

U.S.-China Economic and Security Review Commission

Monthly Analysis of U.S.-China Trade Data



March 6, 2015

Highlights of this Month's Edition

- **Bilateral trade:** U.S. goods deficit with China grew in January 2015 on the weakness of U.S. exports.
- **Bilateral policy issues:** The U.S. Treasury said China reduced foreign exchange intervention in the second half of 2014; USTR is challenging China's export subsidy program at the WTO.
- **Policy trends in China's economy:** New rules by Chinese government would bar U.S. technology firms from key tech-intensive sectors of the Chinese market; Chinese public increases use of e-commerce tools during the 2015 Chinese New Year.
- **Sector spotlight -- Cotton:** China's policy changes reduce U.S. cotton exports price advantage and market access.

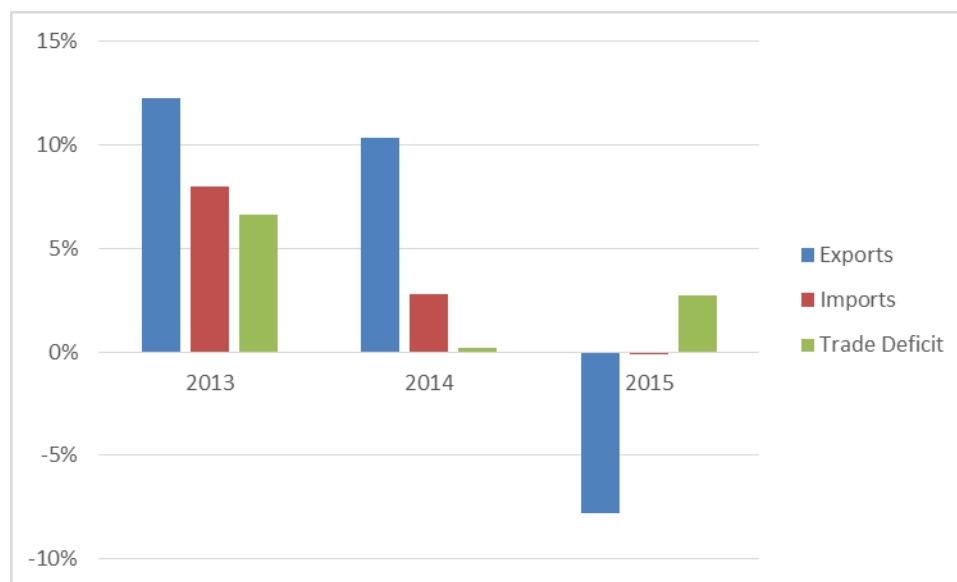
Bilateral Goods Trade

U.S. Export Drop Causes Larger Deficit

The U.S. trade deficit in goods with China totaled \$28.6 billion in January 2015, a 2.8 percent growth year-on-year, and an increase of \$306 million over December 2014. At the same time, the U.S. global goods deficit declined in January 2015, as both exports and imports fell.¹

U.S. exports to China dropped significantly in January, falling by over 20 percent from December 2014 and reaching a low not seen since September 2014. One year ago, monthly exports shrank by a similar margin—about 20 percent from December 2013—but year-on-year growth in January 2014 was 10.4 percent. Imports from China in January 2015 shrank, though by a smaller amount than exports to China—5.9 percent over December 2014. Overall, the bilateral deficit expanded at a faster rate than in January 2014, but still not as quickly as in 2013 (see Figure 1).

**Figure 1: Growth in U.S. Exports, Imports, and the Trade Deficit with China:
January, 2013-2015**
(year-on-year, %)



Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, March 2015).
<http://www.census.gov/foreign-trade/balance/c5700.html>.

Bilateral Policy Issues

U.S. Treasury: China Reduced Currency Intervention

The U.S. Treasury said China reduced foreign exchange intervention since July 2014, claiming victory from a commitment China made during the 2014 U.S.-China Strategic and Economic Dialogue (S&ED).² During a speech on February 19 at the Peterson Institute for International Economics (PIIE), U.S. Treasury Undersecretary for International Affairs Nathan Sheets claimed China reduced its currency intervention:

*China in our S&ED in July [2014] made a commitment that they would reduce their foreign exchange intervention as conditions permit it. And by our reading, the Chinese essentially refrained from foreign exchange purchases since that period. So it feels to me like when I look at the data, when I look at the evidence, that we are making significant progress and as you point out, there's a fair amount of momentum, there's a wind at our back here.*³

According to the official S&ED fact sheet published by the Treasury, China committed “to continue market-oriented exchange rate reform; reduce foreign exchange intervention as conditions permit; and increase exchange rate flexibility.”⁴ However, People’s Bank of China (PBOC) Governor Zhou Xiaochuan declined to define the conditions that would permit reduced foreign exchange intervention.⁵ Subsequently, Chinese officials oversaw a decline in the value of the RMB, which made U.S. exports more costly to Chinese consumers and businesses.

In February, the RMB depreciated to a 28-month low of 6.269 compared to the dollar after the PBOC reduced the reference rate by 0.16 percent.⁶ The reduced reference rate encouraged Chinese investors who hold large amounts of dollar-denominated debt to sell off their liabilities, reducing demand for and weakening the RMB. Although Chinese investors wish to sell dollar-denominated debt to diversify portfolios that are dominated by foreign debt,

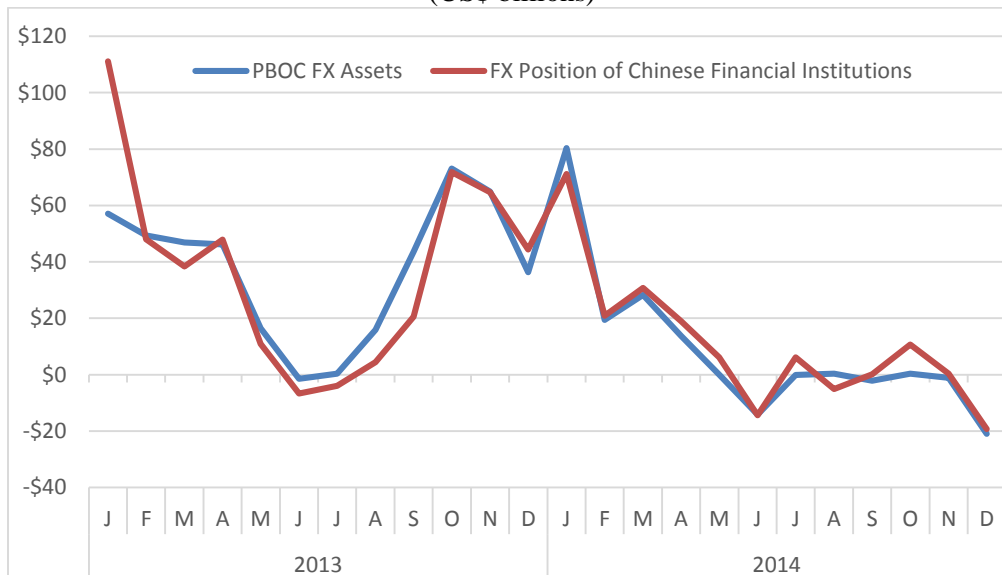
the PBOC’s targeted reduction of the reference rate illustrates how it can purposefully undervalue the RMB in order to support growth.⁷ Given that China’s growth model continues to be heavily reliant upon exports, daily adjustments to the reference rate continue to be tool of currency manipulation for Beijing, even at a time when foreign exchange intervention is on the decline.

Treasury’s Sheets argued the apparent fulfillment of the S&ED commitment implies the success of bilateral engagement on currency intervention and reduces the need to include trade remedies for currency manipulation in U.S. trade agreements, which Congress recommends. Federal Reserve Chairwoman Janet Yellen echoed these remarks in testimony to Congress in February, indicating the Fed’s longstanding opposition to including currency manipulation provisions in trade agreements.⁸ In addition, the Obama Administration has endorsed international forums such as the G20 and the International Monetary Fund as the only proper venues in which to negotiate currency disputes.⁹

However, a bipartisan majority of Congress called on the United States to include provisions against currency manipulation in future U.S. trade agreements, including the Trans-Pacific Partnership (TPP).¹⁰ In addition, Congress is currently considering legislation that would allow for punitive import taxes against countries that manipulate their currencies.¹¹ Given that the Obama Administration is reliant upon Congress for fast-track authority to negotiate TPP, this growing rift on how to address the economic damage caused by currency manipulation could become one of the major hurdles for the administration’s trade agenda.

The most recent reports the Treasury published on China’s currency only cover developments through the third quarter of 2014, the period to which Sheets’ remarks primarily refer. However, the reduction in China’s foreign exchange intervention was foreshadowed in the Treasury’s most recent report to Congress released in October 2014 on China’s exchange rate policies. In that report, the Treasury said the RMB appreciated by almost 2 percent since late April, and that “the gradual depreciation of the RMB in July and August amid low intervention and strong foreign exchange inflows also indicates renewed willingness by authorities to allow the exchange rate to strengthen.”¹² Sheets’ remarks are based on the seven-month period of near-zero or negative foreign exchange purchases shown from June to December 2014 in Figure 2.

Figure 2: China’s Foreign Exchange (FX) Intervention
(US\$ billions)



Source: People’s Bank of China, via CEIC.

The Treasury’s positive view of reduced foreign exchange intervention is offset by China’s daily adjustment of the reference rate, which it also uses to undervalue its currency. In April 2014, just three months prior to the S&ED, the Treasury reported the PBOC had widened the RMB trading band and “intervened and pushed the

reference rate lower to weaken the RMB.”¹³ According to the Treasury, readjusting the reference rate allows China to “shape market expectations on the degree of RMB appreciation that the PBOC will allow, influencing capital inflows, foreign exchange pressure, and the direction of the actual spot rate.”¹⁴ The Treasury reported in October that the RMB was 1.4 percent weaker against the dollar from January to September 2014, with the reference rate down 0.9 percent.¹⁵

U.S. Challenges Chinese Export Subsidies at the WTO

The Office of the U.S. Trade Representative (USTR) announced new action at the World Trade Organization (WTO) over China’s “Demonstration Bases-Common Service Platform” program, which provides WTO-illegal export subsidies* to businesses in seven critical industries: (1) textiles, apparel, and footwear; (2) advanced materials and metals (including specialty steel, titanium, and aluminum products); (3) light industry; (4) specialty chemicals; (5) medical products; (6) hardware and building materials; and (7) agriculture.¹⁶ The request for consultations is a first step in the dispute settlement process. In the meantime, the European Union, Brazil, and Japan requested to join the consultations.

The United States alleges that under the program, “enterprises that meet export performance criteria and are located in 179 Demonstration Bases throughout China” receive, among other things, cash grants and low-cost or no-cost services (such as information technology, product design, and worker training).¹⁷ According to USTR estimates, China has given almost \$1 billion over a three-year period to Common Service Platform suppliers. In addition, certain Demonstration Base enterprises have received at least \$635,000 worth of benefits annually.¹⁸ According to the USTR, exports from Demonstration Bases comprise a significant portion of China’s exports. For example, 16 of the approximately 40 Demonstration Bases in the textiles sector accounted for 14 percent of China’s textile exports in 2012.¹⁹

The United States has a history of challenging China’s export subsidy programs at the WTO, with mixed results. The USTR brought a 2007 case against subsidy programs supporting a wide range of industries, including steel, computers, and other manufactured goods,²⁰ and a 2008 case against China’s “Famous Brands” program, which offered grants, loans, and other incentives to Chinese enterprises in order to promote their global presence.²¹ Both cases were ultimately settled by agreements outside the WTO, with China agreeing to eliminate the prohibited subsidies.²² The new “Demonstration Bases-Common Service Platform” program itself was discovered during consultations with China over export subsidies to the auto industry under China’s “National Auto and Auto Parts Export Base” program.²³ Though the consultations on the auto subsidy program began in September 2012,²⁴ they have not reached a resolution, and USTR officials said they are still “actively engaged” with China.²⁵

Policy Trends in China’s Economy

New Rules Threaten Foreign Tech Suppliers amid Rising Cybersecurity Tensions

A new series of Chinese government rules would effectively bar U.S. technology firms from key tech-intensive sectors of the Chinese market. Amid escalating cybersecurity tensions between the two countries, the China Banking Regulatory Commission (CBRC) decreed last September that financial institutions in China must increasingly utilize “secure and controllable” information communications technology (ICT) products, solutions, and services in order to “meet banking information security requirements.”²⁶ Presumably, the technology would be Chinese and would be shared with government agencies.

The goal, according to the CBRC, is for 75 percent of ICT products utilized by Chinese banking institutions to be considered “secure and controllable” by 2019.²⁷ The CBRC’s guidance was reportedly adopted in a December 2014 document that outlined security criteria for ICT products in 68 categories.²⁸

* While the WTO permits some subsidies, those that are “contingent, in law or in fact, whether wholly or as one of several conditions, on export performance,” are among those deemed prohibited. See WTO, “Agreement on Subsidies and Countervailing Measures.” https://www.wto.org/English/tratop_E/scm_e/subs_e.htm.

While “secure and controllable” is not defined in the CBRC document, a January 28 letter²⁹ signed by 18 U.S. business groups* addressed to the Chinese Communist Party (CCP) Central Leading Group for Cyberspace Affairs warned that, in order to be designated “secure and controllable,” ICT products and services must “undergo intrusive security testing, contain indigenous Chinese intellectual property (IP), implement local encryption algorithms, comply with country-specific (Chinese) security standards, [...] disclose source code and other sensitive and proprietary information to the Chinese government, and engineer their products so as to restrict the flow of cross-border data.”³⁰

In the January 28 letter, the U.S. business groups suggested these policies would violate China’s WTO commitments to refrain from technical barriers to trade, and to not discriminate against imports.³¹ Signatories urged the Chinese leadership to postpone implementation pending further dialogue. CBRC responded that its policies regarding source codes are still under consideration, and that its ICT policies apply to all companies regardless of nationality.³²

U.S. ICT stakeholders have also called upon the Obama Administration to take action. In a February 4 letter, 17 U.S. business associations (not including the U.S.-China Business Council, which signed the January 28 letter) urged several U.S. officials, including U.S. Trade Representative Michael Froman, to request “immediate action to work with Chinese officials” to reverse “intrusive” policies that “threaten the ability of U.S. ICT companies to participate in the \$465 billion ICT market in China.”³³ Republican House leaders continued to press President Obama to confront China on its ICT policies, citing concerns that these policies are “inconsistent” with U.S. goals in the bilateral investment treaty (BIT) negotiations with China.³⁴ Mr. Froman described the rules as “not about security—they are about protectionism and favoring Chinese companies.”³⁵

China’s “intrusive” ICT policies are not expected to be limited to China’s financial industry. To boost its homegrown technology sector and address its cybersecurity concerns, China is shifting from foreign to domestic technology suppliers in sensitive segments of the economy by 2020, including banking, military, state-owned enterprises, and key government agencies, according to Bloomberg.³⁶ House Republican leaders expressed concern that if these new ICT policies are fully implemented, they will “negatively impact other sectors, such as banking, manufacturing, and health care, and harm the U.S. economy and jobs due to falling sales, outright theft of business secrets, and companies simply leaving the market.”³⁷

Despite pressure from U.S. government officials and members of the U.S. business community, there are signs the Chinese government has started to implement these policies. On February 27, Reuters reported the number of foreign tech brands on China’s list of ICT products approved for government purchase fell by a third, while more than half of foreign suppliers of security-related products were dropped from the approval list.³⁸ According to Reuters, the number of government-approved products made by U.S. network equipment maker Cisco Systems Inc. fell from 60 in 2012 to zero in 2014. (A Cisco spokesperson said purchases of the company’s products are still allowed through a competitive bidding process.³⁹) In another display of China’s intensifying “economic nationalism,” China’s National Development and Reform Commission (NDRC) found U.S. chip maker Qualcomm Inc. in violation of China’s antimonopoly law after a yearlong investigation.⁴⁰ On February 9, Qualcomm agreed to pay \$975 million and sharply cut prices on licenses for some of its products, a penalty that is more than the total amount of antimonopoly fines given out by NDRC in 2014, according to Chinese state-run media.⁴¹

Another imminent concern for foreign ICT firms is China’s counterterrorism law, the second draft of which is under consideration by China’s National People’s Congress, and is expected to go into effect within the coming months.⁴² Reuters reports the law would require ICT firms to submit encryption keys to the Chinese government and install security “back doors,” giving credence to U.S. suspicions of China’s forthcoming ICT procurement

* The January 28 letter was signed by the following groups: American Chamber of Commerce in China; American Chamber of Commerce in Shanghai; BSA | The Software Alliance; Coalition of Services Industries, Consumer Electronics Association; Emergency Committee for American Trade; Information Technology Industry Council; National Association of Manufacturers; National Foreign Trade Council; Semiconductor Industry Association; Software and Information Industry Association; TechAmerica, powered by CompTIA; TechNet; Telecommunications Industry Association; U.S.-China Business Council; U.S. Chamber of Commerce; U.S. Council for International Business; and U.S. Information Technology Office.

policies. The initial draft of the law requires companies to keep servers and user data within China, provide communications records to law enforcement authorities, and censor terrorism-related Internet content.⁴³

In an interview, President Obama expressed deep concern over the counterterrorism provisions, which he said “would essentially force all foreign companies, including U.S. companies, to turn over to the Chinese government mechanisms where they can snoop and keep track of all the users of those services.”⁴⁴ President Obama told Reuters he raised his concerns “directly” with Chinese President Xi Jinping, asserting “they are going to have to change [their ICT policies] if they are to do business with the United States.”⁴⁵ In response, National People’s Congress spokeswoman Fu Ying said the ITC proposals in China’s draft counterterrorism law were “in accordance with the principles of China’s administrative law as well as international common practices, and won’t affect Internet firms’ reasonable interests.”⁴⁶

But the Chinese government maintains its ICT policies strengthen cybersecurity in industries it deems critical to national security. China’s Foreign Ministry spokeswoman Hua Chunying defended the policies, saying “China has consistently opposed using one’s superiority in information technology, or using IT products to support cyber surveillance.”⁴⁷ She pointed to Edward Snowden’s February allegations that operatives of the National Security Agency (NSA) and its British equivalent, Government Communications Headquarters, hacked into the internal computer network of Dutch multinational firm Gemalto, the largest manufacturer of SIM* cards in the world, stealing encryption keys that can be used to monitor mobile communications.⁴⁸ Some industry insiders charge that China uses the Snowden security concerns as a pretext for protectionist efforts to help domestic firms get a bigger slice of China’s massive ICT market.⁴⁹

Long-held U.S. suspicions about the security vulnerabilities of Chinese ICT products were recently bolstered by revelations that laptops made by Chinese computer company Lenovo come with a preinstalled program called “Superfish.” The program appears to make users vulnerable to a cyberattack known as SSL spoofing, in which remote attackers can read encrypted web traffic and redirect traffic from official websites to spoofs, among other attacks.⁵⁰ Superfish, an Israeli software company headquartered in Silicon Valley that markets itself as a visual search company, responded in a statement that the vulnerability was “inadvertently” introduced by Komodia, an Israel-based company that built the vulnerable application.⁵¹

Though no official link between the Chinese government and the Superfish vulnerabilities has been established, U.S. fears about Lenovo’s security can be traced back to 2006, when the State Department’s purchase of 16,000 Lenovo desktop computers, 900 of which were to be used on networks that handle classified government information, came under scrutiny.⁵² In response to Congressional concerns and recommendations from the U.S.-China Economic and Security Review Commission, the State Department decided to use the purchased Lenovo computers on unclassified systems only.⁵³

2015 Spring Festival Trends (Part One): The Digital and Mobile Revolution†

Even as China’s government continues to tighten restrictions on foreign suppliers of IT and online services, Chinese public increasingly uses the Internet for interactions and activities traditionally conducted offline: In 2014, the country’s total e-commerce transactions amounted to approximately \$5.3 billion, a 29.28 percent increase over the previous year. Of that total, mobile payments comprised about \$723 million, a 170.25 percent increase over the previous year.⁵⁴ Chinese leadership meanwhile has underscored the importance of this sector for the country’s future economic health. At the opening of this year’s annual NPC and CPPCC joint meetings, on March 5, Premier Li Keqiang outlined an “Internet Plus” strategy supporting e-commerce development and the expansion of other digital innovations.⁵⁵

The 2015 Spring Festival (Chinese New Year) revealed a broad digital and mobile revolution underway across China. Two prominent features of every Chinese New Year holiday—*hongbao* (“red envelopes”) and transport ticket sales—provide clear examples of this large-scale shift toward online technology.

* A subscriber identity module (SIM) is a circuit designed to securely store information to identify and authenticate mobile phone and computer users.

† In concert with the release of additional Spring Festival statistics, Part Two will be published in the April 2015 Trade Bulletin. It will detail other holiday transport, travel, and consumer trends, taking into account the full forty days surrounding Chinese New Year.

Chinese New Year traditionally involved the older generation gifting money in red envelopes to the younger generation. As early as 2004, China's banks began to offer the electronic transfer of *hongbao* funds (*e-hongbao*), but until recently the service did not attract much attention. With the confluence of major promotional campaigns by Chinese Internet companies and a rapidly expanding social networking and e-commerce user base, particularly among the post-1980s generation, *e-hongbao* experienced exponential growth. During the 2015 Spring Festival, Tencent's mobile messaging service WeChat saw its users exchange over one billion *e-hongbao*, Tencent's instant messaging client QQ registered 637 million, while Alibaba's online payment platform Alipay, 240 million, and Sina's Twitter-like service Weibo, 101 million.⁵⁶ At the same time, these companies gifted users and potential customers with *e-hongbao* containing over \$1.1 billion in cash, coupons, and shopping vouchers. Through WeChat and QQ, parent company Tencent distributed the vast majority (about \$1 billion) while Alipay gave out approximately \$95.8 million in corporate *e-hongbao*.*

The Chinese public has also made the switch en masse to online purchasing platforms for ticket sales. In 2010, the China National Railway Administration began piloting an online platform for reserving train tickets through its website 12306.cn. Two years later, it allowed customers to use UnionPay (the country's sole bank card network) to buy tickets online, and by the end of 2013, it added Alipay as an acceptable form of payment. The platform did not achieve immediate success as overloaded website traffic, frequent crashes, and illegal "ticket grabbing" software discouraged customers from abandoning offline ticket purchasing methods.⁵⁷ By the 2014 Spring Festival, however, 50 percent of train tickets were purchased online. On December 7, 2014, the China National Railway Administration opened ticket sales for the 2015 Spring Festival holiday, and in two weeks, it sold over 115 million tickets. Of these tickets, 62.81 million were purchased online, 15.6 million through a mobile application, and 1.15 million over the phone, or 54.4, 13.6, and 1 percent, respectively.⁵⁸ In Beijing, Shanghai, and Guangzhou over 70 percent of tickets were sold online, indicating a close correlation among urbanization, wealth, and e-commerce trends.⁵⁹ On December 19, the state-designated purchase day for February 16 train tickets, the 12306.cn site experienced peak traffic with 29.7 billion clicks. Of the 9.56 million tickets sold that day, 59 percent, or 5.64 million, were purchased online.⁶⁰

Spring Festival plane ticket purchases demonstrated similar trends. According to a 2015 Ctrip survey[†] of 1,331 customers in 30 cities, 80 percent intended to use online platforms to compare and purchase Chinese New Year travel products (e.g., plane tickets, hotels, group tours, insurance, etc.). In addition, 40 percent stated that they would also use mobile applications to prepare for holiday travel. Ctrip remarked that the inclination toward online and mobile technology for Spring Festival travel "far and away surpassed customers' use of traditional travel agencies." Hoping to take full advantage of this digital and mobile revolution among Chinese consumers, online travel companies followed the lead of Tencent and Alipay and employed corporate *e-hongbao* as a promotional mechanism. Over the 2015 Spring Festival holiday, Ctrip awarded customers with \$80 *hongbao* to use toward an array of travel products.⁶¹

Sector Focus: Global Impact of China's Cotton Price Controls

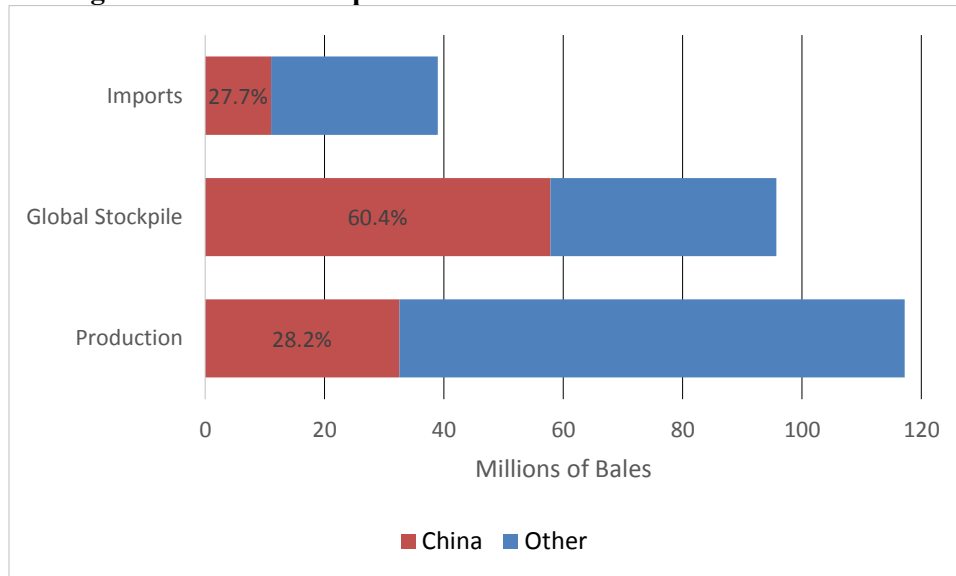
China is the world's largest producer, importer, and holder of cotton stockpiles.⁶² In the 2013-2014 crop season,[‡] China imported more than a quarter of the world's traded cotton despite producing more than 28 percent of world's cotton supply (Figure 3).⁶³ The United States, the world's largest cotton exporter, has benefited from China's price supports, sending roughly a quarter of its cotton to meet Chinese demand.⁶⁴ However, the dismantlement of its price support system, the anticipated release of its national stockpile, and reduced domestic demand in China are expected to slow U.S. cotton exports to China and lower world prices this year.⁶⁵

* For a discussion of this year's *e-hongbao* Spring Festival campaign, see the USCC Chinese Media Digest, Issue No. 6, "Digital 'Red Envelope' War Heats up during Chinese New Year," February 27, 2015. <http://www.uscc.gov/Research/chinese-media-digest-issue-no-6>. For more details on WeChat's new payment system and China's first fully online private bank, WeBank, see the USCC January 2015 Trade Bulletin. http://origin.www.uscc.gov/sites/default/files/trade_bulletins/January%202015%20Trade%20Bulletin.pdf.

† Ctrip is one of China's largest online travel agencies, controlling over 50 percent of online market share and ranking second among all Chinese travel companies in terms of revenue.

‡ The cotton crop cycle runs from August 1 to July 31 of the following year.

Figure 3: China's Composition of 2013-2014 World Cotton Markets



Source: Paul Westcott and James Hansen, USDA Agricultural Projections to 2024, U.S. Department of Agriculture (USDA Agricultural Projections No. OCE-151) February 2015. <http://ers.usda.gov/publications/oce-usda-agricultural-projections/oce151.aspx>.

Since 2011, China artificially increased global demand and raised world cotton prices by imposing a price support for domestic producers. Implemented in March 2011 by the Chinese government, this temporary price support system (Figure 4) provided a minimum guaranteed price for producers at 19,800 RMB/ton (134 cents/lb).⁶⁶ Shortly after the program was implemented, world cotton prices collapsed as global production stabilized and global stocks were replenished.⁶⁷ The resulting imbalance between low world prices and high domestic prices encouraged Chinese textile manufacturers to buy imported cotton because prices were still cheaper than buying domestic cotton despite a 40 percent import tariff. To protect their textile and clothing manufacturers, the Chinese government continued to allow foreign cotton imports while purchasing nearly all of Chinese domestic cotton production.⁶⁸ From 2011 to 2013, China imported between 14 and 24 million bales of cotton annually. This rapid increase in imports reduced global supply and prevented further falls in world cotton prices.⁶⁹

Figure 4: Monthly Price of Cotton, January 2009-January 2015 (cents/pound)

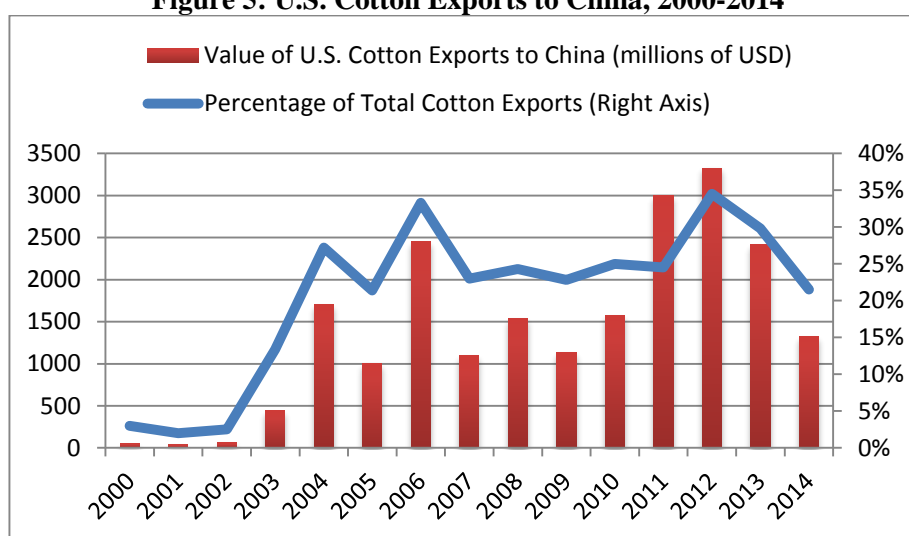


Source: National Cotton Council of America, Economics Data Center. <http://www.cotton.org/econ/prices/monthly.cfm>; Cotton Incorporated, "Issue Addendum: Policy Instruments Regulate the Market," <http://www.cottoninc.com/corporate/Market-Data/SupplyChainInsights/Chinese-Cotton-Policy/item14783.cfm>.

In 2012, the Chinese government increased its price support for cotton to 20,400 RMB/ton (150 cents/lb) despite low world prices, further exacerbating the price imbalance.⁷⁰ For example, textile manufacturers that year paid approximately 136 cents/lb with the import tariff compared with the 150 cents/lb for domestic cotton.⁷¹ As a result, the Chinese government purchased over 90 percent of total domestic production in 2013.⁷² Reluctant to sell the cotton at a loss, the government has been stockpiling the cotton, and current reserves have reached 57.8 million bales of cotton or 60.4 percent of global stockpiles in the 2013-2014 season (Figure 3 above).⁷³

U.S. cotton exporters, particularly in Texas, Georgia, and California, have benefited from the price advantage created by China's price support policy.* Due to the price support system, U.S. cotton exports to China quickly reached a record high of \$3.4 billion in 2012. These exports accounted for 35 percent of total U.S. cotton exports that year. Since then, exports to China have fallen as the Chinese government adjusted its policy to encourage Chinese textile manufacturers to purchase from domestic reserves (see Figure 5). One such domestic promotion policy is the incentivized purchase of Xinjiang-produced cotton where firms could import one ton of foreign cotton for every three tons of Xinjiang cotton purchased.⁷⁴

Figure 5: U.S. Cotton Exports to China, 2000-2014



Source: U.S. Department of Agriculture

In April 2014, the Chinese government announced it was ending its price support system, which was estimated to cost at least \$53 billion.⁷⁵ The government has shifted to a deficiency payment system, which provides subsidies to producers selling cotton below the set price.⁷⁶ This policy reduced the gap between world and domestic prices, lowering the foreign cotton price advantage. In addition, this change reflects the government's shift away from supporting energy-intensive, low profit-margin industries.⁷⁷ Growing labor costs within China are pushing textile manufacturers to move their operations to lower labor cost countries such as Vietnam.

Within China, these changes have met resistance from the largest domestic producer, the Xinjiang Production and Construction Corps (XPCC). The XPCC, which has affiliations with the Chinese government and military, produced approximately a quarter of China's cotton in 2013, accounting for roughly 6 percent of world's total production.⁷⁸ As a result, the Chinese government only reduced the target price by 3 percent from last year for Xinjiang province. In comparison, the Chinese government has provided significantly less support for cotton producers outside of Xinjiang, allowing the effective price for cotton to drop by 25 percent to align more with current world prices.⁷⁹ This disparity suggests the importance of cotton production to its stability program for the restive western province and the limits of country-wide price control reform.⁸⁰

* Texas leads with roughly 25 percent of total U.S. exports in 2013, followed by Georgia with approximately 18.6 percent, and California with 12.5 percent.

In addition, China announced it will limit imports to 4.1 million bales, a significant decrease from the 11.2 million bales imported last year.⁸¹ The National Development and Reform Commission's January action reiterated China's more restrictive import policy for this year.⁸² The government plans to meet domestic demand with either purchases of this year's production or its reserves.

The dismantling of the price support system and the introduction of import restrictions will reduce the price advantage and market access for U.S. cotton exports to China. The price-conscious textile manufacturers in China are unlikely to pay the higher prices for U.S. cotton as domestic prices continue to fall. Beyond lower exports, the profitability of U.S. cotton producers will be further squeezed by lower global demand as a direct result of China's import restrictions and excess global production as well as market pressures from falling prices of manmade fiber substitutes such as polyester.⁸³ Despite these challenges, continued demand for high-quality, machine-picked U.S. cotton will limit overall losses.⁸⁴

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Endnotes

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⁴ U.S. Department of Treasury, *Updated: U.S.-China Joint Fact Sheet Sixth Meeting of the Strategic and Economic Dialogue*, July 11, 2014. <http://www.treasury.gov/press-center/press-releases/Pages/jl2561.aspx>; U.S. Department of State, *U.S.-China Strategic and Economic Dialogue Outcomes of the Strategic Track*, July 14, 2014. <http://www.state.gov/r/pa/prs/ps/2014/07/229239.htm>.

⁵ Kevin Yao and Lesley Wroughton, "China Agrees to Reduce FX Intervention 'As Conditions Permit,'" Reuters, July 10, 2014. <http://www.reuters.com/article/2014/07/10/us-china-usa-cenbank-idUSKBN0FF0BQ20140710>.

⁶ Patrick McGee, "China's Renminbi Falls to 28-Month Low," *Financial Times*, February 27, 2015. <http://www.ft.com/intl/cms/s/0/4320050a-be43-11e4-8036-00144feab7de.html?siteedition=intl#axzz3TSBKnoEA>.

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