U.S.-China Economic and Security Review Commission

Economics and Trade Bulletin

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Highlights of This Month's Edition

- **Bilateral trade:** In Q3 2018, the U.S. goods trade deficit with China grew 12 percent to $115.6 billion on importers rushing orders as tariffs begin to bite; U.S. services exports to China reach a record $20.5 billion.
- **Bilateral policy issues:** The U.S. Department of the Treasury declined to name China a currency manipulator in its October 2018 currency report, but kept China on a monitoring list, citing its significant trade surplus with the United States.
- **Quarterly review of China's economy:** China's GDP grew 6.5 percent in Q3 2018, its slowest pace since 2009; the Chinese government is implementing stimulus measures to support short-term economic growth; Chinese households' falling consumption and rising debt levels prompt worries about China's rebalancing; local governments resurrect share-buying program to placate jittery stock market investors; state-run media ordered to cloak signs of falling consumer confidence; President Xi conjures images of Deng Xiaoping's Southern Tour, stresses the need for "self-reliance" in manufacturing and technology.

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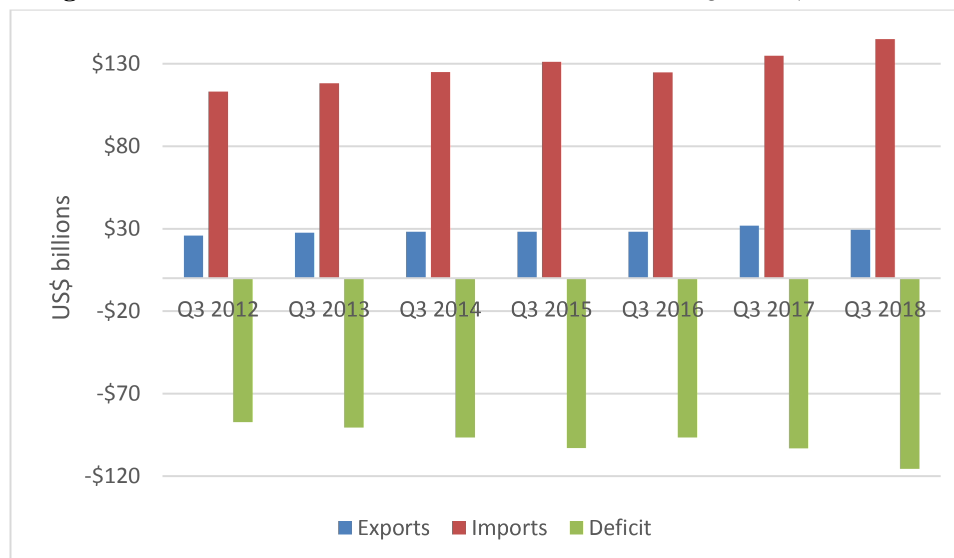
Bilateral Trade

U.S. Goods Deficit with China Rises More than Expected

In the third quarter of 2018, the U.S. goods trade deficit with China reached $115.6 billion, an increase of 12 percent over the third quarter of 2017 (see Figure 1). U.S. exports fell 7.6 percent year-on-year to $29.3 billion, and imports from China totaled $145 billion, up 7.5 percent year-on-year.

September 2018 saw U.S. imports from China reach a record-setting $50 billion, as traders rushed to bring in imports ahead of a new wave of tariffs. (The United States has threatened to impose additional tariffs on Chinese goods in 2019; about $250 billion worth of Chinese are already subject to 10 percent to 25 percent U.S. tariffs.)

Figure 1: U.S. Goods Trade with China in the Third Quarter, 2012–2018



Source: U.S. Census Bureau, Trade in Goods with China, November 2, 2018. *https://www.census.gov/foreign-trade/balance/c5700.html.*

Top Five U.S. Exports to and Imports from China

Although U.S. exports to China saw an overall decline in Q3 2018, some export categories had a strong showing (see Table 1). Exports of machinery (except electrical) came in at nearly $3 billion, up 36.7 percent year-on-year, while exports of chemicals rose 23 percent to $4.2 billion. Exports of agricultural products to China, traditionally a major category, were valued only $456 million in Q3 2018, down 82 percent from $2.5 billion in Q3 2017. Based on 2017 export data, China's tariffs affect 95 percent of all U.S. agricultural and agricultural-related exports to China.[1]

Imports from China, on the other hand, increased across all top five product categories, with electrical equipment, appliances, and component category recording a 13.5 percent increase year-on-year to $13.5 billion. In keeping with established patterns, computer and electronic products dominate U.S. imports from China, accounting for $49.5 billion in Q3 2018, or 34 percent of U.S. overall imports.

Table 1: U.S. Goods Trade with China: Top Five Exports and Imports
(US$ billions)

U.S. Top-Five Exports to China				U.S. Top-Five Imports from China			
Quarter 3 (Jul-Sep'18)	Exports (US$ billions)	Share of total (%)	Change over Q3'17 (%)	*Quarter 3 (Jul-Sep'18)*	Imports (US$ billions)	Share of total (%)	Change over Q3'17 (%)
Transportation Equipment	$7.98	27.2%	-8.0%	Computer and Electronic Products	$49.47	34.1%	3.9%
Computer and Electronic Products	$4.57	15.6%	4.6%	Electrical Equipment, Appliances, and Component	$13.47	9.3%	13.5%
Chemicals	$4.20	14.3%	23.0%	Misc. Manufactured Commodities	$13.13	9.1%	6.6%
Machinery, Except Electrical	$2.97	10.1%	36.7%	Apparel and Accessories	$9.84	6.8%	2.2%
Oil and Gas	$1.25	4.3%	-9.6%	Machinery, Except Electrical	$9.39	6.5%	5.7%
Other	$8.37	28.5%	-10.5%	Other	$49.70	34.3%	11.6%
Total	**$29.35**	**100.0%**		**Total**	**$144.99**	**100.0%**	

Source: U.S. Census Bureau, USA Trade Online, November 2, 2018. *https://usatrade.census.gov/*

Advanced Technology Product Trade

U.S.-China trade in advanced technology products (ATP) continues to be characterized by a sizable U.S. deficit, which reached $98.7 billion in the first nine months of 2018, up 7.3 percent year-on-year (see Table 2). The main contributor to the deficit was imports of information and communications technology (ICT) products, which rose 7.7 percent year-on-year to $114.9 billion through September 2018. The largest U.S. ATP export to China, aerospace products, grew 12.1 percent year-on-year to $12.7 billion.

Table 2: U.S.-China ATP Trade, Cumulative January–September
(US$ millions)

	2018			2017			Balance
	Exports	Imports	Balance	Exports	Imports	Balance	YOY
(01) Biotechnology	712	205	507	708	144	564	-10.1%
(02) Life Science	2,929	2,005	924	2,668	1,946	722	28.0%
(03) Opto-Electronics	576	3,263	-2,687	440	3,378	-2,938	-8.5%
(04) Information & Communications	2,991	114,857	-111,866	3,428	106,604	-103,176	8.4%
(05) Electronics	4,802	4,158	644	4,394	3,291	1,103	-41.6%
(06) Flexible Manufacturing	3,218	1,098	2,120	2,132	977	1,155	83.5%
(07) Advanced Materials	209	335	-126	207	303	-96	31.3%
(08) Aerospace	12,699	859	11,840	11,325	766	10,559	12.1%
(09) Weapons	3	97	-94	2	92	-90	4.4%
(10) Nuclear Technology	67	51	16	213	8	205	-92.2%
TOTAL	**28,208**	**126,926**	**-98,718**	**25,516**	**117,510**	**-91,994**	**7.3%**

Source: U.S. Census Bureau, November 2018. *https://www.census.gov/foreign-trade/statistics/product/atp/select-ctryatp.html.*

U.S. Services Trade Surplus with China Reaches Record High in H1 2018

In H1 2018, the U.S. services surplus with China reached a new record of $20.5 billion, a 3.7 percent increase year-on-year.[2] In the first two quarters of 2018, services accounted for 28.5 percent of all U.S. exports to China.[3]

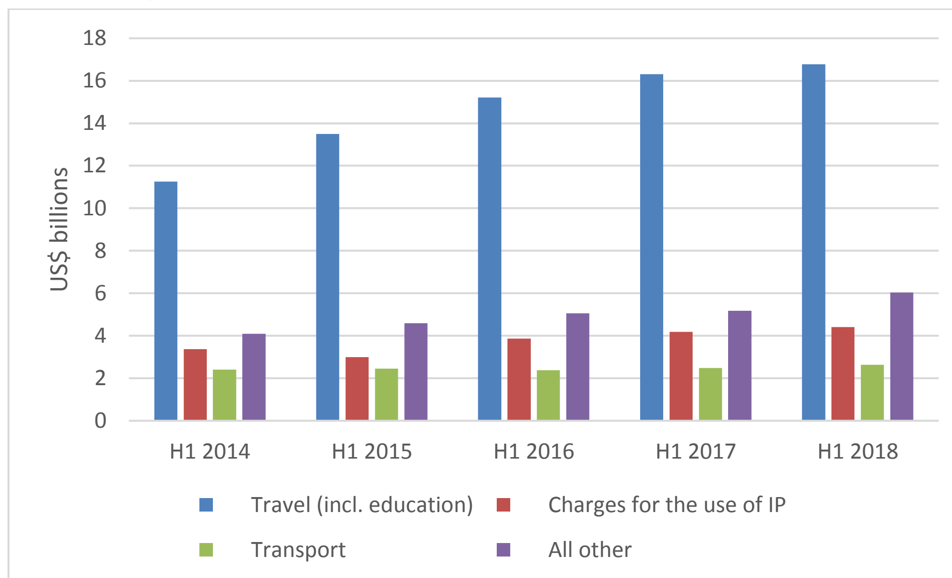
U.S. services exports to China were $29.8 billion in H1 2018, a 6.1 percent increase year-on-year.[4] Exports of travel, which include Chinese students coming to the United States to study,[*] dominate U.S. services trade with China, accounting for $16.8 billion, or 56.2 percent of total U.S. services exports to China in H1 2018 (see Figure 2).[5] U.S.

[*] The U.S. government classifies tuition payments as tourism and travel exports. For more on Chinese tourism in the United States, see Matt Snyder, "Chinese Tourism and Hospitality Investment in the United States," *U.S.-China Economic and Security Review Commission*, July 25, 2016. *https://go.usa.gov/xPVjF*.

exports of intellectual property (IP) charges, the second-largest category, grew 5.4 percent year-on-year to reach $4.4 billion; exports of transport, the third-largest category, totaled $2.6 billion, a 5.9 percent increase.[6]

Unlike U.S.-China goods trade, which is being battered by rising bilateral tensions and multiple rounds of tariffs, the services trade remains a bright spot. Chinese consumers' appetite for travel has been rising along with their incomes: according to World Bank data, in 2016 (latest available) there were over 135 million Chinese tourist departures, up from only 10.5 million in 2000.[7] Cutting off the flow of Chinese tourists is a powerful weapon in the Chinese government's arsenal, but there is no evidence of official action to clamp down on Chinese tourist visits to the United States. China's government has wielded this weapon in other cases of heated political or economic friction. Most recently, in 2017 China retaliated against South Korea's decision to deploy a U.S. antimissile battery by curtailing Chinese group tours to South Korea, among other actions.[*]

Figure 2: U.S. Services Exports to China, H1 2014–H1 2018



Source: U.S. Bureau of Economic Analysis, *U.S. International Transaction, Expanded Detail by Area and Country*, September 19, 2018.

U.S. imports of Chinese services grew 11.6 percent year-on-year to reach $9.4 billion in H1 2018.[8] Transportation, travel (including for education), and other business services accounted for 80 percent of all U.S. services imports from China (see Figure 3).[9] However, imports of smaller services categories saw the highest year-on-year growth in H1 2018: insurance services (55.7 percent), financial services (25.5 percent), and charges for the use of IP (28.9 percent).[10]

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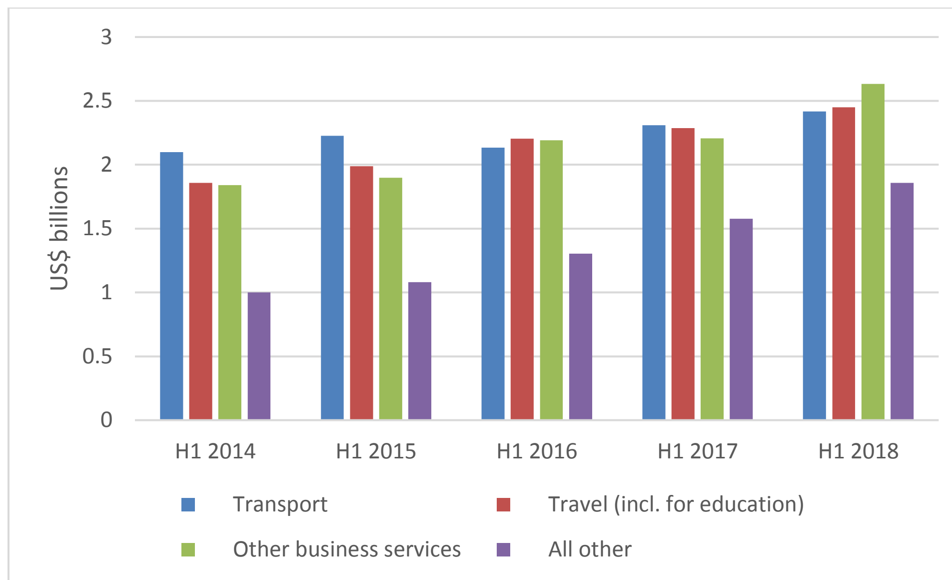
[*] For additional details on this case, see Ethan Meick and Nargiza Salidjanova, "China's Response to U.S.-South Korean Missile Defense System Deployment and its Implications," *U.S.-China Economic and Security Review Commission*, July 26, 2017. *https://go.usa.gov/xPVjM*.

Figure 3: U.S. Services Imports from China, H1 2014–H1 2018



Source: U.S. Bureau of Economic Analysis, *U.S. International Transaction, Expanded Detail by Area and Country*, September 19, 2018.

Bilateral Policy Issues

U.S. Treasury Department Declines to Name China a Currency Manipulator

The U.S. Department of the Treasury opted against labeling China a currency manipulator in the October 2018 issue of its biannual report to Congress on the foreign exchange policies of major U.S. trading partners, but kept China on a monitoring list of economies that merit closer attention to their currency practices, citing its significant trade surplus with the United States.[*] [11] The report singled China out for criticism: the executive summary focused on China's large bilateral trade imbalance with the United States as well as China's long history of currency intervention, concluding that China's exchange rate and intervention practices have imposed "significant and long-lasting hardship on American workers and companies."[12]

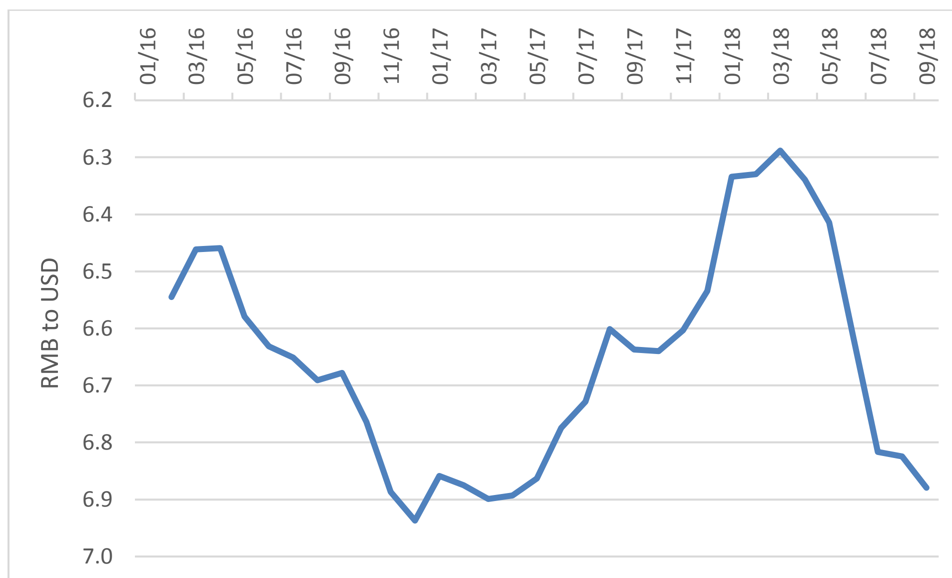
Prior to the report's release, U.S. Treasury Secretary Steven Mnuchin said in an interview with the *Financial Times* that the renminbi (RMB) had depreciated "significantly" during the year, adding that he wanted to "make sure China is not doing competitive devaluations."[13] In a speech earlier in October on the Trump Administration's China policy, Vice President Mike Pence included currency manipulation among a list of unfair Chinese government practices that have driven China's economic growth.[14] The speech warned of a more assertive U.S. approach toward Beijing and stated that the United States "will not relent until our relationship with China is grounded in fairness, reciprocity, and respect for our sovereignty."[15]

[*] Treasury has three criteria for determining whether a country is manipulating its currency: (1) a bilateral goods trade surplus with the United States of at least $20 billion; (2) a current account surplus equal to at least 3 percent of GDP; and (3) persistent, one-sided intervention in currency markets, in excess of 2 percent of GDP over a 12-month period. A country has to meet all three criteria to be designated a currency manipulator. Treasury determined China only met the first criteria by having a goods trade surplus with the United States of $390 billion over the four quarters through June 2018. The United States last labelled China a currency manipulator in 1994. U.S. Department of the Treasury, *Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States*, October 17, 2018, 2–4. *https://home.treasury.gov/system/files/206/2018-10-17-%28Fall-2018-FX%20Report%29.pdf*; Colby Smith, "Manipulation on the Mind," *Financial Times*, July 27, 2018. *https://ftalphaville.ft.com/2018/07/27/1532671200000/Manipulation-on-the-mind/*.

In the October 2018 report, Treasury expressed concern over the RMB's depreciation against the dollar since mid-June 2018 but conceded that "direct intervention by the People's Bank of China (PBOC) this year has been limited."[16] However, the report criticized China for not doing enough to stem the RMB's depreciation, stating that "there have been modest foreign exchange sales recently by state banks, helping stem depreciation pressure, though it is clear that China is not resisting depreciation through intervention as it had in the recent past."[17] In a new development, Treasury said it will monitor "the extent to which intervention by our trading partners in foreign exchange markets is symmetrical"—i.e., whether countries will intervene to resist depreciation to the same extent as they intervene to resist appreciation.[18]

The RMB has come under increasing pressure this year due to trade tensions with the United States, China's slowing economic growth, and expectations of further monetary easing by the PBOC.[19] The RMB has tumbled more than 9 percent against the dollar over the past six months (see Figure 4).[20] On October 30, the RMB closed at its weakest official level since 2008 at 6.957 per dollar, leading analysts to speculate whether the PBOC will allow a slide beyond 7 RMB to the dollar—an important psychological marker of weakness for investors—a level not reached since the global financial crisis.[21] According to Eswar Prasad, senior fellow at the Brookings Institution, "A further depreciation of the [RMB] relative to the dollar would soften the blow of U.S. tariffs but at the considerable risk of triggering substantial capital outflows."

Figure 4: RMB to U.S. Dollar Exchange Rate, January 2016–September 2018



Source: People's Bank of China via CEIC database.

Chinese officials maintain the weakening RMB demonstrates that Beijing is allowing market forces greater sway over the currency's value, and PBOC Governor Yi Gang has said the government would "continue to let the market play a decisive role in the formation of the RMB exchange rate."[22] This view is shared by the International Monetary Fund (IMF). Markus Rodlauer, deputy director of the IMF's Asia and Pacific Department said, "According to our framework, the exchange rate of the RMB is not out of line. It is broadly in line with the fundamentals," adding that the PBOC is allowing the exchange rate to respond to "market pressures" while guarding against large "destabilizing" movements.[23]

Mr. Yi has pledged China "will not engage in competitive devaluation, and will not use the exchange rate as a tool to deal with trade frictions."[24] On October 26, PBOC Deputy Governor Pan Gongsheng said the central bank will use macro-prudential measures to stabilize market expectations, and that it is confident China will be able to keep the RMB "basically stable" due to the country's "healthy economic fundamentals" and vast foreign exchange

reserves.[25] So far this year, the PBOC has largely refrained from directly intervening to prop up the currency. Beijing has intervened indirectly through state commercial banks, which sold $17.6 billion worth of foreign exchange in September 2018.[26] Brad Setser, senior fellow for international economics at the Council on Foreign Relations, notes, "Selling almost $20 billion in a month won't break the bank. But it does indicate the direction of current market pressure."[27]

Quarterly Review of China's Economy

Though China's gross domestic product (GDP) continues to expand at a pace enviable by developed-country standards, deterioration in key macroeconomic indicators (including investment, consumer spending, and business sentiment) points to a steady decline. Even before the Q3 2018 data showed disappointing results, China's government had started taking steps to boost the economy and control economic sentiment. The *New York Times* reported that at the beginning of October, the central government ordered state-run media to stifle negative economic news, including poor indicators, local government debt fears, the impact of trade tension with the United States, and individual horror stories showing "the difficulties of people's lives."[28] China's official state-run press agency Xinhua published a long op-ed professing an optimistic outlook for the economy and advising readers on "how to look upon" economic trends such as slowing foreign investment and "export stability," playing on the use of "stable" as an official euphemism for slowing growth.[29] The op-ed stands out for directly addressing economic misgivings over declining trade revenues, a topic state-run media has been told to avoid according to leaked censorship instructions.[30]

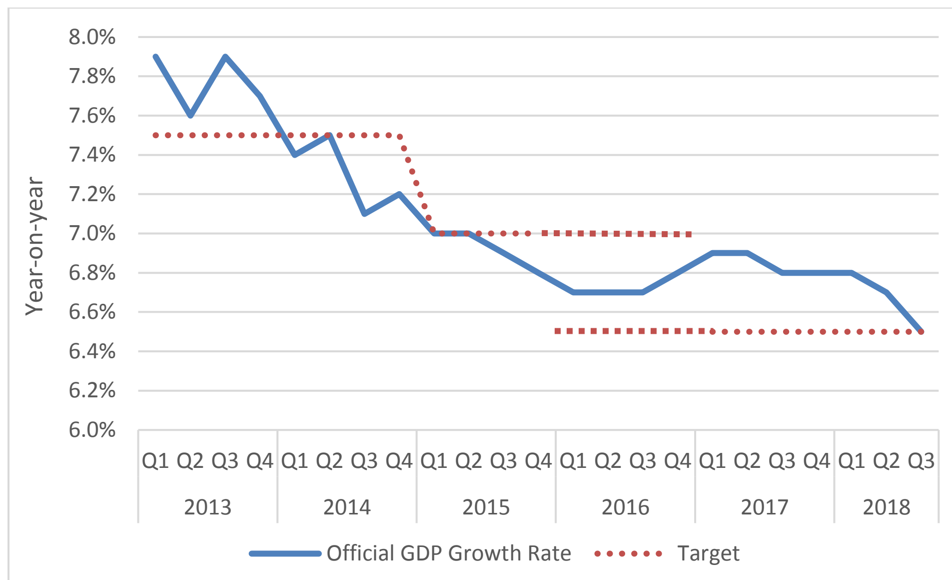
Government attempts to shape the official narrative of China's economic outlook reached a climax with Chinese President and General Secretary of the Chinese Communist Party Xi Jinping's four-day tour of Guangdong Province to celebrate the 40th anniversary of China's economic opening, launched by Deng Xiaoping in 1978. Dominating national media coverage, President Xi's trip paralleled Deng Xiaoping's "Southern Tour" in 1992 that famously reignited economic growth following the Tiananmen Square Massacre.[31] President Xi paid lip service to the principles highlighted in Deng's tour, importantly stopping in Shenzhen to affirm that China would continue economic reform and opening.[*] However, much of the tour highlighted China's economic achievements while casting them as exemplars of Chinese Communist Party guidance.[32] Without directly referencing ongoing trade disputes with the United States, President Xi stressed the importance of economic self-reliance and cultivating advanced manufacturing and technological capabilities.[33] Previously, President Xi incanted a message of self-reliance during a visit to China's industrial graveyard in the northeastern provinces, which took place just after the United States applied the latest round of tariffs on imports from China on September 24.[34]

China's GDP Growth down to Lowest Level since 2009

In the Q3 2018, China's officially reported GDP slowed to 6.5 percent year-on-year (see Figure 5). This was China's slowest GDP growth since the fallout from the global financial crisis in Q1 2009.[35] In the first three quarters of 2018, unofficial proxies for economic growth—electricity consumption (8.9 percent increase year-on-year) and rail freight traffic (7.9 percent increase year-on-year)—saw continued robust growth.[36] In addition, a rebound in exports and imports at 11.7 percent and 20.1 percent year-on-year, respectively, in Q3 2018 helped buttress growth.[37] But growth in fixed asset investment (a traditional driver of China's growth) and retail sales (a proxy for overall consumption) slowed to 5.4 percent and 3.9 percent year-on-year, respectively.[38]

[*] Shenzhen is one of the Special Economic Zones launched by Deng Xiaoping to pilot market reforms. It was especially successful and became an icon of China's reforms during the 1980s. Deng also visited Shenzhen during his Southern Tour as a statement to more conservative political factions that China would continue economic reform. Jonathan Spence, *The Search for Modern China*, W.W. Norton and Company, 1999, 708–709.

Figure 5: China's Official GDP Growth, Q1 2013–Q3 2018



Note: In 2016, the target was set at a range of 6.5–7.0 percent GDP growth.
Source: China's National Bureau of Statistics via CEIC database.

Fixed Asset Investment's Growth Slows to Zombie Pace

Fixed asset investment (FAI)* grew 5.4 percent in the first three quarters of 2018—its slowest pace since data were first published in 1995.[39] In the first three quarters of 2018, private sector investment primarily accounted for FAI growth, increasing 8.7 percent year-on-year as compared to 6 percent year-on-year growth in 2017 (see Figure 6).[40] By comparison, state-owned enterprise (SOE) investment fell to 1.2 percent year-on-year in the first three quarters of 2018, down from 11 percent during the same period a year ago.[41]

In Q3 2018, FAI slowed to 4.6 percent year-on-year growth, a deceleration from 5.5 percent during the same period in 2016 and 7.1 percent in 2015.[42] Private sector investment growth largely accounted for FAI growth, increasing 9.2 percent year-on-year in Q3 2018, up from 4.0 percent in Q3 2017 and 1.9 percent in Q3 2016.[43]

Data showing the rapid slowdown in China's overall FAI and a lack of SOE investment are once again raising doubts about the reliability of Chinese official statistics.[44] In 2018, China's National Bureau of Statistics stopped reporting absolute values of monthly FAI as increasing anomalies in a number of their key economic data raised questions from economists and analysts.[45] According to Nick Lardy, senior fellow at the Peterson Institute for International Economics,

> *How can the partial year 2018 data have such an extreme flip compared to 2017? It is not credible that state FAI is growing at only one-sixth the pace of the private one, the lowest ratio ever, especially when the press is filled with stories on the difficulties of private firms getting bank loans. For the FAI data, they are beginning to wring out some of the vast overstatement of capital formation so the percent change reported most recently is calculated against a prior number that has been adjusted.*[46]

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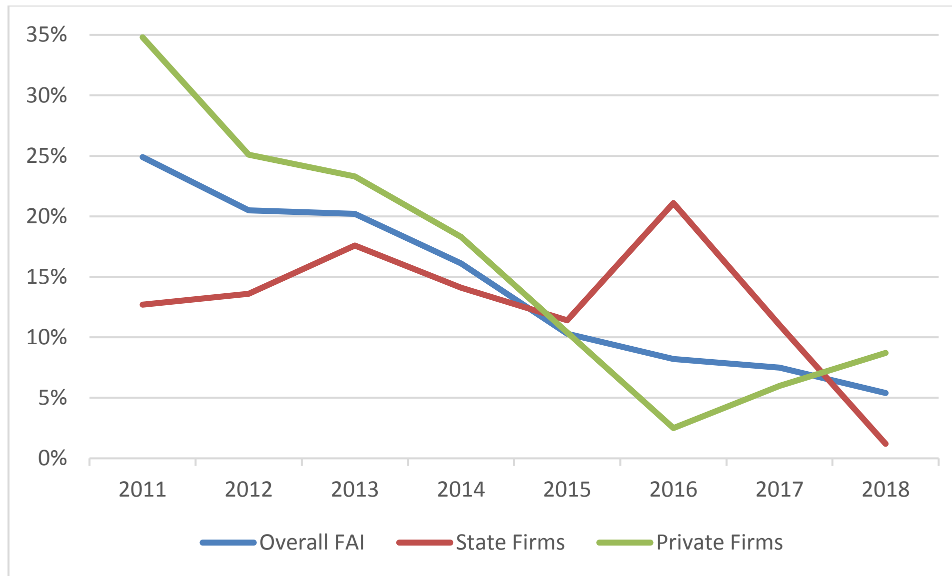
* FAI is a measure of capital spending, or any type of investment by government and the private sector in physical assets such as buildings, machinery, or equipment.

China's National Development and Reform Commission (NDRC), China's industrial policy-making body, sought to bolster economic growth by approving projects worth RMB 437.4 billion ($63 billion) in Q3 2018, roughly double the value of projects approved in the first half of 2018.[*] [47]

Figure 6: Growth in FAI in First Three Quarters, 2011–2018
(year-on-year)



Source: China's National Bureau of Statistics via CEIC database.

Industrial Output, Retail Sales, and Manufacturing Experience Slowdown

China's industrial output, manufacturing, and retail sales all saw slower growth in Q3 2018.[48] Value-added industrial growth (real)—a market indicator for economic growth—expanded 5.8 percent year-on-year in September 2018, compared with 6.6 percent in September 2017.[49] Retail sales of consumer goods—a proxy for overall consumption—slowed to 3.8 percent in Q3 2018, a departure from the robust growth over the same period in 2017 (10.3 percent year-on-year) and 2016 (10.5 percent year-on-year).[50] In Q3 2018, online sales of goods grew 24.1 percent year-on-year compared to 33.4 percent year-on-year for the same period in 2017. Online sales of services grew 14.6 percent year-on-year in Q3 2018, down from 87.1 percent year-on-year in Q3 2017.[51]

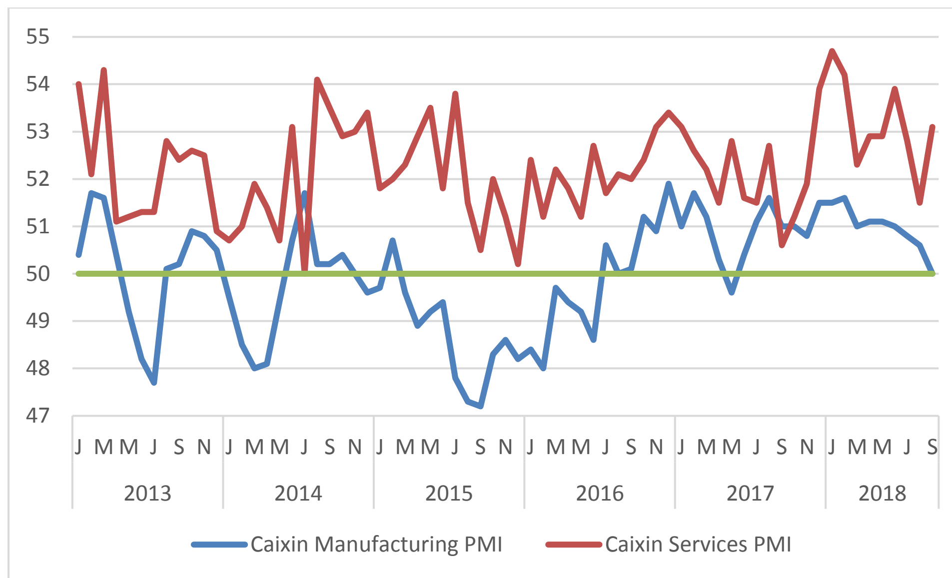
Unofficial estimates by the Chinese financial media firm Caixin found China's manufacturing Purchasing Managers Index (PMI),[†] a measure of economic expansion and industrial utilization, fell to 50 in September 2018, as Chinese companies face rising input prices and a decline in export orders amid a growing trade dispute with the United States.[52] China's manufacturing sector has been contracting or stagnant for several years, with a brief period of recovery (see Figure 3). The situation could worsen in the first half of 2019, as U.S. tariffs on $200 billion worth of Chinese imports will rise from 10 percent to 25 percent. Already, China's National Bureau of Statistics reported manufacturing PMI for new export orders slipping to 46.9 in October 2018, from the anemic 48.0 in September.[53]

[*] The NDRC approved RMB 169.8 billion ($24.5 billion) worth of projects in Q1 2018 and RMB 90.5 billion ($13 billion) in Q2 2018.

[†] The PMI measures the production level, new orders, inventories, supplier deliveries, and employment level to gauge the economic activity level in the services and manufacturing sectors. The global financial information services provider Markit Economics compiles the Caixin-Markit China services and manufacturing PMI from monthly questionnaires answered by more than 400 purchasing executives (including small and medium-sized enterprises). By comparison, China's official manufacturing PMI tracks larger state-owned companies, generally leading to a stronger reading than private PMIs.

China's services sector experienced modest growth (see Figure 7).[54] According to Caixin, China's services PMI jumped to 53.1 in September from 51.1 in August; new orders buttressed growth in September, but higher costs, the trade dispute with the United States, and more restrictive environmental regulations are squeezing services companies' future growth prospects.[55]

Figure 7: Monthly Caixin Services and Manufacturing PMIs, January 2013–September 2018



Note: A reading above 50 indicates expansion; a reading below 50 shows contraction.
Source: Caixin and IHS Markit.[56]

Chinese Government Pauses Deleveraging Efforts in Favor of Supporting Economic Growth

After pledging last year to make deleveraging one of three key government priorities through 2020,[*] Chinese policy makers are pausing the campaign to reduce debt in the face of economic headwinds. Trade tensions with the United States and stagnation in key economic growth indicators like consumption and business activity are causing a slowdown in China's growth.[57] As a result, the Chinese government is prioritizing efforts to fuel economic growth, rather than seeking to contain financial risks. According to Zhu Ning, an economist at Tsinghua University, the government's focus is "no longer on deleveraging, but on transferring leverage from one sector to another."[58]

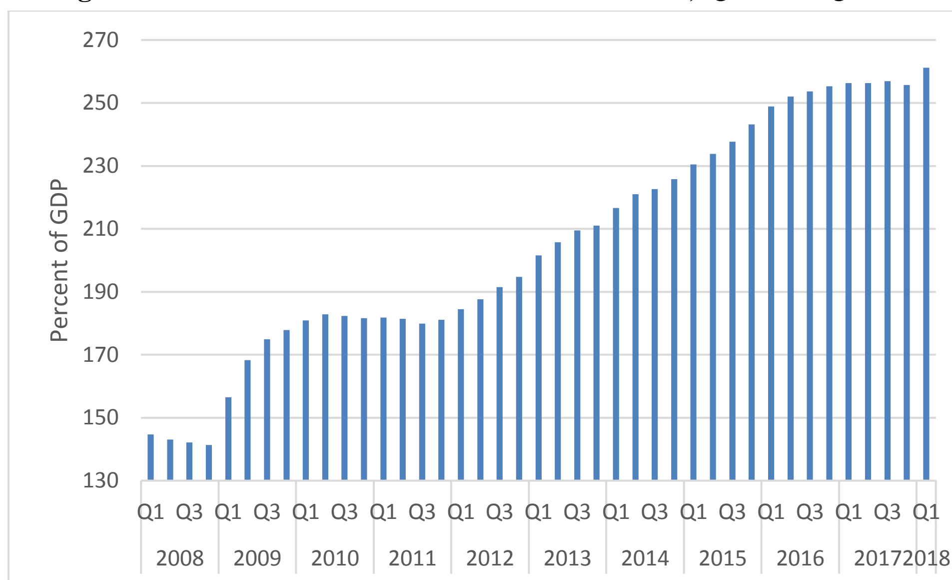
In July 2018, the PBOC lent more than $73 billion to commercial banks in an effort to boost their liquidity, the largest capital injection of this kind since 2014.[59] In October 2018, the PBOC also announced a decision to cut banks' reserve requirement ratio—the fourth time it has done so in 2018—freeing up around $110 billion in hopes of spurring new lending and investment.[60] Economists predict Chinese banks' reserve requirements will continue to be reduced further to spur economic activity and support GDP growth.[61]

For the most part, China's deleveraging campaign has focused on improving oversight of financial markets and discouraging risky lending.[62] These efforts to fuel credit growth come despite signs that China's debt could threaten the country's financial health. The Bank for International Settlements estimates that in the first quarter of 2018, China's total nonfinancial debt (government and private) reached $35.1 trillion, or 261.1 percent of GDP, up from

[*] The other two priorities laid out at the conference were controlling pollution and reducing poverty. *Xinhua*, "China Focus: Xi Steers Chinese Economy toward High-Quality Development," December 21, 2017. *http://www.xinhuanet.com/english/2017-12/21/c_136841067.htm*.

141.3 percent of GDP at the end of 2008 (see Figure 8).[63] Nonfinancial corporations hold the largest category of debt, comprising nearly two-thirds of China's nonfinancial debt.[64]

Figure 8: China's Nonfinancial Debt-to-GDP Ratio, Q1 2008–Q1 2018



Source: Bank for International Settlements, "Long Series on Total Credit to the Non-Financial Sectors," September 12, 2018. *https://www.bis.org/statistics/totcredit.htm*.

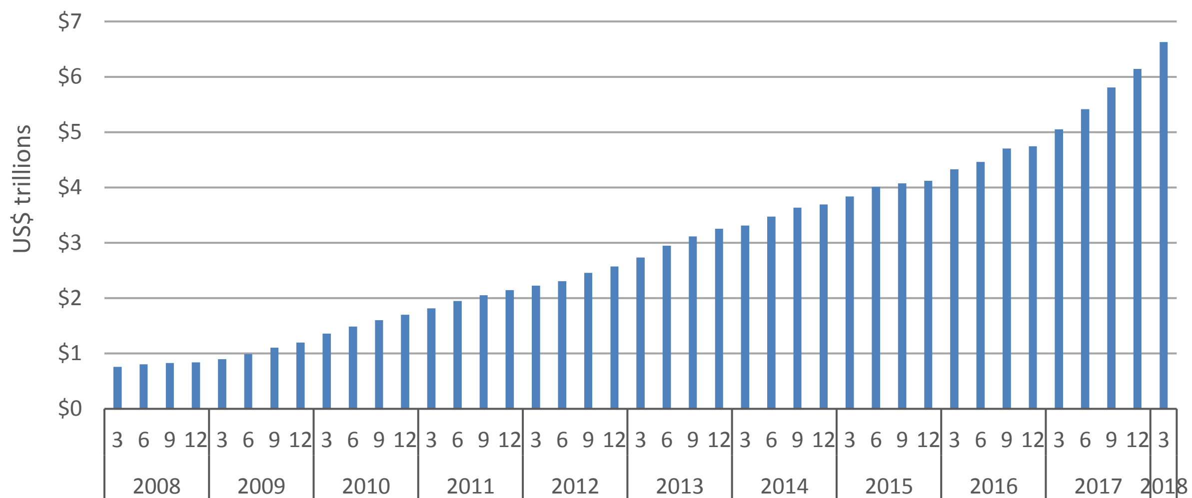
In an October 2018 report, Standard and Poor's (S&P) estimated China's local government debt was worth $5.8 trillion (or more), most of which is held by local government financing vehicles (LGFVs).[65] Because local governments in China are barred from raising money through taxation or selling bonds, they use LGFVs to borrow the money to finance projects like infrastructure and real estate development that do not appear in China's official debt statistics. Beginning in June 2018, however, a series of LGFV bonds began to mature, raising the threat of a wave of defaults from these "hidden" debts. According to the S&P report, missed repayments of publicly issued bonds totaled nearly $50 billion in the first ten months of 2018, more than twice the level from 2017, and the threat from additional debt levels could pose "titanic credit risks."[66] The risks of these debts are quickly becoming clear, as Moody's Investors Service announced in September 2018 it was downgrading the credit ratings of five Chinese LGFVs, while S&P Global Ratings lowered the credit ratings of seven Chinese LGFVs, citing a belief that local government support for these vehicles "could weaken over time."[67]

Rising Household Debt Levels: Proceed with Caution

By international standards, China's household debt is considered low, at 49.3 percent of GDP in Q1 2018,[*] [68] but it is rising rapidly: in early 2013, household debt as a share of GDP stood at just 30.7 percent[69] and increased by 18.6 percentage points—or from $2.7 trillion to $6.6 trillion—in five years (see Figure 9).[70]

[*] For comparison, in Q1 2018, household debt as a share of GDP stood at 77.3 percent in the United States, between 57 and 58 percent in Japan and the EU, 95.2 percent in Korea, and 99.4 percent in Canada. Bank for International Settlements, "Total Credit to Households (Core Debt), as a Percentage of GDP," October 30, 2018. *https://stats.bis.org/statx/srs/table/f3.1*.

Figure 9: China's Household Debt, Q1 2008–Q1 2018



Source: Bank for International Settlements, "Total Credit to Households (Core Debt)," October 30, 2018.

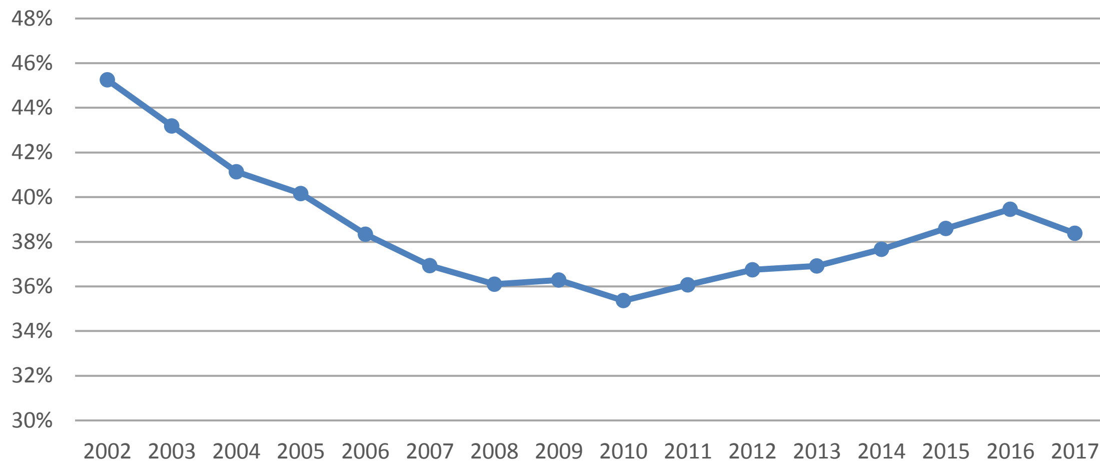
Aside from its rapid growth, Chinese household debt poses two main concerns: (1) its level relative to household disposable income, and (2) its complexity.

1. *Debt to income level:* Some analysts believe Chinese household debt is above 100 percent of disposable income, which may increase financial stress on households as wage growth slows. *Financial Times* economics reporter Matt Klein found that as of mid-2017, households held debt worth 106 percent of their disposable income.[71] China economics observer Christopher Balding estimated household debt at 120 percent of disposable income in mid-2018.[72] If household income growth does not keep pace, this debt burden will continue to increase, hindering China's transition to a demand-driven economy.
2. *Complexity:* High property values, slowing wages, and few commercial investment options mean households have turned to higher-interest financing to fund property purchases or engage in speculation. Mortgages made up nearly 60 percent of Chinese household debt in March 2018.[73] Chinese regulators believe mortgage figures likely underestimate credit put toward real estate[74] because households may also use other forms of consumer credit to finance home purchases, such as credit cards and short-term loans.[75] This lending increases households' interest burden while complicating lenders' assessments of risk and undercutting their intent to fund more broad-based consumption in the real economy. It also shows a high and widely shared expectation that property and other asset values will continue to rise.

Consumption under Pressure

Chinese consumption indicators are closely watched because they are the core of the Chinese government's objective to rebalance the economy away from exports and government investment and toward domestic demand. At year's end 2017, household consumption as a share of GDP stood at 38.4 percent, down from 39.4 percent in 2016 (see Figure 10).[76]

Figure 10: Annual Household Consumption as a Share of GDP, 2002–2017



Source: CEIC database; China National Bureau of Statistics.

Analysis from China International Capital Corporation showed divergence between necessary and discretionary spending in 2018: consumer staples like food and daily-use products mirrored prior trends with growth near 10 percent, while autos, electronics, and home appliance growth slowed to about 5 percent.[77] Consumption has also diverged by location in 2018: rural spending increased at a faster rate than urban spending.[78] Nielsen's Consumer Confidence Index echoed a similar trend, reporting higher confidence in second- and third-tier cities than in first-tier cities in mid-2018.[79]

Analysts are debating whether falling retail sales indicate a "consumption downgrade" among Chinese consumers.[*] Some say lower growth in retail spending indicates a "crowding out" effect rather than slowing consumption growth overall, where the rising cost of necessities like rent and healthcare leaves little room for discretionary spending.[80] George Wu, chief economist at Huarong Securities Co., noted that for those who already own a home, high mortgage payments may also reduce other types of spending.[81] By contrast, Wang Tao, China economic research lead at UBS AG in Hong Kong, expected consumption growth to continue at a steady 6 to 7 percent after inflation despite the slower growth rate due to credit access, support for job creation, and social safety net improvements.[82]

Stock Market Rout and Government Response

China's stock markets performed frightfully in October, with benchmark indexes for the Shanghai and Shenzhen stock exchanges losing 12 percent and 11 percent, respectively, in the first two weeks of trading.[83] Both dipped to four-year lows before rebounding slightly after a flurry of government actions to calm spooked investors.[84] The recent drop continues a poor year for China's markets, with Shanghai's benchmark index closing the month down 27 percent from a peak in January.[85]

Many analysts attribute the current prolonged downturn to a bearish macroeconomic outlook driven by trade frictions with the United States[86]—a notable shift for Chinese stocks, which historically have not followed macroeconomic fundamentals.[87] Downturns in 2015 and 2007 were preceded by clear speculative bubbles; many

[*] See Li Yuan, "China's Consumption Downgrade: Skip Avocados, Cocktails, and Kids," *New York Times*, August 22, 2018. *https://www.nytimes.com/2018/08/22/business/china-consumer-downgrade.html*; Gabriel Wildau and Edward White, "Chinese Household Debt Hits Record High, Study Shows," *Financial Times*, September 26, 2018. *https://www.ft.com/content/5d01b4d8-c1f9-11e8-95b1-d36dfef1b89a*; Xu Xiaoqing, "Opinion: Plenty of Reasons to Be Pessimistic about Consumption," *Caixin*, August 27, 2018. *https://www.caixinglobal.com/2018-08-27/opinion-plenty-of-reasons-to-be-pessimistic-about-consumption-101319349.html*.

observers agree rapid selloffs were triggered by investor panic in response to regulatory measures to contain runaway speculation.[88] By contrast, this time markets had been steadily declining since January 2018 and were not highly valued to start. Even equities that tend to be less prone to market fluctuations, such as high-end spirits distiller Kweichow Moutai, have fallen precipitously.[89]

While a stock market rout in China poses less risk to overall domestic financial stability than declines in more advanced economies,[*] regulators have been keeping a vulture eye on share-pledged loans, or loans issued to companies using shares as collateral. On October 16, Bloomberg reported listed companies had pledged $613 billion in shares, or roughly 11 percent of total market capitalization.[90] A sudden drop in pledged share prices could force creditors to quickly liquidate the collateral, potentially triggering a rapid selloff as investors rush to get out of the market.[91]

Compared to heavy intervention by the state to prop up falling share prices in July and August of 2015, the Chinese leadership has taken less direct measures to shore up market confidence.[92] However, their response has been comparably thorough,[†] and consisted primarily of: (1) creating bailout funds and other mechanisms to provide liquidity to companies with pledged shares; (2) fast-tracking regulatory and legislative decisions that could stabilize prices, in many cases rolling back regulations designed to strengthen market integrity following the 2015 crash; and (3) coordinating media appearances by Vice Premier Liu He, President Xi's top economic advisor, and the heads of all of the financial regulators to convince investors China's economic fundamentals are sound and policy measures to stabilize the market will be effective. (For a full list of government response measures, see the Appendix). Although the recovery has been tepid, the Shanghai Composite Index finished the month 6 percent higher than its lowest point in mid-October.[93] The Shenzhen Component Index, which includes more private and tech stocks, has only recovered 2 percent.[94]

Appendix: Chinese Government Response Measures to Stock Market Decline

Date	Government Action
October 12	Roughly 50 Chinese companies announce share buyback in attempt to stabilize prices.
October 12	China Securities Regulatory Commission (CSRC) overturns rule prohibiting funds raised from mergers and acquisitions (M&A) activity to be used for repayment of debts and operating capital, allowing up to 50 percent of funds or 25 percent of the value of the transaction to be used for those purposes.
October 14	CSRC Chairman Liu Shiyu says CSRC will protect small and medium-sized investors' rights and interests at a forum, seemingly in response to concerns about a 5 percent drop in China's two stock exchanges the previous Thursday.
October 15	The PBOC cuts the reserve requirement ratio for the fourth time in 2018, adding $109 billion in liquidity.

[*] China's economy is not nearly as exposed to or dependent on its 28-year-old stock market as the economies of the United States, Western Europe, Japan, and South Korea are to their respective markets. Chinese households prefer other investments such as property, so a fall in stock prices does not impact consumer spending as strongly by causing a sharp decrease in household wealth. Chinese companies also rely much more on bank loans than capital markets to raise funds, and total market capitalization is only about half of China's GDP, meaning fewer assets are at stake in a downturn relative to the overall economy. By contrast, the U.S. stock market capitalization was over 150 percent of GDP at the end of 2017. Bill Powell, "Behind China's Stock Market Meltdown," *Time*, February 28, 2007. *http://content.time.com/time/business/article/0,8599,1594488,00.html*; Arthur R. Kroeber, "The Financial System," *China's Economy: What Everyone Needs to Know*, Oxford University Press, 2016, 128; World Bank, "Stock Market Capitalization to GDP for China (DDDM01CNA156NWDB)," *FRED*, Federal Reserve Bank of St. Louis. *https://fred.stlouisfed.org/series/DDDM01CNA156NWDB*; World Bank, "Stock Market Capitalization to GDP for United States (DDDM01USA156NWDB)," *FRED*, Federal Reserve Bank of St. Louis. *https://fred.stlouisfed.org/series/DDDM01USA156NWDB*.

[†] Another notable exception to the current government response is the absence of scapegoating "market manipulators," such as short sellers seeking to profit from price drops. For a discussion of the Chinese government's response to the June–July 2015 crash, see Nargiza Salidjanova, "China's Stock Market Collapse and Government's Response," *U.S.-China Economic and Security Review Commission*, July 13, 2015. *http://1.usa.gov/1fCBn9a*.

October 16	Caixin reports the Shenzhen government plans to raise $2.2 billion to boost liquidity of listed companies.
October 16	Caixin reports Shunde, another city in Guandong, is planning a fund to support listed companies.
October 16	The Beijing bureau of the Securities Regulatory Commission orders creditors and brokers of a Beijing company listed on the Shenzhen Stock Exchange not to sell the company's shares or freeze its assets.
October 16	Haidian district government in Beijing sets up a $1.5 billion bailout fund. Haidian is the location of Beijing's tech hubs and many of its major universities.
October 19	Vice Premier Liu, President Xi's top economic advisor; Guo Shuqing, head of the China Banking and Insurance Regulatory Commission (CBIRC); Yi Gang, head of the PBOC; and Liu Shiyu release statements encouraging investors to remain calm.
October 20	President Xi releases letter reaffirming the importance of private firms for China's economic development, seemingly in response to concerns that the government has rolled back support for the private sector.
October 20	CSRC eases requirements for "reverse listing," or acquiring a company that is already listed rather than issuing an initial public offering (IPO). In the summer of 2016, CSRC tightened regulations in response to companies using reverse listings to side-step China's lengthy IPO process.[95]
October 22	PBOC increases relending and rediscount quotas by $22.7 billion for financial institutions that extend a high portion of loans to small and private enterprises.
October 22	Eleven securities brokerages agree to contribute a total of $3 billion toward a bailout fund for companies facing forced sale of pledged shares, the Securities Association of China reports.
October 22	CSRC finalizes regulations on privately offered asset management plans, an investment vehicle commonly used to circumvent restrictions on leveraged share purchases. The regulation aims to reduce market risk by closing loopholes, but is less stringent than an earlier draft.
October 22	CSRC creates a complaint hotline to protect investors' "legitimate rights and interests."
October 24	Shenzhen Investment Holdings Co., Ltd. files a prospectus to sell five- year bonds to raise money to buy shares in order to prevent further price drops.
October 25	CBIRC creates specialized program allowing insurance companies to bypass quotas on the total ratio of equities in their portfolios.
October 26	CBIRC releases draft plan to ease restrictions on insurance companies' stock investments.
October 26	China's legislative body, the National People's Congress, amends the Company Law to make it easier for listed companies to repurchase shares. Repurchasing shares is a technique listed companies often use on mature exchanges to show they believe their current share price is undervalued. Prior to the revision, China's Company Law prevented share repurchases under most circumstances.
October 26	Ping'An insurance group announces plans to buy back 10 percent of its listed shares worth $15.8 billion, a record amount.

Source: Various.[96]

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This report is the product of professional research performed by the staff of the U.S.-China Economic and Security Review Commission, and was prepared at the request of the Commission to support its deliberations. Posting of the report to the Commission's website is intended to promote greater public understanding of the issues addressed by the Commission in its ongoing assessment of U.S.-China economic relations and their implications for U.S. security, as mandated by Public Law 106-398 and Public Law 113-291. However, it does not necessarily imply an endorsement by the Commission, any individual Commissioner, or the Commission's other professional staff, of the views or conclusions expressed in this staff research report.

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