December 6, 2016

Highlights of this Month’s Edition

- **Bilateral trade:** U.S. exports to China jump 11.3 percent year-on-year in October 2016, leading to a smaller deficit.

- **Bilateral policy issues:** At JCCT, China pledges to open entertainment sector to the United States, but U.S. concerns over Chinese biotechnology rules remain unaddressed.

- **Policy trends in China’s economy:** China has passed a broad new cybersecurity law aimed at tightening government control over information flows and technology products, sparking complaints from foreign business and rights advocacy groups; Lou Jiwei replaced as Minister of Finance, raising concerns about China’s commitment to economic reform.

- **Sector focus – Singles’ Day and E-Commerce:** Singles’ Day sets new record for online sales amid the continued rise of electronic transactions in China, offering new market opportunities for foreign firms.

Bilateral Trade

**U.S. Trade Deficit with China Falls 5.5 Percent Year-on-Year in October**

In October 2016, U.S. exports to China reached $12.7 billion, their highest level since December 2013. The monthly U.S. trade deficit in October dropped 5.5 percent year-on-year, driven by an 11.3 percent increase in exports and a 1.2 percent decline in imports (see Figure 1). According to the U.S. Department of Commerce, U.S. vehicle exports to China, which jumped 27 percent month-on-month in October, were a major contributor to U.S. export growth.

**Figure 1: U.S. Goods Trade with China, October 2015–October 2016**

(year-on-year)
The cumulative deficit for the first 10 months of the year was about $289 billion, 6.2 percent smaller than for the same period in 2015. Cumulative imports were down 5.6 percent year-on-year, while exports declined 3.5 percent year-on-year.

Year-on-year, U.S. deficit with China has been falling every month since February 2016 due to shrinking imports and, starting in August 2016, rising exports.

Bilateral Policy Issues

U.S. and China Complete 27th Joint Commission on Commerce and Trade

The United States and China concluded the 27th Joint Commission on Commerce and Trade (JCCT) this November. China pledged to further open its entertainment sector to U.S. media firms, but progress on many other issues was lacking.

Entertainment: China promised to issue a measure to allow foreign-invested firms to distribute music online in China. The United States and China also agreed next year to “seek to increase” both the number of U.S. films that can be screened in China and the share of revenue directed to the U.S. film industry. These developments, if fully realized, could create significant opportunities for U.S. firms. China’s box office sales are growing rapidly, increasing 48.7 percent in 2015 to $6.8 billion. If this trend continues, China could overtake the United States as the largest film market by 2018. However, the Chinese film market remains largely closed to foreign film companies. China currently allows only 34 revenue-sharing foreign films to be screened in the country per year, and foreign studios receive no more than 25 percent of Chinese box office revenues. China’s music market grossed only $170 million in 2015, but digital distribution of music is growing. Chinese digital music revenues increased 63.8 percent year-on-year in 2015, and 66 percent of Chinese listeners regularly use a streaming music service.

Cybersecurity law: China’s cybersecurity law, adopted this year, and a 2015 national security law require telecommunication and finance networks to be “secure and controllable.” U.S. tech companies have expressed worries that this requirement will be used to compel them to provide their source code and corporate secrets to the Chinese government or that it will serve as a tool to favor domestic tech firms over international businesses.

During the JCCT, China said the new legislation was not intended to “unnecessarily limit or prevent commercial sales opportunities for foreign suppliers.” While this comment appears to partially address concerns over discrimination, China made no commitments regarding U.S. tech firms’ concerns over access to source code and trade secrets. (The cybersecurity law is discussed in greater detail later in this bulletin.)

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1 The JCCT is an annual dialogue between the United States and China where each country can seek to resolve commercial and trade issues. The United States is typically represented by the Office of the United States Trade Representative and the United States Department of Commerce while China is represented by the Vice Premier responsible for trade issues. United States Department of Commerce, U.S.-China Joint Commission on Commerce and Trade (JCCT). https://www.commerce.gov/tags/us-china-joint-commission-commerce-and-trade-jcct.
4 Under the 2012 memorandum of understanding, 20 standard-format foreign films and 14 IMAX or 3D-format films can be imported into China under revenue-sharing contracts. Films can also be screened in China for a flat fee under a separate quota; however, distribution under a flat fee is less valuable to U.S. film studios as the fee given is typically a fraction of the value of the film and not proportional to the film’s box office in China. Sean O’Connor and Nicholas Armstrong, “Directed by Hollywood, Edited by China: How China’s Censorship and Influence Affect Films Worldwide,” U.S.-China Economic Security Review Commission, October 28, 2015.
Social credit: This year, the United States and China discussed China’s social credit system for the first time. China is piloting a system that will score its citizens based on the degree to which they comport with the government’s idea of good behavior in areas as diverse as Internet usage, observance of Chinese law, payment of bills, shopping habits, and filial piety.16 Citizens with poor scores are “blacklisted,” which may deny them easy access to credit or the ability to travel by plane or high-speed rail.17 This system could have negative effects for U.S. businesses. If Chinese citizens are blacklisted for purchasing certain imported goods, then U.S. firms purveying those goods will be hurt as Chinese demand falls. Additionally, restricting the ability of Chinese entrepreneurs to travel may interfere with the ability of U.S. companies to do business in China—particularly in sectors where they are required to partner with a Chinese company to operate in China.4–18 During the JCCT, China only agreed to seek public comment on the social credit system.19

Biotech approvals: China failed to make new commitments on its biotechnology approval process. China employs a much slower approval process for biotechnology imports than other countries. While most countries will begin to evaluate whether a biotechnology product is safe for their market as soon as it has been developed, China waits to begin its own inspections until after the United States or another country has completed its own approval process.20 This significantly slows the introduction of new U.S. biotech products into the Chinese market. Additionally, the Chinese committee that evaluates biotech safety applications meets very infrequently, sometimes only once or less per year.21 The United States has repeatedly pressed China to quicken its approval process, and while the issue was raised at the 2016 JCCT, at the conclusion of the session no agreement on biotechnology was reached.22 U.S. Trade Representative Michael Froman lamented the lack of progress on biotechnology, noting that he was “disappointed with our inability to make more progress” and arguing that China’s approval process creates “unnecessary trade distortions” that harm both U.S. farmers and China’s innovation and livestock industries.23

Excess capacity: The United States and China did not reach any new agreements on excess capacity reduction. Both sides agreed to promote a global forum on excess steel capacity created at the G20 in September and to exchange information on excess capacity in the aluminum and soda ash sectors.24 The two countries did agree to make excess steel capacity a focus in 2017 by holding an informal dialogue on the subject at next year’s JCCT, where each country will share their experiences with reductions in the steel sector.25

Policy Trends in China’s Economy

China Passes New Cybersecurity Law

On November 7, the Standing Committee of China’s National People’s Congress passed a sweeping new cybersecurity law aimed at tightening government control over information flows and technology products, raising concerns among foreign business and rights advocacy groups.26 The law will take effect in June 2017 and is part of an aggressive push under Chinese President and General Secretary of the Chinese Communist Party Xi Jinping to strengthen state control over the Internet and reduce the country’s reliance on foreign technology.27

As with many Chinese laws, the cybersecurity law is broad and vaguely worded, providing regulators leeway in implementation.28 According to Rogier Creemers, an expert in Chinese Internet and media law at the University of Leiden, “[The law] is about how the internet might harm the Chinese state in the broadest sense possible.”29 As Article 1 of the law states, “This law is formulated to ensure network security, to safeguard cyberspace sovereignty, national security, and the societal public interest, to protect the lawful rights and interests of citizens, legal persons and other organizations, and to promote the healthy development of economic and social informatization.”30

The law outlines specific cybersecurity requirements for network operators and providers of network products and services. Network operators are required to protect their networks against disruption, damage, or unauthorized access, and to prevent data leakage, theft, or falsification.31 Providers of network products and services are required to comply with “relevant national and mandatory requirements” to ensure the security of their products.32 The law also includes data privacy protections for network users, including restrictions on companies’ collection and use of

personal information and mandatory notifications for personal data breaches. In addition, the law includes provisions addressing online fraud and the online protection of minors.

Companies operating “critical information infrastructure” are subject to stricter cybersecurity requirements. Critical information infrastructure is broadly defined as “infrastructure that, in the event of damage, loss of function, or data leakage, might seriously endanger national security, national welfare, people’s livelihood, or the public interest,” a description that could cover a potentially expansive list of sectors. The law references financial services, information services, telecommunications, and transportation as examples. In addition to requirements generally applicable to network operators, the law requires critical information infrastructure operators to store users’ personal data and “other important data” within China and undergo security review if their products and services “might impact national security.” The law does not specify what security reviews will entail.

Foreign business groups have long expressed concerns that the law will put data security at risk and impede access to China’s technology market. In response to earlier drafts of the law published for public comment, more than 40 business associations from the United States, Europe, and Asia sent a letter to Premier Li Keqiang in August 2016, arguing the law “would weaken security and separate China from the global digital economy.” However, the most contentious provisions have remained in the final version of the law.

According to James Zimmerman, chairman of the American Chamber of Commerce in China, the law’s restrictions on cross-border data flows “provide no security benefits but will create barriers to Chinese as well as foreign companies operating in industries where data needs to be shared internationally.” In addition, foreign companies fear the law’s provisions requiring “secure and controllable” technologies could effectively exclude their products.

In a written statement to the Technical Committee 260, which is in charge of China’s cybersecurity standards, Microsoft noted, “Sharing source code in itself can’t prove the capability to be secure and controllable. It only proves there is source code.” Zhao Zeliang, director-general of the bureau of cybersecurity of the Cybersecurity Administration of China, dismissed these concerns, stating, “The law fits international trade protocol and its purpose is to safeguard national security. China’s cybersecurity requirements are not being used as a trade barrier.”

**Xiao Jie Replaces Lou Jiwei as Minister of Finance**

In early November, the Standing Committee of the National People’s Congress announced the retirement of Lou Jiwei, the reform-minded minister of finance since 2013. His replacement is Xiao Jie, former head on the State Administration of Taxation and deputy minister of finance. Although Mr. Lou had reached the mandatory retirement age of 65, his replacement prior to the completion of his five-year term has raised concerns about China’s commitment to economic reforms. As Barry Naughton, professor of Chinese economy at the University of California San Diego, noted, “Lou’s loss is a big deal. Lou Jiwei is one of the smartest policy minds in China and one of the most committed reformers.”

Mr. Lou’s replacement is about more than the retirement age; Zou Xiaochuan, governor of the People’s Bank of China, and Wang Qishan, secretary of the Central Commission for Discipline Inspection, are both 68. This change may be more about pushing through the next set of economic reforms—such as a national property tax—than a shift away from economic reform. Mr. Lou’s successor, Mr. Xiao, has nearly 30 years of experience at the State Administration of Taxation and Ministry of Finance and has previously expressed support for a national property tax. This bodes well for his continuing Mr. Lou’s efforts to roll out a national property tax, a priority laid out in the 13th Five-Year Plan. Under Mr. Lou’s leadership, the Ministry of Finance took steps toward reining in excessive local government borrowing and restructuring local government debt into longer-term, lower-yielding bonds. But Mr. Lou’s efforts to prevent local governments from taking on new debt squeezed public investment and slowed economic growth, and led local government officials and eventually Premier Li to successfully pressure him to reverse such policies beginning in May 2015.

Eswar Prasad, the Tolani senior professor of trade policy at Cornell University, noted the difficulties ahead, stating, “Lou managed to push through some important fiscal reforms, including reining in local government borrowing, but leaves behind a large and important unfinished reform agenda. Lou’s successor, Xiao Jie, does have substantial experience in fiscal policy, but it remains to be seen whether he has the acumen and clout necessary to push forward those reforms.” Mr. Lou is now chairman of China’s National Council for Social Security Fund, which is currently
seeking higher returns from more risky investments in the stock market and expanding its asset base with the transfer of assets from local and provincial government funds. This position will leverage Mr. Lou’s previous experience as chairman of China’s sovereign wealth fund, China Investment Corporation, where he oversaw two straight years of 12 percent return on its global investment portfolio.

**Sector Focus: Singles’ Day and E-Commerce**

**China’s Singles’ Day Sets New Record for Online Sales**

On November 11, China held its annual Singles’ Day holiday, a 24-hour online shopping event. Originally a holiday for Chinese citizens without romantic partners, Singles’ Day has been promoted by China’s e-commerce giant Alibaba since 2009 as an opportunity for singles to treat themselves with discounted online purchases. Singles’ Day has become the world’s largest online shopping event, with JD.com and other online vendors joining Alibaba in promoting special deals and attractions. This year, Alibaba grossed $17.8 billion over the holiday, more than the total U.S. online sales from Black Friday and Cyber Monday combined. Kobe Bryant, David Beckham, and Scarlett Johansson were among the celebrities who participated in the event, along with more than 16,000 brands, including first-time participants Burberry, Apple, and Victoria’s Secret.

Singles’ Day has rapidly become the largest online one-day shopping event worldwide. As Figure 2 shows, Alibaba’s Singles’ Day sales increased more than 20-fold between 2011 and 2016, while online U.S. sales from Thanksgiving to Cyber Monday increased only 1.5-fold over the same period. In total, Alibaba’s delivery service platform handled 657 million orders during the 2016 holiday, with 54,000 payments made per second through the company’s online payment service, Alipay. However, Singles’ Day 2016 actually saw slower sales growth (a 25 percent increase year-on-year) than 2015 (when sales increased 54 percent year-on-year), a reflection of rising caution among shoppers concerned over China’s slowing economy.

![Figure 2: U.S. Thanksgiving Holiday E-Commerce and Alibaba Singles’ Day Sales, 2011–2016](image)

Source: Various

While online sales growth slowed, however, mobile sales growth surged in China. According to Alibaba and JD.com, more than 80 percent of Singles’ Day transactions took place on mobile phones in 2016, up from 72 percent in 2015 and 43 percent in 2014. This reflects a larger trend toward mobile e-commerce in China; according to analysts at KPMG China, at least 90 percent of online shoppers in China used their smartphones to make a transaction in 2015. Mobile e-commerce now accounts for 51 percent of all online purchases in China, above the global average of 35 percent.
The success of Singles’ Day has raised questions about Alibaba’s sales practices. In May 2016, Alibaba announced it was being investigated by the U.S. Securities and Exchange Commission amid concerns over its growth rate and relations with affiliated companies. The company’s Singles’ Day sales were reportedly part of what prompted the investigation, with accountants and merchants questioning whether sales had been inflated. Alibaba’s accounting practices leave considerable leeway for how its sales are calculated, including allowing consumers to make down payments before Singles’ Day to lift sales figures. Additionally, there have been reports of online Chinese vendors paying customers to purchase products and then return them to boost reported sales and seller rankings. While these allegations of wrongdoing continue to surface, the Securities and Exchange Commission’s investigation into Alibaba’s controversial accounting practices remains ongoing.

Online Sales Continue to Increase amid E-Commerce Boom in China

The success of Singles’ Day 2016 is part of a larger trend toward e-commerce in China. China is the world’s largest and fastest-growing e-commerce market, with official Chinese statistics indicating online retail sales reached $571.4 billion in 2015, an increase of 35.7 percent year-on-year (see Figure 3). China’s e-commerce sales accounted for almost half of global online retail sales, and are nearly 80 percent larger than online sales in the United States. Within China, e-commerce accounts for 13.5 percent of all retail spending, a share exceeded only by the United Kingdom (where e-commerce accounts for 16 percent of retail spending). According to Ma Jiantang, the executive vice president at the Chinese Academy of Governance, the output of these new industries and commercial activity—which includes e-commerce as well as advanced manufacturing and other high-tech industries—now accounts for more than 15 percent of China’s GDP, making it an essential component of the Chinese economy.

![Figure 3: China’s E-Commerce Retail Sales, 2010–2016](image)

**Figure 3: China’s E-Commerce Retail Sales, 2010–2016**

*Note:* Data for 2016 are through June.
*Source:* China e-Business Research Center, via CEIC database.

E-commerce growth in China is expected to continue, with online retail sales reaching nearly $350 billion in the first half of 2016, on pace for a record high. By June 2016, China was home to nearly 450 million online shoppers, up 8.3 percent from December 2015 and an increase of nearly 180 percent since 2010. Analysts at the investment

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banking firm Jeffries Group estimate that by 2018, the number of online shoppers in China will rise to 587 million, or 42.4 percent of the country’s projected population.\(^7\) As e-commerce becomes increasingly popular, so too has the use of online payment methods like Alipay, with more than 450 million people in China using e-pay systems in the first six months of 2016.\(^7\) The total number of e-pay users in the first half of 2016 has already surpassed the total from 2015, when 416 million people were using online payment services.\(^7\)

According to a McKinsey & Company survey conducted in April 2016, everyday items are particularly popular purchases among Chinese online shoppers.\(^7\) For instance, the study found that around 30 percent of consumer electronics and small appliances sales are made online.\(^8\) In addition, nearly 60 percent of Chinese consumers bought clothing or apparel online at least once in the past three months.\(^8\) Meanwhile, nearly 50 percent of consumers were found to have used online markets to purchase food—including both packaged and fresh products.\(^8\) However, these online purchases still represent a small share (5 percent) of consumers’ total food spending.\(^8\)

This rise of online spending in China corresponds with the country’s growing middle class and increasingly widespread use of the Internet. Data from a 2015 Credit Suisse report indicates that China’s middle class comprises around 109 million people, more than Germany, the UK, France, and Spain combined, and 17 million people larger than the United States’ middle class.\(^8\) In 2015 China’s population of Internet users increased 6 percent year-on-year to 688 million people, or more than half of the country’s total population.\(^8\) As seen in Figure 4, Internet use has spread nationwide, with the highest penetration centered in urban hubs like Shanghai, Beijing, and Guangzhou.\(^8\)

**Figure 4: Internet Penetration in China, 2015**

[Image of internet penetration map of China]


\(^8\) Estimates for China’s middle class use a different wealth threshold ($29,245) than the United States ($50,000) and other countries to adjust for differences in local purchasing power.
Along with boosting domestic consumption, e-commerce provides consumers in China with access to foreign products. With over 5,000 cross-border e-commerce platforms, the volume of China’s cross-border e-commerce is expected to reach $970 billion in 2016, and—according to China’s Ministry of Commerce—will soon account for 20 percent of China’s foreign trade. The April 2016 McKinsey & Company survey found that nearly one-fifth of online consumers buy goods from vendors outside China. The most common foreign purchases are luxury goods, including premium healthcare products such as dietary supplements, medicines, and medical instruments. However, purchases of basic products—such as diapers, household appliances, and kitchen wares—are also common, stemming from consumers’ concerns over the safety of domestic products.

In April 2016, the Chinese government adjusted the country’s tax policy to treat retail goods purchased online from abroad as imports. Prior to the rule, overseas shipments of online purchases were treated as personal articles and were not subject to tariffs, import value-added taxes, or consumption tax, making them more competitive in Chinese markets. A week after the new rules were introduced, cross-border e-commerce orders in China declined more than 60 percent. As a result, China’s General Administration of Customs announced in May 2016 that the new tax policies would be postponed for one year in ten e-commerce pilot cities, including Shanghai, Guangzhou, and Shenzhen. These pilot cities are experimenting with new models for technical standards, business procedures, and regulatory mechanisms to attract e-commerce business. Although the new tax policies were temporarily rolled back, U.S. and other foreign companies anticipate further tariff hikes and price increases in China, and are likely to start building warehouses in China to bring down costs.

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Endnotes


70 China e-Business Research Center, via CEIC database.


74 China e-Business Research Center, via CEIC database.

75 China e-Business Research Center, via CEIC database.


77 China e-Business Research Center, via CEIC database.

78 China e-Business Research Center, via CEIC database.


