U.S.-China Economic and Security Review Commission

Economics and Trade Bulletin

July 6, 2017

Highlights of This Month's Edition

- **Bilateral trade:** In May, U.S. experiences the highest goods trade deficit with China since October 2016.
- **Bilateral policy issues:** U.S. beef and dairy products regain access to China's markets, but low levels of traceable U.S. beef remain an obstacle; Chinese chicken in final stages of gaining approval for export to the U.S. market; China approves two U.S. biotech crops for import, but structural causes behind delays for biotech approval remain.
- **Policy trends in China's economy:** MSCI includes 222 China A-shares in its Emerging Markets Index, an important step toward opening China's capital markets to foreign investors.
- **Sector focus – Payments:** In China's payments sector, U.S. companies face regulatory challenges and stiff domestic competition, while Chinese companies are starting to access the U.S. market.

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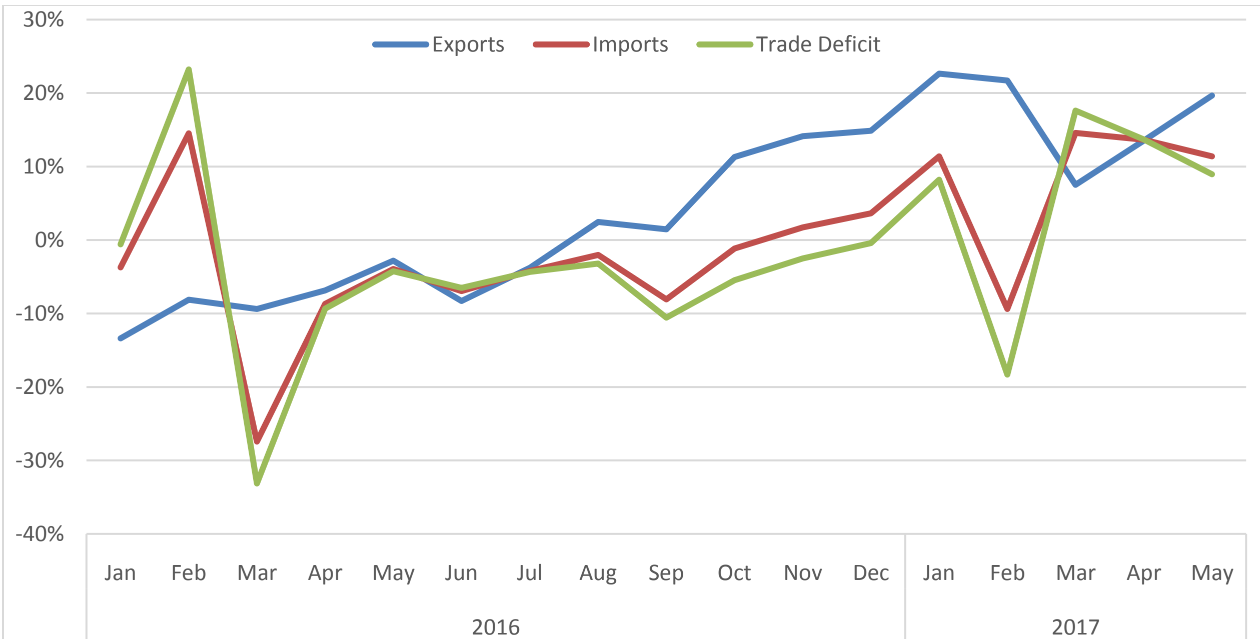
Bilateral Trade

U.S. Exports and Imports Experience Robust Growth in May

In May 2017, U.S. goods trade deficit with China rose 8.9 percent year-on-year to reach $31.6 billion, a 14.4 percent increase over April (see Figure 1).[1] This is the highest bilateral goods trade deficit since October 2016. This month, U.S. exports to China increased 19.7 percent year-on-year to reach $10.2 billion.[2] Passenger cars and pharmaceutical preparations largely contributed to this increase in exports.[3] U.S. imports from China rose 11.4 percent year-on-year to $41.8 billion due to imports of computers and computer accessories.[4] Year-to-date, U.S. deficit totaled $138 billion, an increase of 5.2 percent over the same period last year.

Figure 1: Year-on-Year Change in U.S. Exports, Imports, and the Trade Deficit with China, January 2016–May 2017



Source: U.S. Census Bureau, *Trade in Goods with China*, July 6, 2017. *https://www.census.gov/foreign-trade/balance/c5700.html.*

Bilateral Policy Issues

The Grand Exchange: Chinese Chicken for U.S. Beef

China and the United States checked off the first two items from the initial joint U.S.-China 100-day action plan—launched in May by President Trump and Chinese President and General Secretary of the Chinese Communist Party Xi Jinping—ahead of schedule, addressing two longstanding market access issues: beef and chicken.[5] On June 12, 2017, China and the United States finalized technical standards for U.S. beef exports to China, lifting a 13-year ban on U.S. beef to China.[6] China, the world's second-largest importer of beef, will now permit imports of U.S. bone-in and boneless beef for livestock under 30 months that can be traceable to a U.S. birth farm or first place of residence or port of entry.[7] This agreement largely built off an earlier agreement reached in September 2016 and represents an early trade win for the Trump Administration.[8] However, only 15 percent of U.S. producers participate in the voluntary beef traceability system, which limits gains for U.S. exporters hoping to reach the Chinese market.[9]

The Chinese Certification and Accreditation Administration and the U.S. Food and Drug Administration signed a Memorandum of Understanding on June 15, 2017, to allow U.S. dairy and infant formula certified by the U.S. Department of Agriculture's (USDA) Agricultural Marketing Service to be exported to China.[10] U.S. producers partially lost market access in May 2014 after China implemented new food safety regulations that resulted in delayed importer registration and certification.[11] This new agreement is expected to accelerate registration and certification, reopening the market for U.S. producers.[12]

China has long sought to expand Chinese poultry access to the United States but faced significant consumer and congressional concerns over China's susceptibility to outbreaks of avian flu and its poor food safety record.* The USDA's Food Safety and Inspection Service (FSIS) has separated its review of China's poultry food safety system equivalency with the United States into processing poultry and slaughtering poultry. Since 2013, the FSIS has permitted Chinese processing of chicken raised and slaughtered in either Canada or the United States to be exported to the United States.[13] In March 2016, the FSIS for the first time determined China's poultry slaughter inspection system to be equivalent to the United States'.[14] With this satisfactory audit, on June 16, 2017, the FSIS proposed a regulatory amendment adding China to the list of countries eligible to export poultry products from birds slaughtered in China.[15] The amendment will be open for public comment until August 15, after which the FSIS will make a final determination.[16]

China Approves Two U.S. Biotech Products

As part of the U.S.-China 100-day action plan, China approved two genetically modified (GM) strains of soybeans and corn developed by Monsanto and Dow Chemical, respectively, for import into its market.[17] The two strains were part of eight agricultural biotech products China agreed to review as part of the 100-day action plan. A request from China's National Biosafety Committee to Dow for more information on a separate GM soybean strain indicates China may continue to move forward with reviewing the remaining biotech strains.[18]

U.S. biotech products have faced considerable delays in receiving reviews from Chinese safety inspectors. Unlike most countries, China waits for other countries to finish their approval process for biotech products before beginning its own.[19] This can delay the process of approving biotech crops by several years—safety applications for some of the eight crops China agreed to review in May were first submitted in 2011 and more than a dozen other countries have already approved them for import.[20] Complicating the situation, China's National Biosafety Committee—which reviews biotech safety applications—meets infrequently, sometimes once or less per year.[21] For crops like soybeans and corn, this slow process can delay distribution of crops worldwide, as producers will wait to begin production until they are confident their product will be allowed in China, a major market for U.S. agriculture.† China's slow approval process can also affect U.S. exports of non-GM crops. China has rejected more than a million tons of U.S. non-GM corn after detecting evidence of an unapproved biotech strain in a U.S. corn shipment.[22]

While China's decision to grant Dow and Monsanto safety certifications was welcomed by U.S. agricultural firms, it does not appear to address the underlying cause of delays for biotech products.[23] Under the 100-day action plan, China pledged to review a few U.S. biotech crops but did not commit to speeding up the review process by initiating certification simultaneously with other countries.[24] Barring a change in Chinese policy, future U.S. biotech crops may face similar delays in receiving safety certification from Chinese authorities. The Office of the U.S. Trade Representative (USTR) has repeatedly pressed China to quicken its review process by running contemporaneously with other countries, but so far has received no commitment from China to do so.[25]

The Chinese public views GM foods with suspicion. A 2010 *China Daily* online poll of 50,000 Chinese consumers found that 84 percent of respondents would not use GM food due to safety concerns.[26] Recently the Chinese government started to take steps to dispel misconceptions about GM food. In May, China's central government announced it would begin a social media campaign to provide basic information about GM products and partner with Chinese universities to conduct a poll on Chinese attitudes regarding GM food.[27] Given Chinese public distrust

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* For more information on Chinese product safety and its persistent challenges, see Matt Snyder and Bart Carfagno, "Chinese Product Safety: A Persistent Challenge to U.S. Regulators and Importers," *U.S.-China Economic and Security Review Commission*, March 23, 2017. *https://www.uscc.gov/sites/default/files/Research/Chinese%20Product%20Safety.pdf*.

† China is currently the largest destination for U.S. agricultural exports and the largest importer of soybeans worldwide. In 2016, China accounted for 15.8 percent of all U.S. agricultural exports ($21.4 billion out of $134.7 billion total). Behind China were Canada (15.1 percent of U.S. agricultural exports), Mexico (13.2 percent), the EU (11.5 percent), and Japan (11 percent). Brian Spegele, "China Greenlights Imports of Two New GMO Products," *Wall Street Journal*, June 14, 2017. *https://www.wsj.com/articles/china-greenlights-imports-of-two-new-gmo-products-1497444846?mg=prod/accounts-wsj*. U.S. Department of Agriculture, *Global Agricultural Trade System*. *https://apps.fas.usda.gov/gats/*.

of the government's ability to manage food safety, Chinese consumers may remain wary of GM food.[*] These new efforts to improve the image of GM food in China may be motivated by the purchase of one of the world's largest agriculture biotech companies, Syngenta, by state-owned China National Chemical Corp for $43 billion (the deal was approved by U.S., EU, and Chinese regulators in April 2017).[28] Foreign agriculture firms like Dow and Monsanto, which have not been able to access China's market due to stringent regulations, fear China's acquisition of Syngenta will further limit their market opportunities, with Syngenta's GM products receiving exclusive regulatory approval from Beijing.[29]

Public distrust of GM food has likely led the Chinese government to restrict the import and production of biotech crops. To date, the Chinese government has approved imported GM food only for animal consumption or processing into other products such as oil, and the only GM food that can be grown domestically for consumption is a strain of virus-resistant papaya.[30]

Policy Trends in China's Economy

China A-Shares Gain Approval for MSCI Inclusion

On June 21, 2017, MSCI, the world's largest index provider, announced it will include 222[†] China A-shares[‡] in its Emerging Markets Index effective June 2018.[31] MSCI has previously decided against including Chinese shares for three years in a row, despite intense lobbying by the Chinese government.[32] Beijing assigns great symbolic value to MSCI inclusion, which it believes will enhance the credibility of China's financial sector and facilitate more investments from international institutional investors.[33]

MSCI, Chinese regulators, and global investors had been in discussions since 2014 about adding renminbi (RMB)-denominated shares to the Emerging Markets Index. In June 2016, MSCI decided against including China A-shares, saying significant improvements were needed in the areas of corporate governance and investor access.[§] [34] In March 2017, MSCI took a step toward China's inclusion, relaxing its investment criteria by reducing the number of proposed China stocks included in the decision from the full A-shares market (448 stocks) to the 169 stocks accessible to foreign investors through China's Hong Kong stock connects. The selection was later increased by 53 stocks to include those listed in Hong Kong.[35]

In its June 2017 decision, MSCI cited the introduction of stock connects between Hong Kong and exchanges in Shanghai and Shenzhen, as well as a decline in the number of suspended A-shares in China, as factors for inclusion. However, MSCI remains wary of the number of suspended shares in China and Beijing's continued restrictions for foreign investors, including limits on creating new index-linked investment vehicles. In a press release about the inclusion, MSCI stated it "is very hopeful that the momentum of positive change witnessed in China over the past years will continue to accelerate."[36]

Of the 222 companies included in the index, 69 percent are state-owned enterprises (SOEs), according to research by JP Smith of Ecstrat, an investment consultancy.[37] According to Mr. Smith, this may expose investors to a

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[*] Several Chinese food safety scandals have heightened anxiety among Chinese consumers. In 2008, melamine contamination of infant milk powder killed six Chinese babies and sent more than 50,000 to the emergency room. In 2013, Guangdong's provincial government revealed that 45 percent of tested local rice contained dangerous levels of cadmium. Christina Larson, "Can the Chinese Government Get its People to Like G.M.O.s," *New Yorker*, August 31, 2015. *http://www.newyorker.com/tech/elements/can-the-chinese-government-get-its-people-to-like-g-m-o-s*; Shuping Niu, "China Pushes Public to Accept GMO as Syngenta Takeover Nears," Bloomberg, May 21, 2017. *https://www.bloomberg.com/news/articles/2017-05-22/china-pushes-public-to-accept-gmo-as-syngenta-takeover-nears.*

[†] Of the 222 firms included in MSCI's decision, 50 are finance firms and 44 industrial firms. Dion Rabouin and Michelle Price, "China Shares Get MSCI Nod in Landmark Moment for Beijing," Reuters, June 21, 2017. *http://www.reuters.com/article/us-msci-indexes-idUSKBN19B325*.

[‡] A-shares are the shares of companies incorporated in China and denominated in renminbi. A-shares are currently open to foreign investment only through China's Renminbi Qualified Foreign Institutional Investor program and the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect Programs. B-shares, the other class of shares offered in China, are quoted in foreign currencies and open to both domestic and foreign investors. ETF Securities, "China, Happening Now." *https://www.etfsecurities.com/institutional/no/en-gb/china-a-shares*.

[§] For more on MSCI's June 2016 decision, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, July 6, 2016, 5–6. *https://www.uscc.gov/sites/default/files/Research/July%202016%20Trade%20Bulletin.pdf*.

"minefield" of governance challenges because Chinese SOEs operate "in an environment in which there are no hard budget constraints and which is replete with moral hazard."[38] Alan Brett, head of corporate governance research at MSCI, expressed similar reservations, nothing that in Chinese SOEs, "key decisions are not being made by the board. It all comes down to the [Communist] party." [39]

Even before China's A-shares were included, Hong Kong and U.S.-traded shares of Chinese companies gave China the largest weighting in the Emerging Markets Index (nearly 30 percent).[40] That level will remain largely unchanged by the inclusion of China's A-shares; in total, the new Chinese stocks will represent around 0.73 percent of the weight of the MSCI index, and will be introduced in a two-step process in May and August 2018.[41] The Chinese A-shares will initially be weighted at only 5 percent of their total market capitalization, and thus are expected to have little impact on the index's performance in the short term.[42]

The index could be expanded to include China's full A-shares market and total capitalization if Chinese regulators continue to reduce market barriers for foreign investors.[43] A range of factors will need to be met before MSCI expands inclusion to more Chinese shares, however, including continued improvements in accessibility for foreign investors, removing or significantly increasing daily trading limits, and additional efforts to curb trading suspensions.[44]

Kevin Anderson, senior managing director of the investment management firm State Street Global Advisors, emphasized the importance of the decision for China, saying its inclusion "will create additional flow of capital and potentially a new segment of institutional investors in the China market."[45] According to MSCI executives, the decision will initially lead approximately $17 billion to $18 billion of global assets to flow into Chinese stocks, and could eventually attract more than $340 billion of foreign capital if China achieves full inclusion in the index.[46]

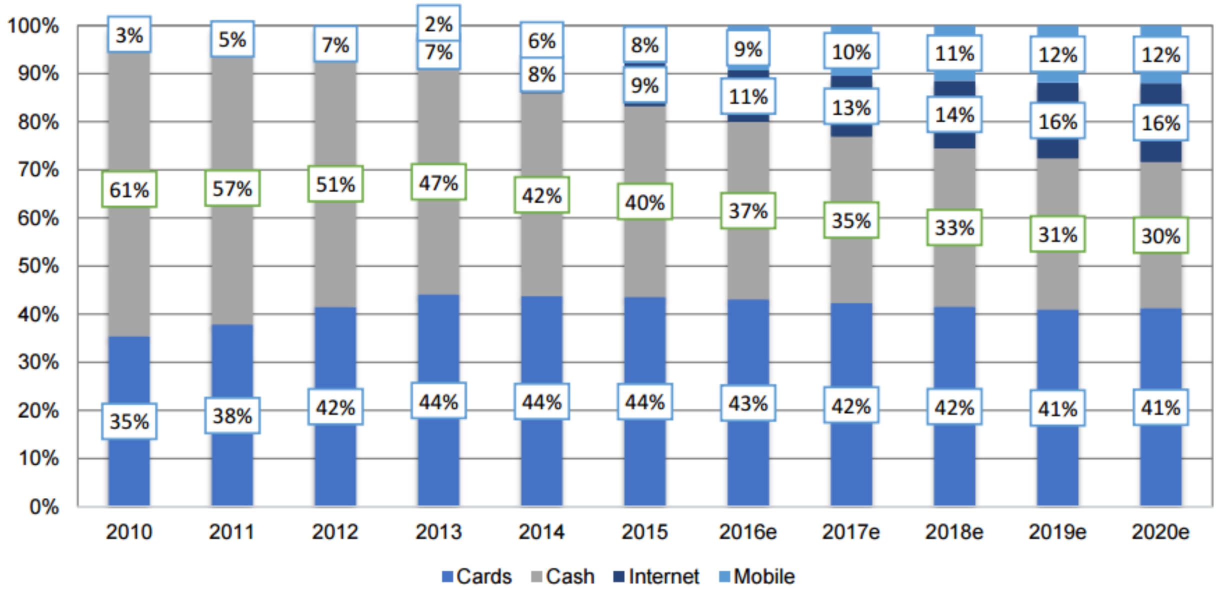
Sector Focus: China's Payments Market

Over the last six years, Chinese consumers have quickly shifted from making payments with cash to cards and digital alternatives.[47] In 2010, 61 percent of China's retail consumption was transacted in cash; that share fell to an estimated 37 percent in 2016, according to data from financial research firm Kapronasia (see Figure 2).[48] In 2016, 43 percent of consumer retail spending in China was card based, up from 35 percent in 2010.[49] Most dramatically, digital (Internet and mobile) payments accounted for 20 percent of retail transaction volumes in 2016, up from 3 percent in 2010.[50] The rapid uptake and use of bank cards and digital payments is due in large part to China's e-commerce boom, with Chinese consumers increasingly shopping and paying for goods online, and government policies promoting noncash payments.[51]

China's payments sector has long been dominated by UnionPay, the country's state-owned payment card clearing and settlement network. Owned by a consortium of Chinese state-owned banks and led by a succession of former People's Bank of China (PBOC) officials, UnionPay has held a near monopoly over China's bank card market.[52] Until 2015, UnionPay was the sole entity allowed to provide clearing services for RMB transactions.[53] According to PBOC data, Chinese bank card payment transactions reached $8.3 trillion in 2016 (see Figure 3) and the market is projected to become the world's largest by 2020.[54]

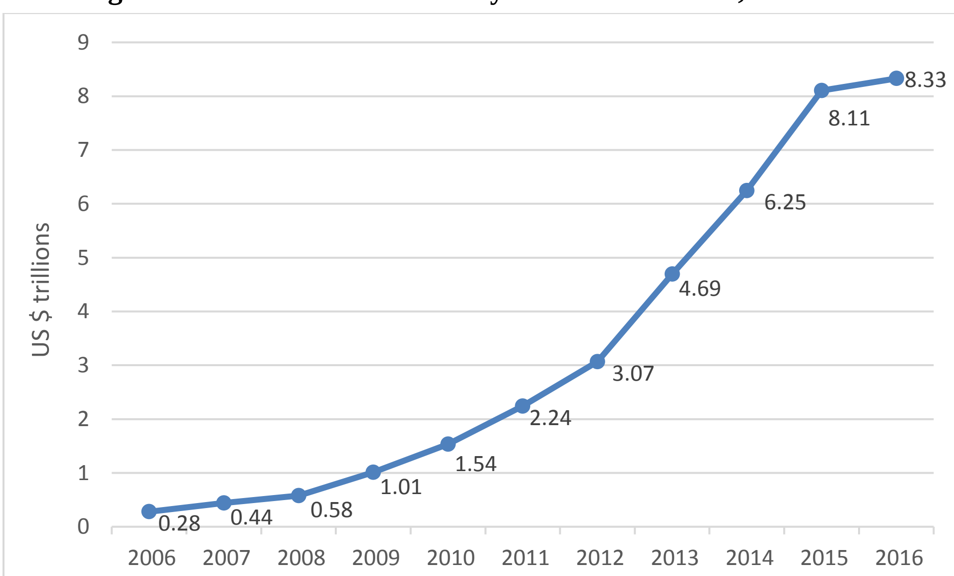
Figure 2: China Retail Consumption by Payment Type, 2010–2020

(% of total payments)



Source: U.S.-China Economic and Security Review Commission, *Hearing on U.S. Access to China's Consumer Market: E-Commerce, Logistics, and Financial Services*, written testimony of Zennon Kapron, June 22, 2017. *https://www.uscc.gov/sites/default/files/Kapron_USCC%20Testimony_22June2017.pdf*.

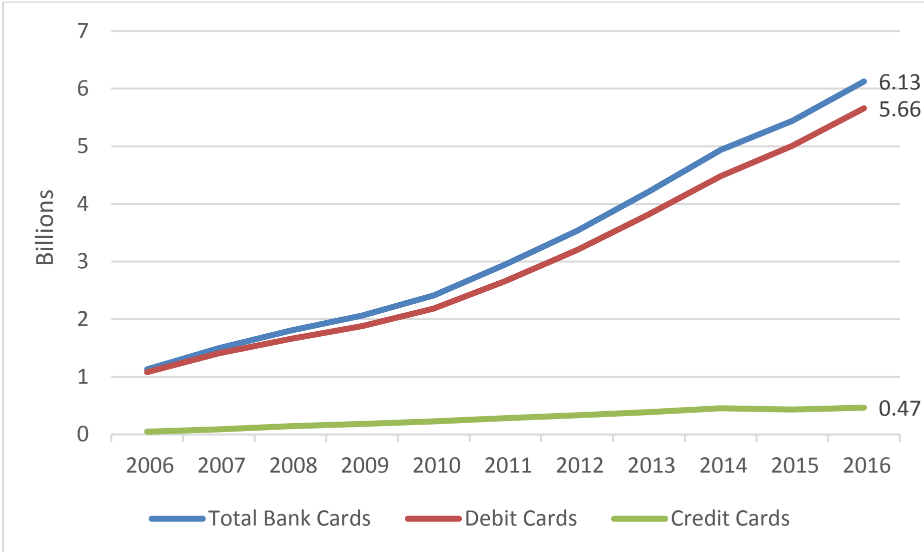
Figure 3: Chinese Bank Card Payment Transactions, 2006–2016



Note: RMB values were converted to U.S. dollars at the current exchange rate.
Source: The People's Bank of China via CEIC database.

Debit cards dominate China's payment card market, accounting for 92 percent of the total number of bank cards in circulation in 2016 (see Figure 4).[55] According to PBOC data, in 2016 China had 6.1 billion bank cards in circulation, of which 5.7 billion were debit cards and 465 million were credit cards.[56]

Figure 4: Bank Cards in Circulation in China, 2006–2016

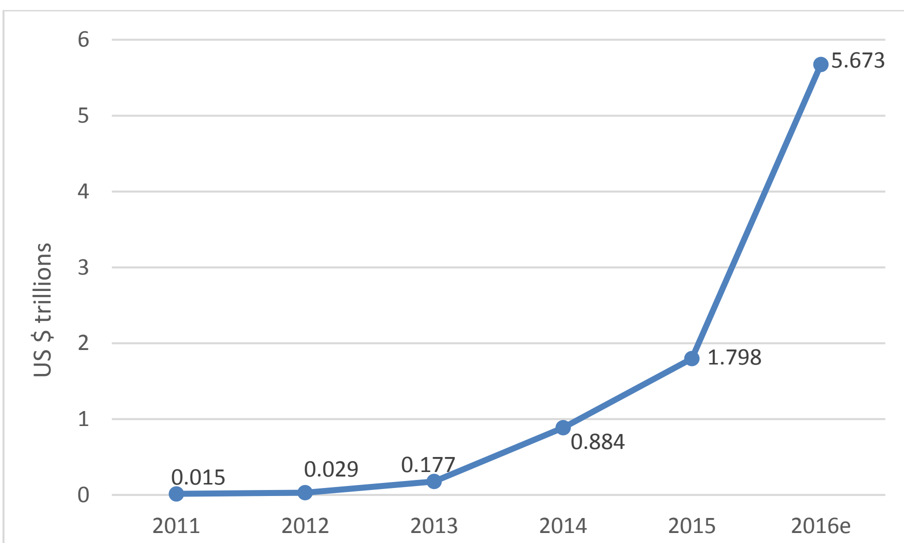


Source: The People's Bank of China via CEIC database.

Low credit card penetration stems partly from a lack of consumer credit ratings.[57] As of 2015, the PBOC had credit histories for 380 million Chinese citizens, less than one-third of China's adult population.[58] In comparison, 89 percent of U.S. adults have credit scores.[59] The number of credit cards in China grew from 49 million in 2006 to 465 million in 2016; however, growth in credit card issuance in China has slowed over the past five years, as digital payments gained popularity with Chinese consumers.[60]

China's Internet giants have emerged as major players in China's payments sector, leading the charge in the rapidly growing digital payments sector. In 2016, the transaction value of third-party mobile payments in China reached an estimated $5.7 trillion (RMB 38 trillion), up from $14.7 billion (RMB 100 billion) in 2011 (see Figure 5).[61]

Figure 5: Transaction Value of Chinese Third-Party Mobile Payments, 2011–2016



Note: RMB values were converted to U.S. dollars at the current exchange rate.
Source: iResearch, "GMV of China's Third Party Mobile Payment, 2011–2019," February 3, 2017. *http://www.iresearchchina.com/content/details7_30408.html*.

Alibaba's Alipay* and Tencent's WeChat Pay dominate the market, accounting for 54 percent and 37 percent of market share, respectively, in the fourth quarter of 2016.[62] These platforms allow users to make payments in online shops—using their phone as wallets—and transfer money between friends all on one app, functions that are generally disaggregated in payment services available in the United States (e.g., in the United States, these functions are served, respectively, by PayPal, Apple Pay, and Venmo).[63] In addition, payment through QR codes† on online payment platforms is increasingly commonplace in Chinese restaurants and shops, where users can make payments by opening up Alipay or WeChat on their smartphones and having their QR codes scanned.[64]

Market Access for U.S. Firms

The size of China's payments market offers opportunities for U.S. companies, but they face regulatory challenges and stiff competition from domestic incumbents. China committed to granting access to foreign payment companies as part of its accession to the World Trade Organization (WTO) in 2000, but did not honor that commitment, prompting a U.S. challenge.[65] A 2012 WTO ruling determined China's policies governing access to its domestic electronic payments market unfairly discriminated against foreign payment card companies.[66] In response to the WTO ruling, in 2015 China's State Council issued the Decision on the Implementation of Market Access Administration for Bank Card Clearing Institutions, which allows qualified domestic and foreign companies to apply for licenses to clear domestic Chinese payments.[67] According to the PBOC, foreign companies can set up bank card clearing businesses by meeting the same requirements as domestic companies.‡ Previously, UnionPay was the only entity allowed to provide clearing services for RMB transactions.[68]

However, the PBOC separately announced a new technical standard that would raise the costs of market participation for foreign card companies.[69] The PBOC rules require bank cards issued in China to comply with a technical standard known as PBOC 3.0. The PBOC 3.0 standard is only used by UnionPay and is incompatible with the global industry standard, EMV, because it uses different encryption methods.[70] Visa, MasterCard, and other foreign payment companies would have to redesign their cards, potentially at great cost, in order to meet the new payment standards.[71]

As part of the initial outcomes of the 100-day action plan between China and the United States, China agreed to issue guidelines by July 16, 2017, to allow U.S.-owned suppliers of electronic payment services to "begin the licensing process."[72] This opening may be too late, however, to make a difference for U.S. companies. According to Ker Gibbs, chairman of the American Chamber of Commerce in Shanghai, "Opening the market for electronic payments is mainly symbolic. This should have been done years ago when it would have made a difference. At this point the domestic players are well entrenched so foreign companies will have a hard time entering."[73] MasterCard and Visa have indicated they are currently preparing applications for a domestic payment license.[74]

In order to operate in the Chinese market, U.S. payment networks like Visa and MasterCard partnered with Chinese banks to offer cobranded cards in China. Under this arrangement, foreign payment networks processed foreign currency payments for Chinese cardholders traveling abroad, while UnionPay processed domestic currency transactions.[75] About 240 million cobranded credit cards have been issued by Chinese banks since 2002, according to Goldpac, China's largest credit card supplier.[76] However, in late 2016 the PBOC issued a notice instructing Chinese banks not to renew cobranded cards.[77] With the phasing out of cobranded cards in China, U.S. payment companies are experiencing declines in their reported volumes for cobranded cards, and it is estimated this negative trend will continue, particularly as UnionPay gains wider acceptance in international markets.[78]

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* Alibaba created Alipay in 2004 to address consumers' concerns over the security of transactions conducted on its online platform. As an escrow service, Alipay allows buyers to verify whether they are satisfied with their purchase before transferring the payment to the seller.

† A Quick Response (QR) code is a type of barcode that can be read by a digital device and stores information. *Investopedia*, "Quick Response (QR) Code." *http://www.investopedia.com/terms/q/quick-response-qr-code.asp*.

‡ These requirements include that applicants hold at least RMB 1 billion ($152 million) in registered capital and meet China's national and industry security standards. In addition, foreign bank card companies are required to set up a local entity and obtain a bank clearing permit. Roy Zou, Mark Parsons, and Andrew McGinty, "China Opens up the Domestic Bank Card Clearing Market to Foreign Competition," *Hogan Lovells*, May 12, 2015. *http://www.lexology.com/library/detail.aspx?g=8b65cd9e-4916-4323-b880-b3fa7868d520*; Shu Zhang and Matthew Miller, "China Opens its Markets to Foreign Bank Card Companies," Reuters, June 7, 2016. *http://www.reuters.com/article/us-china-regulations-idUSKCN0YT1EB*.

U.S. companies are also eying China's mobile payments market. In February 2016, Apple introduced its mobile payments service, Apple Pay, to China through a partnership with UnionPay, some of the country's largest banks, and Chinese digital payments processors Lian Lian, PayEase, and YeePay.[79] The partnership allows Apple to participate in China's payment market while avoiding the challenges foreign companies have encountered with obtaining payment licenses.[80] Third-party providers of payment services were only required to obtain a payment business license beginning in 2010, when the PBOC issued the Administrative Measures on Payment Services Provided by Nonfinancial Institutions, the first set of regulatory measures governing nonbank third-party payment providers.[81] From May 2011—when the PBOC first started issuing third-party payment licenses—to August 2016, when the PBOC announced it would indefinitely halt issuing payment licenses to nonfinancial payment providers, a total of 270 institutions were awarded payment licenses.[82] Of those institutions, only two foreign-invested companies—Edenred China and Sodexo Pass China—have received payment licenses.[83] Despite its partnership with UnionPay and Chinese banks, Apple Pay entered China at a point when the country's mobile payment market is already highly consolidated, and as a result, has struggled to gain traction with Chinese consumers.[84]

Meanwhile, Chinese payments companies are expanding into the U.S. market. In May 2017, Alipay signed a deal with U.S. payment processor First Data that will allow its service to be used at the point of sale for First Data's four million business clients in the United States.[85] "Our goal is to extend reliable payment services to the over four million Chinese consumers that visit North America every year," said Souheil Badran, president of Alipay North America.[86] According to Badran, offering Alipay to U.S. consumers "is not a priority for us right now. We're sitting back and observing the market."[87]

For inquiries, please contact a member of our economics and trade team (Nargiza Salidjanova, *nsalidjanova@uscc.gov*; Michelle Ker, *mker@uscc.gov*; Katherine Koleski, *kkoleski@uscc.gov*; Sean O'Connor, *soconnor@uscc.gov*; or Matt Snyder, *msnyder@uscc.gov*).

Endnotes

[1] U.S. Census Bureau, *Trade in Goods with China*, June 2, 2017. *https://www.census.gov/foreign-trade/balance/c5700.html.*

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[6] U.S. Department of Agriculture, *U.S., China Finalize Details to Send U.S. Beef to China*, June 12, 2017. *https://www.usda.gov/media/press-releases/2017/06/12/us-china-finalize-details-send-us-beef-china*.

[7] U.S. Department of Agriculture, Agricultural Marketing Service, *Beef Exports to the People's Republic of China*, *https://www.ams.usda.gov/services/imports-exports/beef-ev-china*.

[8] National Cattlemen's Beef Association, "Cattlemen on Historic Reopening of China to U.S. Beef: 'Impossible to Overstate How Beneficial This Will Be for America's Cattle Producers,'" May 11, 2017. *https://www.beefusa.org/newsreleases1.aspx?NewsID=6274*; North American Meat Institute, "Deal Reached for Chinese Market Access for Beef by Mid-Summer," May 12, 2017. *https://www.meatinstitute.org/index.php?ht=display/ReleaseDetails/i/135404/pid/287*; U.S. Meat Export Federation, "USMEF Statement on U.S. Beef Regaining Access to China," May 11, 2017. *https://www.usmef.org/news-statistics/press-releases/usmef-statement-on-u-s-beef-regaining-access-to-china/*.

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[11] Abraham Inouye, "People's Republic of China Dairy and Products Semi-Annual – 2017: Consolidation and Modernization of China's Dairy Herd Dairy and Products Semi-Annual – 2017," *U.S. Department of Agriculture, Foreign Agricultural Service*, May 15, 2017. *https://gain.fas.usda.gov/Recent%20GAIN%20Publications/Dairy%20and%20Products%20Semi-annual_Beijing_China%20-%20Peoples%20Republic%20of_5-9-2017.pdf*.

[12] Farmer's Exchange, "China Opens Door to U.S. Dairy Exports," June 23, 2017. *http://www.farmers-exchange.net/detailPage.aspx?articleID=16880*.

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