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Highlights of This Month's Edition

- **Bilateral trade:** U.S. goods deficit with China totaled $30.2 billion in May 2019, down 9 percent year-on-year, reflecting a decline in both exports and imports.
- **Bilateral policy issues:** New tariffs on Chinese goods halted as the United States and China agree to resume trade talks; the United States adds five entities tied to China's development of supercomputers to the Entity List; U.S. importers are attempting to sidestep tariffs on goods from China, but some are reconsidering production in China altogether as a possible fourth wave of tariffs looms; China suspends WTO dispute against the EU over China's market economy status after it allegedly lost the case, allowing the EU and United States to continue treating China as a nonmarket economy.
- **In focus – The Baoshang Takeover:** In a surprise move, Chinese financial regulators took over Baoshang Bank on May 24, sparking a slowdown in interbank lending to small and regional banks, even as the People's Bank of China intervened to keep interbank credit channels open.

Contents

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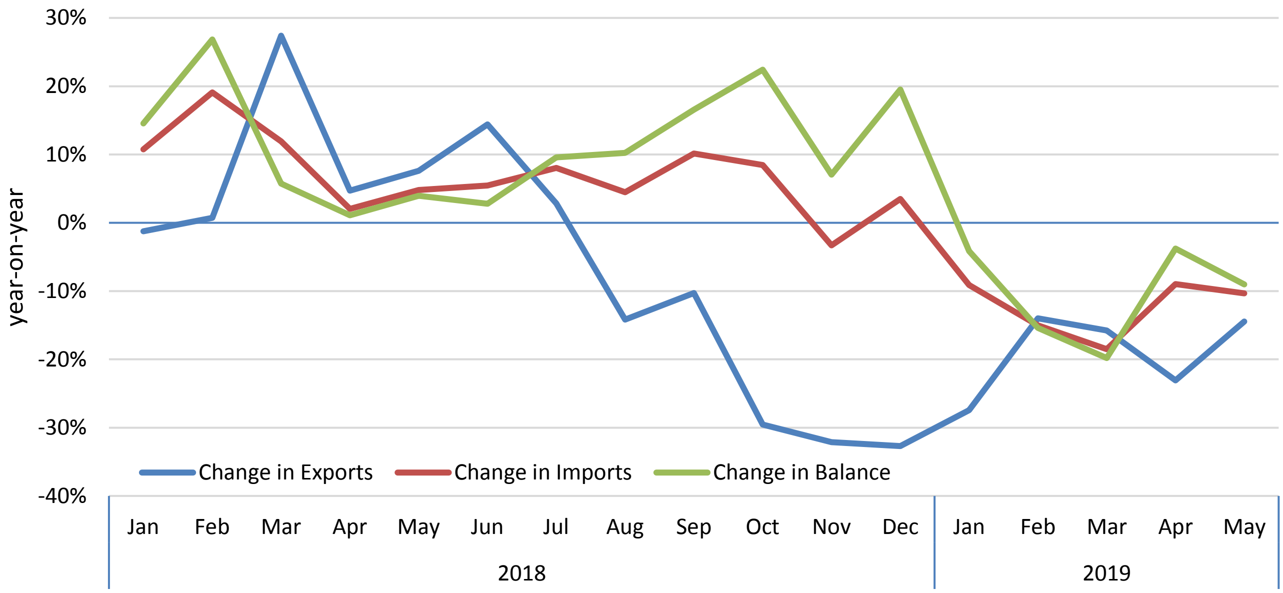
Bilateral Trade

U.S.-China Goods Trade Continues to Shrink in May 2019 as Tariffs Bite

The U.S. goods trade deficit with China totaled $30.2 billion in May 2019, down 9 percent year-on-year (see Figure 1). U.S. exports to China declined 14.5 percent year-on-year to $9.1 billion, while imports from China fell 10.3 percent year-on-year to $39.3 billion. In the first five months of 2019, U.S. exports to China were $43 billion and imports reached $180 billion, down 18.8 and 12.2 percent year-on-year, respectively. Year-to-date, the U.S. deficit with China reached $137.1 billion, down 10 percent from the same period last year. The May 2019 goods trade data reflect an ongoing declining trend in U.S.-China trade as reciprocal tariffs continue to impact exports and imports.

Figure 1: U.S. Exports, Imports, and the Trade Deficit with China, January 2018–May 2019



Source: U.S. Census Bureau, Trade in Goods with China, July 3, 2019. *https://www.census.gov/foreign-trade/balance/c5700.html*.

Bilateral Policy Issues

Trade Truce Reached at G20 Meeting, but a Deal Remains Elusive

During a July 29 meeting at the sidelines of the G20 summit in Japan, President Donald Trump and Chinese President and General Secretary of the Chinese Communist Party Xi Jinping agreed to restart trade talks.[1] The meeting came after negotiations broke down in early May when the United States accused China of reneging from key commitments under a draft deal. Following the breakdown in negotiations, the United States raised tariffs from 10 percent to 25 percent on $200 billion worth of Chinese goods and threatened to target the remaining $300 billion in U.S. imports from China, and China responded with its own set of tariffs on U.S. goods.[*]

As was the case with the agreement reached at the G20 summit in Argentina last December, there was no joint statement. During a press conference following the meeting, President Trump said the United States and China can be "strategic partners," though "right now, China is not open to the United States, but we're open to China."[2] President Trump said the United States will hold off on implementing new tariffs on China "at least for the time being" while China will buy a "tremendous" amount of U.S. food and agricultural products.[3] The Chinese statement

[*] For more on U.S. policy actions against China and the Chinese government's response, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, June 6, 2019. *https://www.uscc.gov/sites/default/files/Research/June%202019%20Trade%20Bulletin.pdf*.

did not mention this commitment, noting instead that President Trump said he hoped China can increase imports to resolve the bilateral trade imbalance.[4] U.S. agricultural goods have been a major target of Chinese retaliatory tariffs on the United States.[5]

President Trump said he would allow U.S. companies to resume sales of U.S. high-technology equipment to Huawei as long as the sales did not involve goods related to national security.[6] In May 2019, the U.S. Department of Commerce added the company and its affiliates to the Bureau of Industry and Security's (BIS) Entity List controlling U.S. technology exports. According to media reports, Beijing views the removal of the U.S. ban on the sale of U.S. technology to Huawei as a precondition for reaching a trade deal.[7] The extent of the reprieve remains unclear—President Trump said he will have a meeting on July 2 to discuss whether the company would be removed from the Entity List.[8] In 2018, Huawei spent $11 billion on U.S. semiconductor chips, software, and other technology products that feed into the company's consumer electronics business and telecommunications equipment business.[9] Huawei's inclusion on the Entity List effectively cut the company off from crucial technology components by requiring companies to apply for licenses from BIS when exporting from the United States to Huawei.[10]

President Trump's decision to relax limits on Huawei was met with congressional resistance. Senator Marco Rubio (R-FL) tweeted on June 29, "If President Trump has in fact bargained away the recent restrictions on #Huawei, then we will have to get those restrictions put back in place through legislation. And it will pass with a large veto proof majority."[11] Senate Minority Leader Charles Schumer (D-NY) also pushed backed on the move, tweeting, "Huawei is one of the few potent levers we have to make China play fair on trade. If President [Trump] backs off, as it appears he is doing, it will dramatically undercut our ability to change China's unfair trade practices."[12]

In a nod to Chinese concerns about reported visa-related challenges faced by Chinese students in the United States, President Trump said the United States welcomed Chinese students and hoped many would remain following their studies.[13] He spoke of looking into ways to help such individuals attain permanent U.S. residency, such as through what he called a "smart person's waiver."[14]

Left unaddressed were U.S. negotiators' primary demands, including that China agree to legally enshrine intellectual property (IP) protections, and no timeline was provided for negotiations.[15] U.S. business groups responded positively to the decision to resume trade talks but emphasized they wanted a trade agreement to be enforceable and address the structural problems in China's economic system.[16]

U.S. Department of Commerce Adds Five Chinese Actors to Entity List

On June 21, the U.S. Department of Commerce's BIS added to the Entity List* four Chinese companies and one research institute involved in building supercomputers, as well as an alias and several new addresses of China's National University of Defense Technology (NUDT), which was added to the Entity List in 2015.[17] The BIS notice indicated that the research institute, Wuxi Jiangnan Institute of Computing Technology, was owned by another research institute under the General Staff of China's People's Liberation Army and had a stated mission of supporting China's military modernization.[18] The four companies include Higon (which was formed in 2016 as a joint venture (JV) between U.S. chip producer American Micron Devices [AMD] and several other Chinese entities to license AMD's IP for chips into China), as well as Higon's majority owner Sugon and two JVs between Higon and AMD.† [19] Sugon, Wuxi Jiangnan Institute, and NUDT lead China's development of military supercomputers,

* The Entity List (Supplement No. 4 to part 744) identifies entities reasonably believed to be involved, or pose a significant risk of being or becoming involved, in activities contrary to the national security or foreign policy interests of the United States. U.S. Department of Commerce, Bureau of Industry and Security, "Addition of Entities to the Entity List," *Federal Register* 84:98 (May 21, 2019).

† The complicated JV structure allowed AMD to license a chip design to its Chinese subsidiaries; AMD has, in turn, a cross-licensing agreement with Intel for this chip design (under this cross-licensing agreement AMD may use Intel's chip design but must share technology it develops based on Intel's IP). At the same time, the JV structure allows Higon to claim that the final chip was indigenously designed in China, a key objective of the Made in China 2025 plan. Kate O'Keefe and Brian Spegele, "How a Big U.S. Chip Maker Gave China the 'Keys to the Kingdom,'" *Wall Street Journal*, June 27, 2019. *https://www.wsj.com/articles/u-s-tried-to-stop-china-acquiring-world-class-chips-china-got-them-anyway-11561646798?shareToken=st300766a15cd44642a022ac9a31490135*; Paul Acorn, "China Finds Zen: Begins Production of x86 Processors Based on AMD's IP," *Tom's Hardware*, July 6, 2018. *https://www.tomshardware.com/news/china-zen-x86-processor-dryhana,37417.html*.

as well as its race against the United States to develop the first exascale computer, or a supercomputer capable of more than one quintillion (a billion billions) calculations per second.[*] Supercomputers are vital to a number of military applications, including cryptography and complex simulations.[20] BIS's 2015 inclusion of NUDT on the Entity List noted the university was employing U.S. technology to simulate nuclear weapons testing.[21]

Increased export restrictions on high-performance computer chips could limit a critical export market for U.S. semiconductor manufacturers like Intel, which drew a quarter of its revenue from China in 2018.[22] Prior to launching its JV with Higon, AMD had suffered losses for six consecutive quarters.[23]

Industry analysts are divided on how substantial a setback the loss of U.S. chips will be for China's supercomputer development, though there is broad consensus it will cause immediate delays. Many observers warn that export restrictions will only catalyze China's efforts to indigenize production of sophisticated chips, although some experts assess that China's hurdles to developing comparable technology domestically are nearly insurmountable.[24] China's nascent semiconductor industry is still heavily reliant on foundational technology dominated by U.S. firms at critical points in the supply chain, from the basic architecture in chip design to advanced manufacturing equipment used in semiconductor foundries.[†] [25]

Importers Seek to Mitigate Tariff Impact, Potentially Shifting Supply Chains

As the Office of the U.S. Trade Representative (USTR) reviews the potential fourth round of tariffs to be levied on $300 billion of goods originating from China, many U.S. importers are exploring various strategies to minimize their exposure to tariffs (see Table 1). An FT Confidential survey of 200 firms found that 91 percent had adjusted their business in response to trade tensions.[26] Some companies are moving capacity altogether: 19 percent of respondents to the American Chamber of Commerce (AmCham) in China's 2019 Business Climate Survey reported relocating capacity or intending to relocate capacity within three years.[27] Such supply chains shifts could outlast current trade tensions, contributing to a longer-term restructuring of global supply chains as policy uncertainty lingers.

Methods to mitigate the impact of tariffs with minimal disruption to existing supply chains pose added uncertainty and compliance costs that may undermine any reduction in tariffs. If U.S. Customs and Border Patrol (CBP) cracks down on a channel for tariff avoidance, savings may be forfeited and companies and officers may face fines.[28] In particular, CBP has tightened review of import categorization and attempts to disguise the country of origin by shipping through multiple locations, or transshipment.[29]

Nonetheless, certain workarounds may be advantageous and fully compliant for individual companies or industries, depending on the structure of their supply chains. For instance, the *Financial Times* reported construction equipment manufacturer Terex was successfully mitigating tariffs by using a first sale valuation for imports (see Table 1).[30] In other instances, importers may simply not have viable alternatives from Chinese manufactures, and must absorb or pass on the added cost of tariffs.[31]

Table 1: Methods to Reduce the Impact of Tariffs

Method	Description
Moving supply chains	Companies can avoid tariffs altogether by manufacturing in other countries. For more intricate supply chains or products that involve materials or components hard

[*] The United States reclaimed the record for fastest supercomputer from China in 2018 with IBM's debut of Summit, a supercomputer housed at IBM's Oakridge Laboratory in Tennessee. An exascale computer would be five times faster than Summit. Before Summit, Chinese supercomputers Tianhe-2 and Sunway TaihuLight held the world record from 2012 to 2015, and from 2016 to 2017, respectively. Jay Greene, "U.S. Says It Reclaimed Supercomputer Crown from China," *Wall Street Journal*, June 8, 2018. *https://www.wsj.com/articles/u-s-says-its-supercomputer-leaps-ahead-of-chinese-rival-1528473600?mod=article_inline&mod=article_inline*.

[†] For instance, although Huawei's chip manufacturing arm HiSilicone is often cited as an example of Chinese parity in chip design, the firm licenses its chips' basic architecture, or the set of instructions which determines how a processor handles comments, from British designer ARM. Because ARM in turn uses technology of U.S. origin, it canceled existing contracts with Huawei in late May to comply with Huawei's inclusion on the Entity List. Dave Lee, "Huawei: ARM Memo Tells Staff to Stop Working with China's Tech Giant," *BBC*, May 22, 2019. *https://www.bbc.com/news/technology-48363772*.

	to source outside China, however, shifting production at meaningful volumes could be a years-long process.
Origin engineering and transshipment	Goods are typically considered to come from the country where they have been assembled or substantially transformed. To avoid tariffs, some companies have retained much of their original Chinese suppliers, but shipped components and partially assembled merchandise to nearby countries such as Vietnam and Burma (Myanmar) for final assembly. Both Chinese and U.S. firms have pursued this method to circumvent tariffs, limiting the tariffs' impact and in some cases accelerating Chinese companies' overseas expansion.
Section 321 de minimis	Under Section 321 of the Trade Facilitation and Enforcement Act of 2015, goods worth less than $800 fall below the de minimis (or trivial) value, and are not dutiable. The rule applies to one shipment per day, per person.
First sale valuation	In some circumstances, if goods have been sold between multiple parties with a markup prior to importation into the United States, the importer may use a price paid prior to markup as the dutiable value of the goods. For instance, in a simple supply chain where a Chinese manufacturer sells $1,000 worth of goods to a Chinese vendor, who in turn sells to the U.S. importer for $2,000, the importer could ask customs to assess tariffs on the initial invoice of $1,000.
Duty drawback	Companies can have tariffs refunded or partially refunded for goods that are re-exported from the United States.
Storage in bonded warehouses	Companies can warehouse imported goods without paying storage fees, and duties are only levied once the goods leave the building. While this method does not enable companies to dodge tariffs altogether, it allows them to manage cash flows by timing the payment of tariffs closer to receipt of sales revenue. Companies can also store extra inventory at the bonded warehouses hoping for a future reduction in tariffs.

Source: Various.[32]

While a quarter of companies moving facilities from China cite tariffs as the primary reason for relocating, according to AmCham China's survey, rising labor costs, continued policy uncertainty, and expectations of declining growth in China are also driving diversification of production.[33] *Nikkei Asian Times* reported in June that Apple is considering moving between 15 and 30 percent of its supply chain out of China, eyeing India and Vietnam as top destinations; the company is already assembling iPhones in India, although at low volumes.[34] Currently, more than 90 percent of Apple products are produced in China, and in 2018 Apple counted more Chinese suppliers than U.S. suppliers for the first time.[*] [35]

Increased scrutiny into the security of tech goods sourced from China may prompt other manufacturers to weigh alternate locations for production. For example, the Trump Administration is considering requiring all components used in U.S. 5G networks to be manufactured outside of China, potentially prompting Scandinavian suppliers Ericsson and Nokia to relocate production facilities.[36]

Unlike the customs workarounds, outright relocation of capacity can be long and costly. Apple's potential production shifts could take 18 months, for instance, and this would only be at small volumes to test the viability

[*] The proposed fourth round of tariffs allows up to a 25 percent tariff on harmonized system category 8517.12.00, which includes the iPhone. The first three rounds of tariffs have focused more on intermediary goods produced in China, sparing consumer goods. According to *Nikkei*, Apple's decision to relocate is based on longer-term uncertainty, higher labor costs, and lower projections for Chinese growth, rather than possible tariffs. Russel Brandom, "Trump's Tariffs Are Aimed at China, but Apple Is in the Line of Fire," *The Verge*, June 25, 2019. *https://www.theverge.com/2019/6/25/18744351/trumps-china-tariff-tech-apple-microsoft-nintendo-price*; Lauly Li and Cheng Ting-Fang, "Apple Mulls Shifting 15%-30% of Output from China amid Trade War," *Nikkei Asian Review*, June 19, 2019. *https://asia.nikkei.com/Economy/Trade-war/Apple-mulls-shifting-15-30-of-output-from-China-amid-trade-war*.

of larger-scale relocation.[37] As a consequence, changes in supply chains could long outlast ongoing trade tensions, reducing economic interdependence between the United States and China.[38]

China Suspends World Trade Organization Case over Market Economy Status

In May 2019, China suspended a dispute it brought to the World Trade Organization (WTO) in 2016 against the EU over China's status as a nonmarket economy.[39] Beijing's dispute claimed that, under the terms of its 2001 WTO accession, China should have automatically qualified as a market economy effective in 2016.[40] China brought a nearly identical case against the United States for failing to recognize China as a market economy.[41] With the dispute suspended, the EU and United States can continue imposing higher margins on duties for dumped Chinese exports. Under the rules of the WTO, the case may be taken up again anytime within the next 12 months, after which time the WTO's authority to review the case will lapse.[42]

China's decision came after Bloomberg reported in April 2019 that the WTO had ruled against China in its dispute with the EU.[43] According to one unnamed trade official close to the case, China suspended the case because it knew it was going to lose, with the official telling Reuters that China "lost so much that they didn't even want the world to see the panel's reasoning."[44] Some Chinese officials, however, are casting the decision as a negotiation tactic in the ongoing trade dispute with the United States. According to Ying Pingguan, an associate dean at the Shanghai University of International Business and Economics, China's decision could be part of a "broad negotiation strategy" to resolve trade tensions.[45]

In Focus: The Baoshang Bank Takeover

On May 24, 2019, city commercial lender Baoshang Bank ("Baoshang") was taken over by the China Banking and Insurance Regulatory Commission (CBIRC), China's primary regulator monitoring compliance in China's banking and insurance sectors.[46] As the People's Bank of China (PBOC) has forced Baoshang's creditors to accept some losses, large bank lenders are reassessing their borrowers, sparking a drop in funding to small and regional banks. This move shows the PBOC's attempt to force financial actors to assume responsibility for risk while also containing any systemic concern in the interbank market and supporting overall credit growth.

This takeover was highly unusual: the Chinese government has not seized a private bank in 20 years.[47] Instead, in 2015 and 2016, China's financial regulators dealt with weak financial institutions by recapitalizing lenders and writing off or transferring troubled assets.[48] To explain the abrupt takeover, the PBOC stated Baoshang had "serious credit risk" and that by assuming its banking operations for a year, the government would "protect the lawful interest of depositors and other clients."[49] The PBOC emphasized Baoshang was seized because of embezzlement from its controlling shareholder, the financial conglomerate Tomorrow Group formerly managed by detained tycoon Xiao Jianhua.[50] According to its Q3 2017 report, Baoshang was one of the 50 largest banks in China by asset size and was known for lending to nonbank financial institutions.[51] Baoshang's debt had grown 65 percent between 2014 and 2016, reaching $22.7 billion in the private bank's most recent published financial statements in 2016.[52]

While the PBOC sought to reassure markets by characterizing Baoshang's takeover as a one-off, financial analysts suggested other small and regional banks are also at risk. Regional lenders are not permitted to operate outside of their local area and are dependent on local enterprise.[53] As such, they often act as intermediary lenders, borrowing funds from larger banks and making loans to local governments, property developers, and other nonbank financial actors. They also play a significant role in shadow banking, meaning that at least until China's central government crackdown on shadow bank activity in 2017, local government and developers' assets held by regional banks often did not appear on those banks' balance sheets and could not be observed by regulators.[54] Jason Bedford, analyst at UBS Group, noted Hengfeng Bank, Jinzhou Bank, and Chengdu Rural Commercial Bank show risks similar to Baoshang (e.g., a large share of holdings in "loan-like investment assets"); these banks have failed to publish their 2018 financial statements.[55] On June 11, the PBOC stepped in to support Jinzhou Bank, backing $289 million in the bank's "negotiable certificates of deposit" (NCDs), short-term bonds that banks issue in interbank lending.[56]

Despite the PBOC's reassurances, market activity shows financial actors do not view this case as isolated. One main consequence of Baoshang's takeover has been increasing interbank "counterparty solvency risk," or a lending bank's concerns that a borrowing bank counterparty may not repay its obligations in full and with interest in the event of insolvency. Due to this risk, smaller and weaker banks are having trouble securing funding through interbank lending: since smaller banks have fewer deposits, they often rely on funding from larger banks. This lack of funding is particularly evident in the drop in sales of smaller banks' NCDs.[57] Because NCDs are based on perceived creditworthiness, rather than collateral, lending banks are now at greater pains to assess whether other borrowing banks have similar credit risks.[58] As economic analysis firm Rhodium Group reported in mid-June, "There is clear evidence that traders are responding to the [Baoshang takeover] by starting to differentiate banks by credit quality, reducing exposure to some banks' NCDs."[59] Julian Evans-Pritchard, senior China economist at Capital Economics, agreed that "liquidity conditions among regional banks have tightened significantly since the takeover."[60]

The PBOC may face conflicting goals when deciding to intervene. On the one hand, the PBOC seeks to reduce the problem of financial actors taking too much risk on the assumption the government will step in to prevent investor losses, referred to as an "implicit guarantee."[61] To that end, the PBOC has not made creditors whole: it guaranteed Baoshang's corporate and interbank liabilities at 90 percent and bankers' acceptances at 80 percent, which Rhodium Group describes as substantial markdowns for an environment where no bank defaults had occurred.[62] According to a government official interviewed by *Caixin*, a Chinese business magazine, the Baoshang takeover caused a "little bit of pain" but ultimately helped market development.[63]

On the other hand, in stepping in to shore up Baoshang and Jinzhou Bank, the PBOC also seeks to keep interbank credit channels open to minimize systemic risk and support economic growth. The risk aversion affecting interbank markets and decreasing credit to small and regional banks could lead to slower credit expansion, which policymakers need to maintain economic growth. As financial experts Allen Feng and Logan Wright of Rhodium Group observed in late June 2019, since small and regional banks and nonbank financial institutions are risk-takers in the Chinese economy, "weaker asset growth among these banks and non-banks will hurt risk sentiment, increase corporate borrowing costs, widen credit spreads, and likely jeopardize the overall economic recovery."[64]

Endnotes

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