U.S.-China Economic and Security Review Commission

Monthly Analysis of U.S.-China Trade Data

May 5, 2015

Highlights of this Month's Edition*

- **Bilateral trade:** Robust growth in imports widened the U.S. goods deficit with China despite a recovery in U.S. exports this month.
- **Quarterly review of China's economy:** China registers slowest quarterly growth in six years; central government introduces measures to boost the economy; two major corporate defaults mark new trend in China's slowdown.
- **Policy trends in China's economy:** China to adopt a broadly discretionary national security review and more comprehensive guidelines for foreign investments in its four free trade zones (FTZs).

Bilateral Goods Trade

Deficit Climbs despite Recovery in U.S. Exports

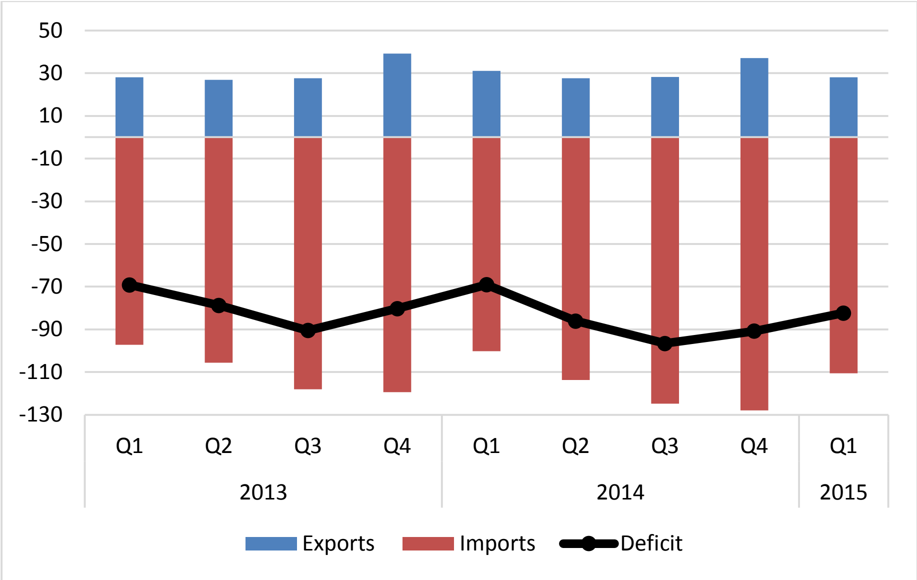
The U.S. trade deficit in goods with China totaled $82.4 billion in the first quarter of 2015, a 19.2 percent increase year-on-year (see Figure 1).[1] U.S. exports to China declined 9.4 percent in the first quarter of 2015, while imports from China rose 10.3 percent compared with the same period last year.

In March 2015, U.S. imports from China reached $41.1 billion, the highest level of monthly imports since September 2014.[2] Imports of cell phones and computers assembled in China largely drove this growth according to U.S. Census Bureau figures.[3] U.S. exports to China in March were $9.9 billion, up 13 percent over February. The U.S. trade deficit in goods with China for March was $31.2 billion, up 38.6 percent from February. The strong dollar and the reopening of the West Coast ports contributed to the surge of imports.[4]

* Note: This bulletin was reposted on June 2. The original version contained incorrect data on the nonperforming loan rate in Figure 6.

Figure 1: U.S.-China Trade in Goods, 2013-2015

(quarterly, US$ billions)



Source: U.S. Census Bureau, Trade in Goods with China (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, May 2015). http://www.census.gov/foreign-trade/balance/c0015.html.

Imports from China Register Strong Growth

Computer and electronic products accounted for a third of U.S. purchases from China in the first quarter, a 17.4 percent year-on-year increase. Other traditional U.S. imports from China also experienced robust year-on-year growth. Apparel and accessories imports grew 41 percent over last year; electrical equipment, appliances, and components grew 40 percent over last year. Although U.S. transportation equipment—primarily aerospace and automotive products—continues to lead U.S. exports to China, accounting for one-fifth of total exports, they registered a 24.6 percent decline year-on-year (see Table 1). Only computer and electronic products, the second largest U.S. export to China, grew year-on-year, increasing 13.5 percent over March 2014.

Table 1: U.S. Trade with China: Top Five Exports and Imports, March 2015

(US$ millions)

U.S. Top-Five Exports to China

	Exports	Share of total (%)	Change over Mar '14 (%)
Monthly (March 2015)			
Transportation Equipment	1,956,411	19.8%	-24.6%
Computer & Electronic Products	1,503,399	15.2%	13.5%
Chemicals	1,130,600	11.4%	-5.6%
Agricultural Products	1,072,893	10.9%	-11.1%
Machinery, Except Electrical	965,640	9.8%	-1.4%
Other	3,258,275	33.0%	-
Total	9,887,218	**100.0%**	
Year-to-date (thru March 2015)			
Transportation Equipment	5,498,321	19.5%	
Agricultural Products	4,862,476	17.3%	
Computer & Electronic Products	4,019,459	14.3%	
Chemicals	3,222,763	11.5%	
Machinery, Except Electrical	2,346,410	8.3%	
Other	8,189,630	29.1%	-
Total	28,139,059	**100.0%**	

U.S. Top-Five Imports from China

	Imports	Share of total (%)	Change over Mar '14 (%)
Monthly (March 2015)			
Computer & Electronic Products	13,935,803	33.9%	17.4%
Electrical Equipment, Appliances & Components	3,599,088	8.8%	40.0%
Machinery, Except Electrical	3,114,428	7.6%	34.4%
Miscellaneous Manufactured Commodities	2,832,467	6.9%	28.8%
Apparel & Accessories	2,301,713	5.6%	41.0%
Other	15,338,404	37.3%	-
Total	41,121,903	**100.0%**	
Year-to-date (thru March 2015)			
Computer & Electronic Products	37,291,930	33.7%	
Electrical Equipment, Appliances & Components	9,394,607	8.5%	
Miscellaneous Manufactured Commodities	8,064,365	7.3%	
Machinery, Except Electrical	7,675,497	6.9%	
Apparel & Accessories	7,159,511	6.5%	
Other	40,934,475	37.0%	-
Total	110,520,385	**100.0%**	

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

China increased its share of total U.S. advanced technology products (ATP) trade to 23.3 percent in the first quarter. China now accounts for 9.2 percent of total U.S. ATP exports and 35.4 percent of U.S. ATP imports, up from 7.4 percent total exports and 29.8 percent total imports five years ago.[5]

The U.S. trade deficit with China in ATP continued to expand, reaching $26.6 billion in the first quarter of 2015 (see Table 2). Information and communications imports accounted for 90.6 percent of total imports in the first quarter. Aerospace remained the largest U.S. export at $3.2 billion, accounting for 41.8 percent of total exports. Nuclear technology experienced the largest year-on-year quarter growth with exports worth $157 million in February. Biotechnology and electronics also experienced strong first quarter growth at 19.3 percent and 19.9 percent year-on-year respectively. However, continued double-digit growth in information and communications imports from China offset these gains.

Table 2: Advanced Technology Product Trade with China, January-March 2015
(US$ millions)

	Monthly			Cumulative year-to-date			
	Exports	Imports	Balance Mar '15	Exports	Imports	YTD Balance Mar '15	YTD Balance Mar '14
TOTAL	**2,703**	**12,705**	**-10,002**	**7,586**	**34,177**	**-26,591**	**-24,120**
(01) Biotechnology	63	9	54	136	27	109	89
(02) Life Science	329	210	119	733	594	139	165
(03) Opto-Electronics	51	596	-545	115	1,159	-1,044	-1,233
(04) Information & Communications	372	11,367	-10,995	1,126	30,952	-29,826	-26,739
(05) Electronics	496	320	176	1,414	874	540	369
(06) Flexible Manufacturing	292	82	210	676	220	456	412
(07) Advanced Materials	23	38	-15	46	104	-58	-24
(08) Aerospace	1,071	75	996	3,174	221	2,953	2,856
(09) Weapons	0	8	-8	1	25	-24	-25
(10) Nuclear Technology	6	0	6	166	0	166	10

Source: U.S. Census Bureau, Advanced Technology Product Data – Imports and Exports – Country by ATP Group (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, May 2015). *http://www.census.gov/foreign-trade/statistics/product/atp/select-ctryatp.html*.

Quarterly Review of China's Economy

China Slows to Lowest Quarterly GDP Growth in Six Years

China registered real gross domestic product (GDP) growth of 7 percent on an annualized basis in the first quarter of 2015, its smallest quarterly increase since early 2009. The Chinese government is in the middle of engineering a major realignment of the Chinese economy from one driven by investment and exports to one driven more by domestic consumption. The leadership under President Xi Jinping has acknowledged that a managed slowdown is a necessary component of this rebalancing—the official GDP target has been reset to "about 7 percent" for 2015.[*] The government has expressed concerns, however, that weakness in key indicators calls for additional measures to prevent growth from falling below that target.

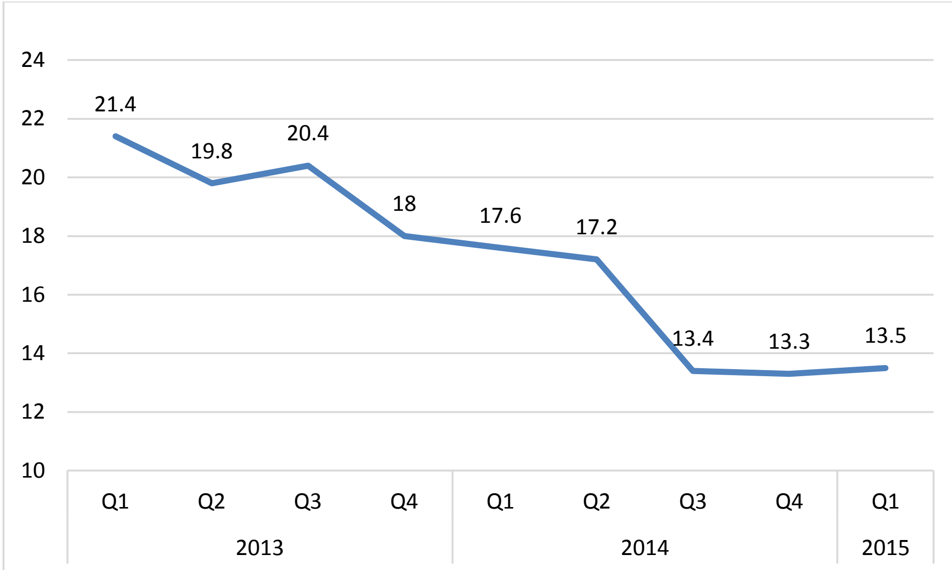
Expansion of fixed asset investment, a key pillar of China's traditional growth model, declined to 13.5 percent in the first quarter of 2015 (see Figure 2). However, consumption of domestic goods and services has not increased fast enough to compensate, growing just 10.2 percent year-on-year in March 2015, down from the already weak growth during the January–February Lunar New Year holiday period (see Figure 3).[†]

[*] For more on the Chinese government's endorsement of the slower "new normal" growth, see the April 2015 USCC Trade Bulletin. *http://origin.www.uscc.gov/sites/default/files/trade_bulletins/April%202015%20Bulletin_0.pdf*.

[†] For more on the consumption during this year's Lunar New Year holiday period, see the April 2015 USCC Trade Bulletin. *http://origin.www.uscc.gov/sites/default/files/trade_bulletins/April%202015%20Bulletin_0.pdf*.

Figure 2: Growth in Fixed Asset Investment

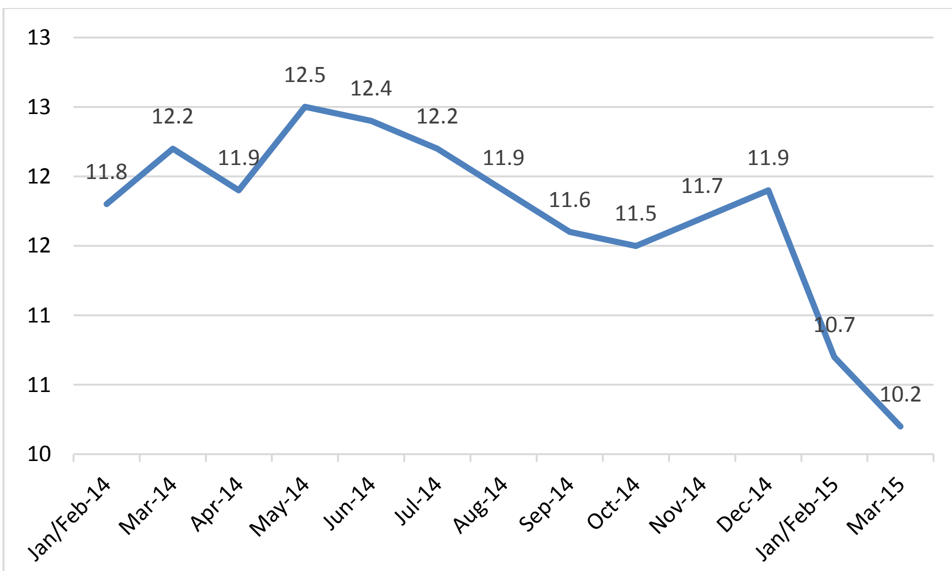
(quarterly, year-on-year, %)



Source: National Bureau of Statistics, via CEIC data.

Figure 3: China Retail Sales of Consumer Goods

(monthly, year-on-year, %)



Source: National Bureau of Statistics, via CEIC data.

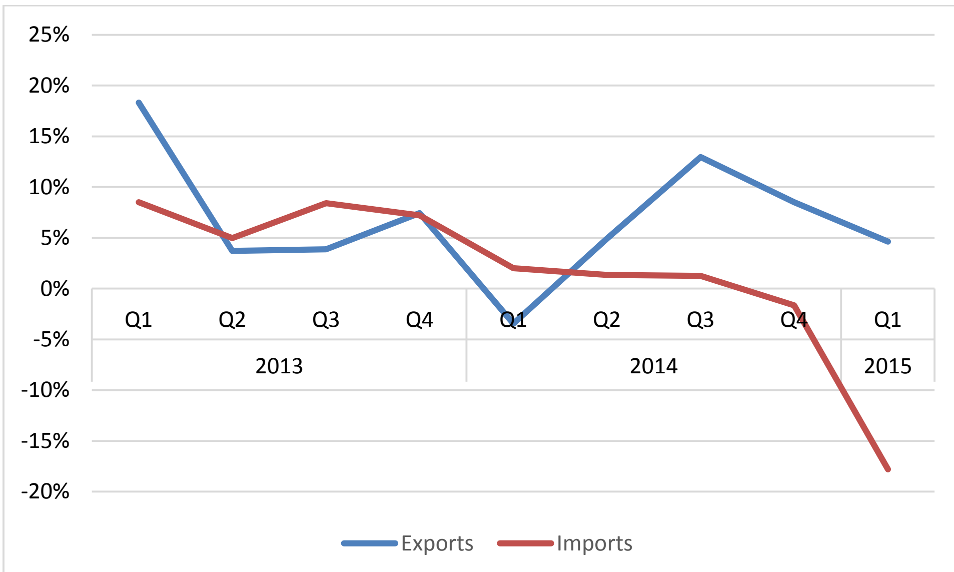
Like investment, manufacturing activity has been sluggish. The HSBC manufacturing purchasing managers' index (PMI) dropped from 49.6 in March 2015 to 48.9 in April 2015, a one-year low.[6] PMI below 50 indicates manufacturers expect their orders to decline. China's official PMI for April was unchanged from March—50.1, barely in the positive territory.[7] HSBC noted in an April 2015 report that "job shedding across manufacturing firms was recorded for the eighteenth month in a row."[8] China's Premier Li Keqiang acknowledged that domestic employment pressures were rising.[9] In late April, State Council, China's cabinet, announced new measures to boost employment, including tax breaks for hiring the unemployed, and preferential loans for recent graduates and migrant workers who return to their hometowns to set up businesses.[10]

Anemic export growth has also hurt manufacturers (see Figure 4), but the government has been resisting falling back on its old tricks for boosting growth. For example, the government has not stepped in to help the export sector. On the contrary, the government has been selling dollars to keep the renminbi (RMB) from depreciating against the dollar—a reversal of China's traditional intervention to boost the export sector by keeping the RMB undervalued. In fact, the RMB has strengthened so much over the last few years that the International Monetary Fund (IMF) is expected to declare China's currency near equilibrium or fairly valued after a decade of calling it "undervalued" (the U.S. government disagrees with IMF's assessment).[11]

The Chinese government's move to keep the RMB strong partly explains why China's foreign exchange reserves declined from $4 trillion last year to $3.73 trillion in April 2015.[12] China's official holdings of U.S. Treasuries[*] declined in tandem with foreign exchange reserves, allowing Japan to overtake China as the top holder (according to data from February 2015, latest available, Japan held $1,224 trillion to China's $1,223 trillion).[13]

Figure 4: Growth in China's Exports and Imports

(quarterly, year-on-year, %)



Source: China Administration of Customs, via CEIC data.

Reinforcing the overall trend is the continued contraction in the demand for imports (see Figure 3). Since China's imports consist primarily of industrial inputs and commodities, they usually correlate with exports of manufactures, and weak imports suggest a lack of underlying demand from factories.

Other traditional growth drivers are also showing signs of weakness. Housing prices continued falling for the seventh consecutive month, though at a slower pace as cities introduced measures to encourage purchases.[14] Revenue at state-owned enterprises (SOEs) fell 6 percent year-on-year and profits fell 8 percent year-on-year in the first quarter of 2015.[15] The central government, long unhappy with poor SOE performance, has big plans to increase SOE efficiency. State media reported in late April that Beijing plans to cut the number of central state-owned conglomerates from 112 to 40 through consolidation.[16] By forcing major SOEs to merge, the central government wants to create industrial giants capable of competing globally.

Restructuring SOEs is a critical component of President Xi's reform agenda. In addition to policy-directed mergers, the central government has stepped up efforts to fight corruption among SOE leadership. The Communist Party's top anticorruption agency, the Central Commission for Discipline Inspection, is in the midst of a two-year investigation of SOEs in strategic sectors.[17] The latest target of the campaign is Wang Tianpu, the powerful head of state-owned oil company Sinopec Group.[18] Several executives at another state-owned energy major, China

[*] Because the Chinese government also buys unregistered Treasuries on the secondary market, which do not show up in official tallies, China's actual holdings of U.S. government securities may be higher than officially reported.

National Petroleum Corp., are also under investigation. In fact, according to Chinese media reports, 25 percent of the 124 senior SOE officials under investigation for corruption are from SOEs in the energy sector.[19]

Central Bank Loosens Lending Policy, Tackles Local Government Debt

Chinese policymakers have unveiled new measures to stimulate the economy. For the second time this year, the People's Bank of China (PBOC) cut the banks' required reserve ratio (RRR). The April 2015 1 percentage point reduction freed up about $200 billion for banks to lend. This is the first time the PBOC reduced the RRR by such a large margin since the financial crisis in 2008. At 18.5 percent, China's new RRR level is still high by global standards. But Chinese authorities have been cautious with measures that stimulate borrowing, as the economy is still recovering from the lending binge unleashed by the government at the height of the global financial crisis.

The PBOC is also laying the groundwork for a local government debt restructuring program announced at the March 2015 National People's Congress meeting.[*] To ease China's nearly $3 trillion local government debt problem, China's Ministry of Finance issued a $160 billion (RMB 1 trillion) quota for local governments to roll over existing higher-cost debt into lower-yielding municipal bonds. China's commercial banks were expected to be the main buyers of these new bonds, but have resisted due to very low yields.[20] Now, the PBOC is taking on the burden itself, allowing commercial banks to swap local government bonds for long-term loans.[21] This would have the added effect of freeing up bank funds for lending—complementing the PBOC's traditional measures of increasing the money supply, including the latest RRR cut.

Corporate Defaults on Rise in China as Economy Slows

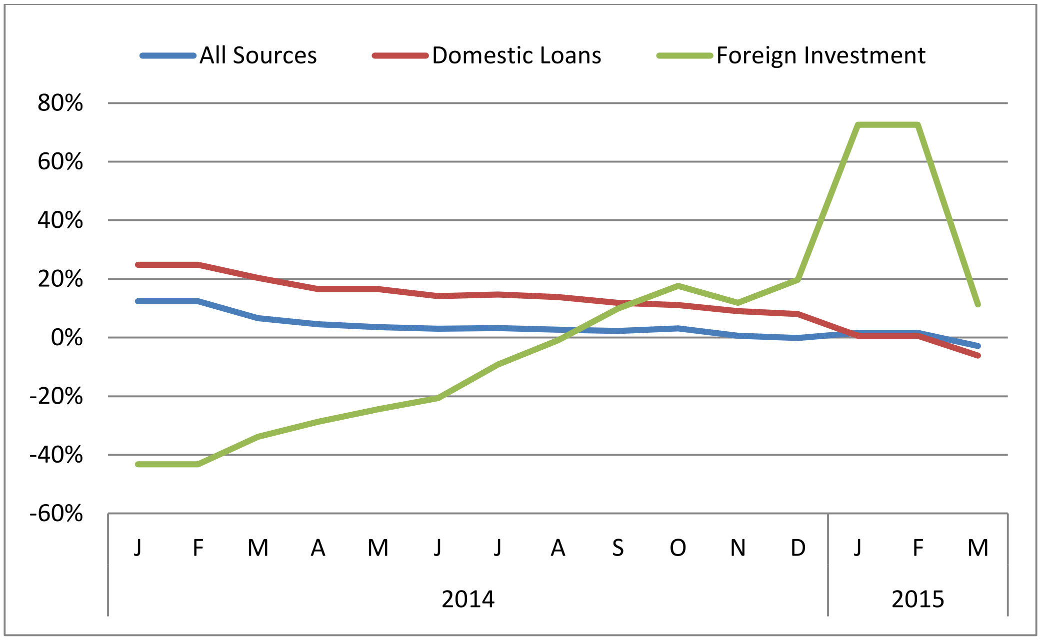
In a span of two days (April 20–21), two major Chinese companies defaulted on debt in an apparent new trend of rising corporate defaults in China. The twin defaults—by the privately funded property developer Kaisa Group Holdings Ltd. and state-owned equipment manufacturer Baoding Tianwei Group Co.—are symbolic of how China's economic slowdown is affecting the country's most debt-ridden industries.[22]

Since 2014, analysts have expected China's property market, which has long been the target of state-subsidized overinvestment, to be among the first sectors to go into decline as China's economy slows.[23] According to Standard & Poor, China's largest property developers are already facing worse economic conditions than in 2014, and the "dark clouds over China's property sector are unlikely to pass anytime soon."[24] Since the start of 2015, rumors have circulated that Shenzhen-based Kaisa would be the first major property developer to default on its debt, valued at $1 billion. On April 20, without any government bailout imminent, Kaisa announced it would miss its April 27 interest payment of $52 million.[25]

Financing to China's property sector is now dwindling rapidly. Throughout 2014, domestic growth in sources of funding for property development in China were already decelerating, and year-on-year change in domestic loans fell to zero by December (see Figure 5). Despite overcapacity, foreign investment in China's property sector paradoxically accelerated throughout 2014 and until January 2015, when rumors of Kaisa's imminent default were more widely known and foreign investment decelerated rapidly. Now, financing in China's property sector—which has been one of the key engines of China's high growth rates since the 1990s—has nearly dried up.

[*] For details on economic targets and reform plans for 2015, see the April 2015 USCC Trade Bulletin. *http://origin.www.uscc.gov/sites/default/files/trade_bulletins/April%202015%20Bulletin_0.pdf*.

Figure 5: Sources of Funding in China's Property Sector
(year-on-year change)

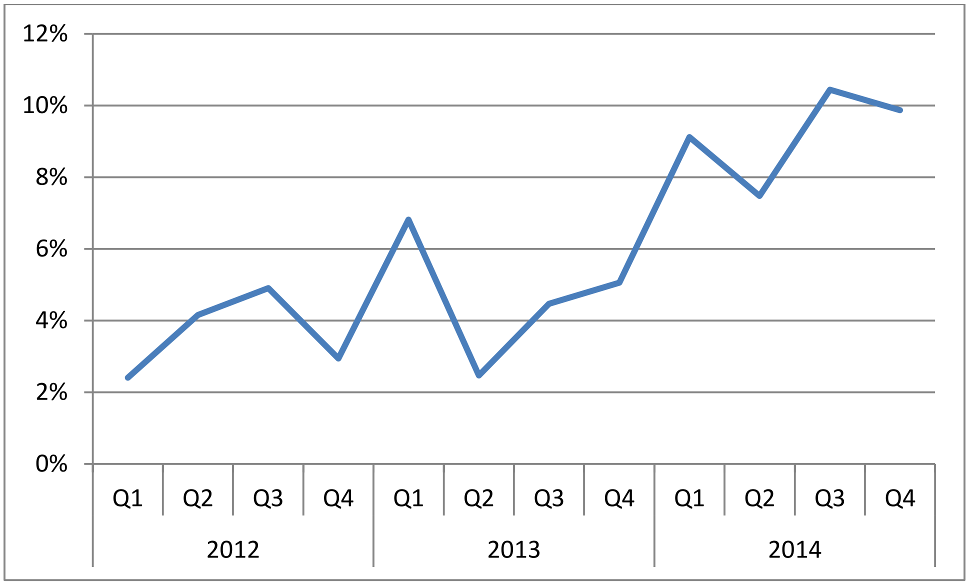


Source: China National Bureau of Statistics via CEIC data.

For the Chinese state-owned sector (another beneficiary of government protection), the default of Baoding Tianwei marks an even more important milestone in China's economic slowdown. For the first time in the history of the People's Republic of China, the government allowed a state-owned company to default.[26] The April 21 announcement that Baoding Tianwei would miss its $13.8 million interest payment on April 28 thus caused many observers to speculate that China is finally allowing market forces to determine the fate of Chinese government-owned corporations.[27] According to Bloomberg, "[The two defaults] provide a dose of market discipline that China sorely needs."[28]

In fact, China's corporate nonperforming loan rate has been increasing steadily since mid-2013 (see Figure 6). Quarter-on-quarter growth in the rate of new nonperforming loans went from an average of 3.6 percent in 2012 to 9.2 percent in 2014. This gloomy outlook has limited domestic sources of investment financing, which could further accelerate China's economic slowdown. In China's bond market specifically, which is now the third largest in the world, the number of newly issued bonds (government, corporate, and financial combined) decreased by about 2 percent in the first quarter of 2015 compared to the same period last year, according to data from the China Central Depository and Clearing Co., Ltd.[29]

Figure 6: China's Commercial Nonperforming Loans
(quarter-on-quarter change)



Source: China Banking Regulatory Commission, via CEIC data.

The rise in China's indebtedness could be especially damaging for overseas holders of Chinese corporate paper.[30] While domestic sources of financing are rapidly drying up in China, foreign investors are still generally eager to invest in China (with the exception of the property sector, as noted above). Domestic RMB assets held by overseas entities increased by about 25 percent in the first quarter of 2015 compared to the same period last year, according to data from the PBOC. The largest growth was in China's equity and bond markets, with increases of 70 percent and 52 percent, respectively. Although Baoding Tianwei's default was only on domestic bond debt, Kaisa's default included overseas debt, and marks the first time a Chinese property company has defaulted on foreign debt.[31] If China's corporate default rate continues to rise as expected, it does not bode well for foreign investors.[32]

Policy Trends in China's Economy

China's Free Trade Zones Test Negative List and National Security Review

Following the establishment of the Shanghai free trade zone (FTZ) in September 2013, Chinese Premier Li Keqiang approved the creation of three additional FTZs—in Guangdong, Tianjin, and Fujian—and subsequent expansion of the Shanghai FTZ to include Lujiazhai, the city's financial district.[33] According to Wang Shouwen, China's Assistant Minister of Commerce, the three new FTZs will play different strategic roles:

> *The one in Guangdong will focus on promoting the in-depth economic cooperation between the Chinese mainland, Hong Kong, and Macao, especially in the services sector. At the same time, the Guangdong FTZ shoulders the responsibility of upgrading China's manufacturing industry. The one in Tianjin will emphasize the joint development of Beijing, Tianjin, and Hebei. The one in Fujian deepens cross-Straits economic cooperation and will support the belt and road initiative.*[34]

Now, the four FTZs will serve as testing ground for China's new foreign investment rules. On April 20, China's State Council published the policy frameworks for its three newest FTZs, and announced the adoption of a unified "negative list" approach within all four FTZs to delineate sectors where foreign investment is restricted. When the negative list becomes effective on May 8, foreign investors in unlisted industries will receive equal treatment to domestic companies, though foreign investments in sensitive areas will be subject to a new national security review.

The 2015 negative list appears to feature many changes compared to the 2014 negative list most recently in effect in the Shanghai FTZ, which was met with disappointment by foreign investors for its length.[35] Since the Shanghai FTZ's 2013 establishment, the number of restricted investments on the negative list decreased from 190 in 2013 to 139 in July 2014, and finally to 122 on the 2015 negative list.[36] In practice, however, though the size of the negative list has been reduced, "many industries and sectors have been merely re-grouped," according to the European Chamber of Commerce in China.[37] On the whole, the 2015 negative list is considered more comprehensive because it incorporates all limitations and restrictions on foreign investment from other laws.[38]

The new list largely maintains restrictions in certain sectors, including publishing, news, Internet content, films, auction houses, law practices, and banking and asset management.[39] Foreign investment remains prohibited in sectors including rare earth mining, air traffic control system management, postal enterprises, and radio and television broadcasters. Foreign investors in industries including oil and natural gas exploration and development, general-purpose airplane design, manufacturing, maintenance, and rare earth smelting will be restricted to joint ventures with Chinese companies.[40] In a positive development, foreign investors can now set up e-commerce companies in all four FTZs.[41]

The FTZ regulations also stipulate that foreign investments deemed relevant to China's national security will be subject to a national security review. Certain kinds of foreign investment, including investment into sensitive agricultural products, key natural resources and energy, strategic infrastructure, transport capabilities, technology and information technology (IT), and investment near military facilities, will trigger review.[42] The review will be conducted by the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM), and will take the following factors into consideration: (1) impact on national security, including China's capacity to provide essential goods and services to that end; (2) impact on the stability of the economy; (3) impact on basic social order; (4) impact on culture and social morality; (5) impact on internet security; and (6) impact on sensitive technology for use in national defense.[43] In effect, Chinese authorities will have broader discretion to review incoming foreign investments for perceived national security threats.

This national security review process builds on provisions first introduced in China's draft foreign investment law (FIL), which was published in January for public comment and will abolish the three existing laws governing foreign investment in China. Under the draft FIL, the definition of a "foreign investor" has been expanded to include instances where the person or entity with ultimate "control"[*] over the company making the investment is foreign, even if the company itself is domestic.[44] This shift in focus from foreign equity to foreign control will allow Chinese authorities to treat variable interest entities (VIEs), a prevalent investment structure for foreign investors in restricted sectors of China's economy, with increased scrutiny and administrative discretion.[45]

Likewise, the draft FIL mandates that the Catalogue for the Guidance of Foreign Investments (Investment Catalogue)—the guidelines that delineate "encouraged," "restricted," and "prohibited" foreign investment categories under the current regime—will be replaced by a national negative list formulated by the State Council.[46] Once the FIL is adopted, foreign investors in most industries will enjoy "pre-establishment national treatment" (i.e.,

[*] The Draft Law defines "control" as follows: (1) directly or indirectly holding 50 percent or more of the shares, equity, property shares, voting rights, or other similar rights and interests of an enterprise; (2) despite holding less than 50 percent of the shares, equity, property shares, voting rights, or other similar rights and interests of an enterprise, (a) being entitled to directly or indirectly appoint at least half of the members of the board or a similar decision-making body; (b) being able to ensure that its nominees obtain at least half of the seats on the board or a similar decision-making body; or (c) being able to exert a material impact on the resolutions of the shareholders' meetings or the directors' meetings; or (3) being able to exert a decisive influence on such matters as the operations, finance, personnel, and technology of an enterprise through contracts, trusts, or other means. Joseph W.K. Chan, Ling Chen, and Calamus Huang, "China Set to Overhaul Foreign Investment Law," *Sidley Austin LLP*, February 26, 2015. ***http://www.sidley.com/news/02-26-2015-china-update***.

only foreign investments in "restricted" industries must obtain an entry license from MOFCOM).[47] It is unclear whether the FIL nationwide negative list[*] will mirror the unified FTZ negative list.

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[*] China's negative list offer for the U.S.-China bilateral investment treaty (BIT) negotiations, which have already gone through 18 rounds, will be decided through U.S.-China negotiations, according to Chinese Vice Finance Minister Zhu Guangyao. China committed to provide a BIT negative list offer "early in 2015," according to a spokesperson for the Office of the U.S. Trade Representative. Liu Jie, "Lou Jiwei: 'Uncomfortable' with Some Content of U.S. Negative List," Xinhua, April 18, 2015. Staff translation. *http://news.xinhuanet.com/fortune/2015-04/21/c_127712120.htm*; "U.S.-China BIT 'Core Text' Still Outstanding, Beijing 'Negative List' Offer Could Spur Progress: Business Rep," *China Trade Extra*, January 26, 2015. *http://chinatradeextra.com/daily-news/us-china-bit-core-text-still-outstanding-beijing-negative-list-offer-could-spur-progres-0*.

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