U.S.-China Economic and Security Review Commission
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Highlights of This Month's Edition

- **Bilateral trade:** In January 2018, the U.S. goods deficit with China grew 14.8 percent year-on-year to reach $36 billion—its highest ever for January and its highest monthly level since September 2015.
- **Bilateral policy issues:** The U.S. Department of Commerce submits its Section 232 recommendations for tariffs or quotas on U.S. steel and aluminum imports; SEC blocks acquisition of Chicago Stock Exchange by Chinese-led investor group based on concerns over transparency, oversight, and compliance with ownership limits; AmCham and USCBC surveys of U.S. businesses in China find some signs of rising optimism due to increasing profits and confidence in China's economic growth, but regulatory and market access challenges persist as firms feel increasingly unwelcome in Chinese markets.
- **Policy trends in China's economy:** In their continuing battle against financial risks, Chinese regulators maintain focus on shadow banking, issuing a series of measures to curb riskier forms of lending.
- **Sector focus – Sorghum and Soybeans:** In response to defensive U.S. trade measures, China considers duties against U.S. sorghum and soybeans, putting 67 percent of U.S. agricultural exports to China at risk.

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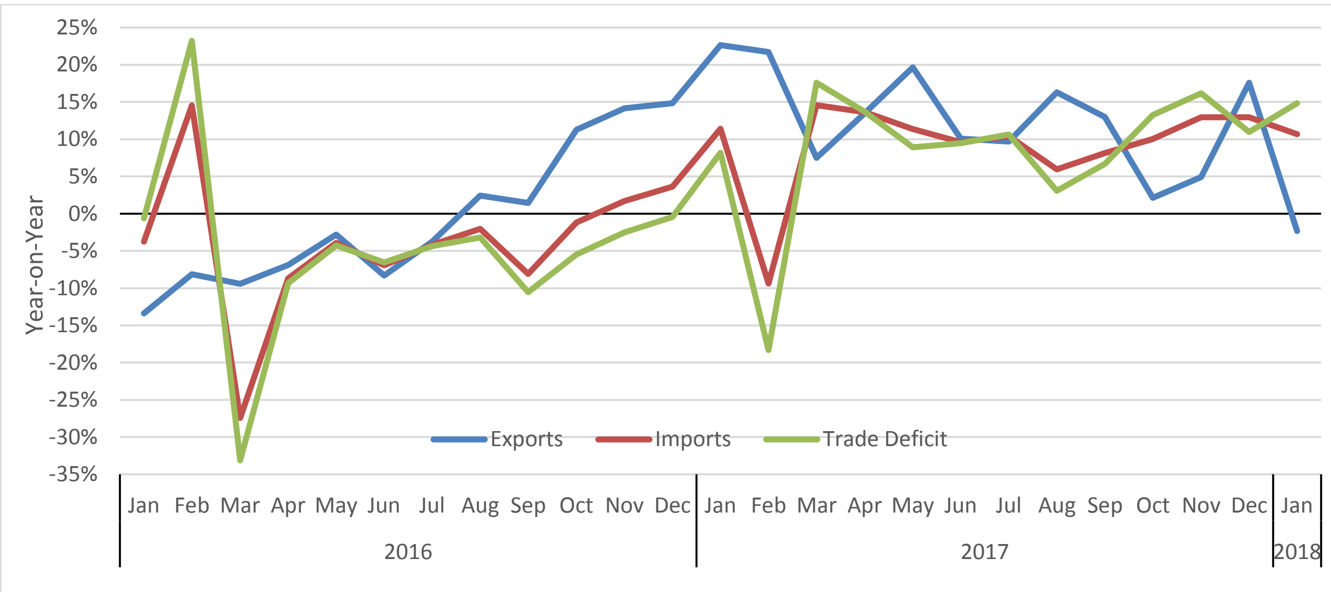
Bilateral Trade

2018 Starts with Highest Ever January U.S. Goods Deficit with China

In January 2018, the U.S. goods deficit with China grew 14.8 percent year-on-year to reach $36 billion— its highest ever for January and its highest monthly level since September 2015 (see Figure 1).[1] U.S. imports from China (largely footwear and apparel) increased 10.7 percent year-on-year, contributing to the high deficit.[2] By comparison, U.S. exports to China, which had experienced robust growth since the third quarter of 2016, fell 2.3 percent year-on-year in the first month of 2018 due to decreases in exports of civilian aircraft and aircraft-related components and soybeans.[3]

Figure 1: U.S. Goods Trade with China, January 2016–January 2018



Source: U.S. Census Bureau, "Trade in Goods with China," March 7, 2018. *https://www.census.gov/foreign-trade/balance/c5700.html*.

Bilateral Policy Issues

Section 232 Reports on Steel and Aluminum Released

On February 16, the U.S. Department of Commerce (DOC) released Section 232 reports[*] on steel and aluminum imports to the United States. As detailed in the reports, Secretary of Commerce Wilbur Ross found that steel and aluminum imports "are 'weakening our internal economy' and threaten to impair the national security as defined in Section 232."[4] Both reports proposed three possible trade policy actions to the Trump Administration. On March 1, President Donald Trump announced a 25 percent global tariff on all steel imports and a 10 percent global tariff on all aluminum imports.[5] The formal proclamations confirming these tariffs, issued by President Trump March 8, exempted Canada and Mexico, owing to the "special circumstances that exist with respect" to these countries.[6]

[*] Section 232 investigations tend to be infrequent. Between 1980 and 2017, DOC conducted 14 Section 232 investigations, most recently in 2001. One 1982 investigation resulted in an embargo on crude oil from Libya. In six cases, DOC found imports did not to threaten to impair national security. In four cases, though a threat to impair was found, no tariff or quota was implemented. In two cases, no threat to impair was found, but remedial policy initiatives were launched as a result of the investigation. In one exceptional case, the president sought and received voluntary restraint agreements from machine tool suppliers in Japan and Taiwan. Cases reviewed in: U.S. Department of Commerce, Bureau of Industry and Security, Office of Technology Evaluation, *Section 232 Investigations Program Guide: The Effects on National Security*, June 2007. *https://www.bis.doc.gov/index.php/forms-documents/section-232-investigations/86-section-232-booklet/file*.

Under Section 232 of the 1962 Trade Expansion Act, the secretary of commerce can investigate any product to determine whether it "is being imported into the United States in such quantities or under such circumstances as to threaten to impair the national security."[7] At the investigation's conclusion, the secretary of commerce submits a report with recommendations for review by the president. Section 232 states the secretary of commerce must consider domestic production requirements for defense, industry capacity to meet those requirements, available raw materials, and human resources. It also states the secretary and the president must consider foreign competition's impact on "economic welfare of individual domestic industries" and any resulting decrease in employment, government revenue, skills, investment, or other effect on domestic production.[8]

To lay out the considerations for steel and aluminum, the current Section 232 investigations undertook two tasks: (I) review the product's national security implications and any industry changes resulting from foreign imports, and (II) propose recommendations for any impact found.

I. Findings of the reports: imported steel and aluminum quantities threaten to impair national security

DOC found imports of steel and aluminum were "weakening our internal economy" and threatened to impair national security.[9] The report on steel cited a "large and ongoing" need for steel in weapons production, as well as in industries classified as "critical to minimum operations of the economy and government."[10] The report on aluminum similarly marked aluminum as a key component of ground systems and weapons, aircraft, and space and naval applications, as well as critical electrical and transportation infrastructure.[11]

Both reports detailed foreign imports' adverse impact on the U.S. steel and aluminum industries:

- *The United States' high share of imports:* The share of steel imports stood at about 30 percent of U.S. domestic consumption in 2017.[12] The share of aluminum imports now stands at nearly 90 percent of domestic consumption.[13]
- *Product prices:* Domestic steel prices are depressed relative to their 2010–2013 levels, and global overproduction has weakened U.S. steel producers' price competitiveness in other markets.[14] The price of aluminum also fell due to international oversupply between 2011 and 2016, prompting closures in U.S. smelters.[15]
- *Facility closures:* Steel manufacturing capacity has fallen since 2000, including a 25 percent decline in blast furnace production.[16] Between 2012 and 2018, six aluminum smelters were permanently closed, removing 1.1 million metric tons (MT) of production capacity.[17]
- *Falling employment:* The steel industry shed around 14,100 jobs between 2015 and 2016.[18] The aluminum industry has lost about 3,500 jobs since 2012.[19]
- *Loss of bidding opportunities:* The Alliance for American Manufacturing's testimony at the Congressional Steel Caucus pointed to three New York infrastructure projects relying on subsidized imported steel.[20] Boston and Chicago have also accepted subway car bids from Chinese companies utilizing imported steel.[21]
- *Financial distress:* As reported by the DOC steel investigation, the U.S. industry has maintained a negative average annual net income from 2009 to 2016.[22] In aluminum, the two remaining domestic producers also maintained negative average annual net income between 2012 and 2016.[23]

In assessing the cause of the decline of U.S. steel and aluminum industries, both Section 232 reports point to steel and aluminum supply gluts resulting from substantial foreign government subsidies. DOC found China produced about 50 percent of global steel and 55 percent of global aluminum in 2015.[24] China's steel output represented only about 73 percent of its production capacity in 2015, which stood at 1.1 billion MT, according to official data.[*] Though China's National Development and Reform Commission (NDRC) announced the steel industry had achieved its target of cutting 45 million MT in 2016, Greenpeace reported that most cuts were made at idle plants.[25] Similarly, subsidies have allowed Chinese aluminum producers to expand despite falling prices. For example, with

[*] For further information on China's overcapacity in steel, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, March 7, 2017, 4. *https://www.uscc.gov/sites/default/files/Research/March%202017%20Trade%20Bulletin.pdf*.

government support, Chinese aluminum producers increased capacity by about 243 percent from 2007 to 2015 during a global price decline of 46 percent.[26]

II. Recommended courses of action

Based on DOC's findings, Secretary Ross recommended several options on which the Trump Administration could choose to act or not act (see Table 1). These recommendations would be in addition to any antidumping or countervailing duties currently applied. The tariffs and quotas are intended to enable U.S. steel and aluminum producers to operate at about 80 percent of production capacity.[27]

Table 1: DOC Section 232 Report Recommendations

Recommendation	Steel	Aluminum
(1) Global Tariff	24.0%	7.7%
(2) Global Quota	63.0%	86.7%
(3) Tariff on a Subset of Countries	53.0%	23.6%
Country Subset	Brazil, China, Costa Rica, Egypt, India, Malaysia, Russia, South Africa, South Korea, Thailand, Turkey, and Vietnam	China, Hong Kong, Russia, Venezuela, and Vietnam

Source: U.S. Department of Commerce, Bureau of Industry and Security, Office of Technology Evaluation, *The Effect of Imports of Steel on the National Security*, January 11, 2018, 58-60; U.S. Department of Commerce, Bureau of Industry and Security, Office of Technology Evaluation, *The Effect of Imports of Aluminum on the National Security*, January 17, 2018, 107-109.

These tariffs or quotas would be applied to the following product categories, though an exclusions process may be run in the future to limit the measure to more specific products:

- *Steel mill products:* (a) carbon and alloy flat products, (b) carbon and alloy long products, (c) carbon and alloy pipe and tube products, (d) carbon and alloy semifinished products, and (e) stainless products.
- *Aluminum products:* (a) unwrought aluminum; (b) aluminum castings and forgings; (c) aluminum plate, sheet, strip, and foil; (d) aluminum wire; (e) aluminum bars, rods, and profiles; (f) aluminum tubes and pipes; and (g) aluminum tube and pipe fittings.

If any recommendation is adopted, DOC recommended the president establish an appeals process for companies to petition for product- or country-specific exclusions to the tariff or quota. For consideration, companies must demonstrate a lack of comparable U.S. product supply or a specific national security concern.[28] Details on an appeals process have not yet been released.

There is significant debate among observers regarding the impact of the proposed measures on U.S. domestic industries. Some have welcomed tougher actions. For example, the American Iron and Steel Institute issued a statement on March 1 applauding the president for his desire to strengthen the domestic industry.[29] While the Aluminum Association initially advised against measures affecting critical trading partners, it also expressed appreciation for the president's support of the sector.[30] Richard Trumka, president of ALF-CIO, the largest federation of unions in the United States, called the tariffs, "a great first step toward addressing trade cheating."[31]

Others have expressed concerns regarding the international reaction to the proposed measures. For example, Secretary of Defense James Mattis cautioned against applying a global tariff given its negative impact on key U.S. allies.[32] The Business Roundtable responded similarly to the Administration's initial announcement, stating: "We urge the President to pursue other approaches that target unfair traders without putting various parts of the economy at such high risk."[33] The Automotive Association, representing Fiat Chrysler, Ford Motor Co., and General Motors, echoed this sentiment: "We are concerned with the unintended consequences the proposals would have, particularly that it will lead to higher prices for steel and aluminum here in the United States."[34]

Any tariff or quota may also prompt retaliatory measures or cases brought against the United States at the World Trade Organization (WTO). Trade ministers from Canada, South Korea, Japan, and the EU have expressed their concern.[35] Jean Claude Juncker, president of the European Commission, noted that far from the national security justification, the policy appeared intended purely as a domestic industry protection, saying, "The [European] Commission will bring forward ... a proposal for WTO-compatible countermeasures against the [United States]."[36] Canadian Prime Minister Justin Trudeau also questioned the national security measure, calling it "a little bit silly," as Canada is a Five Eyes partner and close ally on a broad range of defense issues.[37] American Economic Institute resident scholar Derek Scissors suggested U.S. agricultural and aircraft exports could be targeted.[38] China's Commerce Ministry has already announced an antidumping and antisubsidy investigation into U.S. sorghum imports (see this issue's Sector Focus), and warned that U.S. soybean exports could also be targeted.[39]

The Securities and Exchange Commission Rejects Chicago Stock Exchange Acquisition, Citing Transparency Concerns

On February 15, 2018, the Securities and Exchange Commission (SEC) voted unanimously to reject the sale of the Chicago Stock Exchange (CHX)—which makes up less than 1 percent of all U.S. stock transactions—to an investor consortium led by a Chinese firm.[40] The Committee on Foreign Investment in the United States (CFIUS) reviewed the bid in 2016 and found "no unresolved national security concerns."[41] The SEC ultimately blocked the deal on the grounds that CHX Holdings had not met its burden to demonstrate compliance with ownership and voting limitations, also expressing concerns about its ability to conduct continuous monitoring and oversight were the deal to go through.[42]

CHX announced on February 5, 2016, that it would be acquired by an investor group led by Chongqing Casin Enterprise Group, a privately owned Chinese company that focuses on investments in real estate development and financial holdings.[43] The participation of Chinese investors prompted Members of Congress to write multiple letters to CFIUS and the SEC, citing lack of transparency as a major obstacle, particularly with regard to assessing the level of Chinese state influence over the firm, monitoring, and enforcement.[44] For example, a February 16, 2016, letter from 46 Members of Congress to CFIUS noted that Chongqing Casin "is involved in a number of important Chinese sectors that would likely require close ties to the state," and characterized the company's chairman, Shengju Lu, as occupying "a seat on an important industry committee overseen directly by the mayor of the Chongqing Municipality."[*] [45]

In August 2017, just after its staff had approved the transaction, the SEC put a hold on the decision for further review.[46] According to the SEC, requests for information pertaining to the proposed upstream owners continuously raised additional questions, leading the SEC to conclude it could not determine the nature of the relationship between several of the purportedly unrelated members of the investor group. In particular, the SEC discovered evidence suggesting previously undisclosed financial links between Chongqing Casin and three other investors: U.S.-based Xian Tong Enterprises and Chinese firms Chongqing Longshang and Chongqing Jintian. After SEC staff requested information to clarify the nature of these linkages, these three investors withdrew from the transaction.[47]

The final makeup of the investor consortium then consisted of:

- **NA Casin Group:** An entity incorporated in Delaware, wholly owned by Chongqing Casin (29 percent ownership).
- **Castle YAC Enterprises, LLC:** An entity organized in New York, the sole member of which is Jay Lu. Mr. Lu is a U.S. citizen, vice president of NA Casin Group, and son of Shengju Lu (11 percent ownership).
- **Raptor, LLC:** An entity organized in Delaware, owned by Jim Pallotta (25 percent ownership).

[*] Shengju Lu's Baidu Baike (a Chinese equivalent of Wikipedia) page lists him as a member of both the Chinese Communist Party and the Chongqing Federation of Industry and Commerce Standing Committee, the regional branch of the All-China Federation of Industry and Commerce (ACFIC). ACFIC is a chamber of commerce under the leadership of the Chinese Communist Party, linking the Party and government with nonpublic economic activities as a part of the Party's united front work. Baidu Baike, "Shengju Lu" *https://baike.baidu.com/item/卢生举*; All-China Federation of Industry and Commerce, "About Us." *https://www.chinachamber.org.cn/About_Us/*.

- **Saliba, LLC:** An entity organized in Illinois, owned by Anthony Saliba (24.5 percent ownership).
- **Five members of the CHX Holdings management team:** All five members are U.S. citizens (collectively, 8.32 percent ownership; individually, no more than 5 percent).
- **Penserra, LLC:** A trading, investment banking, and asset management company organized in New York (2.18 percent ownership).[48]

According to the SEC, concerns about other potential inaccuracies in the proposal were exacerbated by the fact that NA Casin and Castle YAC collectively continued to hold the largest stake in the investment, and that Raptor, Saliba, and Penserra held put agreements that "heighten potential for circumvention of the ownership limitations."[*] The structure of the deal led the SEC to suspect that control of the exchange would "as a practical matter be dominated by those entities that appear to be bearing the bulk of the risk of equity ownership"—that is, Chongqing Casin and its related entities.[49]

The lengthy and ultimately unsuccessful attempts to acquire sufficient information about the relevant owners also suggested to the SEC that ongoing monitoring and enforcement would have been untenable. The SEC also asserted that, although the only remaining foreign upstream owner—Chongqing Casin—had submitted to U.S. jurisdiction and pledged to maintain relevant books and records in the United States, this was insufficient for ensuring the SEC's ability to access all relevant documentation and properly conduct oversight.[50]

Finally, the SEC noted the concerns raised about possible Chinese state influence over Chongqing Casin. The SEC concluded that because the burden of proof necessary for approval was not met for the aforementioned reasons, it was not necessary "to consider either the relevance of such foreign investment concerns ... or the merits of the concerns themselves."[51]

AmCham China, USCBC Surveys Find Cautious Optimism, Lingering Concerns among U.S. Businesses Operating in China

American Chamber of Commerce in China Releases *2018 Business Climate Survey Report*

In January 2018, the American Chamber of Commerce (AmCham) in China released its *2018 China Business Climate Survey Report*, which found growing optimism about China's economic situation among U.S. companies doing business in China. However, the report also highlighted the businesses' lingering concerns over China's online censorship, unclear or unfair business regulations, and rising labor costs. These regulatory barriers have led U.S. firms to feel unwelcome in China, with 75 percent reporting feeling less welcome in 2017, compared to 81 percent in 2016.[52] The following are some of the key findings from the survey:[†]

- *Strengthening confidence in China's economy:* More than half of respondents estimated their industry will grow more than 5 percent in 2018, with the respondents on average predicting 6.3 percent gross domestic product (GDP) growth. This marks a slight increase from the 2017 survey, when respondents predicted 6.1 percent growth.[‡] [53] Businesses operating in technology and other research and development (R&D)-intensive industries are the most optimistic about their growth prospects; 64 percent of tech firms saw a rise

[*] A put agreement gives the owner the right, but not the obligation, to sell a specified amount of an underlying security at a specified price within a specified time. The put agreements gave Saliba, Raptor, and Penserra the right to sell their shares after 24 months for a guaranteed return on their investment. Consequently, those firms appeared to the SEC to be taking "minimal economic risk." The SEC noted that put agreements in similar acquisitions did not provide a guaranteed return on the initial purchase price, concluding that although there may be "reasonable business purposes for the premium guaranteed by the terms of the Put Agreements ... neither the Exchange nor the proposed upstream owners have sufficiently explained what those purposes are." Investopedia, "Put Option." *https://www.investopedia.com/terms/p/putoption.asp*; U.S. Securities and Exchange Commission, *Self-Regulatory Organizations; Chicago Exchange, Inc.; Order Setting Aside Action by Delegated Authority and Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and No. 2, Regarding the Acquisition of CHX Holdings, Inc. by North America Casin Holdings, Inc.*, February 15, 2018, 28–29. *https://www.sec.gov/rules/sro/chx/2018/34-82727.pdf*.

[†] AmCham China asked a total of 849 companies, out of which 411 responded in whole or in part. American Chamber of Commerce in the People's Republic of China, "2018 China Business Climate Survey Report," January 2018, 12.

[‡] In January 2018, China's National Bureau of Statistics announced that China's economy grew 6.9 percent in 2017. China's National Bureau of Statistics via CEIC database.

in China-based revenue in 2017, and 77 percent expect industry market growth in China to reach or exceed 5 percent in 2018.[54]

- *Increased revenue and profits:* U.S. firms' revenue growth hit its highest level since 2014, with 64 percent reporting a rise in revenue and only 7 percent seeing a revenue decline (a record low).[55] Overall profitability also rose for the second year in a row, with 73 percent of respondents describing 2017 as a profitable or very profitable year in China.[56] Large employers (defined as businesses with more than 250 employees) were the most profitable, with 83 percent reporting a net profit for the year, compared to 57 percent for small employers.[57]
- *Improving investment environment:* Thirty-five percent of respondents indicated the investment environment in China improved in 2017, up from 24 percent in 2016.[58] Firms planning to decrease investment growth in China in 2018 cited rising business and labor costs (25 percent of respondents) and expectations of slower growth (22 percent of respondents) as the number one and number two reasons, respectively, that they plan to slow their investment growth in China.[59]
- *Challenges remain in intellectual property (IP) protection:* Although respondents reported encountering fewer innovation barriers in general in 2017, insufficient IP protection, restrictive data security-related policies, and insufficient talent remain key challenges for U.S. firms operating in China.[60] Fifty-two respondents reported that IP and data security threats are greater in China than in other regions where they operate.[61] Insufficient IP regulations ranked the highest of all IP challenges firms face in China (selected by 25 percent of respondents).[62]
- *Concerns over censorship and online content:* Eighty-two percent of respondents said internet censorship either extremely or somewhat negatively impacted their firm's competitiveness in China in 2017. Moreover, 88 percent said cross-border internet access via virtual private networks (VPNs) negatively impacted their firm's competitiveness in China, while 81 percent said Chinese cybersecurity laws had detrimental impacts on business.[63] At the end of March 2018, China will begin to enforce new restrictions that ban all overseas VPNs not licensed by the Chinese government. The move has sparked concern in the United States, which warned the WTO that the measure will disrupt cross-border corporate communications in China and increase business costs.[64]
- *Business challenges:* Inconsistent and unclear regulations, rising labor costs, and regulatory compliance risks top the list of business challenges in China (see Table 2).[65] Despite rising optimism about the prospects of business growth in China, businesses' concerns around these top issues have only grown in recent years. More than half of respondents indicated that restrictions on market participation and uneven enforcement of rules and regulations provide local competitors with favorable treatment compared to foreign companies, a sentiment that is shared across all sectors of the economy.[66]

Table 2: Top Five Business Challenges in China for U.S. Firms, 2014–2018

2014	2015	2016	2017	2018
Labor costs: 46%	Labor costs: 61%	Inconsistent regulatory interpretation and unclear laws: 57%	Inconsistent regulatory interpretation and unclear laws: 58%	Inconsistent regulatory interpretation and unclear laws: 60%
Inconsistent regulatory interpretation and unclear laws: 39%	Inconsistent regulatory interpretation and unclear laws: 47%	Labor costs: 54%	Labor costs: 58%	Labor costs: 56%

Shortage of qualified employees: 37%	Shortage of qualified employees: 42%	Obtaining required licenses: 29%	Chinese protectionism: 32%	Regulatory compliance risks: 37%
Shortage of qualified management: 31%	Shortage of qualified management: 32%	Shortage of qualified employees: 29%	Shortage of qualified management: 30%	Shortage of qualified employees: 32%
Obtaining required licenses: 31%	Increasing Chinese protectionism: 30%	Industry overcapacity: 29%	Obtaining required licenses: 29%	Chinese protectionism: 32%

Source: American Chamber of Commerce in the People's Republic of China, "2018 China Business Climate Survey Report," January 2018, 40.

U.S.-China Business Council *Business Environment Member Survey*

The U.S.-China Business Council (USCBC) *2017 Member Survey* highlighted two main conclusions: U.S. businesses' sale performance and profitability in China improved in 2017, but companies are less optimistic about the business environment in 2018 due to the uncertain policy environment and continued regulatory barriers.[67] According to the survey, 75 percent of respondents expect sales performance in China to increase in 2018, up from 62 percent in 2017. That optimism comes after a strong 2017, in which 40 percent of USCBC respondents saw double-digit sales growth in China. However, U.S. businesses' optimism about China's business climate has dropped 40 percent since 2015, with the three largest challenges for U.S. firms operating in China including (1) competition with Chinese companies, (2) licenses and approvals, and (3) investment barriers.[68]

Competition with Chinese firms has been the number one issue identified in the USCBC survey every year since 2014. State-owned enterprises (SOEs) in particular benefit from government support, with respondents citing preferential government financing (63 percent of respondents), preferential licensing and approval (58 percent of respondents), and preferential access to government contracts (53 percent of respondents) for SOEs as a top challenge of operating in China. In addition, half of respondents reported that privately-owned Chinese competitors receive government benefits not available to foreign firms.[69]

Technology transfer requirements remain a significant cost associated with entry into the Chinese market. Although only 19 percent of respondents reported being directly asked to transfer technology to China, 30 percent of those firms agreed to transfer their technology. In some cases, the agreement to transfer technology was made in return for an acceptable licensing fee paid to the company. Other firms, however, had to choose between withdrawing from the proposed transaction or transferring their technology without commensurate payment. In cases where technology transfer was requested, the Chinese corporation involved in the transaction asked for the technology transfer 67 percent of the time, China's central government asked 33 percent of the time, and a local Chinese government entity asked 25 percent of the time.[*] [70]

Although 48 percent of U.S. companies expect to expand their investments in China in 2018, the survey indicates that these projects are largely focused on expanding current facilities rather than investing in new facilities.[71] Factors contributing to firms' unwillingness to invest in new China projects include increasing market access restrictions, the availability of superior business prospects in markets outside China, and competition from domestic companies. Moreover, the survey reveals that China's uncertain policy environment—which 36 percent of respondents viewed as worse than other emerging markets—has undermined investors' confidence in China.[72]

[*] In some cases, more than one party (i.e., a corporation or government representative) involved in the transaction requested the technology transfer, which leads the total to exceed 100 percent.

Policy Trends in China's Economy

China's Financial Regulatory Crackdown Continues

At the annual session of China's legislature on March 5, Chinese Premier Li Keqiang announced an annual growth target of "about 6.5 percent," unchanged from the previous year, signaling that Chinese leaders will continue to prioritize economic growth.[73] Premier Li called for "reasonable" credit expansion while noting the government's resolve to control debt expansion.[74] Chinese policymakers face a difficult balancing act in their campaign to deleverage and de-risk the country's financial system: "If [they] want to maintain growth, they have to boost government investment, which would run counter to their deleveraging efforts," said Larry Hu, China economist at Macquarie Group.[75] There is recognition within the Chinese government that the country cannot cut debt levels or stop relying on bank financing without hurting growth. Beijing has opted to place less emphasis on deleveraging, seeking instead to control the growth of debt rather than cut the overall stock.[76]

In their battle against financial risks, Chinese regulators are focusing on the country's massive shadow banking sector. Since early 2017, Chinese regulators have issued a series of measures to curb off-balance-sheet lending and adopt more rigorous risk controls.[77] Notably, Chinese financial regulators published sweeping draft rules last November targeting the country's $15 trillion asset management market, to be fully implemented in mid-2019.[*] [78] Under the rules, financial institutions are prohibited from guaranteeing a rate of return on wealth management products[†] (WMPs); instead, investment yields must reflect the risks and returns of the underlying assets.[79] In addition, financial institutions will be required to set aside 10 percent of their management fee income from asset management products as risk reserves, and will be barred from acting as intermediaries to help other financial institutions bypass regulatory requirements and funnel money into higher-risk investments.[80] According to David Yin, a senior analyst at Moody's, "The [rules] will reduce the scope for regulatory arbitrage and the economic incentives beyond shadow banking practices."[81] China's commercial lenders have lobbied to soften or delay implementing the regulations.[82] Small and medium-sized banks—which rely on wealth management product sales to raise funds—are concerned the new financial regulations will make it harder for them to raise money and potentially face a liquidity crunch.[83]

In January 2018, the China Banking Regulatory Commission clamped down on the entrusted loans market,[‡] issuing regulations preventing banks from guaranteeing entrusted loans and prohibiting borrowing companies from using entrusted loans to purchase equities, bonds, or derivatives.[84]

These measures appear to have curbed riskier forms of lending. The growth of WMPs—the largest component of shadow banking—slowed in 2017. The outstanding balance of banking WMPs grew just 1.7 percent year-on-year in 2017, compared with a 24 percent increase in 2016 from the year before.[85] In January 2018, Chinese banks issued a record $461 billion (renminbi [RMB] 2.9 trillion) in new loans, up 43 percent from a year earlier.[86] Overall credit growth, however, slowed. Total social financing, a broad measure of credit that includes bank loans and off-balance-sheet financing, reached $483.6 billion (RMB 3.1 trillion) in January 2018, a 17 percent year-on-year decline.[87] According to analysts, the divergence between January's new loan and total social financing data reflects a shift from off-balance-sheet loans to traditional lending as a result of the government's crackdown on shadow banking, rather than reflecting a new round of government stimulus.[88]

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[*] The rules are going through final amendments and are expected to be finalized in March 2018. Wu Hongyuran and Leng Cheng, "Tough Rules to Tame Asset-Management Industry Coming Soon," *Caixin*, February 20, 2018. *https://www.caixinglobal.com/2018-02-20/tough-rules-to-tame-asset-management-industry-coming-soon-101211681.html*.

[†] In China, WMPs are short-term investments that banks market to investors as higher-yielding alternatives to standard bank deposits. A WMP typically contains financial assets—such as bonds, loans, and stocks—that carry different risks, but provides limited information on the composition and the value of the underlying assets. Emily Perry and Florian Weltewitz, "Wealth Management Products in China," *Reserve Bank of Australia*, June 2015. *https://www.rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615-7.pdf*.

[‡] Entrusted loans are a type of intercompany financing, where a bank acts as an intermediary for a fee. In China, banks that guarantee such loans do not disclose that liability on their balance sheet and are not constrained by loan-to-deposit rules or capital adequacy measures. Don Weinland, "China Shadow Bank Clampdown Eyes $2 Trillion of Entrusted Loans," *Financial Times*, January 8, 2018. *https://www.ft.com/content/da246038-f43f-11e7-88f7-5465a6ce1a00*.

In addition, Beijing has tightened scrutiny of local government spending on infrastructure projects. In November 2017, China's Ministry of Finance issued criteria for provincial finance bureaus to identify and remove "unqualified" public-private partnership (PPP) projects from the official PPP registration system and tightened rules for approving new PPP projects.[*] [89] These measures have led to the suspension of multiple subway projects, including two separate $4 billion subway projects in Inner Mongolia.[90] Analysts believe these and other measures aimed at containing local government borrowing could help slow debt growth this year, which in turn could result in weaker economic expansion.[91]

Sector Focus: China Launches Probe on U.S. Sorghum Imports, Considers Trade Action on U.S. Soybeans

In apparent retaliation against U.S. defensive trade measures, China's Ministry of Commerce announced on February 4 that it had begun a year-long countervailing duty probe against U.S. sorghum imports, citing "preliminary evidence" that sorghum production in the United States receives government subsidies.[†] China's Ministry of Commerce asserted imports of U.S. sorghum have harmed Chinese producers by decreasing the price of similar grain products in China.

Since 2009, China has been the United States' largest or second-largest agricultural market.[92] While sorghum exports account for only about 4 percent of U.S. agricultural exports to China, U.S. sorghum farmers are heavily dependent on China as an export market, making them particularly vulnerable to Chinese retaliation.[93] Since 2014, China has been the largest market for U.S. sorghum exports; at their peak in 2015, exports to China accounted for 92 percent of all U.S. sorghum exports (see Figure 2).[94]

China's position as the world's largest importer of sorghum makes it difficult for U.S. exporters to diversify to other markets. In 2016, China accounted for 74 percent of global imports of sorghum.[95] The relatively small size of the U.S. domestic market would also preclude U.S. farmers from transitioning to domestic buyers. In 2016, 83 percent of all sorghum produced in the United States was exported.[96] The prospect of Chinese tariffs on U.S. sorghum prompted a 9.9 percent drop in domestic sorghum prices in the week following China's announcement.[97]

China has applied duties against U.S. agricultural products before. For example, in January 2017, China imposed antidumping duties of 42 to 54 percent against U.S. distillers dried grains (DDGs).[‡] According to the Renewable Fuels Association (which represents U.S. ethanol firms), these duties caused U.S. DDG exports to China to collapse, falling 89 percent year-on-year in 2017.[§]

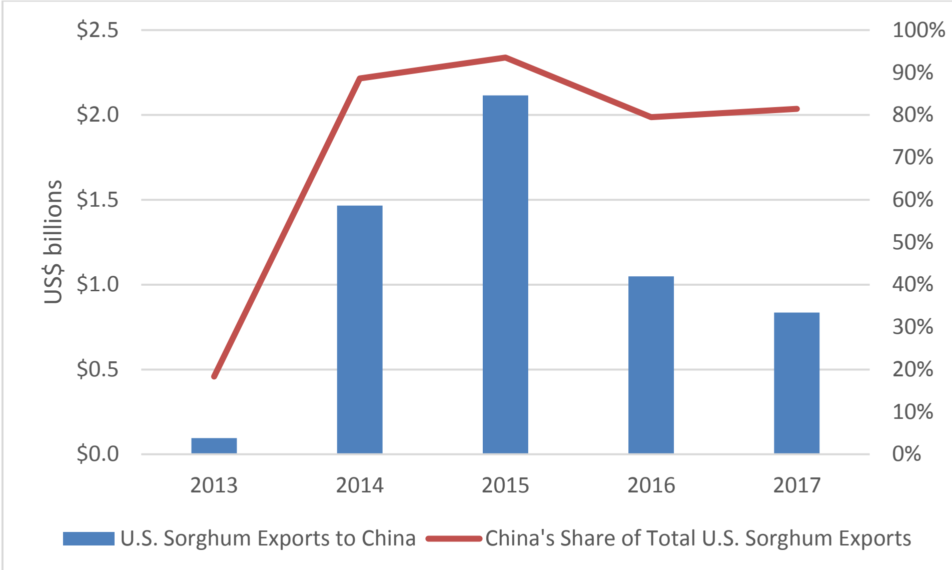
[*] While Beijing has promoted PPPs for infrastructure projects as a way to increase capital investment while easing the burden on debt-strapped local governments, the rapid expansion of PPP projects has raised concerns that some local governments are using PPPs and government investment funds as "disguised channels" for raising debt. Yawen Chen and Ryan Woo, "China Overhauls $2.69 Trillion Public-Private Projects as Debt Fears Rise," *Reuters*, November 16, 2017. *https://www.reuters.com/article/us-china-economy-ppp/china-overhauls-2-69-trillion-public-private-projects-as-debt-fears-rise-idUSKBN1DH0DE*; Kevin Yao, "China Vows to Curb Rise in Local Government Debt via 'Disguised Channels,'" *Reuters*, July 28, 2017. *https://www.reuters.com/article/us-china-economy-debt/china-vows-to-curb-rise-in-local-govt-debt-via-disguised-channels-idUSKBN1AD1AM*.

[†] The Chinese government did not elaborate on the nature of these subsidies or its evidence. According to the United States' most recent subsidy submission to the WTO, in 2014 the United States provided $139 million in support for sorghum production, $138 million of which consisted of crop insurance premium subsidies. This support equaled roughly 8 percent of sorghum production in the United States by value. Ministry of Commerce of the People's Republic of China, *MOFCOM Announcement No. 13 of 2018 on Countervailing Investigation against Imports of Grain Sorghum Originating in the United States*, February 4, 2018. *http://english.mofcom.gov.cn/article/policyrelease/buwei/201802/20180202710853.shtml*; Office of the United States Trade Representative, *Notification 109 – Domestic Support*, January 19, 2017. *https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-DP.aspx?language=E&HasEnglishRecord=True&HasFrenchRecord=True&HasSpanishRecord=True&CatalogueIdList=234231,234232,234152,234174,234128,234901,233917,233918,233786,228954&CurrentCatalogueIdIndex=6&FullTextHash=-1887872463#*.

[‡] DDGs are byproducts from brewing and ethanol production. These byproducts are commonly sold as animal feed. *Inside U.S. Trade's China Trade Extra*, "Ethanol Industry Slams Chinese Grain Duties as Exports Plummet," February 22, 2018. *https://chinatradeextra.com/daily-news/ethanol-industry-slams-chinese-grain-duties-exports-plummet*.

[§] In 2016, China was the United States' largest export market for DDGs, accounting for 51 percent of all U.S. DDG exports. In 2017, following the imposition of duties, China accounted for only 3 percent of U.S. DDG exports. Renewable Fuels Association, "2017 U.S. Distillers Grains Exports and Imports Statistical Summary," 2018. *http://www.ethanolrfa.org/wp-content/uploads/2018/02/2017-U.S.-Distillers-Grains-Trade-Statistics-Summary_PDF.pdf*.

Figure 2: U.S. Sorghum Exports to China, 2013–2017



Source: U.S. Department of Agriculture Foreign Agricultural Service, *Data Analytics*. *https://apps.fas.usda.gov/gats/default.aspx*.

U.S. government officials and economic analysts interpret China's probe into U.S. sorghum as retaliation for recent U.S. trade actions affecting China, including the January 2018 duties on washing machines and solar panels,* the ongoing Section 301 probe into Chinese technology transfer policy and intellectual property right violations, and the recently announced tariffs on steel and aluminum, a measure designed to defend against Chinese excess capacity in these sectors.[98] Chad Bown, a senior fellow at the Peterson Institute for International Economics, noted that the timing of China's probe indicated the probe was likely an effort by the Chinese government to send a message that it is prepared to retaliate against the United States.[99] U.S. Secretary of Agriculture Sonny Perdue told Congress China's probe was a reaction to U.S. trade actions and highlighted the susceptibility of the United States' agricultural sector to foreign trade barriers.[100]

According to AmCham China, prior to Beijing's probe into U.S. sorghum, Chinese officials reportedly warned they would respond to U.S. trade action by imposing market restrictions.[101] A member of AmCham China's leadership predicted China would target the U.S. agricultural sector.[102] Chinese state-affiliated media have proposed restricting access to China's agricultural market as a reprisal measure against the United States.[103] China has a history of imposing restrictions on food and agricultural products as a punitive measure against other countries, including placing duties on U.S. chicken parts in response to U.S. safeguard duties on Chinese tires, restricting imports of Norwegian salmon following the selection of Chinese dissident Liu Xiaobo for a Nobel Peace Prize, and blocking Philippine banana exports during China's confrontation with the Philippines over territorial claims in the South China Sea.[104]

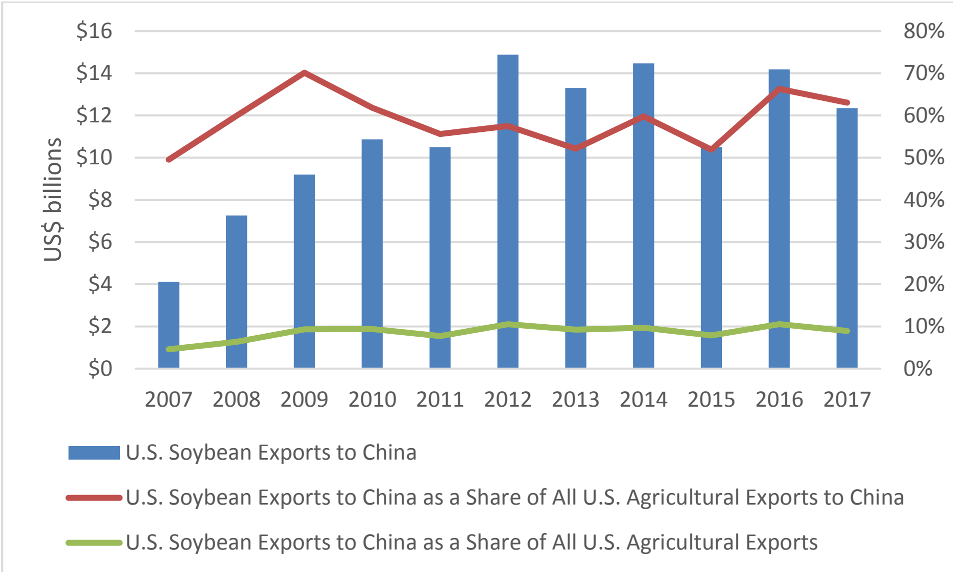
According to several news outlets, Chinese officials are reportedly also considering imposing duties on U.S. soybeans exports, the largest component of U.S. agricultural exports to China.[105] In February, China's Ministry of Commerce held a meeting with Chinese companies that would be affected by trade measures against U.S. soybeans—such as soybean crushers, processors, and importers—to evaluate the implications of restricting market access.[106]

Soybeans represent the lion's share of U.S. agriculture exports to China.[107] In 2017, U.S. soybean exports to China accounted for more than $12 billion, roughly 63 percent of all U.S. agriculture exports to China (see Figure 3).[108]

* In January 2018, the United States imposed duties on solar panels and washing machines. Chinese subsidies for solar panels have been cited by the Administration as harming U.S. solar production firms. David Lynch, "Trump Imposes Tariffs on Solar Panels and Washing Machines in First Major Trade Action of 2018," *Washington Post*, January 22, 2018. *https://www.washingtonpost.com/news/wonk/wp/2018/01/22/trump-imposes-tariffs-on-solar-panels-and-washing-machines-in-first-major-trade-action/?utm_term=.1a2fe7d7b54e*.

Soybeans have accounted for a majority of U.S. agricultural exports to China since 2008.[109] In 2017, U.S. soybean exports to China accounted for almost 9 percent of all U.S. agriculture exports to the world.[110]

Figure 3: U.S. Soybean Exports to China, 2007–2017



Source: U.S. Department of Agriculture Foreign Agricultural Service, *Data Analytics*. *https://apps.fas.usda.gov/gats/default.aspx.*

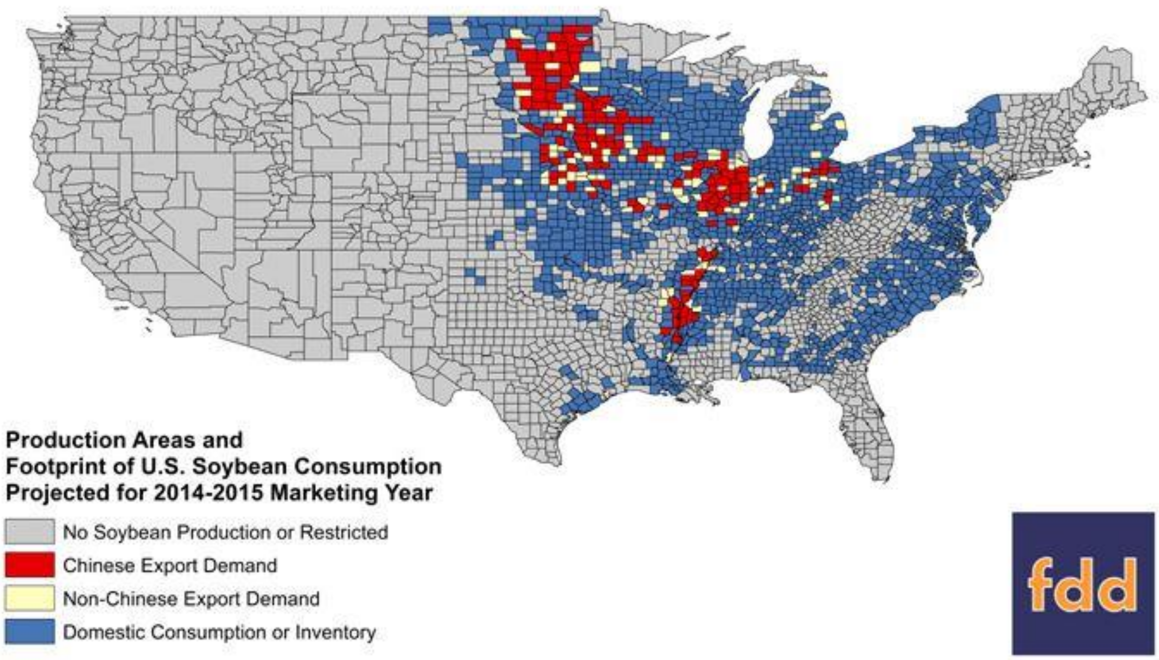
China is the world's largest importer of soybeans (in 2016 it accounted for 63 percent of all soybean imports in the world), which would make it difficult for U.S. firms to transition to other markets.[111] Given the value of U.S. soybean exports to China, Chinese duties would impose large costs on U.S. farmers. In 2017, China accounted for 57 percent of all U.S. soybean exports, and roughly a third of all soybeans grown in the United States were exported to China by value.[112] According to John Newton, professor of agricultural economics at University of Illinois at Urbana-Champaign, in 2014 China's estimated demand for U.S. soybeans required the entire crop of the top 133 soybean-producing counties in the United States (see Figure 4).[113] The United States has at least 300,000 soybean farmers.[114]

While China relies heavily on imports of U.S. sorghum and soybeans, Chinese buyers may be able to transition to other international sources or use alternate crops to mitigate the effect of Chinese duties, increasing the likelihood that China will impose retaliatory tariffs. The United States supplied China with 88 percent of its sorghum imports in 2016 (see Figure 5) and China's domestic sorghum production is insufficient to meet its domestic demand.[*] However, China has the world's largest public stockpile of corn, estimated to be close to 250 million tons, which may serve as a substitute for sorghum in Chinese animal feed.[†]

[*] According to the U.S. Department of Agriculture, from October 2015 to October 2016 China consumed 11 million metric tons of sorghum but only grew 2.75 million metric tons domestically. Yoonhee Macke, "China – People's Republic of, Grain and Feed Update: Reform Continues in the Corn Sector," *U.S. Department of Agriculture Foreign Agricultural Service*, September 26, 2017. *https://gain.fas.usda.gov/Recent%20GAIN%20Publications/Grain%20and%20Feed%20Update_Beijing_China%20-%20Peoples%20Republic%20of_9-26-2017.pdf*.

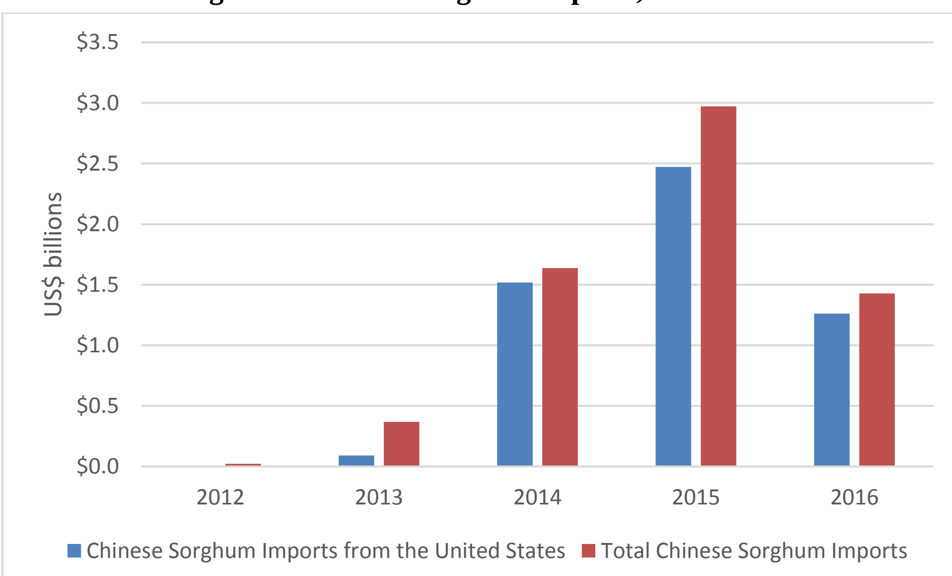
[†] Most of China's sorghum consumption is driven by animal feed. From October 2015 to October 2016, 80 percent of China's sorghum consumption went to animal feed. China's domestic production of sorghum is sufficient to supply other uses, such as food and industrial applications. Yoonhee Macke, "China – People's Republic of, Grain and Feed Update: Reform Continues in the Corn Sector," *U.S. Department of Agriculture Foreign Agricultural Service*, September 26, 2017. *https://gain.fas.usda.gov/Recent%20GAIN%20Publications/Grain%20and%20Feed%20Update_Beijing_China%20-%20Peoples%20Republic%20of_9-26-2017.pdf*; Tim Worledge, "Corn Set to Edge out Sorghum as China Signals Subsidy Probe," *AgriCensus*, February 5, 2018. *https://www.agricensus.com/Article/Corn-set-to-edge-out-sorghum-as-China-signals-subsidy-probe-771.html*.

Figure 4: Estimated Footprint of Chinese Soybean Consumption on U.S. Production, 2014



Source: John Newton and Todd Kuethe, "The Footprint of Chinese Demand for U.S. Soybeans," *University of Illinois at Urbana-Champaign FarmDocDaily*, March 27, 2015. *http://farmdocdaily.illinois.edu/2015/03/footprint-of-chinese-demand-for-us-soybeans.html*.

Figure 5: Chinese Sorghum Imports, 2012–2016

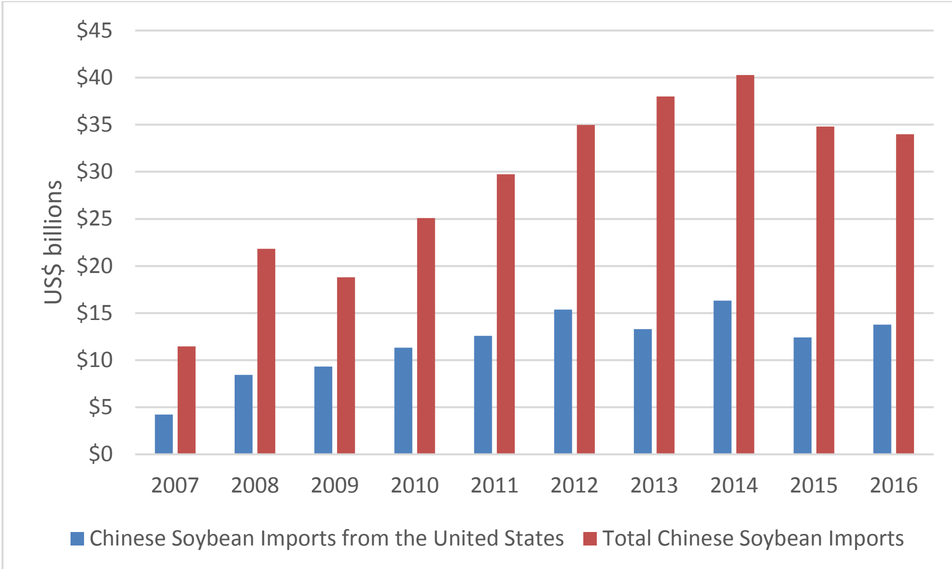


Source: UN Comtrade, "International Trade Statistics Database." *https://comtrade.un.org/data/*.

Similarly, China relies on U.S. soybean imports for animal feed and soybean oil. Over the 2015–2016 growing cycle, China imported 74 percent of its total soybean supply.[115] The United States is China's second-largest supplier of soybeans to China, after Brazil, and accounts for 40 percent of China's imports in 2016 (see Figure 6).[116] In the event China applies duties on U.S. soybeans, Chinese importers may be able to source more soybeans from Brazil, which is estimated to have a soybean stockpile equal to 5 percent of China's 2018 projected soybean import demand,

and may be able to increase long-run soybean production to fill Chinese demand currently supplied by U.S. farmers.[117]

Figure 6: Chinese Soybean Imports, 2007–2016



Source: UN Comtrade, "International Trade Statistics Database." *https://comtrade.un.org/data/*.

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"Presidential Proclamation on Adjusting Imports of Steel into the United States," March 8, 2018. *https://www.whitehouse.gov/presidential-actions/presidential-proclamation-adjusting-imports-steel-united-states/*.

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