U.S.-China Economic and Security Review Commission

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Highlights of this Month's Edition

Bilateral trade: U.S. goods deficit with China continued to decelerate in May 2016 as growth in U.S. imports from China slowed.

Bilateral policy issues: At the eighth U.S.-China Strategic and Economic Dialogue, participants failed to achieve any major breakthroughs on fundamental strategic and economic issues, but left with some deliverables on financial sector and environmental cooperation.

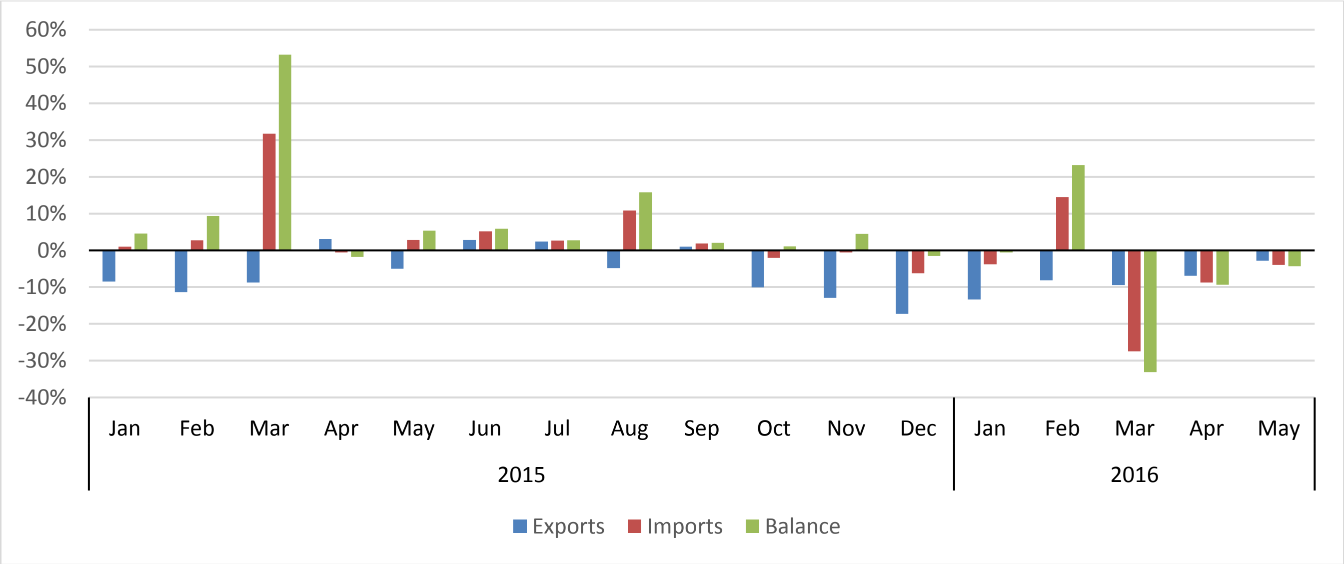
Policy trends in China's economy: Brexit raises economic questions in Beijing, but the reaction in Chinese markets is largely muted; MSCI, the world's largest index provider, once again delayed the inclusion of China's domestic shares in its emerging markets benchmark; China takes more steps to internationalize the RMB, meanwhile the PBOC spends $473 billion in foreign reserves to stabilize its value.

Bilateral Goods Trade

Fall in U.S. Exports and Imports from China Slow Growth in Trade Deficit

The U.S. trade deficit in goods totaled $29 billion in May 2016, a 4.3 percent decrease year-on-year (see Figure 1). May imports fell 3.9 percent year-on-year from $39.1 billion in 2015 to $37.5 billion in 2016, while U.S. exports to China declined 2.8 percent year-on-year from $8.8 billion in 2015 to $8.5 billion in 2016.[1]

Figure 1: Year-on-Year Change in U.S. Goods Exports to, Imports from, and the Trade Balance with China: January 2015–May 2016



Source: U.S. Census Bureau, Trade in Goods with China (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, May 2016). *http://www.census.gov/foreign-trade/balance/c5700.html.*

In May, U.S. imports from China grew 13.8 percent over April imports, while U.S. exports fell 1.7 percent month-on-month.[2] The rapid rise in U.S. imports over U.S. exports contributed to the 19.4 percent month-on-month increase of the trade deficit.[3] Overall, the drop in May trade figures continues the year-on-year declines that begun in March this year.[4] U.S. exports have experienced year-on-year declines since reaching a high of $11.4 billion in October 2015.[5] Growth in U.S. imports from China has also slowed with year-on-year declines in seven of the last eight months. The late start of China's Spring Festival and weak start to the U.S. summer consumer spending may be contributing to these unseasonable drops.

Bilateral Policy Issues

Limited Progress at Eighth U.S.-China Strategic and Economic Dialogue

At the final round of the Strategic and Economic Dialogue (S&ED) talks under the Obama Administration, held in Beijing June 6–7, 2016, participants failed to achieve any major breakthroughs on fundamental strategic and economic issues, but left with some deliverables on financial sector and environmental cooperation. On the economic side, overcapacity topped the U.S. agenda, replacing currency as the primary concern. The lack of improvements to the investment climate for U.S. companies in China, along with China's recently passed law restricting foreign nongovernmental organizations (NGOs),[*] added friction to the talks.[6]

The S&ED has been touted as a valuable high-level forum for the United States and China to communicate policy decisions, find common ground, and prevent misunderstandings.[7] While S&EDs have rarely produced major deliverables, outcomes from this year's talks were modest, with a number of the announcements merely restatements of previous commitments. The limited outcomes of the S&ED include:

- *Addressing excess production capacity*: China pledged to ensure that its central government policies and support do not "target the net expansion" of its steel capacity, but did not make similar assurances for other key industrial sectors or for local government policies.[8] China also promised to "wind down consistently loss-making 'zombie enterprises' through a range of efforts, including bankruptcy and liquidation."[9]
- *Exchange rate reform*: China repeated its pledge to "continue market-oriented exchange rate reform that allows for two-way flexibility and to refrain from competitive devaluation."[10] China stressed that "there is no basis for sustained depreciation of the RMB [renminbi]," which investors fear could amplify global financial instability, as happened in January 2016.[11] In turn, U.S. Treasury Secretary Jack Lew acknowledged moves by the People's Bank of China (PBOC) to make the RMB exchange rate more market-oriented: "We were pleased to see reforms made last year and the recognition of that progress in the IMF [International Monetary Fund] decision to include the renminbi in the SDR [special drawing rights] basket."[12]
- *Expanding RMB trading and clearing capacity in the United States*: China announced it will allow U.S. investors to directly access China's financial markets through an RMB Qualified Institutional Investors (RQFII) quota of $38 billion (RMB 250 billion), the second-largest quota China has granted after Hong Kong.[13] The RQFII program allows approved foreign fund managers to use RMB raised outside China to invest in the country's financial markets. China also agreed to allow certain U.S. financial institutions to

[*] There was significant high-level engagement on China's new foreign NGO law at the S&ED, with both Secretary of State John Kerry and Treasury Secretary Jack Lew raising U.S. concerns over the law. In his opening remarks at the S&ED, Secretary Lew said, "We are very concerned that China's recently passed Foreign NGO Management Law will weaken [China's integration with the global economy] by creating an unwelcome environment for foreign NGOs. President Obama and President Xi have discussed this issue, and addressing it will be important for our bilateral relationship." U.S. Department of the Treasury, "Remarks by Treasury Secretary Lew at the 2016 U.S.-China Strategic and Economic Dialogue Joint Opening Session," June 6, 2016. *https://insidetrade.com/sites/insidetrade.com/files/documents/jun2016/wto2016_1356a.pdf*. For more information on China's new foreign NGO law, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, June 3, 2016. *http://origin.www.uscc.gov/sites/default/files/trade_bulletins/June%202016%20Trade%20Bulletin.pdf*.

act as clearing houses for settling RMB transactions, which can lower transaction costs for U.S. firms doing business in China.[14] These new measures advance Beijing's goals of internationalizing the RMB and attracting more capital inflows while giving U.S. investors greater access to China's tightly regulated financial markets.[15]

- *Accelerating BIT negotiations*: The United States and China agreed to submit revised negative list[*] offers in mid-June, after both countries missed a March 2016 deadline for exchanging offers. Both sides agreed to accelerate negotiations, but did not set a deadline for concluding BIT negotiations.[16] After both sides exchanged new offers, an Office of the U.S. Trade Representative (USTR) spokeswoman said the negotiations "continue to be productive," but did not provide details on China's latest negative list.[17]
- *Enhanced cooperation on climate change and environment*: The United States and China strengthened their cooperation on climate change and environmental protection, which comprised nearly half of the listed strategic outcomes; however, most of the outcomes highlighted existing exchanges and agreements.[18] For instance, the two countries committed to working toward full implementation of the Paris Agreement.[†][19] The listed outcomes also enumerated multiple collaborative projects under the Climate Change Working Group, including initiatives on smart grids, heavy-duty vehicles, and building and industry energy efficiency.[20]

Policy Trends in China's Economy

Brexit's Economic Impact on China Remains Unclear

On June 23, 2016, the United Kingdom (UK) held a nonbinding referendum on whether to remain in the EU. In the final tally, 52 percent of UK citizens voted in favor of leaving the EU, or "Brexit," setting in motion a process to formally negotiate the terms of Britain's withdrawal from the bloc.[21] Britain is the second-largest destination of Chinese investment in Europe (behind Italy); as such, its decision to leave the EU could cause China to readjust its economic strategy in the region.[22]

China-UK economic cooperation is growing, with the two countries signing over 30 commercial deals worth over $57 billion during Chinese President and General Secretary of the Chinese Communist Party Xi Jinping's state visit to the UK in October 2015.[23] Chinese companies completed 22 acquisitions in the UK in 2015, and have made investments worth $2.3 billion in 17 UK companies in the first six months of 2016.[24] Shortly after the referendum, Britain announced plans to launch high-level trade missions to China in the coming months to maintain the countries' strong economic ties, though the announcement provided few specifics.[25]

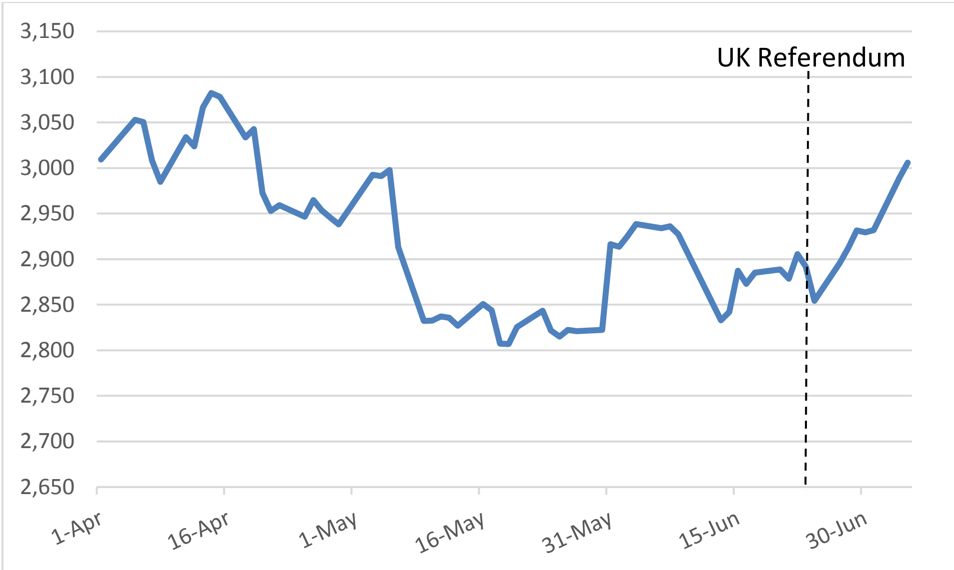
Chinese leaders hoped Britain would remain in the EU, with President Xi reportedly telling British Prime Minister David Cameron as much during the October 2015 state visit.[26] In the same month, China's foreign ministry released a statement that "China hopes to see a prosperous Europe and a united EU, and hopes Britain, as an important member of the EU, can play an even more positive and constructive role in promoting the deepening development of China-EU ties."[27] After the referendum results came in, China's Ministry of Foreign Affairs released a second statement urging "all related parties [to] calm down and evaluate the situation," a message Chinese Premier Li Keqiang reiterated at a World Economic Forum Meeting in June 2016 when he encouraged investors not to panic over the referendum result.[28] An op-ed in the state-run media outlet *Global Times* also addressed the Brexit decision, writing, "Britain's exit reflects the general decline of Europe" and railing against the British people for "showing a losing mind-set."[29]

[*] Under a negative list approach, countries specify which sectors are restricted or prohibited for foreign investment. China's previous negative list offer contained more than 40 sectors, which U.S. officials deemed overly broad. Felicia Schwartz and Mark Magnier, "U.S.-China Talks Limited by Disagreements," *Wall Street Journal*, June 7, 2016. *http://www.wsj.com/articles/u-s-china-talks-limited-by-disagreements-1465300155*.

[†] For more information on China's commitments at the Paris Climate Conference, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, January 6, 2016. *http://origin.www.uscc.gov/sites/default/files/trade_bulletins/Jan%202016%20Trade%20Bulletin.pdf*.

Despite the alarm raised by the Brexit vote, the reaction in Chinese markets has been largely muted. The Shanghai Composite Index, for instance, dropped just 1.3 percent the day after the referendum, and had rebounded 5.3 percent by July 5 (see Figure 2).[30] The RMB, on the other hand, dropped significantly in the aftermath of the vote, with the PBOC devaluing the RMB by nearly 1 percent following the referendum, the largest devaluation since August 2015.[31] However, the PBOC released a statement following the devaluation saying it will keep the RMB stable against a basket of currencies and not engage in further devaluations.[32] Lou Jiwei, China's minister of finance, downplayed market fears as "knee-jerk" and "excessive," while Xu Shaoshi, the chairman of the National Development and Reform Commission, indicated he expects the economic impact to be relatively small.[33]

Figure 2: Shanghai Composite Index, April–July 5, 2016



Source: National Bureau of Statistics via CEIC database.

While the long-term consequences of the UK's decision are largely unknown, economists and international affairs experts are weighing in on Brexit's potential impact for China's economic growth and development. Scenarios proposed by experts reach diverging conclusions, including:

- *China will not be significantly impacted:* Some economists and business executives believe Brexit will not have a significant long-term effect on the Chinese economy. For example, David Dollar, a senior fellow at the Brookings Institution, believes China's economic growth model—in the process of shifting from one driven by investment and export-led growth to one led by consumption—will not be impacted by reduced investment and trade with the UK.[34] John Veihmeyer, chairman of KPMG International, concurred, arguing Brexit will not have a significant impact on Chinese companies and adding that "Western Europe collectively has been a big destination for outbound investment," with enough other potential Chinese partners—namely Germany—in the region to offset any potential losses from declines in China-UK ties.[35] Wang Chuanfu, the chairman of Chinese automaker BYD Auto,[*] agreed with this conclusion, saying he did not anticipate making any major changes to his business strategy as a result of Brexit.[36] In fact, Mr. Wang said he will seek to increase BYD's investment in the UK in the coming years.[37]

- *China's economic development will slow:* Brexit could make China more vulnerable to external shocks, contribute to slower gross domestic product (GDP) growth, and limit China's access to European markets.[38] The British banking and financial services giant Barclays estimates Brexit will cause China to lose a tenth of a point off its GDP in both 2016 and 2017, and expects the RMB to fall another 10 percent against the

[*] BYD works extensively in Europe, including on a joint venture with Scottish manufacturer Alexander Dennis to produce electric buses. The deal is potentially worth more than $2.5 billion. Elias Glenn, "China's Li Won't Allow 'Rollercoaster' Markets after Brexit," Reuters, June 28, 2016. *http://www.reuters.com/article/us-britain-eu-china-idUSKCN0ZE0XQ*; BBC, "Falkirk-Based Alexander Dennis Signs Bus Deal with China's BYD," October 21, 2015. *http://www.bbc.com/news/uk-scotland-scotland-business-34587365*.

dollar as investors search for stable places to put their money.[39] Barclays is not alone in predicting negative consequences. Craig Chan, the head of Asia FX strategy at the financial services group Nomura, said he could "imagine the case that China becomes much more vulnerable ... because exporters would be hoarding foreign currencies."[40] Further declines in the RMB's strength against the dollar could also reignite capital outflows, which caused an estimated $1 trillion to leave China in 2015 after a surprise devaluation in August by the PBOC.[41] Additionally, Philippe Le Corre, a visiting fellow at the Brookings Institution, believes Brexit could undermine China's economic relationship with the EU, limit China's network of global partners and its access to European markets, and reduce Chinese investment and trade in the region.[42]

- *China will benefit from Brexit in the long run:* Over the longer term, a less stable European market could be in China's economic and political interests.[43] Mark Mobius, the executive chairman of the emerging market investing firm Templeton Emerging Markets Group, argues China will benefit from increased trade flows as a result of Brexit.[44] Under this scenario, a fractured EU would allow Chinese negotiators to strike better bargains with trade partners, undercut complaints about China's market-distorting behavior, and allow Chinese companies to increase their market share in Europe.[45] In addition, Wy Cheng, a researcher and writer on global politics and economics, believes the UK's decision will open the door for exclusive bilateral negotiations between China and each EU member state, where China stands a better chance of gaining concessions than it did negotiating against the EU as a whole.[46]

MSCI Once Again Delays China A-Shares Inclusion

On June 14, MSCI Inc., the world's largest index provider, announced it would delay the inclusion of China A-shares[*] in its Emerging Markets Index for the third straight year.[47] China has lobbied intensely for inclusion in the index, a widely used benchmark for fund managers with global equities portfolios, and took a number of steps to address MSCI's concerns.[48] Inclusion in the index would enhance the credibility of China's financial sector and facilitate more investments from international institutional investors. The Chinese government, which has sought to elevate the status of China's markets in the international financial system, also assigns great symbolic value to MSCI inclusion.[49]

In its announcement, MSCI credited China for recently introducing "significant improvements in the accessibility of the A-shares market for global investors."[50] However, it noted that "international institutional investors clearly indicated they would like to see further improvements in the accessibility of the China A-shares market before its inclusion in the MSCI Emerging Markets Index."[51] China's improvements address, to varying degrees, the four issues MSCI previously identified as the key impediments to inclusion: beneficial ownership, trading suspensions, the quota allocation process, and capital mobility restrictions.[52] With its decision, MSCI has taken a wait-and-see approach; global investors want to see China deliver on promised reforms before they take the plunge.

According to MSCI, concerns about beneficial ownership of investments[†] were resolved following clarification from the China Securities Regulatory Commission (CSRC) in May 2016.[53] MSCI also pointed to investor concerns over the prevalence of trading halts during last summer's rout, which at one point left half of China's stock market suspended.[54] This made it difficult for fund managers to value their holdings and meet redemptions.[55] To address these concerns, the CSRC introduced new rules in May to regulate and limit trading suspensions.[56]

The main issue at hand, however, has been accessibility—namely, the ability of investors to move their money in and out of China. MSCI noted that recent Qualified Foreign Institutional Investor (QFII) policy changes introduced by China's State Administration of Foreign Exchange (SAFE) "largely resolve, at least on paper, the critical accessibility issues on quota and capital mobility."[57] These changes include linking QFII quota allocation to

[*] Most companies listed on Chinese stock exchanges offer two shares classes: A-shares and B-shares. A-shares are denominated in RMB and largely restricted to domestic investors, while B-shares are quoted in foreign currencies and open to both domestic and foreign investors. Foreign investment in A-shares is permitted through the Qualified Foreign Institutional Investor (QFII) and RFQII programs.

[†] Previously, it was unclear whether the beneficial owner of securities (the foreign client) actually owned securities invested through separate accounts held by local asset managers (known as the QFII/RQFII nominee holder) under China's securities trading system. The CSRC's statement issued in May 2016 confirmed its recognition of the rights and interests of beneficial owners of securities held in the QFII/RQFII nominee accounts. China Securities Regulatory Commission, *FAQs on Beneficial Ownership under QFII/RQFII Regime*, June 5, 2016. *http://www.csrc.gov.cn/pub/csrc_en/laws/overRule/PolicyInterpretation/201605/t20160506_297071.html*.

investment fund size, relaxing capital mobility restrictions under the QFII scheme, simplifying the QFII application and quota granting process, and expanding the RQFII program from 12 cities to 16 cities.[58] But MSCI said many investors remained bothered by the operational challenges posed by China's monthly repatriation limit of 20 percent for foreign investors. "This poses a potential liquidity concern for investors who need to honor redemption outflows from their clients, and thus must be removed or substantially increased with a shorter repatriation horizon, otherwise the effectiveness of the QFII channel would be significantly reduced," said MSCI.[59]

Investors also cited concerns over Chinese exchanges' requirement that all financial products linked to indexes that include A-shares seek their pre-approval.[60] MSCI said the breadth of the requirement, which applies to both new and existing financial products, was "unique among Emerging Markets" and runs the risk of disrupting trading if a Chinese exchange were to withhold approval.[61]

MSCI's decision surprised both Chinese and international observers. Before MSCI's announcement, a senior CSRC official claimed the A-shares' inclusion was a "historical certainty."[62] Goldman Sachs had estimated the chances of inclusion at 70 percent, citing Beijing's recent efforts to facilitate MSCI inclusion.[63] Many analysts argue that the inclusion of China's A-shares is inevitable given the size of the country's capital market.[64] At $8 trillion in market capitalization, China has the world's second-largest capital market, behind the United States' S&P 500 ($19 trillion) and ahead of Japan's TOPIX ($4.7 trillion).[65] After the decision, a commentary published by state-run media outlet Xinhua granted that MSCI's decision was "understandable," but went on to argue that "[i]nternational investors should not hold out for 'the perfect scenario,'" as China's capital markets were "too big to be ignored."[66]

Caixin Media's editor-in-chief Hu Shuli took a sanguine view of MSCI's decision, arguing that it can serve as "an impetus for further reforms in the context of China's ongoing campaign to develop a more market-oriented, properly regulated equities market."[67] But implementing further reforms may be a tall order for China. Faced with slowing economic growth and the prospect of higher U.S. interest rates, Chinese officials are unlikely to further relax capital controls in the near term.[68] MSCI said it would reconsider A-shares for inclusion in 2017 and "does not rule out a potential off-cycle announcement should significant positive developments occur."[69]

RMB Conversion Pilot Program Expansion and Stabilization Policies Adopted

To promote RMB internationalization and global integration of the Chinese financial system, on June 15 SAFE[*] relaxed restrictions on foreign exchange conversions by allowing companies to convert 100 percent of the money in their capital accounts.[70] Depending on the state of the international balance of payments, SAFE can continually adjust the permissible percentage ratio of foreign exchange converted.[71] SAFE also expanded upon a 2013–2015 pilot program by covering incidental expenses for all mainland-based nonfinancial companies, rather than limiting the program to companies within free trade zones (FTZs)[†] in Shanghai, Guangdong, Tianjin, and Fujian, as it had in the past.[72] Effective immediately, companies are no longer required to submit paperwork or currency conversion reports with each transaction.[73]

This new policy demonstrates a shift to less risk-averse policymaking and greater flexibility to respond to potential shocks from hot money inflows and outflows, which may destabilize exports, dramatically change foreign reserve holdings, or fuel asset bubbles.[‡74] In addition, the new policy allows domestic institutions and individuals to regulate cross-border foreign exchange payment business through online payment institutions regulated by the PBOC Payment Services Measures,[§] and guard against risks arising from cross-border capital flows through e-commerce transactions, such as identity theft and fake payment accounts.[75] SAFE maintains a negative list[76] of transactions that cannot use the converted RMB in a firm's capital accounts; while this list will be reduced, many items will

[*] Together with the PBOC, SAFE manages and controls foreign currencies in China. Both determine the official RMB exchange rate and the availability of foreign currencies on capital account items.

[†] Shanghai's FTZ—China's first—was approved by the State Council on August 22, 2013. Additional FTZs were launched in Guangdong, Tianjin, and Fujian in April 2015. FTZs are characterized by looser capital controls and foreign investment rules, and no government permission needed for startup plans or shutdowns.

[‡] Hot money flows refer to capital outflows to countries with higher interest rates or impending changes in the exchange rate, and are unrelated to exports.

[§] The Payment Services Measures, effective September 2010, prohibit entities that are not CBRC-regulated from engaging in online payment, issuing or accepting prepaid cards, or accepting bankcards, unless these entities obtain a Payment Business License from the PBOC. HG.org, "Online Payment Systems Technology in China." *https://www.hg.org/article.asp?id=36651*.

continue to be prohibited, including: expenditures that fall outside a firm's business scope, nonbank-issued securities and wealth management products that do not have a guaranteed principal investment amount, entrusted loans to nonrelated enterprises, and real estate purchases that will not be used by the firm alone.[77]

Alongside new measures to promote RMB internationalization, the PBOC has been drawing down China's foreign exchange reserves to manage the RMB exchange rate. Since August 2015, the PBOC has spent $473 billion to stabilize the RMB and prevent a rapid depreciation, which stemmed from the PBOC's August 2015 decision to change the daily guidance rate for the RMB.[78]

The PBOC's intervention has been criticized for interfering with market-led determination of the exchange rate and dragging out the RMB's inevitable weakening. Despite the PBOC intervention, the RMB has weakened 5.3 percent since August 2015 (the foreign exchange reserves declined from $3.99 trillion in June 2014 to $3.19 trillion today).[79] The RMB's value took a further hit after MSCI's surprise decision on June 15 to delay adding mainland Chinese shares to its Emerging Markets Index for the third time.[80] Brexit, too, forced the RMB to fall 1 percent against the dollar.[81]

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