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U.S.-China Economic and Security Review Commission

Monthly Summary of U.S.-China Trade Data **March 7, 2014**

Highlights of this month's edition

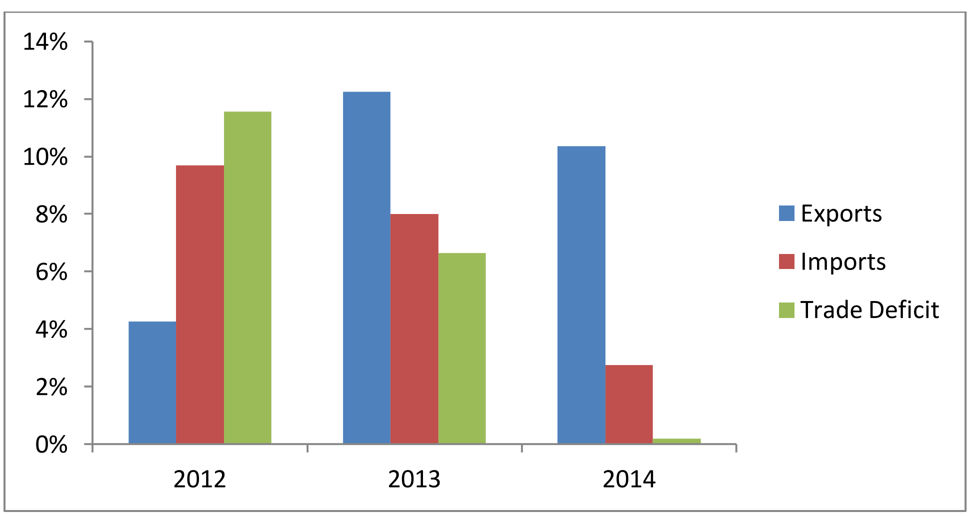
- **Bilateral trade:** Strong increase in exports but overall trade slows; transportation equipment continues strong gains; info technology imports from China decline
- **Bilateral policy issues:** Kerry signs climate agreements in Beijing; GAO criticizes administration for lax follow-up on China commitments; AmCham releases member survey
- **Sector spotlight:** China's movie market is booming but Hollywood lacks access; disappointment about China's failure to lift film quota
- **China's economy:** China sets 2014 growth target at 7.5 percent; shoddy export and FDI data causes confusion; NPLs and lending surge add to concerns over debt bubble; RMB decline ignites speculation

Strong Increase in U.S. Exports

The U.S. trade deficit in goods with China, which notched a new annual record last year, totaled $27.8 billion in January 2014. While the U.S. trade deficit with the world contracted by $755 million, due to reduced demand for foreign oil, the U.S. trade deficit in goods with China rose by $52 million.

U.S. exports to China eased back from their torrid pace, expanding by 10.4 percent in January, year-on-year, compared to an average of 24 percent in October through December. A year ago, monthly exports grew by 12.3 percent. Monthly imports from China increased by just 2.8 percent, compared to 8 percent in 2013 and 9.7 percent in 2012. Overall, the bilateral deficit expanded at a slower rate than in past years (see figure 1).

Figure 1: Growth in U.S. Exports, Imports, and the Trade Deficit with China: January, 2012-2014
(year-on-year, %)



Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, March 2014). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Top Exports and Imports

Agricultural products topped the list of U.S. exports to China in January, with 23.4 percent year-on-year growth (see table 1). Crop shipments to China stagnated last year, raising questions about whether the farm export boom can be sustained. Exports of transportation equipment, which accounted for two-thirds of the growth in U.S. exports to China last year, continued to grow at a rapid clip in January. On the import side, computers and electronics, the predominant U.S. import from China, declined 7 percent year-on-year.

Table 1: U.S. Trade with China: Top-Five Exports and Imports, January 2014
(in US$ millions)

U.S. Top-Five Exports to China	Exports	Share of total (%)	Change over Jan'13 (%)	**U.S. Top-Five Imports from China**	Imports	Share of total (%)	Change over Jan'13 (%)
Monthly (January 2014)				*Monthly (January 2014)*			
Agricultural Products	2,836.9	27.4%	23.4%	Computer and Electronic Products	12,214.6	32.0%	-7.0%
Transportation Equipment	1,622.6	15.7%	32.8%	Electrical Equipment, Appliances, and Component	3,088.6	8.1%	17.9%
Chemicals	1,135.4	11.0%	2.1%	Miscellaneous Manufactured Commodities	2,981.5	7.8%	-1.0%
Computer and Electronic Products	1,117.4	10.8%	18.1%	Apparel and Accessories	2,918.7	7.6%	3.8%
Machinery, Except Electrical	701.4	6.8%	-13.7%	Machinery, Except Electrical	2,496.7	6.5%	27.3%
Other	2,943.3	28.4%		Other	14,496.6	38.0%	
Total	**10,357.0**	**100.0%**		**Total**	**38,196.6**	**100.0%**	

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, March 2014). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Advanced Technology Products

The U.S. trade deficit with China in advanced technology products was $9 billion in January, a decrease of $1 billion in January of last year (see table 2). As in previous years, the largest deficits were in information & communications technology and in opto-electronics. For the other eight ATP products, the U.S. trade surplus increased by $277 million, to $997 million.

Table 2: Advanced Technology Product Trade, January 2014
(in US$ millions)

	Exports	Imports	Balance Jan'14	Balance Jan'13
TOTAL	**2,111**	**11,172**	**-9,061**	**-10,076**
(01) Biotechnology	32	12	20	24
(02) Life Science	162	203	-41	15
(03) Opto-Electronics	19	437	-418	-324
(04) Information & Communications	397	10,037	-9,640	-10,454
(05) Electronics	381	288	93	54
(06) Flexible Manufacturing	218	82	136	56
(07) Advanced Materials	17	24	-7	1
(08) Aerospace	883	80	803	560
(09) Weapons	0	10	-10	-11
(10) Nuclear Technology	3	0	3	2

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, March 2014). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Bilateral Policy Issues

Secretary of State Kerry Signs Climate Agreements in Beijing as China Bolsters Anti-Pollution Efforts

In February, Secretary of State John Kerry visited Beijing as part of a tour of Asia. At a Beijing car-making factory, the Cummins-Foton Joint-Venture Plant, Secretary Kerry highlighted China's air pollution problems and the importance of U.S.-China cooperation on climate change.[1] At the conclusion of his trip, the State Department announced that the United States and China have reached agreement on the implementation plans on the five initiatives launched under the U.S.-China Climate Change Working Group (CCWG),[i] including emission reductions and smart grids. The two sides committed to "secure concrete results by the Sixth U.S.-China Strategic and Economic Dialogue in 2014."[2]

Secretary Kerry has made climate change a priority since taking office. At last July's talks, the United States and China signed a series of agreements on energy cooperation, including reducing emissions of soot and carbon dioxide from heavy vehicles, cutting energy use in buildings and factories, and developing carbon sequestration technology.[ii] Energy is an area of strong consensus between the two countries, even as bilateral diplomacy is frayed by other disputes.

The agreement also comes at a time when China is taking renewed steps to combat pollution and the effects of climate change. A new study, released by China's National Bureau of Statistics in February, estimated that natural disasters, such as droughts and floods, cost China $69 billion last year, double the amount in 2012.[3] The central government in January ordered 15,000 large and small factories to make real-time data about and water pollution available to the public. It is likely a response to the U.S. Embassy's @Beijing Air Twitter feed, which has gained a wide following among ordinary Chinese by exposing the hazardous levels of pollution in the capital.[4] The U.S. embassy reading of PM2.5 was 268 micrograms per cubic meter in mid-February, or 11 times the recommended exposure limit set by the World Health Organization. Chinese officials also announced on February 13 that that they were offering a total of $1.65 billion this year to cities and regions that make "significant progress" in air pollution control.[5] Meanwhile, China National Petroleum Corporation (CNPC), the country's biggest oil producer, was placed on a pollution blacklist for the second time in six months after breaching regulations at one of its refineries.[6]

In tandem with these anti-pollution directives, Beijing continues to pour vast sums into cleaner technologies. New data published in February showed that for the first time China spent more on energy efficiency than the United States last year, with the $4.3 billion it invested accounting for almost a third of the world's total.[7] Beijing also recently announced a new round of subsidies to develop electric vehicles and install solar panels.[8] Government support is rubbing off on investors, who are eager to tap a dynamic source of growth. Private equity firms, for example, poured a record $1.2 billion into environment-related businesses last year.[9] The consultancy EY's latest Renewable Energy Country Attractiveness Index, published quarterly, ranked China second behind the United States in a list of 40 countries.[10]

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[i] Launched in 2013, the CCWG is a multiyear initiative aimed at reducing vehicle emissions; increasing carbon capture, utilization, and storage; increasing energy efficiency in buildings, industry, and transport; improving greenhouse gas data collection and management; and promoting smart grids. See the "U.S.-China Climate Change Working Group Fact Sheet," July 10, 2013. http://www.state.gov/r/pa/prs/ps/2013/07/211768.htm.

[ii] For more information, see the August 2013 edition of the USCC Monthly Trade Bulletin.

GAO Criticizes the Administration for Not Keeping Track of China's Trade Commitments

In a February 2014 report, the Government Accountability Office (GAO) criticized top government agencies of poorly tracking and implementing China's commitments at the U.S.-China Joint Commission on Commerce and Trade (JCCT) and the Strategic and Economic Dialogue (S&ED) (and its predecessor, the Strategic Economic Dialogue). The report directed criticism explicitly at the Office of the U.S. Trade Representative (USTR), and the U.S. Department of Commerce (Commerce).[11] Conducted in response to a request by Reps. Dana Rohrabacher (R-CA), Frank Wolf (R-VA), and J. Randy Forbes (R-VA), the study sought to assess the U.S. executive branch agencies' ability to track China's promises to remove barriers to trade and investment.

GAO identified 298 trade and investment commitments made by China since 2004 in 11 issue areas[iii] spanning government procurement, innovation and intellectual property rights.[12] There is no method to track implementation, according to GAO's findings. Worse, with the exception of one commitment, there are no metrics (such as export data) for tracking implementation. GAO's case-study analysis of 10 software-related commitments made by China between 2008 and 2011 showed that no implementation status could be clearly identified for any of them.

GAO also faulted agencies for not specifying timeframes for implementing the commitments, although it noted that the joint 2013 S&ED fact sheet explicitly stated that "[t]he two countries reached consensus to work expeditiously to implement the commitments made […] before the next Strategic and Economic Dialogue […]."[13] GAO further noted instances in which commitments were made by China and then not mentioned again by USTR. For example, the report pointed out:

> *[I]n the 2011 JCCT, China reported on the development and publication of revised safety standards for medical devices, acknowledged the value of closer cooperation with the United States on those standards, and committed to participate in an information exchange program with the United States in 2012. The status of that commitment was not addressed in either the 2012 or the 2013 reports.*[14]

GAO noted that in response to its recommendations on better coordination and reporting:

> *USTR and Commerce did not directly agree or disagree with the recommendation, but raised several concerns. USTR maintained that current reporting is comprehensive and Commerce noted resource constraints. GAO continues to believe improved reporting would benefit policymakers.*[15]

AmCham Shanghai Releases China Business Report 2013-2014 Survey

On February 25, the American Chamber of Commerce in Shanghai (AmCham Shanghai) released its 2013 member survey (399 respondents, 22 percent response rate), on opportunities and challenges facing U.S. companies operating in Shanghai.[16] While the survey focused on Shanghai, the general trends reflect the countrywide plans to transition

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[iii] At the JCCT, a large share of commitments are related to intellectual property rights (62 commitments or 34 percent) and technical and regulatory barriers to trade (45 commitments or 24 percent). In addition, 110 commitments (or 60 percent of all China's JCCT commitments) refer to a specific sector, including 28 commitments related to pharmaceuticals and medical devices, 19 commitments related to agriculture, and 18 commitments related to software use. For the S&ED, 70 percent of the trade and investment commitments are related to one or more of the following three issue areas: investment (30 commitments or 26 percent), multilateral issues (26 commitments or 23 percent), and transparency (24 commitments or 21 percent).

from manufacturing for export to producing for the local market, as well as the increasing costs within the developing service sector.[iv] In 2013, a strong majority of U.S. companies reported profitable operations (74 percent, on par with performance in 2012), revenue growth (67 percent, down from 71 percent in 2012, and a peak of 87 percent in 2010) and positive cash flow (75 percent, up from 72 percent in 2012).

Other highlights of the report:

- *Services strong.* According to the survey, services in 2013 accounted for 52 percent of U.S. companies' revenue in Shanghai, up from 41 percent in 2012. Over the same period, manufacturing declined from 47 percent to 37 percent. Small- and medium-sized enterprises were the key driver behind the increase in services revenue. On average, 76 percent of SMEs had significant services revenue in 2013 (calculated as more than 20 percent), while only 43 percent of larger firms reported the same.
- *China remains attractive, but the investment outlook is down.* Continuing the trend from 2012, in 2013, 59 percent of respondents said they were manufacturing or sourcing goods for the Chinese market, while 23 percent said their primary strategy was to increase exports to the United States or third markets. Although China remains a critical destination for companies' global investments, the percentage of companies that reported making additional investments in their Mainland operations fell to 65 percent (from 74 percent in 2012), perhaps reflecting uncertainty over the political climate and regulatory environment.
- *Rising costs.* For the third consecutive year, rising costs were the top business challenge: 89 percent of companies said increasing costs in China hinder their business. Human resource constraints (82 percent) and local competition (73 percent) were the second- and third-most reported hindrance. Companies cited labor (90 percent) as the main driver of cost increases, followed by taxes (46 percent) and material costs (37 percent).
- *Regulatory challenges*. Legal and regulatory challenges in 2013 remained unchanged from the past three years: 80 percent of respondents cited bureaucracy as the top challenge; 72 percent complained of an unclear regulatory environment; and 70 percent were concerned over problems with tax administration. A key issue was fraud and corruption, with companies' worries over malfeasance increasing to 21 percent in 2013, from 12 percent in 2012. At the industry level, in 2013 the retail sector (42 percent) and healthcare industry (41 percent) were most affected by China's opaque regulations. Further, 54 percent of respondents (unchanged from 2012) believed that the regulators favored local companies, and 63 percent said they saw no improvement in the regulatory environment (up from 48 percent in 2012).

Sector Focus: The Film Industry

As incomes rise in China, the country's film industry is booming. According to numbers released by the State General Administration of Press, Publication, Radio, Film and Television, Chinese cinema operators last year added 5,077 new cinema screens and opened 903 new complexes across the country, annual increases of 25 percent and 39 percent respectively. While the average price of movie tickets fell, strong sales led gross box office receipts to surge by 27 percent year-on-year, to $3.37 billion, cementing China as the second-largest film market after the United States. As in other sectors of China's services economy there is ample room for expansion.[17] Although China is home to one

[iv] A survey published by the U.S.-China Business Council (USCBC) in October 2013 identified similar trends. Rising wages were cited as the main driver of cost increases. Similarly, preferential treatment of local companies, including regulatory and financial support, was among main complaints. For our analysis of the USCBC survey, see the November 2013 bulletin,
http://origin.www.uscc.gov/sites/default/files/trade_bulletins/November%202013%20Trade%20Bulletin.pdf.

billion more people than the United States and Canada, it is only about one-third as large in terms of total movie screens and box office revenue.[18] Due to large regional gaps, the biggest potential for cinema in China lies in smaller tier-2 and 3 cities.

China has been described as Hollywood's "pot of gold." Cinema admissions in most mature markets have been flat over the past decade, in spite of new innovations, such as 3D effects and better sound. The drop in household consumption growth since the global financial crisis has not helped. For large studios, the business has thus become riskier, with a few blockbusters making the difference between a good and a bad year.[19] Increasingly, cinema growth is shifting to emerging markets; for example, in South Korea, people are now buying an average of four movie tickets a year. [20] In China, a much larger market, it is only 0.5 per capita.

Hollywood so far has reaped only limited returns from China's cinemas. Like much of China's services economy, film production and distribution is cosseted against foreign competition, for both economic and political reasons. China is keen to nurture its own film industry to eventually rival Hollywood's market power, and to maintain high profit margins for its quasi-monopoly of film distributors. The authoritarian government also reserves the right, via a government censorship board, to edit films for what it considers inappropriate moral or political content. Compounding this state interference is a market in which intellectual property violations and box office fraud are commonplace.

Two of the biggest market barriers for U.S. films in China – import quotas and revenue sharing – can be traced back to China's WTO accession agreement in 2001. The United States agreed to China's request at the time to only allow 20 foreign films each year to be shown in its theaters, and moreover, to allow China's cinemas to pocket 87 percent of the revenue. In contrast, WTO members ordinarily have no quota on the number of films, and revenue sharing is usually a 50-50 split between the film's owner and the theater. In addition, some films are allowed into China on a flat fee basis, which is much less profitable to the foreign film's owners.[21] Chinese distributors typically pay less than $1 million to foreign film makers for each movie under this arrangement. Foreign films, meanwhile, earn $20 million to $40 million apiece in box office receipts in China, with blockbusters like "Titanic 3D" ($105 million) and "Avatar" ($182 million) earning far more.

The U.S. film industry has lobbied in recent years to overcome these barriers, but the outcome has been contradictory. Following a complaint filed by the United States and other countries in April 2007, the WTO ruled in August 2009 that China's position on foreign media imports violates principles of fair market access and fair national treatment. Essentially, the WTO ruled that it is unfair to subject foreign films to a separate and unequal process of censorship and distribution. After losing its appeal in December 2009, China was given 14 months to comply – but by March 2011, it had failed to do so.

China's non-compliance placed the onus on the United States to take retaliatory action. What resulted instead was a bilateral settlement, signed during then Vice-President (and current President) Xi Jinping's official visit to Los Angeles in February 2012. In spite of the protracted negotiations that preceded it, involving the Motion Picture Association of America (MPAA), the settlement did little to widen market access. China neither scrapped its film quota, nor increased it to the 40 films that the MPAA demanded. Rather, the quota was raised from 20 to 34 movies per year, with the agreement that the additional 14 films allowed must be enhanced-format films, such as IMAX and 3D movies.[22] Nor did the deal move the bar much on revenue-sharing – China only agreed to raise Hollywood's stake from 13 percent to 25 percent.[23] The MOU was also notable for its opacity – no written summary of the deal was released by the Chinese government, the USTR, or the White House.

Since this settlement two years ago, Hollywood has become more aggressive in courting the Chinese market. In 2012, Hollywood films for the first time grossed more box office revenue in China than local films, and last year, four out of China's top-ten highest-grossing films were from Hollywood, led by "Iron Man 3," which ranked second on the list with earnings of $124 million. Co-productions are increasing: "Kung Fu Panda 3" will be co-produced by DreamWorks Animation and several Chinese partners;[24] "Iron Man 3" was co-produced with China-based DMG entertainment;[25] and "Transformers 4" inked a sponsorship deal with Beijing Pangu Investment.[26]

An assortment of business ventures are also in the works. One of the Hollywood magnates most bullish on China is James Cameron, the Oscar-winning director of "Titanic," who claims that President Xi Jinping is a "movie buff." Cameron announced in August 2012 that CPG China Division, the new arm of Cameron Pace Group, would open a joint venture in China to sell 3D camera technology to Chinese film makers.[27] In parallel, DreamWorks Animation SKG Inc., looking to boost its presence in a fast-growing market, signed deals with Chinese partners to build a $350 million movie studio in Shanghai and help design an entertainment complex meant to capitalize on the success in China of its "Kung Fu Panda" film franchise.[28] It was recently followed by Legend 3D, another Hollywood visual effects company.[29] Fox International, a subsidiary of Rupert Murdoch's Newscorp., also purchased a 19.9 percent stake in China's Bona Film Group, to jointly produce and distribute Chinese-language films in China.[30]

Still, for most of Hollywood without partnerships with Chinese film companies, market access barriers remain a huge hurdle. To counter its concessions on revenue sharing in the 2012 agreement, China last year proposed to levy new value-added taxes on box-office receipts of Hollywood films. It took MPAA until August 2013 to resolve the dispute.[31] In February 2014, the *Hollywood Reporter* published a rumor that China might increase its import quota from 34 to 44 films, but those hopes were quickly dashed by China's State Administration of Press, Publication, Radio, Film and Television, which told Xinhua News Agency that the 2014 quota would hold in-line with the agreement signed with the MPAA in 2012.[32] Moreover, since the 2012 agreement, China has repeatedly staged "blackouts" on screenings of U.S. movies and forced new imported movies to be released the same day, a practice known as "double booking" or "double dating" that forces these films to compete against each other and reduces overall box office receipts.[33] In individual cases, Hollywood films have been canceled at will; for example, in April of last year, Quentin Tarantino's "Django Unchained," a gory revenge tale set in the Wild West, was suddenly cancelled due to unexplained "technical reasons."[34]

The "Django Unchained" incident points to the pervasive problem of censorship. The film industry arguably suffers the brunt of China's media censorship – the government preempts the production of controversial domestic films, and reserves the right to edit or block foreign films, based on their content. That partly explains why most of the Hollywood films that perform well in China are anodyne action films like "Fast & Furious" and animation pictures like "Kung Fu Panda," rather than more serious Oscar fare.

Optimists might argue that Beijing is now buckling under pressure to reduce film censorship. In April last year, during an acceptance speech for winning "director of the year" from the China Film Directors Guild, China's most famous commercial filmmaker Feng Xiaogang complained of the "great torment" of censorship."[35] Three months later, new regulations approved by the State Council, China's cabinet, stated that Chinese filmmakers will no longer have to submit screenplays to officials for review and approval before they can shoot a movie.[36] This past month, three gritty Chinese films about present-day life in small-town China – Diao Yinan's "Black Coal, Thin Ice," Lou Ye's "Blind Massage" and Ning Hao's "No Man's Land" – were featured at the Berlin Film Festival. The directors of these films have experienced censorship in the past but the success of their newest films in Berlin garnered cautious praise from China's state-run print media. "Blind Massage" has been approved for distribution on the Mainland.[37]

Even if Beijing were to lift its quota, share more revenue, eliminate censorship, and allow private distributors into the market, it would still leave problems endemic to China's marketplace – intellectual property theft and box office fraud. China's pirated DVDs have caused hundreds of millions of dollars in foregone revenue for Hollywood studios. In November of last year, China's State Administration of Press, Publication, Radio, Film and Television acknowledged that, due to manipulation of box office figures, $826 million, or 18.7 percent, of box office sales in China were not reported last year.[38] The government is taking some steps to crack down on these issues. For example, Beijing announced in its Third Plenum Decision in November 2013 that it would set up a new court to protect intellectual property rights, without providing specifics. The dearth of intellectual property lawyers in China, and corruption in the judicial system, raise questions about how effective such a court can be.[39]

China's Economy

Amid Statistical Confusion about Economy, China Sets 7.5 Percent Growth Target

As is customary, China's leadership used the annual meetings of the National People's Congress this week to announce its annual growth target for the economy. At 7.5 percent, it was the same as the target set for 2012 and 2013, continuing a policy of moderation, at least relative to ambitious targets of the previous decade. According to Bloomberg, about two-thirds of China's provinces have followed suit, with real-GDP expansion targets that are lower than 2013's goals.[40] Given the current state of China's economy, however, economists surveyed by Bloomberg in January forecast only 7.4 percent growth for China this year.[41] Still, Beijing's influence over credit expansion, economic data, and other levers means that the official targets are likely to be met. Similar doubts were voiced last year, when GDP growth ended up exceeding the target by 0.2 percentage points.

Lou Jiwei, China's recently appointed Minister of Finance argued at the NPC meetings that "whether GDP growth is to the left or to the right of 7.5 percent" is less important than job creation. The problem with this statement is that employment data in China is very unreliable – the reported unemployment rate has been unchanged for years, and total employment numbers were last published 13 months ago.[v]

Limited and shoddy data remain widespread. January data, published by China's customs officials, showed a year-on-year increase in exports and imports of over ten percent. That is much higher than forecast by most economists, given the decline in Taiwan's and South Korea's exports, the lack of an economic rebound in Europe, and the fact that China's monthly export growth was just 4.3 percent in December.[42] Just as odd was data from the Ministry of Commerce that showed a 16 percent jump in foreign direct investment inflows, to $10.8 billion, after those inflows had *declined* by 42 percent year-on-year in December. Analysts attributed these anomalies in China's external accounts to efforts by Chinese companies to evade the country's tight capital controls.

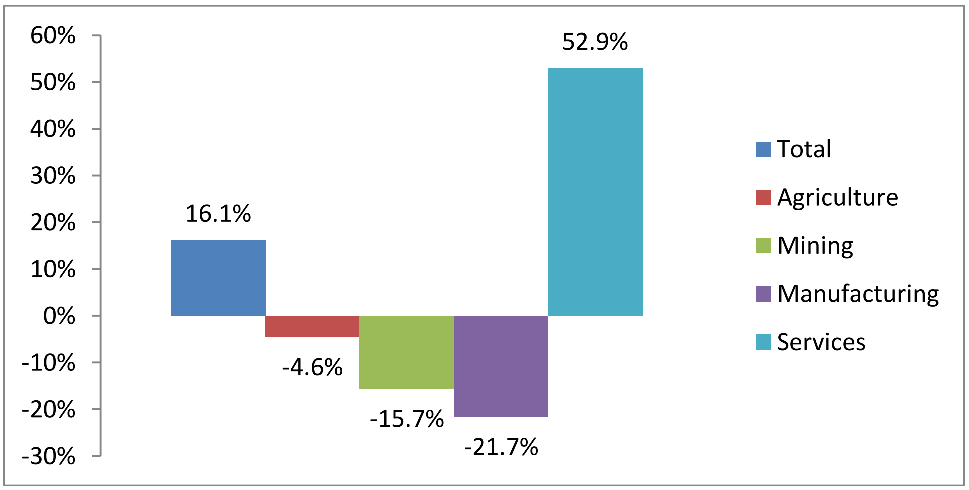
China's State Administration of Foreign Exchange (SAFE) took measures last April and December to clamp down on the over-invoicing of export receipts, yet the illegal practice has tended to resurface quickly. No less problematic is round-tripping, the practice of selling a product or making an investment overseas to generate foreign currency, which is then re-invested by the same company in China.[43] In the case of FDI, the jump in inflows is largely

[v] This assessment is based on data culled from CEIC, a U.S.-based service that collects Chinese government data.

attributable to services, not manufacturing (see figure 2), most of it going into real estate (46.2 percent), the wholesale & retail trade (13.6 percent), and commercial services (12.7 percent).[44]

China's response to criticism of the data was mixed. On February 12, Ma Jiantang, the head of the National Bureau of Statistics, vowed that China would investigate and punish any cases of falsified statistics. He acknowledged that "falsification can be considered as the biggest form of corruption."[45] But six days later, the spokesman for China's Ministry of Commerce, Shen Dayang, argued that, while it was possible that there was still a little fudging of trade data, the recent surge in exports was real.[46]

Figure 2: Growth of Foreign Direct Investment in China by Sector, January 2014
(year-on-year, %)

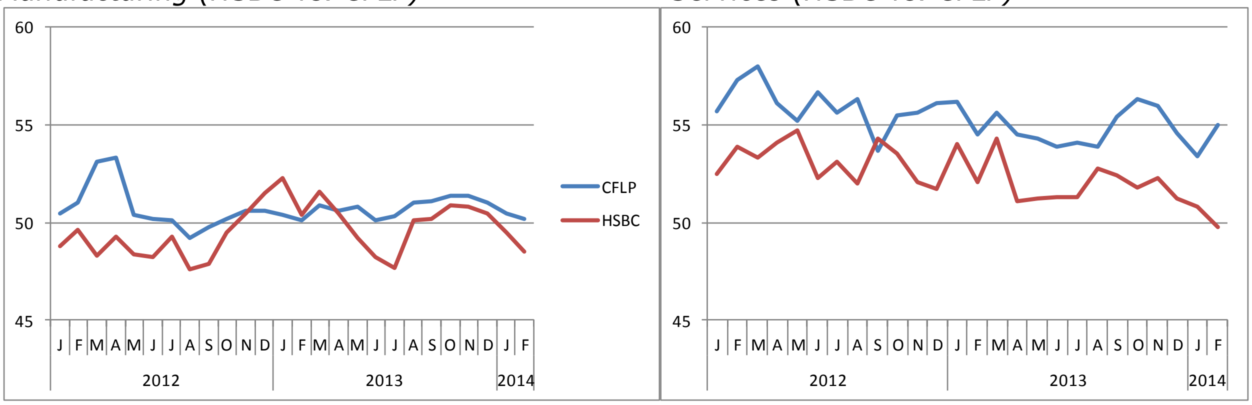


Source: Ministry of Commerce, via CEIC data.

Meanwhile, data on activity in the domestic economy also raised eyebrows. A study by Bloomberg showed that the discrepancy between GDP figures reported by China's provincial authorities and the central government for 2013 was over $1 trillion, equivalent to the size of Indonesia's economy.[47] To avoid misleading signals around China's Lunar New Year holidays, the government delayed publication in February of key economic indicators for the beginning of 2014, such as fixed investment, industrial output, and retail sales. One important indicator that was available was the purchasing managers' index (PMI), a survey of businesses conducted separately by the Hong Kong bank HSBC and the China Federation of Logistics and Purchasing (CFLP). HSBC, which surveys primarily private firms, showed a steep contraction in both manufacturing output and services. The services PMI, which tends to be more expansionary, had its worst showing in over two years. While some argued that this was owing to China's holidays, the survey is in fact seasonally adjusted. The CFLP survey, which samples more state-owned enterprises (and probably fewer exporters), was less subdued, but also showed declining optimism in manufacturing (see figure 3). These surveys cast further doubt on customs data that showed a surge in exports.

Figure 3: Purchasing Managers' Index through May 2013
(<50 = contraction, >50 = expansion)

Manufacturing (HSBC vs. CFLP) *Services (HSBC vs. CFLP)*



Source: China's National Bureau of Statistics, via CEIC data; HSBC Purchasing Managers' Index. *http://www.hsbc.com/1/2/emerging-markets/em-index/purchasing-managers-index.*

NPLs and January Lending Surge Renew Concerns about Debt

A new round of financial data released in February added to questions about a debt bubble. Non-performing loans (NPLs) rose by RMB 28.5 billion ($4.7 billion) in the last quarter of 2013 to RMB 592.1 billion, the highest since September 2008, at the height of the global financial crisis.[48] A big difference this time around is that banks have set aside more capital to deal with potential defaults, with a ratio of provisions to NPLs of 2.83, compared to 1.17 in 2008. However, the share of NPLs at the country's largest commercial banks has also declined over that period, from 74.7 percent to 59.1 percent. Hence, while the provision coverage ratio is up, if the big banks account for most of these provisions, and the smaller banks are more exposed to NPLs, there are still significant risks in the banking system (see table 3).

While some of the borrowers are indebted state-owned enterprises, others are part of China's "shadow banking" sector. China averted its first trust default in at least a decade in January as investors in a RMB 3 billion high-yield trust product issued by China Credit Trust Co. and distributed by Industrial & Commercial Bank of China Ltd., China's largest commercial bank, were bailed out days before it matured.[49] Similarly, credit-default swaps on China Development Bank Corp., Export-Import Bank of China and Bank of China rose to their highest level on the Asian benchmark this year.[50]

Table 3: Non-Performing Loans and Loan-Loss Provisions at China's Commercial Banks, 2007-2013

	Non-performing loans			Bank provisions	
	Total (RMB bn)	Large commercial bank (RMB bn)	Large commercial bank share (%)	Loan loss provision (RMB bn)	Provision coverage ratio
2007	1,270.2	1,115.0	87.8%	525.9	0.41
2008	563.5	420.8	74.7%	657.1	1.17
2009	506.7	362.7	71.6%	776.2	1.53
2010	433.6	312.5	72.1%	944.0	2.18
2011	427.9	299.6	70.0%	1,189.9	2.78
2012	492.9	309.5	62.8%	1,456.4	2.95
2013	592.1	350.0	59.1%	1,674.0	2.83

Source: China's Banking Regulatory Commission, via CEIC data.

January data indicates that credit expansion will not let up this year. As the *Financial Times* has noted, a January surge in lending is an annual tradition in China: The central bank controls lending over the full year through a rough quota system, so commercial banks rush to book loans at the start of the year to grab as big a share of the quota as possible.[51] Even so, the lending increase this year was the highest since 2010, when China was in the middle of a massive stimulus program (see figure 4). Another worry is that short-term lending is outpacing total lending (see figure 5) and marking a rebound in short-term lending over the past year, which accounted for 40 percent of all lending in January.

These numbers call into question the central bank's policy agenda. In June and December of last year, the People's Bank of China refused to inject more capital into the financial system. Although these moves caused brief spells of financial panic that drove up interbank lending rates, they steadily guided up market interest rates, and were viewed by markets as a necessary effort to discipline lenders. But the latest data has led respected analysts, such as Lu Ting of Merrill Lynch, to suggest that the PBOC is "not really tightening," due to its concern about sustaining liquidity to fuel economic growth.[52]

Banks seem to be responding to this loose monetary policy by taking on even more risk. China's top-five banks, Industrial and Commercial Bank of China, Bank of China, Agricultural Bank of China, China Construction Bank, and Bank of Communications, all said in late February that there was no policy change in their real estate-related lending business, in spite of what many see as a looming property bubble.[53] Banks have also shown an appetite for guaranteeing dollar-denominated corporate bonds by some very indebted companies. In January, the Bank of China's Macau branch backed $500 million of securities sold by China Shipping Group Co., while Agricultural Bank of China Ltd.'s Beijing arm supported a $300 million issue by Beijing Energy Investment Holding Co. last week.[54]

Figure 4: China's Lending Increases in the Month of January, 2007-2014
(year-on-year, %)

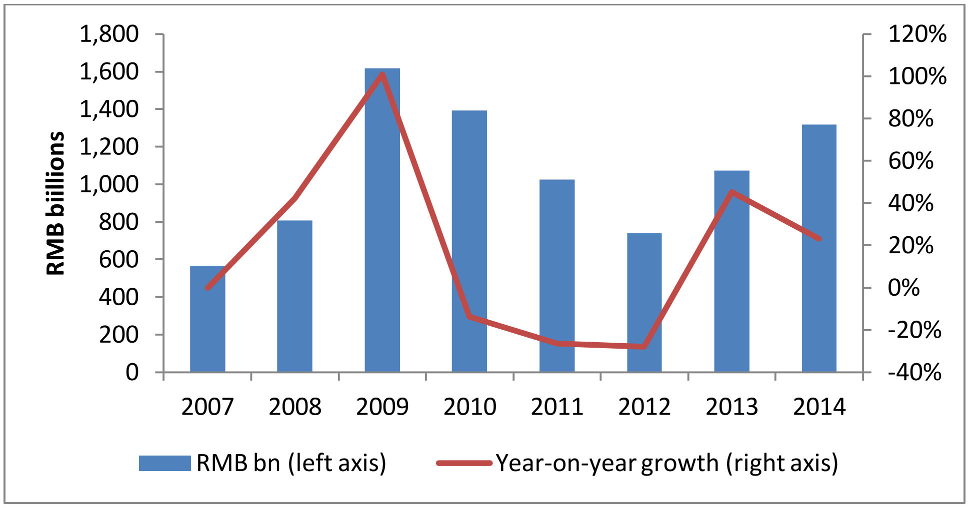
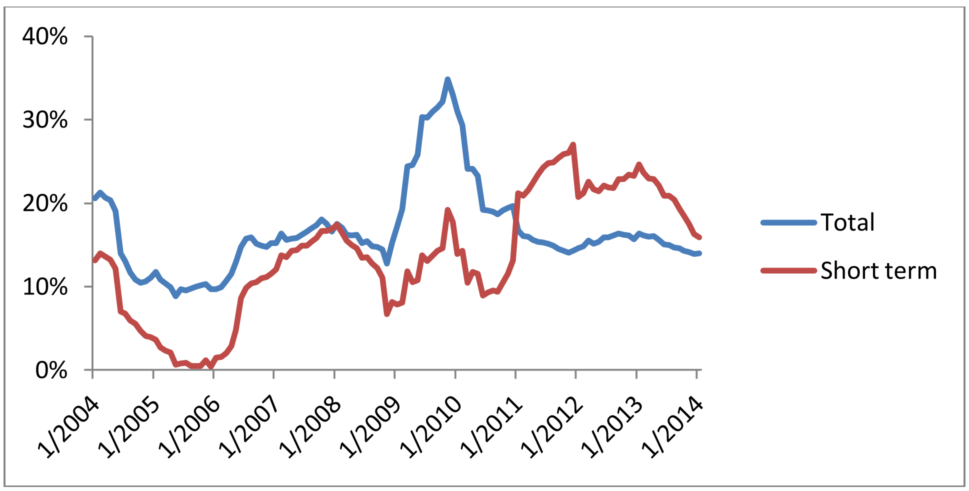


Figure 5: Growth in Short-Term and Total Loans in China, January 2004 – January 2014,
(year-on-year, %)



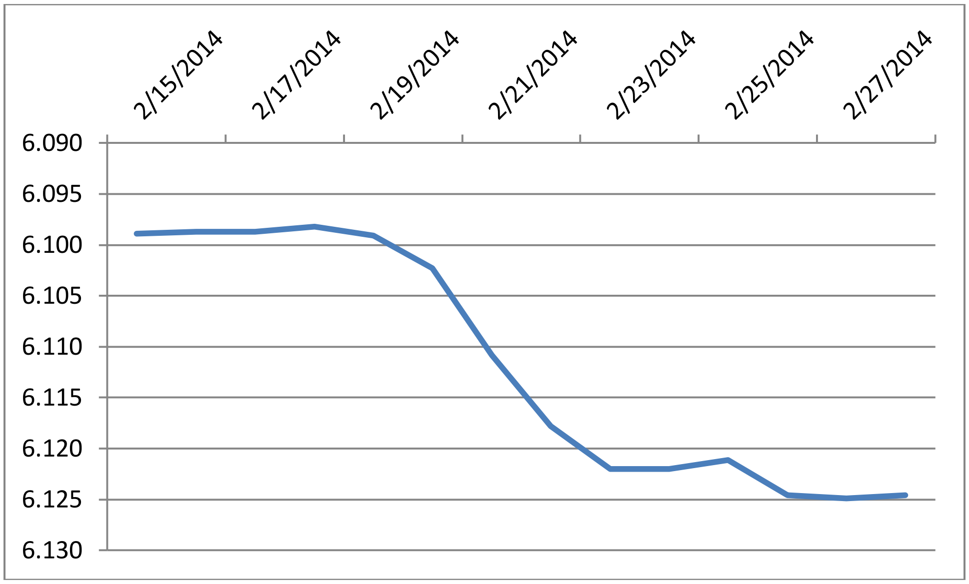
Source: The People's Bank of China, via CEIC data.

In tandem with issuing more loans, China's banks are also seeking ways to retain depositors. Many Chinese households, frustrated by low deposit rates, have sought ways to diversify their savings into higher-yielding products. While banks have offered attractive wealth management products (WMPs) – many of them tied to shadow banking instruments – they have been unable to stem the tide of internet investment products offered by internet companies such as Alibaba. These internet products are particularly popular among the younger generation, offering more flexibility than banks in terms of how much money savers must put in and how much they can take out at any given time. While China's banks have lobbied the government to more tightly regulate these internet products, they have recently begun to get in on the act as well. One example is ICBC's money-market WMP "Everyday Benefit." The tradeoff for banks is that they will have to offer higher deposit rates. The Swiss bank UBS predicts that this will result in a cut in the banks' net interest margin of 0.1 percent, and lost fee income of up to 4 percent of estimated 2014 net profit.[55] While this is good news for Chinese consumers, the question is how long the government will tolerate a loss of profitability at its largest banks, which are already plagued by bad loans.

RMB's Decline Ignites Speculation

In the final week of February, the RMB showed its steepest decline in value since the exchange rate reform of 2005 (see figure 6). Although the RMB has been slowly strengthening against the dollar, the rate of appreciation slowed to a crawl in 2013, when it gained barely 2.8 percent. Since the beginning of 2014, the RMB actually fell 1.5 percent.

Figure 6: Chinese RMB per U.S. Dollar, February 2014



Source: Oanda Historical Exchange Rates. http://www.oanda.com/currency/historical-rates/.

According to an unnamed official interviewed by the *Wall Street Journal*, the decline in the RMB's value was engineered by the People's Bank of China (PBOC) to discourage speculators (who have been betting on the RMB's appreciation) as it prepared to widen the RMB trading band.[56] The tightly managed band, which allows minor daily fluctuations in the RMB's value, was last widened in April 2012, when it was increased from 0.5 percent to 1 percent. The PBOC said in 2013 that it plans to widen the band in the future, but there have been no official policy announcements. SAFE, an agency under the PBOC, dismissed the reports of deliberate involvement, saying that the RMB's decline was "the result of market players adjusting their … strategies." It did note that "exchange rate volatility is normal," perhaps in an effort to break the market assumption that RMB rate will continue appreciating indefinitely.[57]

According to UBS estimates, so-called "hot-money inflows" amounted to more than $150 billion out of the $244 billion of China's total capital inflows in 2013.[58] Although most of the money is put to productive use, a substantial share is "carry trade" – speculators who have borrowed abroad at rock bottom rates and then seek higher returns on investments in China. Because of their inherent volatility, speculative inflows betting on the RMB's one-way appreciation have been a persistent headache for China's financial regulators.

Weakening the RMB is one way to discourage speculators, but it is also very helpful to Chinese exporters, who have been struggling in recent months. The lower RMB makes Chinese exports cheaper on international markets. Nonetheless, analysts dismissed speculation that this bout of RMB weakness marks a return to currency depreciation.[59]

The weakening of the RMB had an unintended side-effect, which highlights the complexity of managing money flows in China. Because of the RMB's weakness, investors have been selling the local currency and buying dollars for the past two weeks, flooding China's money markets and driving down short-term interest rates.[60] China has been on a quest to tamp down on borrowing and investment, pushing interest rates to around 4 percent to 5 percent. However, the latest indicators show the benchmark cost of short-term loans among banks down to 2.83 percent, from 3.84 percent in February and a high of 8.94 percent on December 23, 2014.[61]

NOTE: An updated version of this bulletin was published on March 10, 2014, after initial publication on March 7. Key corrections: (1) "Exports to China drop as overall trade slows" changed to "Strong increase in exports but overall trade slows"; (2) "given the decline in exports to Taiwan and South Korea" changed to "decline in Taiwan's and South Korea's exports"; (3) HSBC PMI was not a flash reading (note deleted).

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