U.S.-China Economic and Security Review Commission

Economics and Trade Bulletin

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Highlights of This Month's Edition

- **Bilateral trade:** In April 2019, U.S. goods exports to China fall, while imports are up, pushing the U.S. goods deficit to $26.9 billion, from $20.7 billion in March.
- **Bilateral policy issues:** An impasse in trade negotiations in early May preceded a volley of policy actions from the United States, including a tariff hike and an additional proposed list of tariffs affecting the remainder of U.S. imports from China. China responded to U.S. actions by threatening rare earths export blockades, stringent cybersecurity reviews, and regulatory retaliation.
- **In focus – Chinese financial markets:** Beijing's efforts to liberalize financial markets remain stalled, but there have been signs of progress over the last year, increasing foreign access to China's financial sector.

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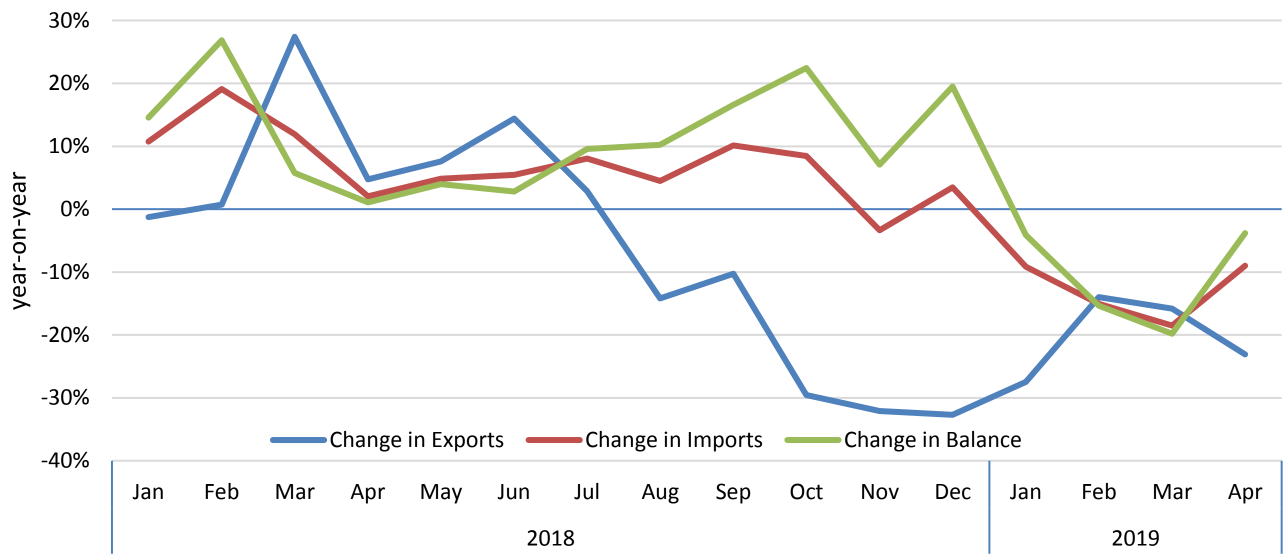
Bilateral Trade

U.S. Goods Exports to China Down in April, Deficit up to $26.9 billion

In April 2019, the U.S. deficit in goods with China totaled $26.9 billion, down from $20.7 billion in March 2019, and a decline of 3.8 percent year-on-year (see Figure 1). U.S. exports to China totaled $7.9 billion in April, down from $10.4 billion in March, but imports rose to $34.8 billion in April, from $31.2 billion in March. Year-on-year, in April 2019, U.S. exports to China were down 23 percent, and imports down 9 percent.

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



Source: U.S. Census Bureau, Trade in Goods with China, March 27, 2019. *https://www.census.gov/foreign-trade/balance/c5700.html*.

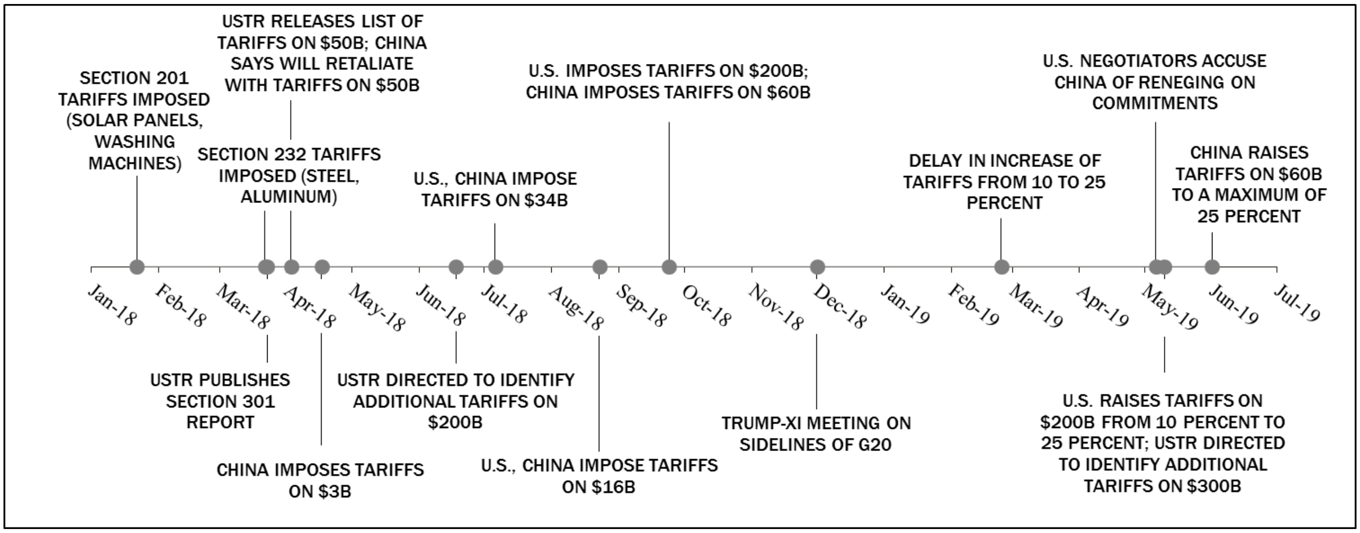
The year-to-date U.S. goods deficit with China was $106.9 billion, down 10.2 percent from $119 billion last year.

Analysts expect that ongoing tit-for-tat tariff escalation to start showing up in the trade data within a few months as new rounds of duties go into effect.

Bilateral Policy Issues

An impasse in U.S.-China trade negotiations in early May preceded a volley of bilateral policy actions later in the month. After U.S. negotiators accused China of reneging on commitments in the deal to resolve trade tensions, the United States increased tariffs on $200 billion in U.S. imports from China from 10 percent to 25 percent; President Donald Trump also directed the Office of the U.S. Trade Representative (USTR) to identify tariffs of up to 25 percent on additional imports worth about $300 billion (see Figure 2).[1] Apart from these actions, the U.S. Department of Commerce released two policy initiatives: the Bureau of Industry and Security (BIS) added Huawei Technologies Co. Ltd. ("Huawei") and its affiliates to the Entity List controlling U.S. technology exports, and the International Trade Administration issued a proposal to consider whether a deliberately undervalued currency could qualify as a government subsidy to exporters, allowing U.S. companies to apply for relief. Separately, President Trump signed an executive order barring the use of telecommunications equipment from companies "owned by, controlled by, or subject to the jurisdiction or direction of a foreign adversary"; the executive order did not mention any one company or country.[2]

Figure 2: Timeline of U.S.-China Trade Tensions, 2018–2019



Source: Various.[3]

U.S. Policy Actions toward China

Tariff Hike on $200 Billion and Pending Tariffs on $300 Billion

On May 10, following an impasse in trade negotiations on May 6, the USTR announced it would increase the tariffs originally applied to about $200 billion in U.S. imports from China, raising them from 10 percent to 25 percent.[4] In addition to the tariff increase, on May 17 the USTR published an additional list of products to be covered by a 25 percent tariff, the fourth list of tariffs associated with the Section 301 investigation on China's technology transfer practices.[5] The new tariff list is projected to impact previously unaffected U.S. imports from China.[6] The proposed tariff list has entered a public comment period ending June 17, when a public hearing will be held.[7]

U.S. Companies Respond to Supply Chain Impact of Initial U.S. Tariffs

In a joint survey conducted after the tariff increase announcement, the American Chamber of Commerce in the People's Republic of China (AmCham China) and the American Chamber of Commerce in Shanghai (AmCham Shanghai) found that 74.9 percent of respondents have been negatively impacted by tariffs on U.S. imports from China.[*] This negative impact was reported most by manufacturers, of whom 81.5 percent stated they had experienced a negative impact due to U.S. tariffs.[8] To cope, companies have adopted a range of strategies, from delaying or cancelling planned investments (33.2 percent) to considering or relocating manufacturing production (40.7 percent) to restricting operations to manufacturing for the local Chinese market (35.3 percent).[9]

Huawei Included on U.S. Entity List

On May 16, BIS added Huawei and 68 international affiliates to the Entity List,[†] which requires companies to apply for additional licenses from BIS when exporting from the United States to those entities.[10] BIS stated that the

[*] This survey of business membership was conducted from May 16 to May 20, 2019, and received about 250 responses. By sector, 61.6 percent of respondents worked in manufacturing, 25.5 percent worked in services, 3.8 percent worked in retail and distribution, and 9.6 percent identified a different industry. American Chamber of Commerce in China and American Chamber of Commerce in Shanghai, "Joint Press Release: May 22, 2019," May 22, 2019, 1.

[†] 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).

interagency End-User Review Committee* determined Huawei had undertaken "activities determined to be contrary to the national security or foreign policy interests of the United States."[11] In justifying its decision, the committee cited Huawei's indictment on 13 counts for knowingly exporting goods, technology, and services from the United States to Iran, a country subject to U.S. sanctions, without obtaining licenses from the U.S. Department of the Treasury's Office of Foreign Assets Control.[12]

Commerce Proposes Currency Undervaluation Be Viewed as a Subsidy

On May 28, the Department of Commerce International Trade Administration issued a proposal through which currency undervaluation could be considered a countervailable subsidy, if a country's currency were found to be undervalued by Treasury.[13] Under the proposal, U.S. companies could petition the Department of Commerce for countervailing duties as a form of relief from this subsidy. For instance, the Department of Commerce stated it could accept an analysis that "[views] currency undervaluation under a unified currency regime as a domestic currency premium" from which local exporters benefit when they convert U.S. dollars to local currency.[14] In this example, when state-owned banks or other government authorities—or private entities directed by government authorities—"provide [local] currency in exchange for U.S. dollars" from exporters, the Department of Commerce could find this transaction provides a government financial contribution made on nonmarket terms.[15] In determining which currency-related actions could be examined, the proposal clarified that monetary and credit policy pursued by an independent central bank or monetary authority would not be included in these analyses.[16] Following this announcement, the Department of Commerce's proposal entered a 30-day comment period. While Treasury did not declare any country a currency manipulator in its most recent report, it listed China—as well as other countries such as Japan, Vietnam, and South Korea—on its "monitoring list."[17]

China Drums up Nationalist Rhetoric, Threatens Further Retaliation for Tariffs

Because the United States exports $120 billion in goods to China but imports $540 billion, based on 2018 figures China is unable to respond dollar for dollar to the United States' escalation of tariffs.[18] Beyond the $60 billion of tariffs China's Ministry of Commerce (MOFCOM) announced on May 13 (effective June 1), few actions have been taken, but the intensity of rhetoric and threats has continued to escalate. The list below reviews the Chinese government response and outlines potential retaliatory actions.

Nationalist Rhetoric and Censorship on the Rise

Chinese President and General Secretary of the Chinese Communist Party (CCP) Xi Jinping has framed the breakdown in trade negotiations as part of a longer national struggle, invoking Mao-era imagery of a "protracted war."[19] During a trip to Jiangxi Province, President Xi visited a monument at Yudu, the start of the CCP Long March to evade the Nationalists during China's civil war. State run media drew parallels between the CCP's resolve and fortitude in its battle for survival and the escalation of trade tensions with the United States.[20] Domestically, the Chinese government has singularly portrayed the trade dispute as motivated by the United States' desire to contain China's rise.[21]

President Xi has also used Huawei's inclusion on the Department of Commerce's Entity List to reiterate calls for economic and technological autonomy. The authoritative CCP journal *Seeking Truth* republished a statement by President Xi calling the economy's limited innovation capabilities its "Achilles' heel."[22] In a relatively minor tangible policy outcome of heightened nationalist rhetoric, Chinese chipmakers and software developers were granted five-year tax breaks.[23]

Media experts disagree on the extent to which propaganda efforts are centrally coordinated and how effective they will be.[24] It is clear, however, that contrary and even moderate views will be censored, as in the case of an editorial from economics news outlet *Caijing* cautioning against radical nationalism that quickly disappeared after going

* The interagency End-User Review Committee comprises representatives from the Department of Commerce, the Department of State, the Department of Defense, the Department of Energy, and "where appropriate," the Department of the Treasury. U.S. Department of Commerce Bureau of Industry and Security, "Addition of Entities to the Entity List," *Federal Register* (May 21, 2019). *https://www.federalregister.gov/documents/2019/05/21/2019-10616/addition-of-entities-to-the-entity-list*.

viral.[25] Even ahead of the talk breakdown, censorship was in full swing: for example, in April former Finance Minister Lou Jiwei was removed from his post managing China's national social security fund after he claimed Made in China 2025 subsidies waste taxpayers' money.[26]

Rare Earths Ban Threat

During his trip to Jiangxi, President Xi also visited a rare earths mining processing facility, highlighting China's outsized global share in one of the few Chinese exports not subject to U.S. tariffs.[27] On May 28, China's economic planning agency, the National Development and Reform Commission (NDRC), released a question and answer document insinuating China could cut rare earths exports to the United States as a retaliatory measure, after which state-run media outlets issued a chorus of articles reiterating the warning.[28]

Some analysts argue that a limit on China's rare earths exports would have only a muted effect, because most goods consumed by the United States that require rare earths area actually assembled in China.[29] Others suggest that rare earths supplies are critical to the United States' national security, citing a 2018 Pentagon assessment that China accounted for 80 percent of the U.S. supply from 2004 to 2017.[30]

State-owned Enterprises Included in China's Economic Sovereignty

In response to U.S. criticism that Chinese negotiators walked back earlier agreements in trade talks, Chinese state media issued a series of counter accusations, including that U.S. demands undermined China's sovereignty. A May 25 editorial in state news outlet Xinhua argued that U.S. demands China curb subsidies for state-owned enterprises violated its economic sovereignty under the 1974 United Nations Charter of Economic Rights and Duties of States by forcing China to make injurious changes to its fundamental economic system.[*]

The editorial is notable both for invoking a new domain within China's broad definition of sovereignty and framing the United States as a global bully. Sovereignty is a loaded term in China's rhetoric; China's government often uses protection of sovereignty as a justification for everything from denying foreign companies market access and censoring internet to pursuing disputed land and maritime territorial claims.[31] The Xinhua commentary said violating China's economic sovereignty was one of five reasons the United States is harming global economic interests, citing the number of entities on the Department of Commerce's Entity List—1,013 as of August 2018—as evidence of the United States' overreach into other countries' internal affairs.[32]

Regulatory Retaliation and Other Nontariff Barriers

China regulators may use a variety of regulatory tactics to impede U.S. business interests in retaliation for the latest round of U.S. tariffs on Chinese goods. Beijing often exerts economic pressure as a geopolitical response through delayed customs inspections and regulatory approvals, additional licensing requirements, and other discretionary red tape.[†] [33]

In a more overt tit-for-tat response, the NDRC may use its new authority as the sole agency conducting national security reviews under China's new Foreign Investment Law to block U.S. companies: Article 40 allows Chinese authorities to take reciprocal measures on any behavior they deem "discriminatory, prohibitive, or restrictive."[34] The Cyberspace Administration of China may also use an expanded definition of national security to increase control over data storage under draft cybersecurity review measures issued at the end of May.[35] While the measures

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[*] The Charter does not codify, or even use the term, "economic sovereignty." It does indicate states must ensure prices of goods traded internationally are equitable, stable, and remunerative (i.e., not subsidized to be sold below costs of production and dumped on world markets). UN Charter of Economic Rights and Duties of States, General Assembly Resolution 3281 (XXIX), 1974. *https://www.un.org/ga/search/view_doc.asp?symbol=a/res/3281(XXIX)*.

[†] For instance, after Philippine warships confronted Chinese fishing vessels near Scarborough Shoal in spring 2012, China suddenly quarantined shipments of Philippine bananas and other fruit, claiming inspection had revealed over 100 harmful organisms contained in the fruit. Extended quarantine and decreased purchases severely impacted exporters of the highly perishable goods. Andrew Higgins, "In Philippines, Banana Growers Feel Effect of South China Sea Dispute," *Washington Post*, June 10, 2012. *https://www.washingtonpost.com/world/asia_pacific/in-philippines-banana-growers-feel-effect-of-south-china-sea-dispute/2012/06/10/gJQA47WVTV_story.html?utm_term=.2b6fb866733a*.

are part of an ongoing effort to create a policy framework around China's vague 2017 Cybersecurity Law, nationalist tabloid *Global Times* explicitly suggested the measures be used as a means to strike back at the "U.S. crackdown on Huawei."[36]

MOFCOM Threatens to Place Foreign Companies on an "Unreliable Entities" List

On May 31, MOFCOM indicated it would soon publish an "unreliable entities" list modeled on the Department of Commerce's Entity List, after Huawei was added on May 16. At a press conference, MOFCOM spokesperson Gao Feng said the "unreliable entities list" could include companies, government bodies, and individuals who had "taken discriminatory measures on Chinese entities, caused actual damage to Chinese firms and related industries, and posed actual or potential threats to China's state security."[37]

Two days later, MOFCOM published a nearly 20-page white paper on trade talks with the United States, blaming the United States for the breakdown in negotiations.* The white paper chiefly summarizes views already articulated by MOFCOM and other officials, namely: (1) U.S. criticism of China's intellectual property rights protection is unfounded; (2) the Chinese side did not renege on earlier promise, but the United States did at several junctures; (3) China does not want to fight a trade war and believes it would harm both sides, but is not afraid of fighting and will not compromise on its core interests, including the U.S. removal of all tariffs imposed in response to the Section 301 investigation.[38] The paper also calls the United States' pursuit of unilateral trade remedies "economic bullying" and claims it harms global supply chains.[39] Although the white paper introduces few new arguments, both Chinese and foreign analysts agreed that codifying existing views in an official statement signaled a willingness to prolong tensions.[40]

In Focus: Chinese Government Continues to Tout Financial Reforms, but Progress Lags

The Chinese government has dragged its feet on financial reform for many years, leaving foreign companies unable to access the Chinese financial market. China has repeatedly pledged to open up sectors such as financial services, including after a 2012 World Trade Organization (WTO) ruling that Beijing was discriminating against foreign payment card companies and a promise in 2017 to provide "full and prompt market access" to U.S. payment network operators.[41] But despite gradual reforms liberalizing China's financial sector in recent years, foreign firms still only account for a fraction of China's financial market. For example, in China's banking sector, foreign banks' share of China's overall holdings actually declined from 2.4 percent in 2007 to 1.4 percent in 2015, despite promises to open the banking sector to foreign businesses.[42]

Amid a slowing economy, ballooning levels of nonperforming loans, and increased trade tensions with the United States, however, Chinese regulators have begun taking incremental steps toward financial liberalization such as (1) liberalizing market access in the banking, securities, and insurance industries; (2) granting foreign institutions equal treatment in credit and payment sectors; and (3) opening up the domestic bond market to foreign investors.[43]

Liberalizing Market Access in the Banking, Securities, and Insurance Industries

On March 28, 2019, Chinese Premier Li Keqiang stated China would expedite measures ensuring "full market access for foreign investors to the banking, securities and insurance industries."[44] This decision followed similar pronouncements from the Chinese government in recent years calling for liberalizing market access to China's financial sector, which have been continuously delayed.[45] However, shortly after Premier Li's remarks, the People's Bank of China (PBOC) and China Banking and Insurance Regulatory Commission (CBIRC) began enacting incremental reforms aimed at expanding foreign investor access to China's banking, securities, and insurance industries.

* The Chinese government and government agencies frequently publish "white papers" as responses to international scrutiny. Recurrent topics include white papers defending China's human rights record, particularly in Tibet and Xinjiang, and China's WTO record. State Council Information Office, *White Papers*. *http://english.scio.gov.cn/m/whitepapers/node_7247532.htm*.

In an effort to spur additional foreign investment inflows, the Chinese government revised its foreign investment law to reduce caps and restrictions on foreign investments in the financial sector.* Wang Zhaoxing, vice chairman of the CBIRC, also signaled that other rules preventing foreign investors from operating in the Chinese banking industry—such as quantitative requirements on scale, years of operation, and share proportions of foreign financial institutions—will continue to be eased, allowing foreign banks to provide more diversified financial products and services.[46] Vice Chairman Wang did not provide a timeline of when these reforms would be fully implemented.[47] On May 1, Guo Shuqing, party secretary of the PBOC and chairman of the CBIRC, laid out 12 concrete measures for opening up, including:

- Remove shareholding limits for local banks and asset requirements for foreign financial firms operating in China;
- Allow overseas financial institutions to participate in foreign-invested insurance companies in China;
- Encourage and support foreign financial institutions to cooperate with private Chinese banks and insurers on equity, operations, and technology; and
- Allow foreign-invested insurance groups in China to set up insurance entities, based on the same rules for Chinese insurance groups.[48]

Under the new foreign investment law, barriers to foreign investment in the insurance and securities sectors—such as equity caps—have also been removed. In May 2018, Chinese regulators lifted equity caps from 50 to 51 percent for foreign insurance companies, securities, and mutual-fund management ventures, with a promise to permit full control in three years.[49] There remains skepticism these measures will significantly improve foreign companies' access in China, however; Derek Scissors, a China analyst at the American Enterprise Institute, stated that "there is still a long list of things you are not allowed to do.... The Chinese simply don't permit competition with a large range of their firms. They have a set of state-owned businesses they don't allow to go out of business."[50] For example, despite efforts to liberalize the banking, insurance, and securities sectors, Chinese firms maintain more than 90 percent market share, limiting opportunities for U.S. and other foreign firms.[51]

Equal Treatment for Foreign Firms in Credit and Payment Sectors Remains Elusive

In 2012, the WTO ruled that China's tight control over its credit and payment sectors discriminated against U.S. card companies, a decision card issuers hoped would lead to equal opportunity in China's fast-growing payments market.[52] Although the PBOC began allowing foreign card companies to selectively apply for market access starting in 2016, it was not until late 2018 that a foreign company was granted access (American Express was approved to have a 50 percent stake in a card-clearing service in China).[53]

While American Express received approval, other card service providers' applications remain stalled.[54] Executives of Mastercard and Visa, which submitted applications at the same time as American Express, say that Chinese regulators have informally pressured them to enter the market through joint ventures to gain regulatory approval.[55] Although Chinese law requires that regulators must respond within 90 days of an application being submitted, the PBOC has stalled their applications for nearly three years.[56]

A key concern for foreign credit and payment companies is that the PBOC, which is responsible for processing and approving foreign applications for entry into China's payment market, is the largest shareholder of China UnionPay, which controls 90 percent of the Chinese credit and payment market.[57] This clear conflict of interest is cited as one reason approvals for foreign companies continue to be processed well beyond the initial 90-day timeframe.

Promise of Opening up the Domestic Bond Market to Foreign Investors

Beginning in January 2019, Beijing began a series of policy changes to open up the domestic bond market for the first time. That month, China raised the quota for the Qualified Foreign Institutional Investor (QFII) program from

* For more on the new foreign investment law, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, April 2019, 5–7. *https://www.uscc.gov/sites/default/files/trade_bulletins/April%202019%20Trade%20Bulletin.pdf*.

$150 billion to $300 billion, giving foreign investors greater access to China's bond market.[58] Two months later, Premier Li announced the government's plans to "further open China's bond market and introduce relevant policies to make it easier for overseas investors to invest in and trade Chinese bonds"[59]

In March 2019, Bloomberg began adding what will total 363 Chinese government bonds and policy bank securities to its Bloomberg Barclays Global Aggregate index, kicking off inflows of up to $2 trillion into China's $12.5 trillion domestic bond market.[60] To qualify for inclusion on Bloomberg's index, the Chinese government had implemented new bond access programs (i.e., allowing foreign investors to convert currency into renminbi [RMB] to invest in onshore bonds and repatriate the proceeds upon sale/exit of the market) and improved hedging capabilities, which allow international investors direct access to China's onshore foreign exchange market.[61]

Two regulatory decisions in May 2019 signal that the Chinese government intends to continue opening up its bond market to foreign investors. First, the PBOC released a "Notice on Further Facilitating Foreign Institutional Investors' Investment in the Inter-Bank Bond Market," which outlined foreign registration requirements as well as monitoring and reporting responsibilities for banks and settlement agents.[62] It also specifies that the registration system would be managed by China Government Securities Depository Trust and Clearing and the Interbank Market Clearing House.[63] Second, the China Securities Regulatory Commission signaled its intention to prepare to open up China's bond futures market to domestic commercial banks, such as ICBC. This measure would encourage foreign investors to participate in the Chinese bond market, boosting liquidity and helping with price discovery across the broader bond market.[64]

Endnotes

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