutes leadership's recognition of the present danger of continued credit expansion and limitations of earlier reforms, but fails to address the bigger risk to its economy—the quality and structure of Chinese debt. He argues China has two main options to address ongoing deceleration and potential risk of future stagnation: one, to recognize the productivity growth will not relieve its rising debt burden and liquidate assets to pay down debt; or two, to pursue the supply-side reforms to unleash productivity strong enough to counter the debt burden.[37] Mr. Pettis assesses that further avoidance of reducing debt on the part of China's economic policymakers risks a "near permanent state of economic stagnation."[38] Columbia University professor and award-winning economist Joseph Stiglitz argues such supply-side measures would ultimately be much more effective and tenable if Beijing embraces aggressive, better-designed demand-side reforms, which would diffuse deflationary pressures resulting from China's excess capacity problem.[39] Because comprehensive demand-side reforms would reduce excess supply, he writes, the magnitude and scope of supply-side reforms needed to prop up growth will be diminished.[40]

Stock Market Volatility Continues into 2016

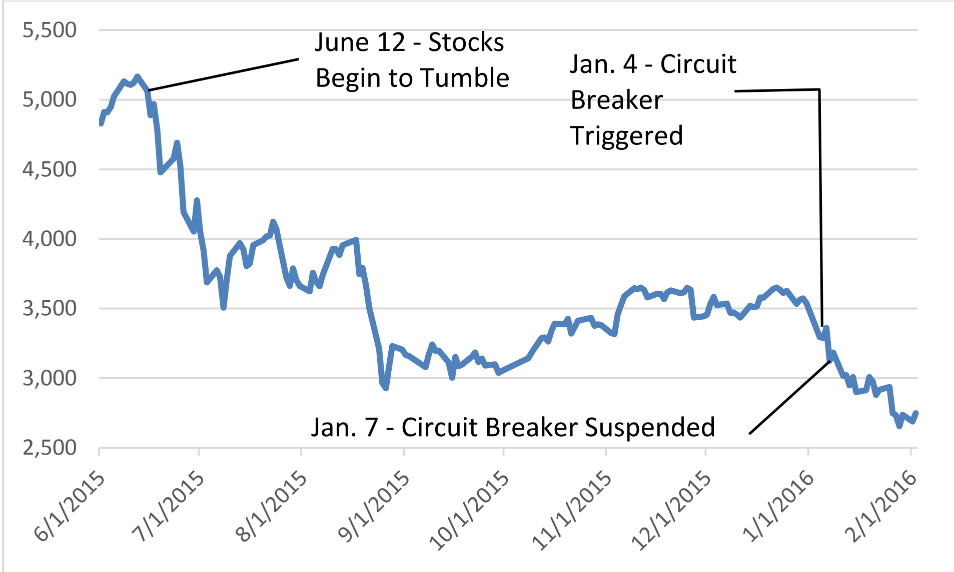
Six months after its widely felt crash, the Chinese stock market experienced further declines in January, with the Shanghai Composite Index (SCI), China's main exchange, falling 22.6 percent.[41] The slide was triggered in part by the devaluation of the renminbi (RMB) against the U.S. dollar in early January, sparking concerns over the strength of the Chinese economy.[42] Since reaching its June 12 peak, the SCI has fallen 46.8 percent, while Shenzhen, the smaller, technology-dominated exchange, has fallen 45 percent.[43]

Volatility continued despite a new circuit breaker mechanism implemented at the start of the year intended to prevent dramatic falls in the market.[*] The mechanism was designed to suspend trading for 15 minutes when the benchmark CSI300—an index that tracks the largest listed companies in Shanghai and Shenzhen—dropped 5 percent. If the index dropped an additional 2 percent, markets would close for the remainder of the day.[44] However, the system had the opposite of its intended effect, speeding up stock declines as investors scrambled to sell before trading was suspended.[45] On January 4, the first day the system was implemented, the CSI300 dropped 7 percent, activating the circuit breaker and ending trading for the day 80 minutes early.[46] On January 7, the market once again fell 7 percent, this time after they had been open for less than 30 minutes.[47] The same day, the China Securities Regulatory Commission (CSRC) suspended the circuit breaker, citing its negative effects.[48]

Since the circuit breaker was suspended, markets have continued to decline, with the SCI dropping below the key 3,000 mark, an indicator of sentiment (see Figure 15). To limit further market volatility, the CSRC announced on January 6 that large shareholders—defined as those holding 5 percent or more of shares in listed companies—will be prohibited from selling over 1 percent of their total shares for the next three months.[49] The CRSC also set a requirement that large shareholders must disclose share reduction plans 15 trading sessions in advance of taking action.[50]

[*] For more information on the recent stock market turmoil, see Nargiza Salidjanova, "China's Stock Market Meltdown Shakes the World, Again," *U.S.-China Economic and Security Review Commission*, January 14, 2016. *http://1.usa.gov/1SKu6Dh*.

Figure 15: Shanghai Composite Index, June 2015–February 2016



Source: Shanghai Stock Exchange via CEIC database.

China Capital Outflows Surge amid Economic Slowdown

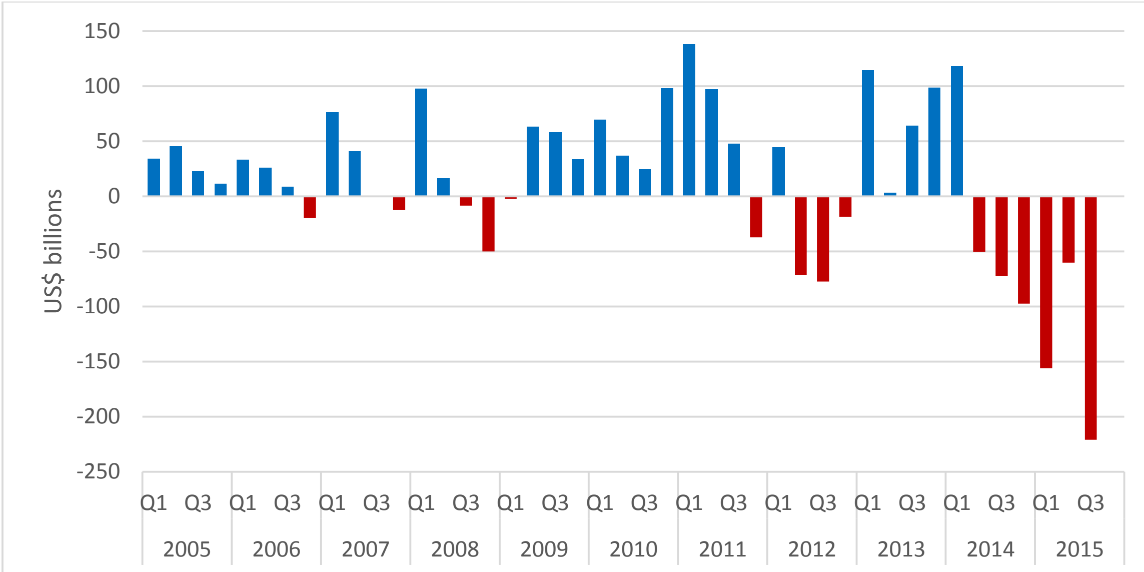
China's calibrated opening of its capital accounts, expectations of an RMB depreciation, and rising concern over its economic growth contributed to slower capital inflows and a surge of capital outflows in 2015.[*] While a number of factors are fueling this shift, a major exodus of financial assets slows economic growth by reducing the availability of domestic capital and generally signals a loss of confidence in a country's economic strength. China's annual inflows of foreign capital dropped from an average of $387 billion during 2010–2014 to $110 billion in 2015.[51] Net capital flows shifted from a surplus of inflows in 2013 to significant outflows in 2015. In the first three quarters of 2015, capital outflows totaled $275 billion; total capital outflows (excluding foreign reserve loss) reached $460 billion in 2015 based on calculations from the Institute of International Finance, a financial industry trade group.[52]

This figure rises significantly with the inclusion of "errors and omissions," a proxy for the amount of unofficial capital flows by investors circumventing China's tight capital controls.[53] A review of recent trade figures between China and Hong Kong revealed that Chinese citizens get money out of the country by over-invoicing imports and under-invoicing exports.[54] A comparison of China's imports from Hong Kong and Hong Kong's exports to China—figures that should match—revealed that according to Chinese numbers, imports from Hong Kong were $142.5 billion higher than reported by the corresponding numbers from Hong Kong.[55] In December 2015, China's General Administration of Customs reported $164.1 billion (1.05 trillion RMB) worth of imported goods from Hong Kong, while Hong Kong's Census and Statistics Department reported $21.57 billion (HK$168.13 billion) in exports to China.[56]

With the inclusion of errors and omissions, capital outflows totaled $436.8 billion in the first three quarters of 2015 (see Figure 16).[57] Capital outflows accelerated in the last few months of 2015 based on unofficial estimates. The Institute of International Finance calculated $676 billion in total capital outflows for 2015.[58] Bloomberg Intelligence measured nearly $1 trillion in outflows for 2015 compared with $134.3 billion in 2014.[59]

[*] In closed capital accounts like China, balance of payments are a proxy to estimate net capital flows. Institute of International Finance, "Capital Flows to Emerging Markets," January 19, 2016, 14.

Figure 16: China's Capital Inflows and Outflows, 2005-Q3 2015



Note: Data incorporate errors and omissions.
Source: State Administration of Foreign Exchange via CEIC.

The significant rise in capital outflows reflects both anxiety about the Chinese market and pursuit of higher returns abroad. Main drivers of China's capital outflows include:

- *Loosening of Capital Controls:* Over the last year, China has been gradually and selectively loosening its controls on capital inflows and outflows—a key component of its financial reform agenda and broader goals for the internationalization of the RMB.* As controls have been slowly relaxed, Chinese investors have moved money abroad to take advantage of higher returns and diversify their portfolios.[60] But an annual $50,000 cap on the purchase of U.S. dollars for Chinese citizens remains in place, prompting illicit capital outflows.[61]

- *Debt Repayment*: Chinese firms borrowed heavily in U.S. dollar-denominated debt, taking advantage of the appreciating value of the RMB and low U.S. interest rates following the global financial crisis. The sudden devaluation of the RMB in August 2015 raised the cost of servicing their foreign debt by approximately $15 billion.[62] The U.S. Federal Reserve's interest rate hikes in December 2015 strengthened the value of the U.S. dollar and made borrowing more expensive, further incentivizing Chinese firms to reduce their existing dollar-denominated debt.[63]

- *Depreciation of the RMB:* Chinese citizens and global investors are seeking to move their assets abroad before a depreciation of the RMB erodes the value of their assets. After years of steady appreciation, investor expectations are shifting toward a weakening value of the RMB.[64] Goldman Sachs expects a 6 percent depreciation in the RMB in 2016.[65] Several other hedge funds, such as Hayman Capital Management, Greenlight Capital Inc., and PointState Capital LP, are betting the RMB's value will fall.[66]

- *Concern over the State of China's Economy:* In 2015, China's economic growth slowed to its lowest pace in a quarter of a century at 6.9 percent (for more information on the slowdown, see "Growth Hits 25-Year Low" section).[67] In addition, the Chinese government's muddled responses to the volatility of the stock market and the sudden devaluation of the RMB in August 2015 have shaken investors' confidence in the ability of the Chinese government to run the economy.[68]

* For in-depth analysis on China's efforts to internationalize the RMB, see: Eswar Prasad, "China's Efforts to Expand the International Use of the Renminbi" (prepared for the U.S.-China Economic and Security Review Commission, February 4, 2016). *http://1.usa.gov/1QeJEui*.

- *Surge in Outbound Mergers and Acquisitions:* Based on data from the research consultancy Rhodium Group, Chinese companies spent around $1 trillion on outbound mergers and acquisitions in 2015, a 16 percent increase from 2014.[69] Outbound acquisitions by Chinese firms are accelerating. According to international financial software firm Dealogic, announced acquisitions in 2016 already total $12.5 billion, the fastest start to a year on record.[70]
- *Increasing Numbers of Chinese Citizens Traveling and Studying Overseas:* China has rapidly become the world's largest source of outbound international tourists and tourism-related expenditures.[71] Chinese international travel grew from 10 million departures per year in 2000 to 98 million in 2013, and Chinese spending abroad has also increased at a faster rate than any other country in the world, growing 28 percent from 2013 to 2014.[72] In addition, increasing numbers of Chinese students are studying abroad. In 2014 alone, more than 350,000 Chinese students traveled to the United States.[73]

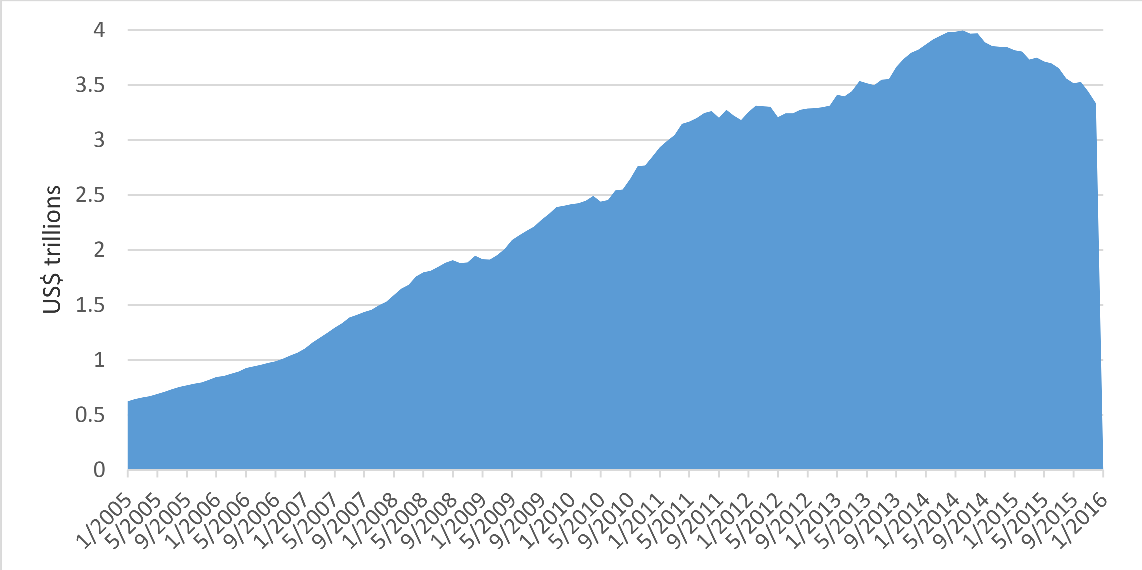
"They [the Chinese government] have a clear choice: tightening the capital account or allowing the currency to depreciate more quickly," explained Kit Juckes, a global strategist at the French-based multinational banking and financial firm Societe Generale.[74] Continuing current policies runs in opposition to the "impossible trinity" that a central bank cannot simultaneously maintain an independent monetary policy, a fixed exchange rate, and free capital borders. If capital outflows continue to grow, it will place pressure on the RMB to depreciate, forcing the People's Bank of China (PBOC) to either allow the currency to depreciate or defend the currency with its reserves. Thus far, the Chinese government has sought to maintain both the value of the RMB and last year's incremental reforms to loosen capital controls.[75]

Foreign Reserves Fall

Rather than let the RMB devalue, the PBOC has been buying up RMB with its foreign reserves to artificially create demand, contributing to a $483.1 peak decline of reserves in 2015 alone.[76] China's foreign reserves have fallen $662.9 billion from their $3,993.2 billion height in June 2014 to $3.33 trillion in December 2015 (see Figure 17).[77] Charles Collyns, chief economist for the Institute of International Finance, noted this fall "was unprecedented in magnitude."[78] These holdings are expected to drop further in the coming year as economic growth slows.[79]

The PBOC has sought to stem the outflow of foreign reserves by increasing the cost of betting the RMB will weaken.[80] Private equity and hedge funds have taken out loans in RMB that become easier to pay off as the RMB devalues. To prevent such a devaluation, the PBOC is squeezing liquidity in Hong Kong—a major center for onshore and offshore RMB trading. On January 25, the PBOC expanded reserve requirements on Hong Kong-based RMB deposits from just mainland banks to all offshore banks, thus reducing the availability of RMB funds by around $23 billion (150 billion RMB).[81] The PBOC has pressured mainland banks to raise interest rates for Hong Kong-based bank loans, effectively killing the offshore RMB-lending business with higher borrowing costs.[82] In addition, the PBOC has prohibited foreign asset managers such as private equity and hedge funds from raising RMB-based funds for overseas investments.[83] Beyond regulatory and administrative measures, the Chinese government has signaled its unwillingness to allow the RMB to depreciate further. After billionaire investor George Soros predicted "a hard landing" for China's economy, China's state-run media made veiled threats that "radical speculators" would "suffer huge losses" from trying to bet against the RMB.[84]

Figure 17: China's Official Foreign Reserves, 2005–2015



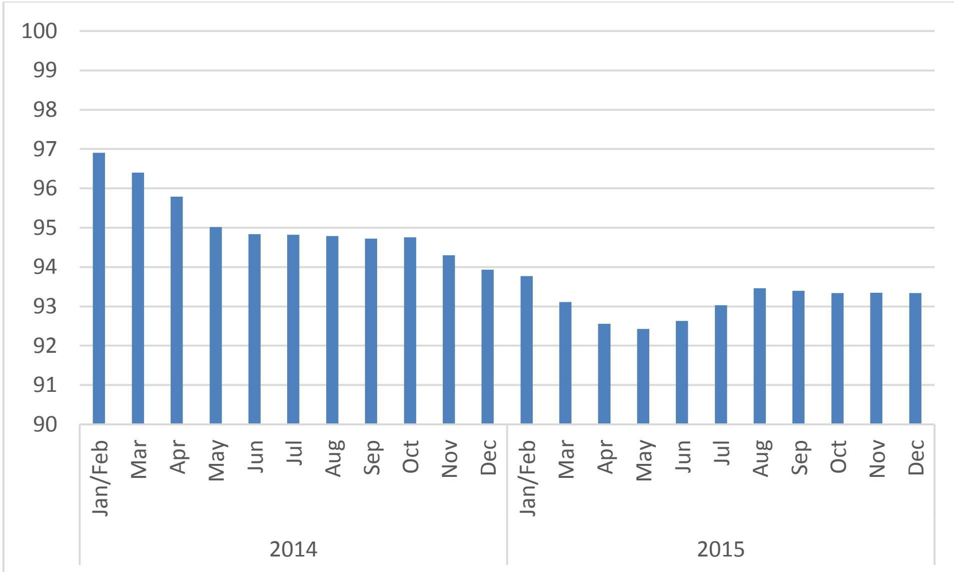
Source: People's Bank of China via CEIC.

Sector Focus: Declining Real Estate Market Weighs on GDP Growth

China's Property Market Continues Weakening despite Rising Prices

The slowdown in China's real estate sector remains a drag on GDP growth and has spurred government action to restore confidence in the sector. China's Real Estate Climate Index (RECI), a measure of the country's business activity in land sales and real estate, reveals that year-on-year real estate activity declined every month in 2014 and 2015, and dropped to 93 in December 2015, well below the 100 mark that distinguishes market growth from contraction (see Figure 18).[85] This decline has significant implications for China's economic growth. Enam Ahmed, a senior economist at the banking and financial services firm Standard Chartered, described China's housing sector as the "single most important sector in the world economy at present."[86] Mr. Ahmed's emphasis on the property market is supported by a recent Standard Chartered study calculating that China's housing and related property sectors—including demand for construction materials—contributed just 1.1 percent to the country's GDP in 2015, down from 3 percent in 2010.[87] Analysts suggest that housing market declines were responsible for around half of the slowdown in China's economic growth, which decelerated from 10.6 percent to 6.9 percent during the same period, highlighting the significant role the sector plays in China's economy.[88] While growing housing prices could signal a recovery in the country's real estate market after a multiyear slump, stagnant investment, coupled with a glut of available housing, have thus far derailed government efforts to support property sector growth.[89]

Figure 18: Real Estate Climate Index, 2014–2015



Note: In the RECI index, figures below 100 indicate a slowdown in China's real estate market.
Source: China's National Bureau of Statistics via CEIC database.

New home prices and property sales began to trend positive in the final months of 2015 following a series of policy changes aimed at supporting the real estate sector.[90] To promote home buying, Beijing lowered the national first-home down payment requirement from 25 percent to 20 percent starting in February.[91] This is the second cut to down payment requirements since September 2015. In August 2015, Beijing relaxed restrictions on property sales for foreign nationals, abolishing rules requiring foreigners to live in China for a year before investing in property and removing limits on how many properties foreign buyers can purchase.[92] Shortly after these policies took effect, the property market began to show signs of improvement: average new home prices rose 1.6 percent year-on-year in December, up from a 0.9 percent year-on-year increase in November (the third consecutive month of increasing housing prices after over a year of steady declines).[93] Of the 70 cities China's National Bureau of Statistics monitors for fluctuations in property prices, 39 saw new home prices increase in December 2015, compared to 33 a month earlier.[94] Property sales also increased in the final months of the year, reaching 14 billion square feet in December, a 6.5 percent increase year-on-year and up 17.6 percent from November 2015.[95] Additionally, annual home sales reached a record high in 2015—exceeding $1 trillion—in large part because of rising prices in major cities like Beijing and Shanghai.[96]

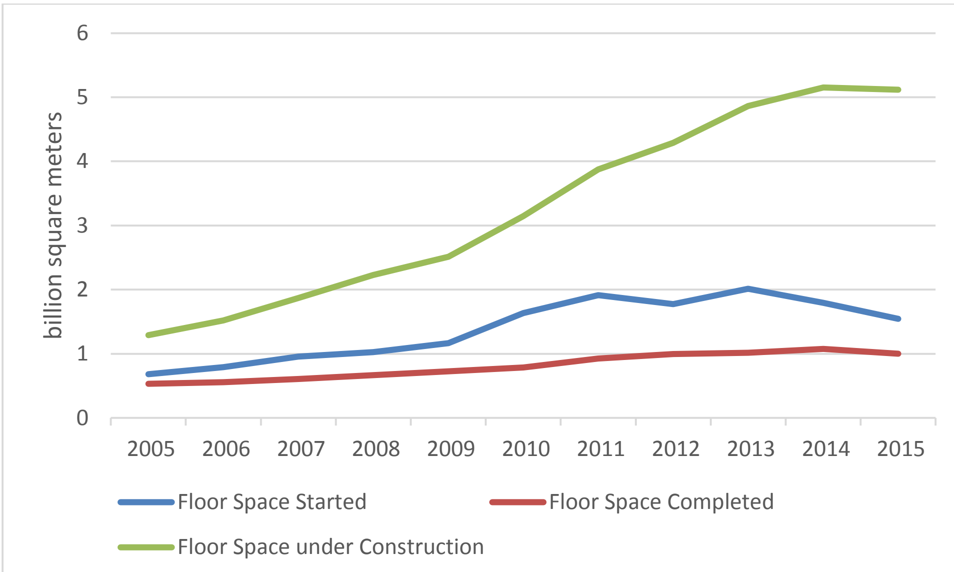
Despite recent increases in property prices and sales, Chinese real estate investment, which affects more than 40 sectors of the Chinese economy, remains sluggish.[97] Although the central government has cut interest rates six times over the past year and eliminated caps on deposit rates, property investment increased just 1.2 percent in 2015 compared to a 10.5 percent increase in 2014.[98] In December 2015, real estate investment grew at its slowest monthly rate since February 2009, increasing 1 percent.[99] According to data from the real estate analytics firms CBRE Research and Real Capital Analytics, China ranked just 13th globally in foreign investment for commercial real estate in 2015, well behind its rankings from the previous years.[100,*] According to Liu Xuezhi, an analyst at Bank of Communications Co. in Shanghai, "The biggest factor damping the momentum in [China's] economic growth now is the slowdown in [property] investment," with government efforts to attract investors falling short.[101]

If the Chinese government successfully boosts property investment, however, it risks further increasing the country's growing housing glut. Unsold new homes in China occupied 4.9 billion square feet in 2015, an 11.2 percent increase year-on-year from 2014, despite government programs to buy unsold properties and convert them

[*] The same CBRE Research and Real Capital Analytics report ranked China the eighth-largest recipient of foreign real estate investment in 2013 and the tenth-largest recipient in 2014. Esther Fung, "Bargain Hunters Look to Shanghai amid Property Slowdown," *China Real Time* (*Wall Street Journal* blog), October 28, 2015. *http://blogs.wsj.com/chinarealtime/2015/10/28/bargains-hunters-looks-in-shanghai-amid-property-slowdown/*.

into public housing.[102] As a result of the massive oversupply, new housing construction projects fell by 14 percent year-on-year in 2015.[103] However, the floor space of commodity buildings[*] still under construction has increased by 32 percent since 2011, indicating construction completion rates will remain high even as the number of new construction projects declines (see Figure 19).[104] The Chinese government hopes urbanization, rising incomes, and changes to the national housing registration system—known in China as *hukou*[†]—will result in increased demand for housing, possibly by as much as 175 million new homes by 2030.[105] The rate of inventory destocking, however, will vary between provinces and cities, with urban areas taking two to three years to normalize, while oversupply could exist in regional cities for over ten years.[106] To successfully destock inventories while also increasing property investment, China's property sales must continue to rise; otherwise, Beijing risks increasing the housing glut as construction rates rise relative to demand.

Figure 19: Property Construction of Commodity Buildings, 2005–2015



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

New Policies Needed to Address Market Declines

To increase property market growth, Beijing will have to reconcile major discrepancies between top-tier and lower-tier housing markets. Housing demand is focused disproportionately in China's four first-tier cities—Beijing, Shanghai, Shenzhen, and Guangzhou—leaving property prices in the second- and third-tier cities much lower.[107] Lower-tier cities, which are categorized by their lower population, GDP, infrastructure, and cultural or historical significance,[‡] account for around 60 percent of national property sales, and thus are essential markets for improving China's national property sector. However, while property prices in Shenzhen increased nearly 50 percent year-on-year in December, prices in Dandong—a third-tier city—dropped 5 percent year-on-year in the month.[108] Since February 2015, housing prices in second- and third-tier cities have increased only 2 to 3 percent, compared to around 15 percent in first-tier cities over the same period (see Figure 20).[109] Investment in lower-tier cities is also declining: according to a survey by the Asian Association for Investors in Non-Listed Real Estate Vehicles (ANREV), China's

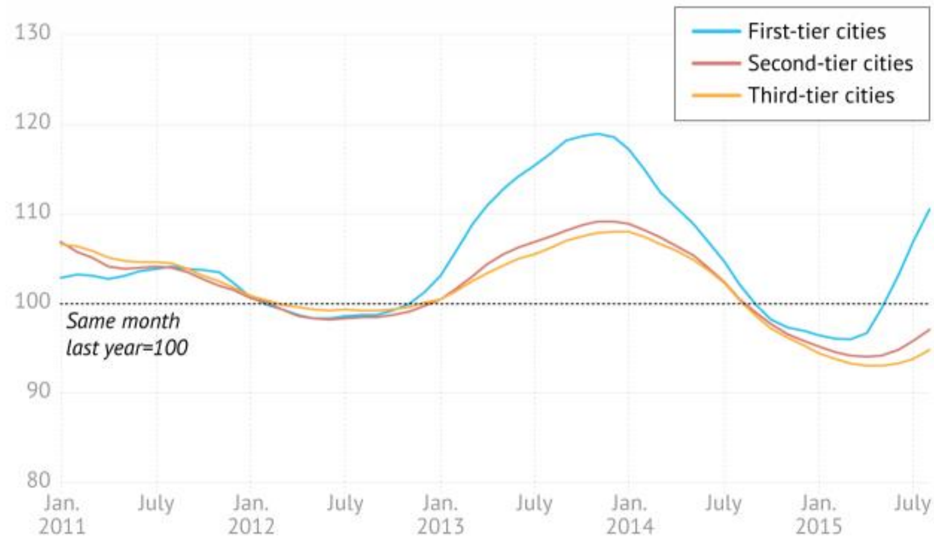
[*] Commodity buildings are housing properties that are sold in the private market. Leon Berkelmans and Hao Wang, "Chinese Urban Residential Construction to 2040," *Reserve Bank of Australia*, September 2012, 2. *http://www.rba.gov.au/publications/rdp/2012/pdf/rdp2012-04.pdf*.

[†] For more on *hukou* reforms, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, January 6, 2016. *http://origin.www.uscc.gov/sites/default/files/Research/Jan%202016%20Trade%20Bulletin.pdf*.

[‡] Second-tier cities are often defined as the provincial capitals and special administrative cities, while third-tier cities are generally classified as prefecture level or county-level capitals. Alex Frew McMillan, "The Rise of China's 2nd and 3rd Tier Cities," *CNBC*, February 10, 2011. *http://www.cnbc.com/id/41420632*.

second-tier cities, which had been a top ten investment destination in 2014, attracted investments from 12.3 percent fewer investors year-on-year in 2015.[110]

Figure 20: Newly Constructed Residential Sales Price, Year-on-Year Percent Change, 2011–2015



Source: Stratfor, "China: No Easy Cure for Local Governments' Addiction to Real Estate Revenue," October 16, 2015. *https://www.stratfor.com/analysis/china-no-easy-cure-local-governments-addiction-real-estate-revenue#*.

As a result of the stagnant property prices and declining investment in China's smaller cities, Chinese property developers are quickly losing revenue: one-third of China's property developers reported an operating loss in 2015, and in January the Wanda Group, one of China's largest property developers, cut its forecast for 2016 housing sales by 37.5 percent from 2015.[111] Foreign capital has provided temporary relief for property developers' rising debt levels, with currency devaluations in the second half of 2015 enabling China's real estate developers to either swap foreign currency debts for domestic ones or to pay them down.[112,*]

If Beijing is unable to reverse market declines, however, local government debt, which increased to around 40 percent of GDP in 2015, will continue to rise.[113] While the central government takes 48 percent of the country's total annual tax revenue, it is only responsible for 20 percent of the country's annual fiscal expenditures, forcing local governments to make up the difference.[114] To bridge the budget gap, provinces and towns rely on loans from state-owned banks as well as revenue generated from selling land use rights.[115] As the property market becomes increasingly unprofitable, local governments are struggling to pay off their loans and borrowing more from banks.[116] If a local government becomes unable to pay off its debts, Beijing will have to bail out the losses of state-owned banks, leading to entrenchment of moral hazard.[117]

Moving forward, China is reportedly considering a number of fiscal reforms to increase housing prices in lower-tier cities and rein in the nationwide property glut.[118] According to the state-run news outlet Xinhua, in August 2015 Beijing began laying out plans to introduce a real estate tax, which economists say would go a long way toward reducing the oversupply of property.[119] A Fitch report in August detailing the implications of a national property tax also indicated the policy would provide local governments with "more stable, sustainable, and diverse revenue" to reduce debt levels, though at a higher cost for property buyers.[120] In early December, China's Politburo also vowed to reduce home inventory, although it did not offer specific plans to achieve this goal, which is intended to spur investment in the sector.[121] A working plan for 2016 laid out by China's Ministry of Finance did not mention

[*] In 2014, debt levels for China's largest land developers rose 29 percent year-on-year. Neil Gough, "China's Housing Market Shows Signs of Hope," *New York Times*, May 18, 2015. *http://www.nytimes.com/2015/05/19/business/international/chinas-housing-market-shows-signs-of-hope.html*.

the national real estate tax, indicating the central government may be prioritizing destocking inventories over introducing the new tax.[122]

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